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## Triumph of the realists, Part II

“HBOS’ share price began to drop last summer when the City became nervous about its reliance on UK mortgages. There were denials that the firm was in crisis, which is always a terrible sign. In September 2008, the Big Four bank Lloyds bought HBOS after its boss, Victor Blank – this is the part you couldn’t make up – bumped into Gordon Brown at a drinks party and got him to give an assurance that a takeover would not be referred to the monopolies commission..

Most of us have had a few drinks at a party and done something embarrassing, usually along the lines of I’ve-always-fancied-you-isn’t-it-time-we-did-something-about-it, but let’s take comfort in the following truth: none of us has ever done anything as embarrassing as buying HBOS.”

- John Lanchester, London Review of Books, “It’s Finished”, May 2009.

“Kenneth Feinberg, the Obama administration’s special master for executive compensation, said he is “very concerned” about the possibility his pay cuts may drive talent away from companies bailed out by US taxpayers.”

- Bloomberg News, 12<sup>th</sup> November 2009.

Well, with talent like that, who needs grubbily self-interested morons ? And yet in our Looking Glass world, the overarching policy mistakes just keep coming. Last week saw an announcement from the UK’s Nursing and Midwifery Council that from 2013, all would-be nurses will have to have a degree. Two thoughts spring to mind by way of response. One is that the current Labour government has done its damndest to dilute the rigour of a university degree with its fatuous and statistically arbitrary objective of pushing 50% of the young population into higher “education,” resulting in a strangely underpowered graduate workforce that in some cases can barely read or write. The second is that the City has, for at least the past two decades, insisted that all front office positions should be held exclusively by graduates. That comparably arbitrary hurdle has not had a particularly successful outcome, in anything other than the narrowest economic and financial terms. From 2013, sick people may wish to try and heal themselves, or to self-medicate via random pharmaceutical internet sites, rather than take their chances on the NHS. Let us hope that at least some of those nursing graduates do not hold previous qualifications in economics.

In last Friday’s Financial Times Lex, a longstanding (and so far wrong-headed) bear of gold and its relevance, repeated his critique not just of the metal but of those who choose to invest in it:

“..gold is almost always just being held in order that it might later be sold, to a greater fool, at a profit.”

Which is rather presumptuous, not to say sweeping. It is also likely to alienate some of the FT's core readership, many of whom earn a very comfortable living from their supposedly foolish speculations, not just in gold, but across all forms of financial assets. Lex concludes with a somewhat confused rationale for the late surge in the gold price:

“Gold has been a great investment recently, but psychology rather than supply and demand are responsible. Suggestions to the contrary come mostly from brokers and miners talking their own book.”

Surely supply and demand are the primary forces behind price action in all finite assets (we exclude paper currency which can be created on demand at negligible cost and which can therefore be considered, on a relative basis, to be infinite) – the role of psychological forces is no doubt significant, but it would be arrogant in the extreme to claim unique knowledge into the insight and actions of millions. But then that is the stock in trade of the financial journalist, so perhaps we should overlook such deductive peccadilloes.

What is harder to accept without question is Lex's implicit assumption that gold is inferior to modern currency. As a wise friend recently reminded me, gold at any given time may or may not be a good investment, but it is always money. It is surely open to rational debate whether the trillions of dollars, pounds sterling, euros, and other fiat currencies currently being “printed” to stave off a deflationary depression represent anything approximating to a store of value.

There is undoubtedly risk in gold speculation, just as there is risk in everything under the sun. Jonathan Spring, Managing Partner of True North Partners and The Stable Fund in New York, makes some shrewd observations about this risk:

“I fear that the value of gold will be difficult to recognize for most investors. It will make them feel wealthy for a while, just as their investments in real estate did a few years back, but it will be hard to time the exit successfully due, not to illiquidity this time, but to its extreme volatility.

“Gold, for most people, is best for jewellery, just as for most investors, real estate should simply be the place where they live, and tulip bulbs are best collected to produce cut flowers. The problem is never getting in; it's getting out – for which few people have a plan.

“I believe we are living through a major shift in the investment paradigm in which electronic access to assets has shrunk the stage of true “alternatives” much more than investors currently imagine. I suspect that only the very nimble folks with carefully laid plans for timely exits will inherit the new world. Think about it: you are either a front-runner or being front-run and the pace is picking up. (Goldman Sachs just showed everyone how it's done. Yes, they are very unsociable, but they are richer than us all.) To maintain the “slow” pace of just a few years ago will necessitate deeper pockets than most people can afford. Of course, when the world economy recovers, investors may again be able to make money by hitching a ride, but the economy hasn't recovered and may not for a while. Modern Portfolio Theory still works, it's just going at warp speed.”

It is not just the seemingly inevitable decline of fiat currencies of countries with unsustainable deficits that is creeping to the forefront of global investor concerns: the spectre of sovereign default is also slowly advancing to centre stage. The (admittedly conflicted) ratings agencies have already started to worry aloud about the outlook for the UK's creditworthiness. But Japan is in many respects already the ghoul at the credit market feast: as David Einhorn warned last month, with its domestic debt forecast to amount to roughly 200% of GDP (OECD 2010 forecast), Japan may be fiscally “past the point of no return”. For investors taking an ‘old paradigm’ approach to

government bond markets (namely that G7 government debt is intrinsically riskless), we would reiterate the catchphrase of Hill Street Blues' Sergeant Esterhaus, "Let's be careful out there". For some time we have voiced our preference for fundamentally sounder sovereign debt issued by explicitly creditworthy (as opposed to heavily indebted) investment grade nations. That preference, needless to say, remains.

At a simplistic level, grave concern about the prospect of significant capital loss – whether in the deteriorating purchasing power consistent with currency decline, or the catastrophic loss of capital consistent with government bond default – is often treated as pessimism. We would prefer to think of it as realism. Is insurance only bought by pessimists ? More portfolio value, we would suggest, is protected by honest realism towards the world than by dishonest optimism. More on this topic next week.

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