

# PRICE VALUE PARTNERS

## Under the influence

“I must create a system, or be enslaved by another man’s. I will not reason and compare: my business is to create.”

- William Blake.

**It started with [Cluetrain](http://www.cluetrain.com)** in early 1999. Roughly five hundred years after Martin Luther allegedly nailed his ninety-five theses to the door of the church at Wittenberg, a new polemic was posted online, at [www.cluetrain.com](http://www.cluetrain.com). This correspondent stumbled upon a reference to it within a research note from Merrill Lynch’s (now discredited) internet analyst, Henry Blodget. ‘The Cluetrain Manifesto: the end of business as usual’ was the brainchild of four technologists and visionaries: blogger Christopher Locke; columnist David ‘Doc’ Searls; philosopher David Weinberger and entrepreneur Rick Levine. Its essential premise is that:

Networked markets are beginning to self-organize faster than the companies that have traditionally served them. Thanks to the web, markets are becoming better informed, smarter, and more demanding of qualities missing from most business organizations.

Or to put it another way, the Internet really does change everything.

You can read each thesis at the Cluetrain website, but for us, a few among them stand out, namely:

- All markets are conversations;
- The Internet is enabling conversations among human beings that were simply not possible in the era of mass media;
- People in networked markets have figured out that they get far better information and support from one another than from vendors;
- To traditional corporations, networked conversations may appear confusing. But ‘digital natives’ are organizing faster than traditional corporations, with better tools, more new ideas, and no legacy rule baggage to slow them down.

You can trace the lineage of companies like Facebook, Google and Twitter (and clearly legions more) directly back to the philosophy espoused in Cluetrain. At around the same time, the

ground was palpably shifting beneath our then employer's feet. The market capitalisation of the 'full service' stockbrokerage Merrill Lynch had been overtaken by that of the internet broker, Charles Schwab. Some of us didn't need to be asked twice. By early 2000, we had left Merrill Lynch to set up on our own. Others at the firm reacted differently, i.e. by denial. John "Launny" Steffens, the vice-chairman of Merrill Lynch, warned that

The do-it-yourself model of investing, centered on Internet trading, should be regarded as a serious threat to Americans' financial lives..

The next major influence upon our financial worldview was [this presentation](#) by the late Professor Albert Bartlett, emeritus professor of physics at the University of Colorado at Boulder. Yes, a presentation with the inauspicious title of 'Arithmetic, Population and Energy' that has nevertheless garnered over 5 **million** views on YouTube.

In the video, Professor Bartlett shares his observations about the power of the exponential function – what happens when the supply of anything grows, and compounds, at a fixed rate over time. As Professor Bartlett warns,

The greatest shortcoming of the human race is our inability to understand the exponential function.

Here is an example from the world of bacteria.

Bacteria grow by division so that 1 bacterium becomes 2, the 2 divide to give 4, the 4 divide to give 8, etc. Consider a hypothetical strain of bacteria for which this division time is 1 minute. The number of bacteria thus grows exponentially with a doubling time of 1 minute. One bacterium is put in a bottle at 11:00 a.m. and it is observed that the bottle is full of bacteria at 12:00 noon. Here is a simple example of exponential growth in a finite environment. This is mathematically identical to the case of the exponentially growing consumption of our finite resources of fossil fuels. Keep this in mind as you ponder three questions about the bacteria:

- 1) When was the bottle half full ? Answer: 11:59 a.m.
- 2) If you were an average bacterium in the bottle, at what time would you first realize that you were running out of space ? Answer: There is no unique answer to this question, so let's ask, "At 11:55 a.m., when the bottle is only 3% filled and is 97% open space, would you perceive that there was a problem ?

Some years ago someone wrote a letter to a Boulder newspaper to say that there was no problem with population growth in Boulder Valley. The reason given was that there was 15 times as much open space as had already been developed. When one thinks of the bacteria in the bottle one sees that the time in Boulder Valley is 4 minutes before noon !

Suppose that at 11:58 a.m. some farsighted bacteria realize that they are running out of space and consequently, with a great expenditure of effort and funds, they launch a search for new bottles. They look offshore on the outer continental shelf and in the Arctic, and at 11:59 a.m. they discover three new empty bottles. Great sighs of relief come from all the worried bacteria, because this magnificent discovery is three times

the number of bottles that had hitherto been known. The discovery quadruples the total space resource known to the bacteria. Surely this will solve the problem so that the bacteria can be self-sufficient in space. The bacterial “Project Independence” must now have achieved its goal.

- 3) How long can the bacterial growth continue if the total space resources are quadrupled ? Answer: Two more minutes.”

As Professor Bartlett also observes,

We must realize that growth is but an adolescent phase of life which stops when physical maturity is reached. If growth continues in the period of maturity it is called obesity or cancer..

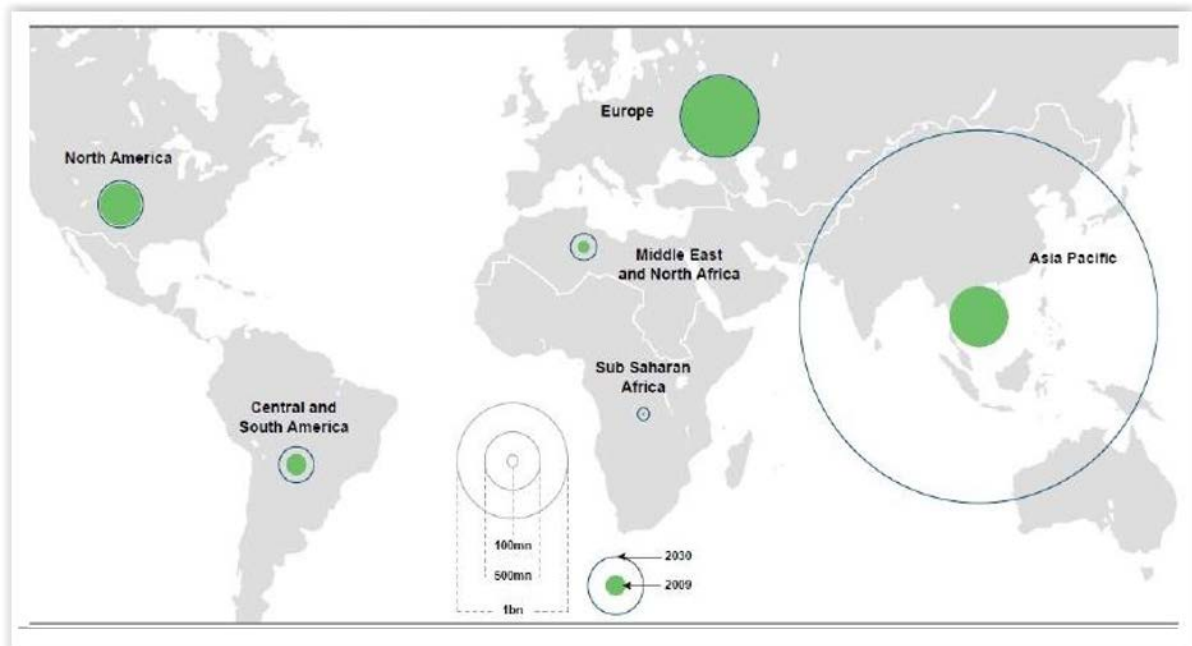
Satyajit Das, in his book *The Age of Stagnation*, goes on to develop the thesis that our economic obsession, perpetual growth, is now an unattainable goal. One reason it is unattainable is because for the last several decades, economic activity and growth have been increasingly driven by financialization and borrowing to finance consumption and investment. By 2007, \$5 of new debt was necessary to create an additional \$1 of American economic activity – a fivefold increase from the 1950s. We are now drowning in debt.

There can only be three outcomes by way of resolving the debt crisis. One is for government to engineer sufficient economic growth to service the debt. In the euro zone, that outcome may be unachievable. One is to repudiate, restructure or ‘jubilee’ the debt – not easy, given that one government’s liability is another investor’s asset. The third way is the time-honoured governmental solution: official, state sanctioned inflationism – which is presumably what the (failed) policy of QE has always been about.

We are also, courtesy of QE, now drowning in money and, as [Josh Brown](#) nicely points out, much else besides. In his book *Tomorrow’s Gold*, Marc Faber uses the analogy of a large, flat bowl perched on top of the earth. At its base, investors surround the bowl. A continuous supply of fresh water (money) flows into the bowl, controlled by the world’s central bankers. The bowl will lean whichever way investors tilt it. “..The direction of the overflow will depend on the bias of investors, which in turn can be manipulated by opinion leaders, the media, analysts, strategists, politicians and economists.” If we can anticipate where the “water” will flow, we can emulate as investors the sporting success of Wayne Gretzky – we can skate to where the puck will be, not where it has been.

The map below, courtesy of the OECD, is one of our favourites. It shows plausibly where the puck might be headed.

## Growth of the Asian middle class; forecast: next 20 years



(Source: OECD)

The solid green circles represent the current middle class population as defined by the OECD. The wider blue circumferences represent the forecast middle class population, again from the OECD, by 2030.

The US middle class population is expected to be largely static – reasonably so, since it represents a mature economy. Ditto that of Europe. The middle class populations of South America and Africa are forecast to grow somewhat, albeit from a very low base.

But if the OECD is correct, the middle class population of Asia is forecast to explode – from roughly 500 million people today to something like 3 billion people over the next two decades. If this comes to pass it will constitute the greatest creation of wealth in human history.

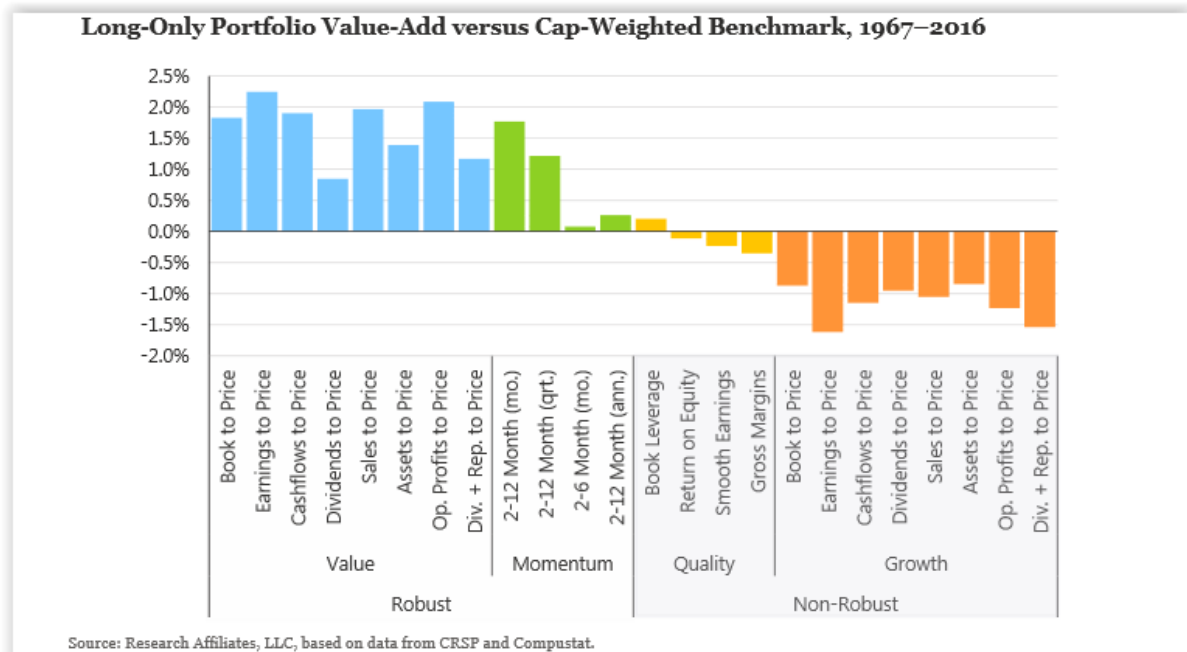
So owning the shares of businesses catering to that emerging middle class is a plausible investment thesis – especially if the shares of those businesses can be bought at attractive prices.

The good news is that they can. Which is why our single largest equity exposure within client portfolios, and our fund, is to Asia (notably to Japan and Vietnam, in that order).

A third influence on our investment worldview has been the strategy known as systematic trend-following. Michael Covell's recently reissued *Trend Following* remains the definitive guide to the strategy, and his [website](#) is still as an excellent primer on the topic.

Systematic trend-following is essentially a simple price momentum strategy. If the price of a given instrument rises, buy it. If the price of a given instrument falls, sell it short. Diversify by market. Manage downside risk. Use stop losses. Cut losses. Let winners run. There is clearly more to the strategy than these crude rules, but they capture the essence of the philosophy.

We use systematic trend-following funds in part to gain access to price movements in less traditional markets (such as those for currencies and hard and soft commodities), and so to benefit from asset class diversification. But even within the context of just the equity market, the momentum strategy has been a solid performer. Research Affiliates [crunched the data](#) for the performance of various ‘styles’ of equity in the US stock market over a period of 50 years, and the results are shown below.



In short, ‘value’ and ‘momentum’ (i.e. trend-following) both tended on average to add value, per annum, relative to the market. Interestingly, both ‘quality’ and ‘growth’ tended, on average, to perform less well than the market. That may well be especially the prevailing case for 2018 (and 2019 ?), now that the FAANGs have started to implode.

A friend separately crunched the data on what effectively became a list of some of the best funds in the world. He required the funds in question to have an audited track record of at least 20 years (difficult), and then to have generated average annualised returns of at least 20 percent (almost impossible). Those funds that made his final cut are 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 / Chris Clarke

Note that Berkshire Hathaway (not strictly a fund) just squeaked onto the list. At the bottom. More to the point, note that of these top 11 superfunds, fully six of them are trend followers.

Things feel weird in Market City today. The politics are fiercely divisive and the financials are starting to feel increasingly ropey. This commentary summarises some of the major influences on our investment thinking over the past 20 years or so. Notably, since both 'value' and 'momentum' appear to have a rock solid investment thesis underpinning them, we are more than happy to use both of them. It beats trying to solve impossible and intractable macro dilemmas any day of the week.

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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.

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