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A Year To Remember ? **29th June 2020**

"Andrews: "The pumps are keeping the water down in this boiler room, but the first five compartments are flooding."

Captain Smith: "Well, what's the answer ?"

Andrews: "She's going to sink, Captain."

Captain Smith: "But.. She can't sink. She's unsinkable."

Andrews: "She can't float. Look.. She could float with any three of her first five compartments flooded. She could even float with four of them gone. But she can't float with all five full up."

Captain Smith: "Yes, but.."

Andrews: [cuts him off]: "These watertight bulkheads only go as high as E Deck. The weight of the water in the bow is going to pull her down by the head. So, you're going to get the fifth compartment overflowing into the sixth; the sixth into the seventh; and so on, as she goes lower. It's a mathematical certainty. With that amount of underwater damage, she can't stay afloat.. How many people are there on board ?"

Captain Smith: "2,200 or more. And room in the boats for.. ? How many ?"

Andrews: "1,200."

Captain Smith: "I don't think the Board of Trade regulations visualized this situation. Do you ?"

- From Eric Ambler's screenplay for the film *A Night to Remember* (1958).

Time moves at strange rates during a crisis. Hemingway's Mike Campbell in *The Sun Also Rises* famously went bankrupt "Gradually and then suddenly". But once the *alea* is definitively *iacta*, the worst sort of fate is the one that pursues you slowly – but relentlessly, and unavoidably. Yul Brynner's malfunctioning robot gunslinger in the original *Westworld* is scary not despite his casual swagger but precisely because of it. The same holds for Arnold Schwarzenegger's murderous cyborg in the first *Terminator*. He can afford to take his time the same way a cat toys with a mouse – because he knows he's going to win.

Which is precisely why the story of RMS Titanic is so compelling, both literally and metaphorically. Once its five compartments are flooded, the die is cast; it becomes somewhat academic whether the ship will sink quickly or slowly, it's only a matter of rearranging its deckchairs. Probably many of its victims went to their watery graves *gradually and then suddenly*.

Roy Ward Baker's *A Night to Remember* will always be the definitive account of the disaster. In the more than 60 years since its 1958 release, it has lost none of its raw emotional power. (The James Cameron version, by comparison, is just a pompous, inflated mess.) There are a number of sequences in the former version that depict a lounge in one of the upper class quarters of the ship as it slowly sinks beneath the waves. Notwithstanding the vessel listing alarmingly, a motley band of toff revellers are determined to go out in the finest Hooray Henry style. Some continue to play at cards with a fatalistic resolve while behind them, a group of braying nobs determinedly quaff spirits direct from the bottle. One may be doomed, but one can still party on. As the millionaire Benjamin Guggenheim remarks to the shipbuilder Andrews as the story reaches its grim climax,

> We have dressed now in our best, and are prepared to go down like gentlemen.

There was indeed once a type of businessperson who behaved with moral elegance under duress, as opposed to trampling over men, women and children in search of a bailout.

A few years ago, Jeremy Grantham's wrote a market letter that is particularly good on the professional asset manager's need to navigate not just irrational markets but to cater to clients hungry for performance and intolerant of the bad kind:

> Over the years, our estimate of "standard client patience time," to coin a phrase, has been 3.0 years in normal conditions. Patience can be up to a year shorter than that in extreme cases where relationships and the timing of their [portfolio's inception] have proven to be unfortunate. For example, 2.5 years of bad performance after 5 good ones is usually tolerable, but 2.5 bad years from start-up, even though your previous 5 good years are well-known but helped someone else, is absolutely not the same thing !
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> With good luck on starting time, good personal relationships, and decent relative performance, a client's patience can be a year longer than 3.0 years, or even 2 years longer in exceptional cases. I like to say that good client management is about earning your firm an incremental year of patience. The extra year is very important with any investment product, but in asset allocation, where mistakes are obvious, it is absolutely huge and usually enough.

We make just one cavil with Grantham's observations in this piece. Like most of the financial services industry, he restricts his asset universe to the two conventionally dominant classes of listed equities and (investment grade) debt. The problem with this perspective is that the asset management industry tends to view those asset classes as both uncorrelated and representative of the entirety of investor choices available.

But the reality is a) that investors can pursue other distinct types of assets (we would single out real assets as an obvious and relevant alternative), and b) that there can and will be times when both debt and equity markets together underperform, in both relative and absolute terms (the relative benchmark being cash since developed government debt can in no way now be considered a risk-free asset class).

We may be fast approaching a macro environment that threatens conventional portfolios with exactly that outcome – a bear market in both stocks and bonds simultaneously. In other words, the authorities and central banks could *attempt* to throw a bull market party for both bonds and common stocks, but nobody would show up.

Having long since exhausted the armoury of conventional policies to keep the unsustainably indebted and now almost randomly releveraging and deleveraging show on the road, increasingly desperate politicians are doing increasingly desperate things – courtesy not so much of the spread of Covid-19 as of the mass governmental insanity that attended it. The madness that is Modern Monetary Theory is now with us, *de facto* if not quite yet *de jure*.

Project 'End Up Like Japan' (1990 – c. 2010 vintage) continues to advance well throughout the western economies. The Eurozone continues to perform like a group of drowning men lashed together for buoyancy. Here in the UK the Bank of England has the dubious privilege of being able to print money with abandon, and it is taking every opportunity to duly abuse the purchasing power of Britons with savings. We continue to hear Mr. Takashi Ito's sad refrain, published as a letter to the FT back in August 2010:

"..after a huge housing bubble bursts, there is nothing to do except suffer many years of economic indignity."

Politicians, of course, are not in the business of sitting idly by while the country collectively suffers that economic indignity (the savers, at least). They must be seen to be doing something. The ironic triumph of the Keynesians means that in trying to save the economy, our central bank may end up losing control of the printing press. Having put much of the world and its economy under virtual house arrest for several months in the guise of avoiding risk, politicians may now about to get a powerful lesson in what risk really means.

As the debt burden and currency debauchery satire rise together toward some form of climactic end-game, the sense of politicians simply not getting the point is almost palpable. Just when it were most needed, evidence of social urgency and economic priority from government is almost invisible. Instead, we get the likes of an almost comical U-turn on indefinite free school meals facilitated by a premiership footballer.

So, in a portfolio sense, we close all water-tight doors. Debt holdings, having previously been restricted to those of only the most objectively creditworthy borrowers, are now almost entirely eliminated. Equity exposure is kept modest and restricted to only the most defensive.

We diversify further into the one actively managed strategy that doesn't attempt to predict future market performance, namely systematic trend-following. And we diversify further still into the highest quality currency available, namely the monetary metals, both gold and silver – together with cash-flow rich bullion miners, trading on modest multiples, with little or no outstanding debt.

With Grantham's sensible caveats about investor patience still ringing in our ears, we repeat our increasingly urgent suggestion that investors in debt and equity products (especially debt) enjoy the party but those pursuing more of an indexed mandate may wish to dance near the door. And if you do intend to panic, please have the good grace to panic early. Developed market debt investors, for example, have enjoyed a 40-year bull trend in interest rates (and credit creation) but the fat lady in the next room, courtesy of the international authorities' aggressive collective monetary and fiscal responses to Covid-19, seems to have started tuning up. Unlike 'Molly' Brown, this particular fat lady may ***not*** be unsinkable.

Ben Inker, Jeremy Grantham's colleague at GMO, offers the following as part of the company's latest quarterly letter to investors. We think his conclusion is worth citing in full:

> Investing always involves making decisions under uncertainty. We seldom feel we know what the market will do in the near term. We do not feel we know what the short term will bring here, either. While many stocks appear to us to be overvalued today, overvalued stock markets are nothing new. What is new is the meaningful possibility of a disastrous economic outcome combined with a substantially overvalued stock market. The disaster scenario is by no means a certainty. But it is plausible enough that we want to invest in a way that mitigates the losses should it occur, as long as that can be done without costing too much in expected returns for less dire scenarios. Simply holding cash would remove the downside in the disaster scenario, but cash offers no return today. Moving from stocks to cash would be trading the possibility of a horrible outcome against the certainty of an inadequate one. Happily, we are not restricted to that choice. In aggregate, global value stocks are cheaper relative to the market than they have ever been apart from a month or two in the TMT bubble. That cheapness buys a lot of margin of safety for a bad economic outcome while still providing an expected return higher than developed stock markets.12 We believe that a combination of that spread and a long position in emerging market value stocks – the cheapest stocks in the world – provides a far better risk/reward trade-off than a traditional equity position at this point in time.

In both asset allocation and instrument selection, having diversified well beyond defensive equities into uncorrelated funds and real assets, we have already left the party in all but name. Our portfolios are not particularly dependent on the continuation of any kind of bull market environment – for either conventional debt or equity indices. We are already essentially sipping non-alcoholic drinks at the after-party (waiting impatiently for the pubs and restaurants to re-open, admittedly). We look with keen interest at our watches to see how many other revellers will end up joining us.

To put it another way, the ship is listing badly, but time moves on. So what colour is ***your*** life-jacket ?

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