PFP Wealth Management

3 Windsor Court
Clarence Drive
Harrogate, HG1 2PE
01423 523311

Lion House
72-75 Red Lion Street
London, WC1R 4FP
020 7400 1860

www.pfpg.co.uk

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Too many c(r)ooks

"You're not only wrong. You're wrong at the top of your voice."

- John J. Macreedy (Spencer Tracy), 'Bad Day at Black Rock'.

The seemingly vampiric permanence of the investment banking survivors versus their peers in hedge funds, property or private equity suggests, as one correspondent posits, that "the end result is going to be very messy". While Lehman was Wall Street's singular blood offering, what will it take to put a stake through the heart of rejuvenated risk-mongering ? The Financial Times last week carried a refreshingly outspoken interview with Paul Purcell (brother of Morgan Stanley's Philip) who laid the blame for the financial crisis on "the greed of fixed-income people": "Go back and look at the history of Wall Street – Drexel Burnham, Salomon Brothers, Kidder Peabody, Bear Stearns, Long-Term Capital Management, Lehman Brothers, Merrill Lynch – the fixed-income guys blow up every firm." On first sight this seems perverse, given the tendency of bonds as a whole to be largely mundane investments, seemingly offering little by way of either return or risk. But once you add leverage to the mix, in order to generate those super-sized profits (and bonuses), all becomes clear. Mr. Purcell continues to take Wall Street to task: "We [investment bank RW Baird] didn't do the bad things that the rest of Wall Street did. The difference is we actually take care of our clients. We want to make money for people. The big firms created proprietary product they put through their own distribution systems to make them more money, whether the clients needed the product or not. Our business is to sell people the right product at the right time for the right price." Which sounds fair enough; the problem being, says Mr. Purcell, in the "75% of the people in our business [who] are not honest."

The problem with Wall Street, other than systemic dishonesty, would seem to be that it simply cannot be "right-sized". (Or that the only "right" size is, erm, zero.) Fundamental overcapacity during the boom led to an arms race of competitive risk-taking; the 'nuclear winter' compression of capacity in the brokerage industry has only led to expansion in bid-offer spreads and inflated margins for players that don't even deserve to be in the game. If only government treated infrastructure or education with the cowed awe it dispenses to banks, imagine what society might be capable of.

Time, perhaps, to shift focus from an irredeemable 'sell side' to a now comparatively overpopulated and continually dysfunctional 'buy side' – the motley universe of asset managers. Notwithstanding last year's annus horribilis, David Swensen, manager of the Yale Endowment, has written nicely of the characteristics which should be sought out in fund management counterparties:

“Attractive investment management organisations encourage decisions directed toward creating investment returns, not toward generating fee income for the manager. Such principal-oriented advisers tend to be small, entrepreneurial and independent.. Entrepreneurial capitalism constitutes a behavioural process with three driving forces: innovation, ownership and adaptation. Each characteristic contributes to the core of successful money management organisations.” (David Swensen, ‘Pioneering Portfolio Management’, Free Press.)

In essence, the buy side world would seem to be polarised between institutional heavyweights with heft in assets under management (ordinarily an ultimate handicap to performance) and individuals within boutiques. To quote Swensen again,

“In selecting external managers, investors attempt to identify individuals committed to placing institutional goals ahead of personal self-interest. Alignment of interest occurs most frequently in independent investment management firms run in an entrepreneurial fashion by energetic, intelligent, ethical professionals. Engaging investment advisers involves consequences beyond issues of financial returns, as fiduciaries entrust both the institution’s assets and reputation to the external management firm.”

While it may well be psychologically difficult for the client to embrace, a degree of contrarianism is also a prerequisite:

“Without creative portfolio choices, investment managers face dismal prospects since the old combination represents the consensus view. Market efficiency drives returns on market-like portfolios to the average, causing conventional portfolios with conventional ideas to produce conventional results, a poor outcome for active investment managers.”

All of which may assist those leafing through the roughly ***8,500*** funds listed in the Financial Times’ managed funds section in search of inspiration. The figure is a pure guesstimate on my part, and the fonts for some fund names were so small I started worrying about my eyesight. (That also presumes that what those searchers are looking for actually exists, which is a moot point.)

Relative to conventional ideas, Argonaut Capital partner Barry Norris highlights a number of common current high conviction “beliefs” and concludes with a distinctly non-consensus view. He suggests that among those widespread popular beliefs are:

- That the economic recovery will be anything ***other than*** “V” shaped
- That emerging markets, or specifically China, will continue to outpace the developed world in both economic growth and stock market returns
- That the US dollar will continue to weaken.

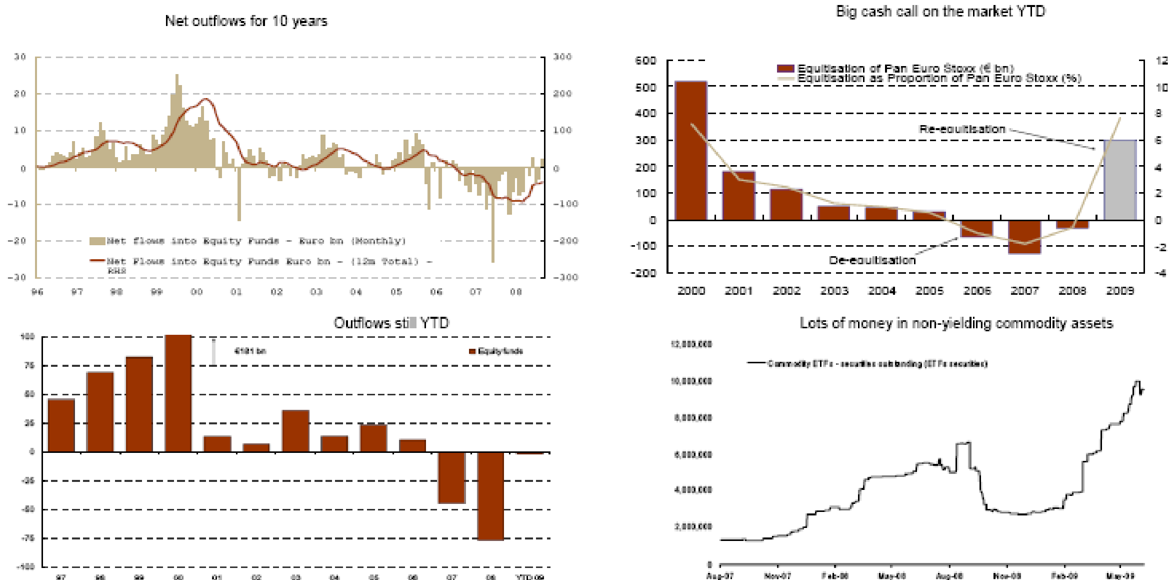
He admits to having had enough of “Dollar bears and China bores”. So are there other themes worthy of consideration for the active investor ? He highlights European equities, in no small part because “there is no compelling secular growth narrative for Europe. This is its strongest point.”

Any natural contrarian will warm to a sector bathed by an absence of animal spirits, or indeed an absence of enthusiasm of any kind. Norris points to the extent to which Europe is out of favour. Asset allocators don’t like equities and more to the point they don’t like European equities either, as the charts below make clear:

- Net flows into European equity funds have been negative for several years and fund outflows still persist
- European companies have been making big cash calls on the market
- Non-yielding commodity assets have been big recipients of investor cash

Europe – "the undiscovered Continent"

Fund Flows: "Don't like Equities and don't like Europe"



European Equities are the ultimate contrarian investment

Source: Citigroup

Perhaps most compelling of all, European equity valuations are at multi-decade lows. And Norris believes that the profits cycle is likely finally to turn positive for European companies. In any event, the complete absence of any form of growth narrative may serve European equity investors well. As Warren Buffett has said on numerous occasions,

"The time to get interested is when no one else is. You can't buy what is popular and do well."

Tim Price
Director of Investment
PFP Wealth Management
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Email: tim.price@pfpg.co.uk Weblog: http://thepriceofeverything.typepad.com

Bloomberg homepage: PFPG <GO>

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