PRICEVALUEPARTNERS

**Markets and the meaning of life**

"God grant me the serenity

to accept the things I cannot change;

courage to change the things I can;

and wisdom to know the difference."

- From 'Serenity Prayer' by Reinhold Niebuhr.

**Of course,** Marcus Aurelius got there first. His *Meditations* may be the most valuable collection of observations ever made by any leader in history. At a time of extraordinary political, economic and technological change, its practical wisdom endures. Consider, for example, the following:

- If you are distressed by anything external, the pain is not due to the thing itself, but to your estimate of it; and this you have the power to revoke at any moment.
- You have power over your mind – not outside events. Realize this, and you will find strength.
- Everything we hear is an opinion, not a fact. Everything we see is a perspective, not the truth.

In the Stoic tradition, the world is more complex than it might appear, but that complexity is to be welcomed rather than feared. The free individual is the one who acknowledges that he or she is in control of their own thoughts, and thus how they choose to respond to the slings and arrows of outrageous fortune. Viktor Frankl, the Austrian psychologist who also survived the Nazi death camps of Theresienstadt, Auschwitz, and Dachau, built on the legacy of Marcus Aurelius by developing his philosophy of logotherapy, which suggests, essentially, that the meaning ***of*** life for every individual is to seek out the meaning ***in*** life.

Financial markets are also more complex than they might appear to the unelected technocrats at the central banks who are attempting to tame them. Are they, for want of a better phrase, ***safe*** ? We would use the analogy of the sand pile. Imagine dropping grains of sand, one by one, onto a level table top. For a while, the sand pile grows, but remains stable. At a certain point, however, the sand pile shifts from being in ***stable*** equilibrium to ***unstable*** equilibrium. Beyond this point, any single grain of sand dropping onto the pile might cause a precipitous slide. The problem is that we do not know – until it actually happens – which grain will topple the pile.

That is the state of financial markets today, notably in credit. Financial analyst Doug Noland:

> Crisis-period QE changed the functioning of global markets. Permanently including QE in central banks' standard toolkit has transformed global finance and Capitalism in ways not comprehensible at this juncture. The bond "vigilantes" are extinct. This has provided central banks unprecedented latitude to discard convention and follow their every whim. It has also conveniently removed a major risk (spike in yields) for equities. But is has also opened the fiscal floodgates, where monetary policies ensure the accommodation of huge deficit spending at extremely low borrowing costs. QE and the resulting death of the vigilantes have also empowered the strongman leader to subvert central bank independence.
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> Remember James Carville's, "I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody." That was before QE. Today's bond market intimidates no one. Threatening - or even firing - the head of a central bank for not cutting rates – is a non-issue for today's bond market. Ditto massive deficits. Why worry about supply, myriad excesses or politicizing monetary management when the magic of QE can make everything good?
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> Today's "crazy" is incredibly dangerous. No check and balances. Markets have lost the capacity to self-adjust and correct. Sovereign debt, the foundation of global finance, has succumbed to unprecedented price distortions – and it only gets worse from there: The Speculative Blow-Off for Global Financial Assets. And I appreciate it all appears reasonable and unsustainable - so long as securities prices continue to inflate. But it will function poorly in reverse. The crazier things get the more unsustainable Bubble prices become.

There are things we cannot change. Delusional central bankers are one of them. But the beauty of investing is that there are almost infinite numbers of things that we ***can*** change: financial markets today are nothing if not vast realms of opportunity sets.

What follows is perhaps the most extraordinary narrative in investment. It is all the more extraordinary because it happens to be true.

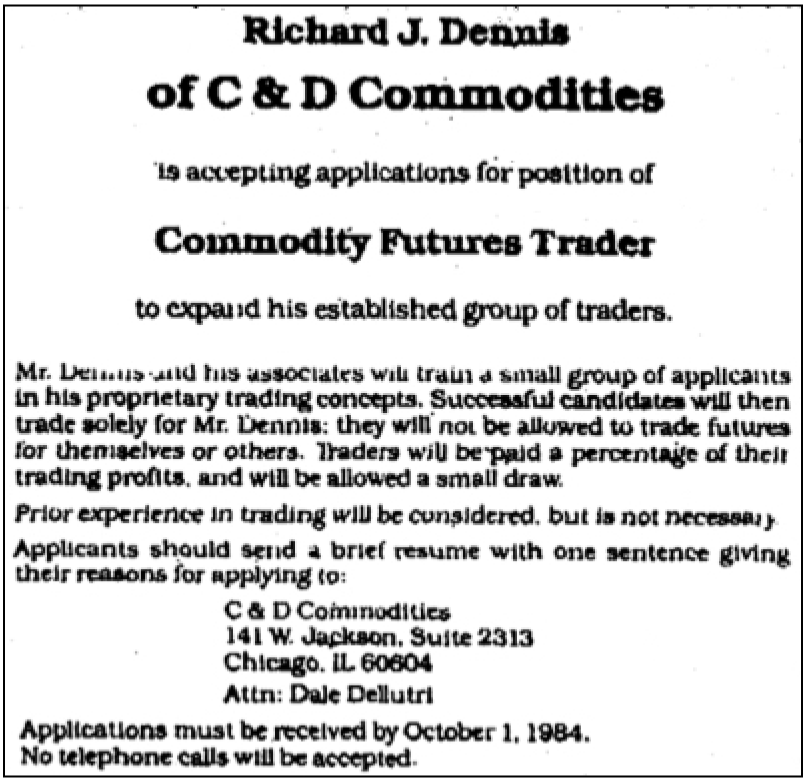
The film 'Trading Places' was based on a true story.

Two unscrupulous commodity brokers, played by Don Ameche and Ralph Bellamy, have a bet. They wager that they can take a vagrant (Eddie Murphy) off the street and turn him into a successful trader. The bet also involves defenestrating the patrician blue-blood trader (Dan Aykroyd) in their own company and turning him into a bum.

More or less at exactly the same time, the real world commodities trader Richard Dennis set out to show that anybody could become a successful trader provided they were simply taught properly.

His partner, Bill Eckhardt, disagreed – and a wager was born.

Dennis placed classified ads in the back of Barron's magazine. This is a facsimile:




Prior experience was not a requirement. But applicants did have to complete a psychological profile. Among the test were some true-false questions, such as:

- The majority of traders are always wrong
- It's good to follow hunches in trading
- It's good to average down when buying
- A trader should be willing to let profits turn into losses
- Needing and wanting money are good motivators to good trading..

Dennis ended up with two classes of what he called 'turtles', named after a visit to a Singaporean turtle farm. He believed that successful traders could be nurtured, like baby turtles in a vat of water, simply by being taught the fundamental principles of trading.

Nor was the experiment rigged in favour of Wall Street types. Among those selected for the trial were graduates in piano and music theory, an accountant, a geologist, an unemployed guy, and a graduate of the United States Air Force Academy. These were not typical business or finance students.

Long story short, Richard Dennis won his bet.

He hired fewer than two dozen novice traders. Jerry Parker was among them. He now runs Chesapeake Capital and is believed to be worth upwards of $700 million.

$1000 invested with fellow 'turtle' Tom Shanks' Hawksbill Capital in 1988 would now be worth something north of $100,000.

Turtles Paul Rabar, Mike Carr, Howard Seidler and Jim DiMaria all set up fantastically successful trading firms after their experience with Dennis.

So what did Dennis teach them ?

There are only two ways consistently to make money from the financial markets. One of them is value investing. Buying high quality assets for less than they're fundamentally worth is an immensely successful strategy over the medium term.

The other is what we can call ***momentum***.

Old hands in the City and on Wall Street tend to favour fundamental analysis of the markets. They waste their time discussing and debating the future course of the economy, of interest rates, and inflation. This is all very interesting – perhaps – but fundamentals tell you ***nothing*** about how to make money. All of that information is already in the price. And fundamentals are also somewhat subjective – take two economists, ask for their opinion, and you'll likely get at least three answers.

Another way to look at financial markets is by using technical analysis. This is not as complicated as it might sound. It simply means looking at the price history of financial assets.

The reality, which is something that Dennis intuitively knew, and that he went on to teach his turtles, is that ***price is the only metric worth trusting***. You can have a view about the future path of interest rates, for example. Probably very low for very long. But that view might be 100% wrong.

Everything else is subjective.

So this is the system that Dennis taught. It's a trading strategy that today goes by the title of 'systematic trend-following'.

'Systematic' because there's a clearly articulated system. This is a rules-based approach to trading. For example, one rule might be:

- When a given market trades at a new 52-week high, then buy it.

Another rule might be:

- When a given market trades at a new 52-week low, then sell it.

These are clearly simple examples. A decent 'systematic, trend-following' system will likely incorporate a wide variety of rules, incorporating guidance on when to get in, when to get out, and how to size positions.

The point being, once you have established that set of rules, you don't deviate from them. At all. They can clearly be refined, over time. But they should never, under any account, be abandoned.

Unlike many trading approaches, systematic trend-following requires no special understanding of any given market. Trend-followers also tend not to pay any attention to "news".

What does interest trend-followers is catching a ride on big market trends. This is the key to the success of trend-following as a trading strategy. Markets have a tendency to make big moves that come as a complete surprise to most investors. But not to trend-followers: big "surprise" moves is precisely what they live for. It's the source of their outsized profits.

Today's trend-followers are following a path laid down by one of the most successful stock traders in history – Jesse Livermore (1877-1940). Livermore's nicknames included 'the Boy Plunger' and 'the Great Bear of Wall Street'. Livermore managed to make, and then lose, several fortunes. But he was not a creature of some long-lived bull market, like so many of today's accidentally successful hedge fund managers. After the 1929 Crash, he ended up worth $100 million, when many of his trading rivals lost everything.

Happily for the wannabe trader today, Jesse Livermore's approach is just as valid as it's always been. As he said himself,

> There is nothing new in Wall Street. There can't be, because speculation is as old as the hills. Whatever happens in the stock market today has happened before and will happen again.

The beauty of trend-following is that it requires just two things: greed and fear. And not even on your part, but on the part of your fellow investors. As the market oscillates between these two emotional extremes, prices form trends. The direction and intensity of those trends reflect whichever emotion currently has the upper hand in the psychology of the average fund manager. (And they are almost all average.)

The principles of trend-following, then, are not complex. Most of them are concerned with determining how much risk to take on each trade. This remains the case whether you are buying shares or shorting them. This type of positioning and position sizing is known in the trade as risk management.

A particularly appealing aspect of trend-following is that it's typically a low risk strategy. The best trend-following funds are actually very low risk vehicles. We define risk here as "the possibility of a permanent loss of capital". If a trend-following manager knows how to size his positions appropriately, and rigidly obeys his own system no matter what, he is highly unlikely to incur a blow-up. Managers blow up when they don't know what they're doing, when they don't follow a system, or when their systems are obviously flawed.

Trend-following might be the perfect antidote to Wall Street machismo and excess. (One of Richard Dennis' most successful 'turtles' was Liz Cheval, the founder of EMC Capital Management, who sadly died in March 2013.)

It certainly flies in the face of traditional theories about efficient markets. The Efficient Market Hypothesis is nonsense.

But trend-following is not easy. It requires an iron psychological discipline in buying or selling when your system's signals say so, irrespective of how you might feel about the market's overall direction. The trick is to abandon ego altogether, and just follow the momentum of the market. That said, having the discipline to follow the instructions of your system without question can be immensely difficult. Imagine buying a futures contract – in anything – nine times in a row, only to be stopped out by an adverse short term price movement each time. And then your system tells you, once again, to buy that instrument. Sometimes it's like coming in to work and having your arm broken, ten days in a row.

Jesse Livermore understood this. As he said himself,

> The game of speculation is the most uniformly fascinating game in the world. But it is not a game for the stupid, the mentally lazy, the man of inferior emotional balance, or for the get-rich-quick adventurer. They will die poor.

So trend-following isn't necessarily easy, but it can be extraordinarily profitable.

Trader Chris Clarke recently crunched the numbers on 'the best funds in the world'. To make the final cut, funds had to a) have an unbroken 20 year track record and b) have generated average annualised returns of 20%. The short list is shown below.

**Funds with a 20 year track record that have generated 20% annualised average returns**

| Fund | Class / Share / Programme | Manager | Inception | CAGR % |
|---|---|---|---|---|
| Eckhardt | Standard Programme | William Eckhardt | Jan-87 | 23.81% |
| EMC Capital Management | The Classic Programme | Liz Cheval | Jan-85 | 23.20% |
| Hawksbill Capital Management | Global Diversified | Jerry Parker | Nov-88 | 22.24% |
| Blenheim GL Markets LP | | William Kooyker | Dec-86 | 22.06% |
| Tudor Investment Corp | BVI Global Fund | Paul Tudor Jones | Oct-86 | 21.76% |
| MJ Walsh | Standard Programme | Mark Walsh | Sep-85 | 21.33% |
| JW Henry & Co | Financials & Metals Programme | John Henry | Oct-84 | 21.10% |
| Moore Capital | Global Inv Fund, Ltd | Louis Bacon | Dec-89 | 20.64% |
| Abraham Trading Company | Diversified Programme | Salem Abraham | Jan-88 | 20.33% |
| Gamut Investments | | Bruce Kovner | Jun-86 | 20.31% |
| Berkshire Hathaway | Per share book value | Warren Buffett | 1965 | 20.30% |

(Source: Lawrence Clarke Investment Management)

Of these eleven funds, six of them were systematic trend-followers. Note that Berkshire Hathaway, which is not even technically a fund, only just squeaked onto the list.

There are things we cannot change. The collapse of 'centrist mush' politics is one of them. The current preponderance of brain donor central bankers is another.

But there are things we can change. We can invest wherever we like. So we invest, quite deliberately, in high quality, listed 'value' businesses, which in aggregate happen to comprise the top performing investment strategy in the stock market over the long run.

With one eye on an insoluble debt predicament, we invest in inflation hedges such as precious metals and 'value' mining companies.

But we also invest in systematic trend-following funds. Because we simply don't know what the future holds. And no matter how good a financial analyst you might be, neither do you.

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*Tim Price is co-manager of the VT Price Value Portfolio and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets'. You can access a full archive of these weekly investment commentaries here. You can access the archive of our regular 'State of the Markets' podcasts, with Paul Rodriguez of ThinkTrading.com, here.*

Price Value Partners manage investment portfolios for private clients. We also manage the VT Price Value Portfolio, an unconstrained global fund investing in Benjamin Graham-style value stocks and specialist managed funds.