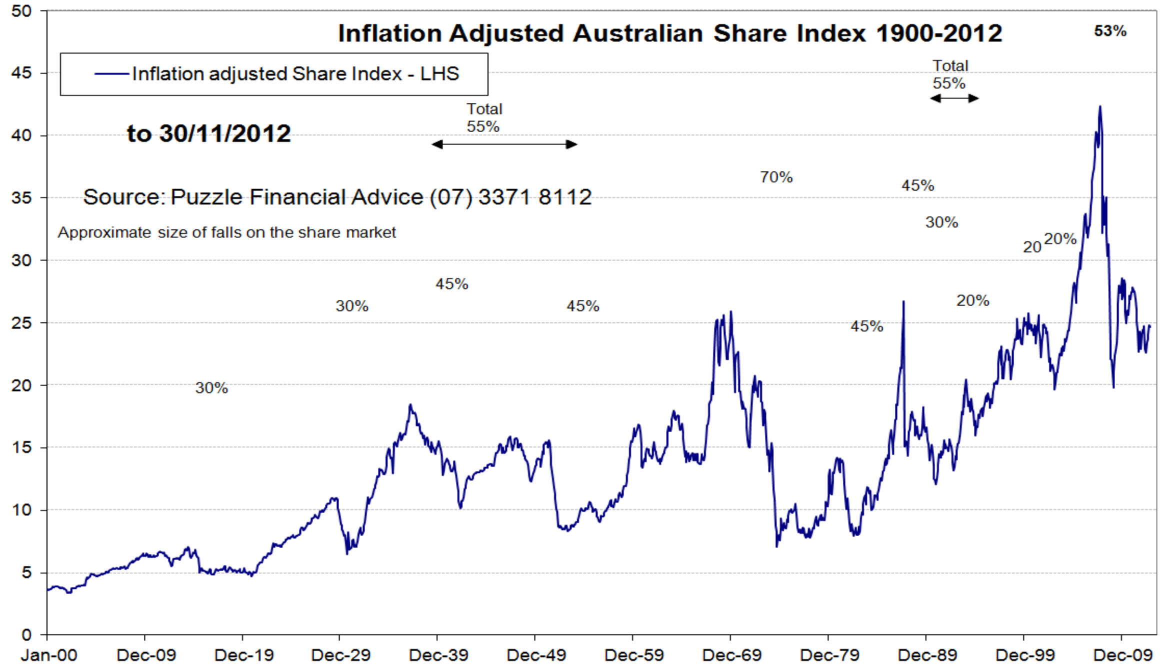
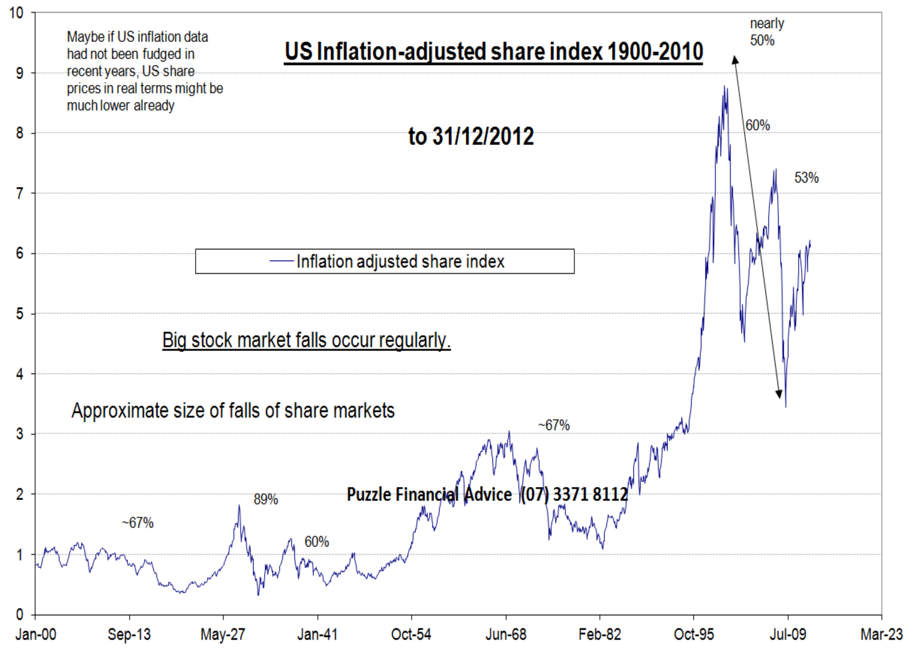
Puzzle Investment Philosophy.
By Bruce Baker for clients of Puzzle Financial Advice
28/9/13

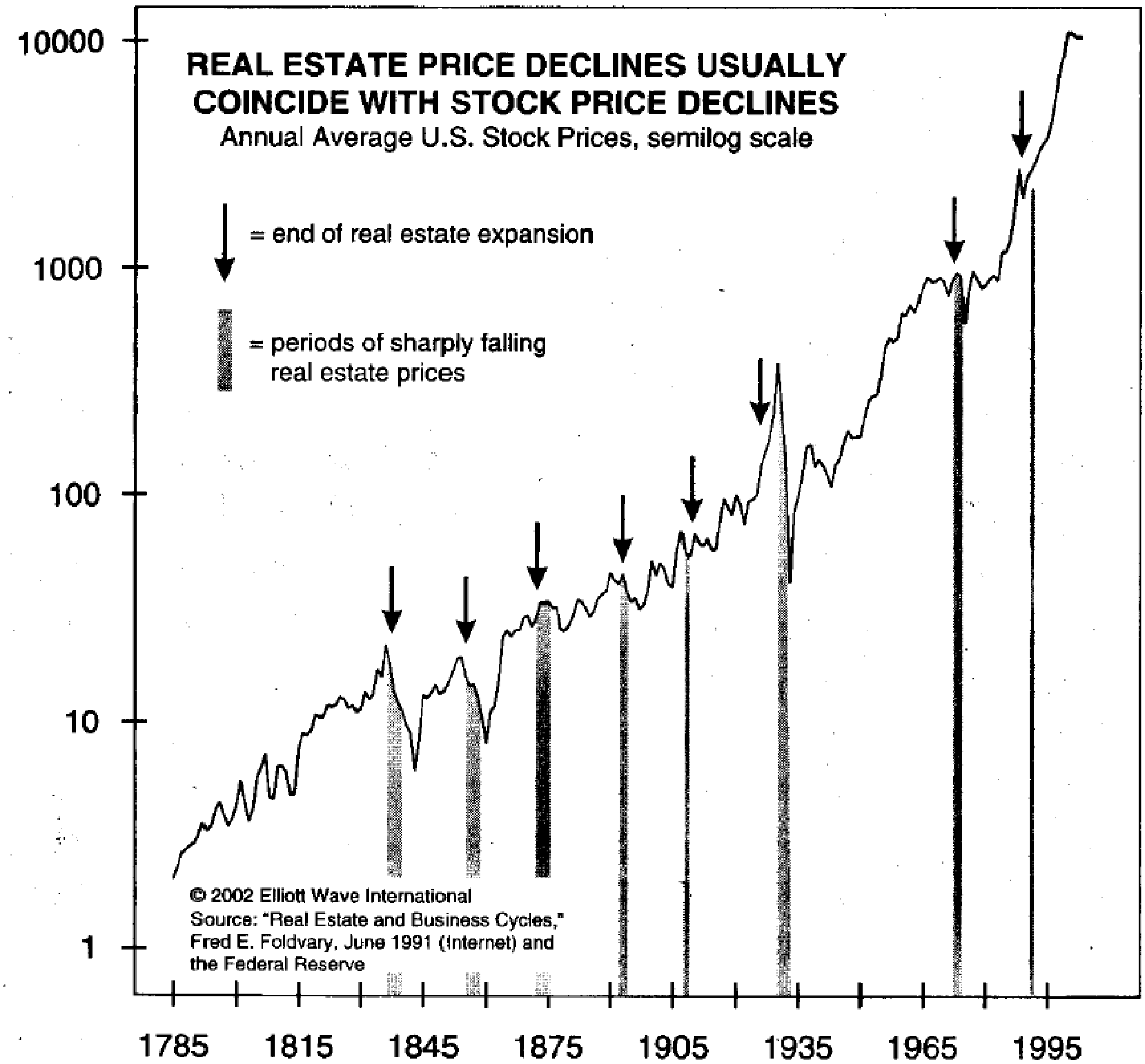
Before you begin. It is always critical to remember that the first step in portfolio strategy is to ensure that there is enough cash fixed interest in the portfolio to try to ensure that the overall portfolio volatility is within a range that you can tolerate without losing sleep. The second key point to is to remember to focus your portfolio monitoring on the portfolio bottom-line because too much focus on volatility of individual line items can lead to sub-optimal portfolio adjustments.

First key choice. When you invest, you have a choice between having the risky (shares & property) portfolio behave like the indices (see charts below) with extreme volatility from time to time ….. or trying to avoid the really big crashes. This is the choice between passive investing and actively managing your portfolio.

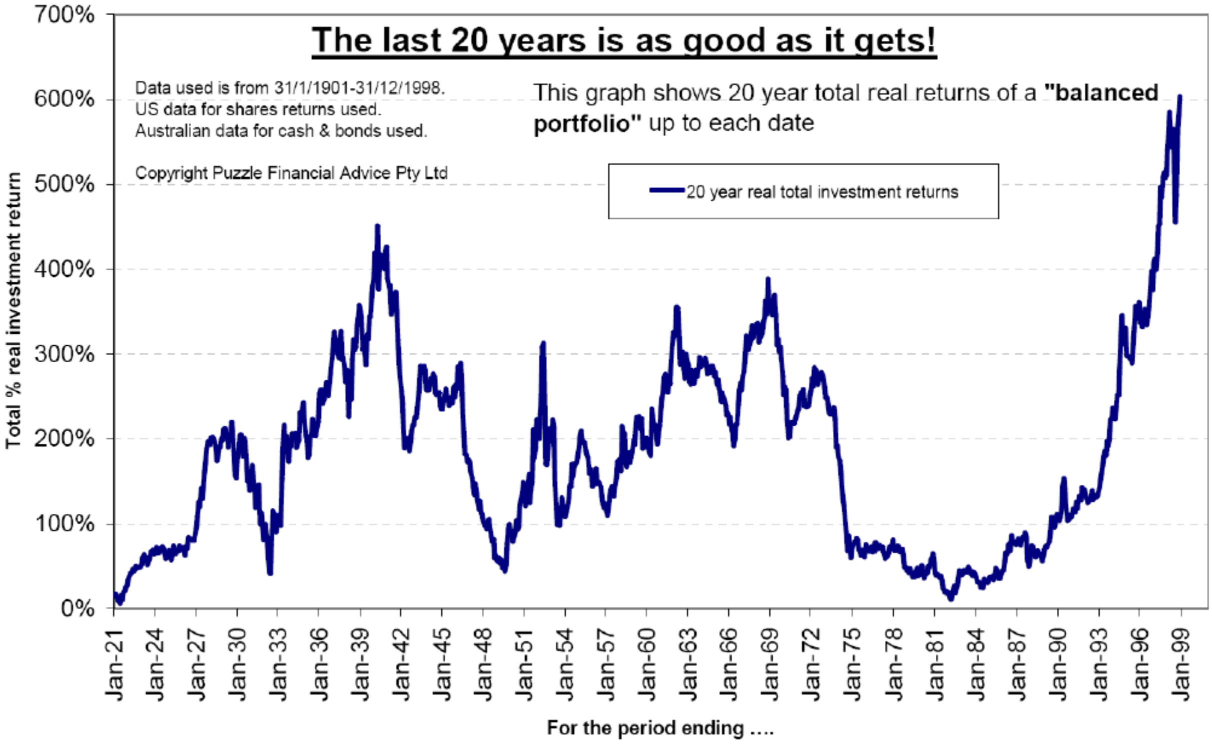




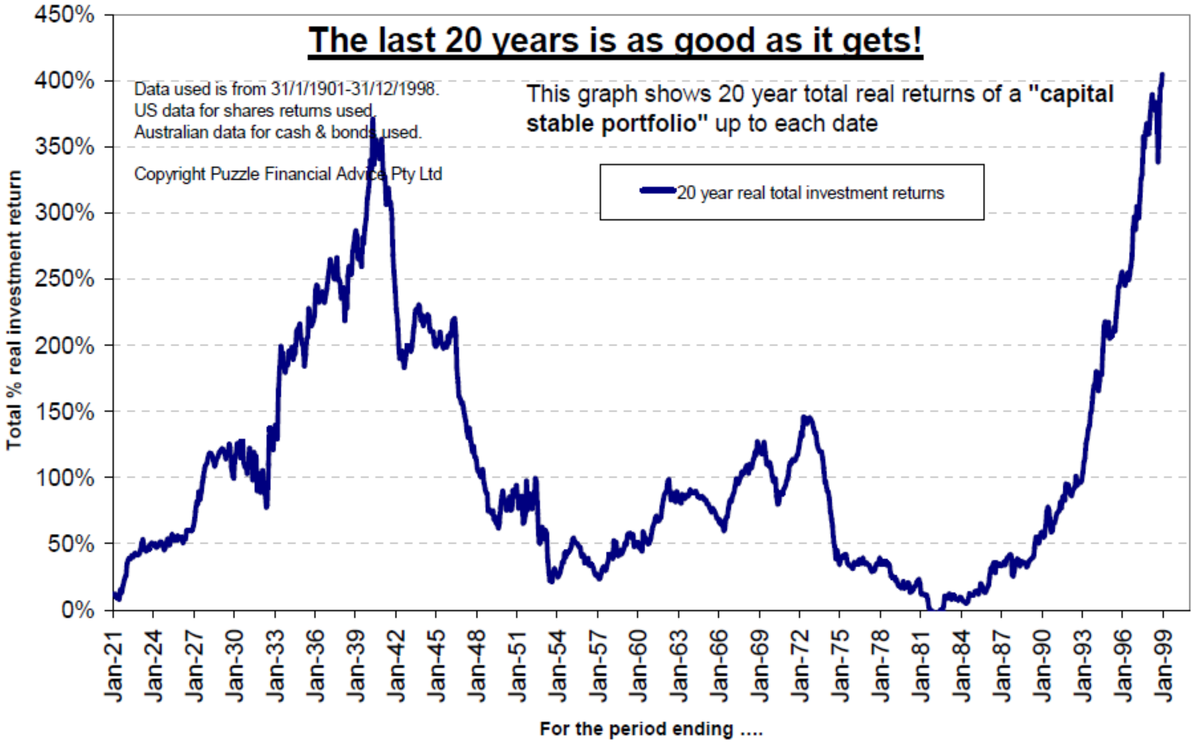
And property can be as volatile as shares …. tends to have big crashes at the same time as big share price crashes as a long-term study by the US Fed shows – and as seen more recently in the Japan 1989 crash, 1998 Asian crisis (Hong Kong prices), and the GFC in various parts of the world. Property investment is often geared – and this can exacerbate, for investors, the big property price crashes.



So for portfolios with passive asset allocation you should "normally" expect volatility and variability of returns something like this:-



For the purpose of the chart above, "balanced" = approx 65% shares, 35% bonds.
For the purpose of the chart below, "capital stable" = approx 35% shares, 65% bonds.

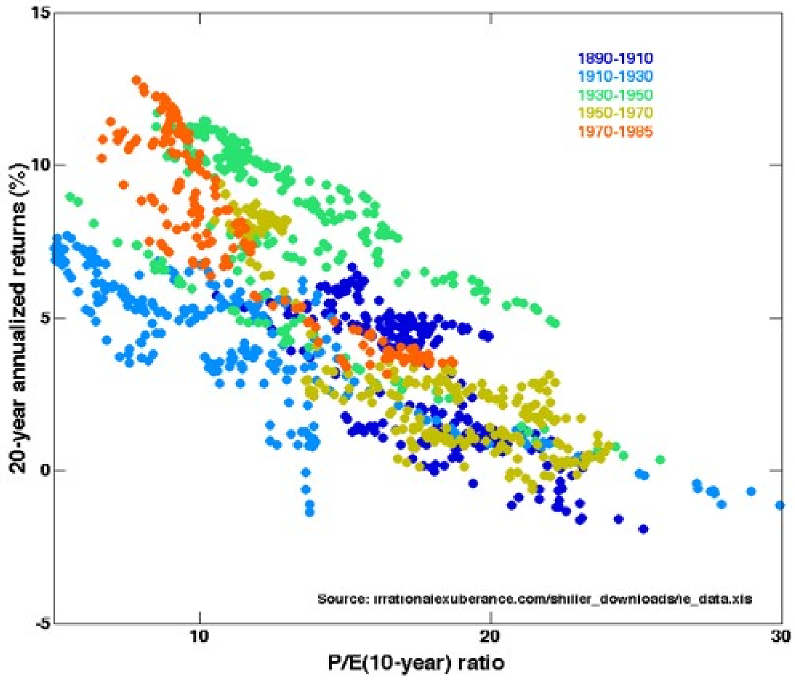


To make these numbers more meaningful, the following table shows you how compounding works over 20 years. So a 400% real return after 20 years is an average real return of about 8.5%pa.

Rate of return pa	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%
Compound return after 20 years	22%	49%	81%	119%	165%	221%	287%	366%	460%	573%	706%	865%

If you can live with this sort of volatility and investment return variability, this traditional static asset allocation strategy (i.e. Passive investing) might suit you.

But do we really want to take the risks that we might get really terrible returns (eg something around NIL real return) over the next 20 year period? We know for example, from the Robert Shiller research, that if we invest in shares when they are very expensive, then we should expect low or negative real returns over the next 20 years. It would be better to simply not buy expensive shares for example.

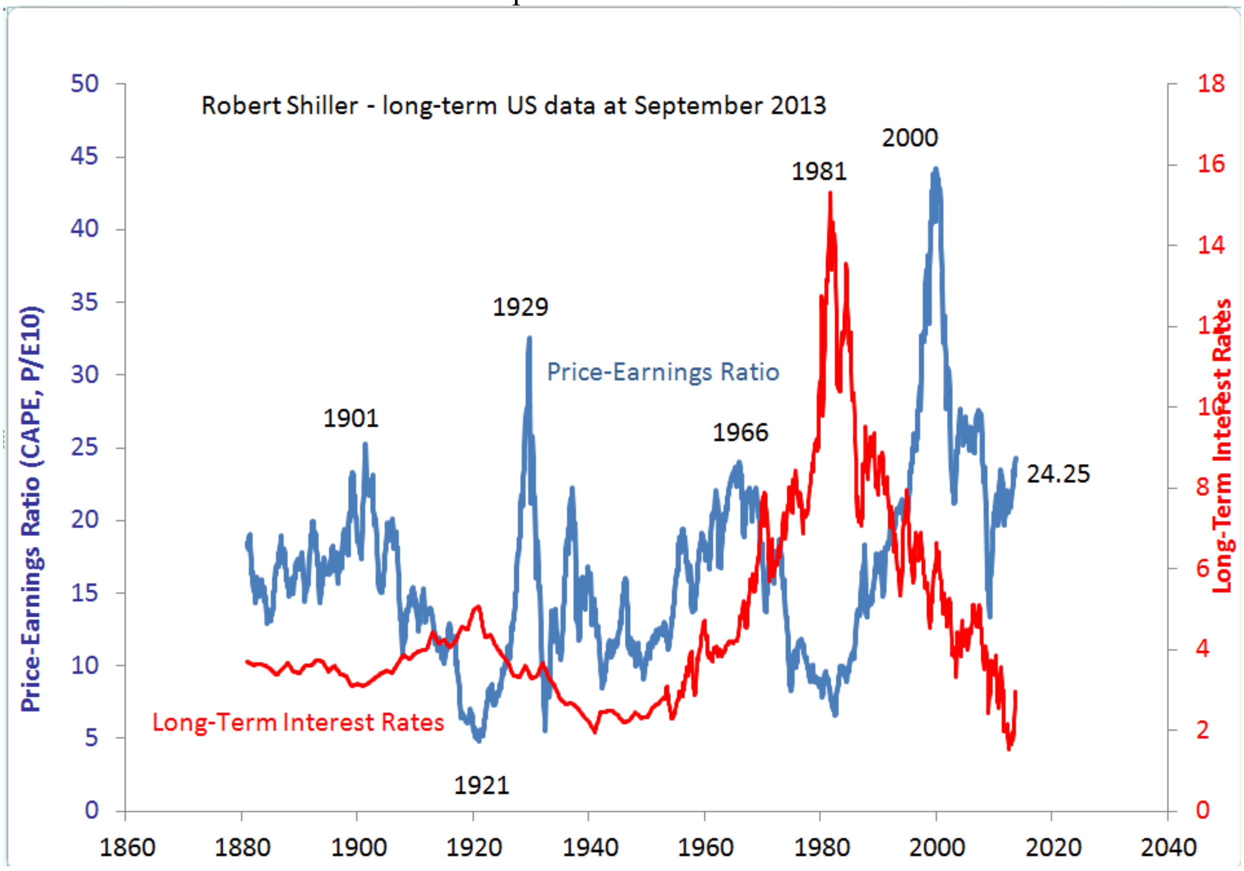


To broaden this type of thinking, I think we we can try to be a better investor by:-

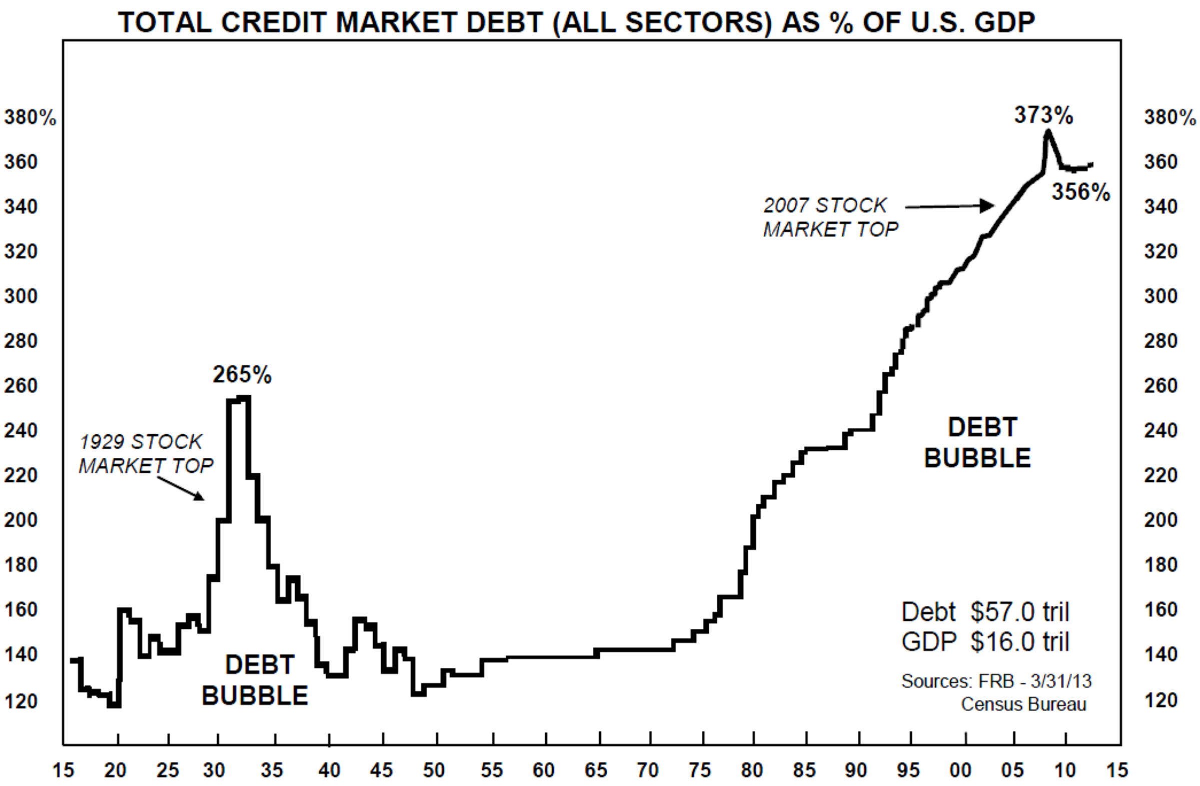
- identifying and focusing on the major risk factors – seeking to try to manage (eg time the exit) or avoid those risks AND
- identifying and exploiting the major opportunities and secular themes. The last few years (to 2013) has reinforced that even when playing the major secular themes of the time, managing cyclical issues and transitory trends could make the journey more palatable. But at least it would help us to focus on the long-term secular trends looking for the right timing to jump into and out of these trends.

And RIGHT NOW, I think it is critical that we try to be smarter than simply accepting the volatility and variability dished up by a static asset allocation – and that is because we live in a period of extreme historical risk which is best summed up by two charts:-

- Shiller long-term P/E ratio – showing the USA on broad averages is still in its biggest share market bubble in history – a bubble that has been aloft for about 14 years …. and has not yet deflated to "safe levels". I think this chart characterises the extreme high valuations of share markets around a lot of the developed world.



- **Historical extreme debt bubbles** – as characterised for example by the USA and Aussie debt bubbles, including the biggest personal debt bubble Australia has ever seen. This is important because history indicates that extreme bad things tend to happen in a debt bubble. Why? Think of it this way. If you are carrying a huge personal debt (very high gearing levels) ….., while everything is going well things are all good ……. but it only takes a few minor things to go wrong, and the whole thing falls like a pack of cards – leaving a financial wreck.
    - Note: The fragility from this excessive debt, created a precursor to set the conditions for the Global Financial Crisis in 2008, AND those precursors for a further crisis (or further crises) have not been eliminated ….. because debt in much of the Western world is still at historically extreme levels.



I believe these 2 charts tell us that as at September 2013, if you invest using a "traditional" unthinking asset allocation, you have a high probability of getting a poor or negative investment return over the next 5 and 10 years.

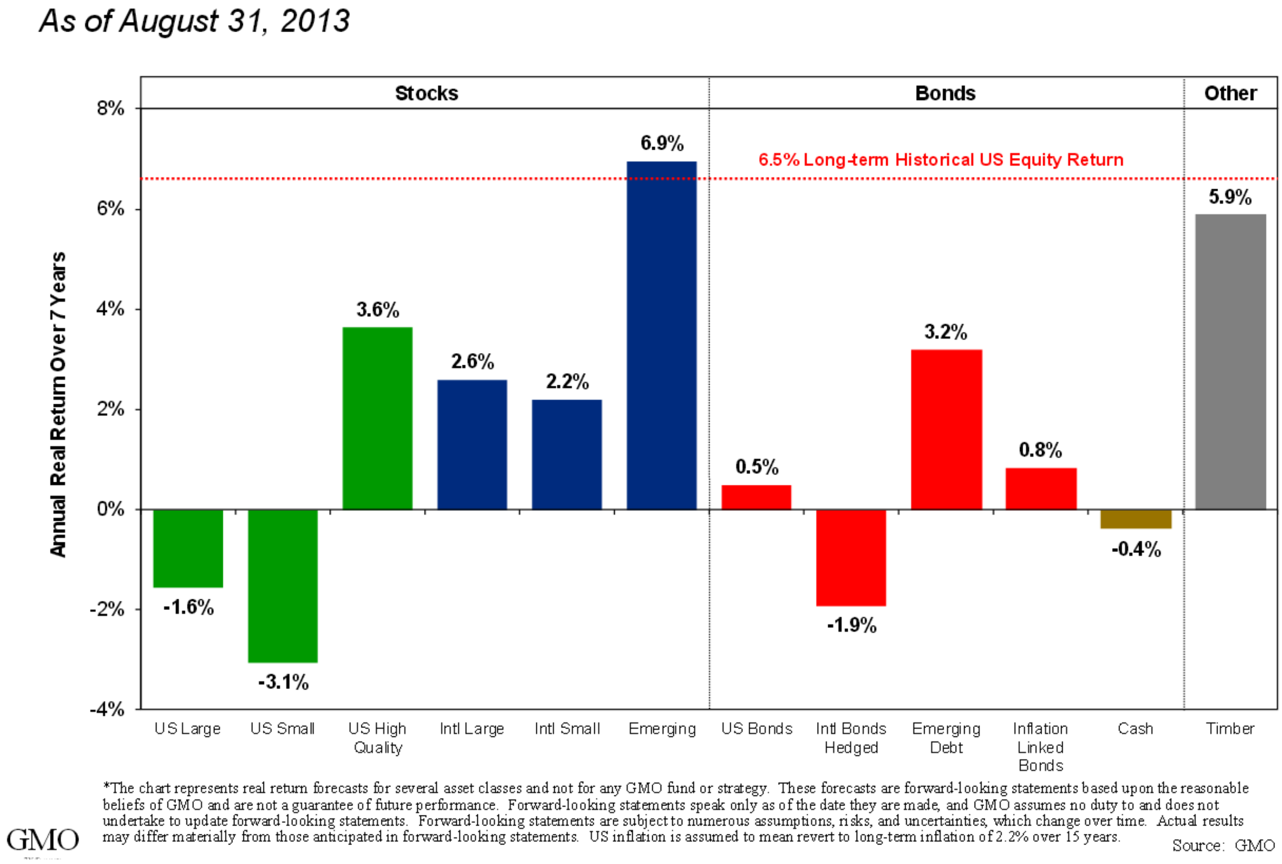
This is why we put so much time and effort into:-

- identifying and focusing in the major risk factors – seeking to try to manage (eg time the exit) or avoid those risks AND
- identifying and exploiting the major opportunities and secular themes. The last few years (to 2013) has reinforced that even when playing the major secular themes of the time, managing cyclical issues and transitory trends could make the journey more palatable. But at least it would help us to focus on the long-term secular trends looking for the right timing to jump into and out of these trends.

We are seeking to find a path for our clients that gets a better medium-term investment result – in an extremely risky investment environment …. and we seek to inform our clients of the issues as we travel through this investment journey together.

So which markets are going to perform best? Before summarising my views, let you give you the summary from GMO (from a US perspective) because I have found that they are one of the few sources whose forecasts provide some degree of reliability – courtesy of the analytical skills of Jeremy Grantham, and the culture that he has instilled at GMO.

https://www.gmo.com/Asia-Pacific/CMSAttachmentDownload.aspx?target=JUBRxi51IIAQai1j4sLUDQ0TwH0MQ8fWS1Qeet50hpiVN%2b4vGhQXlXqX9EwwdbqDGkQllCRnWSjfIT8rOlxtCRjgxre8urD32fcjxqs8jtw%3d



Now to my views.

Long-time clients know the key investment themes that I believe are important at this point in time:-

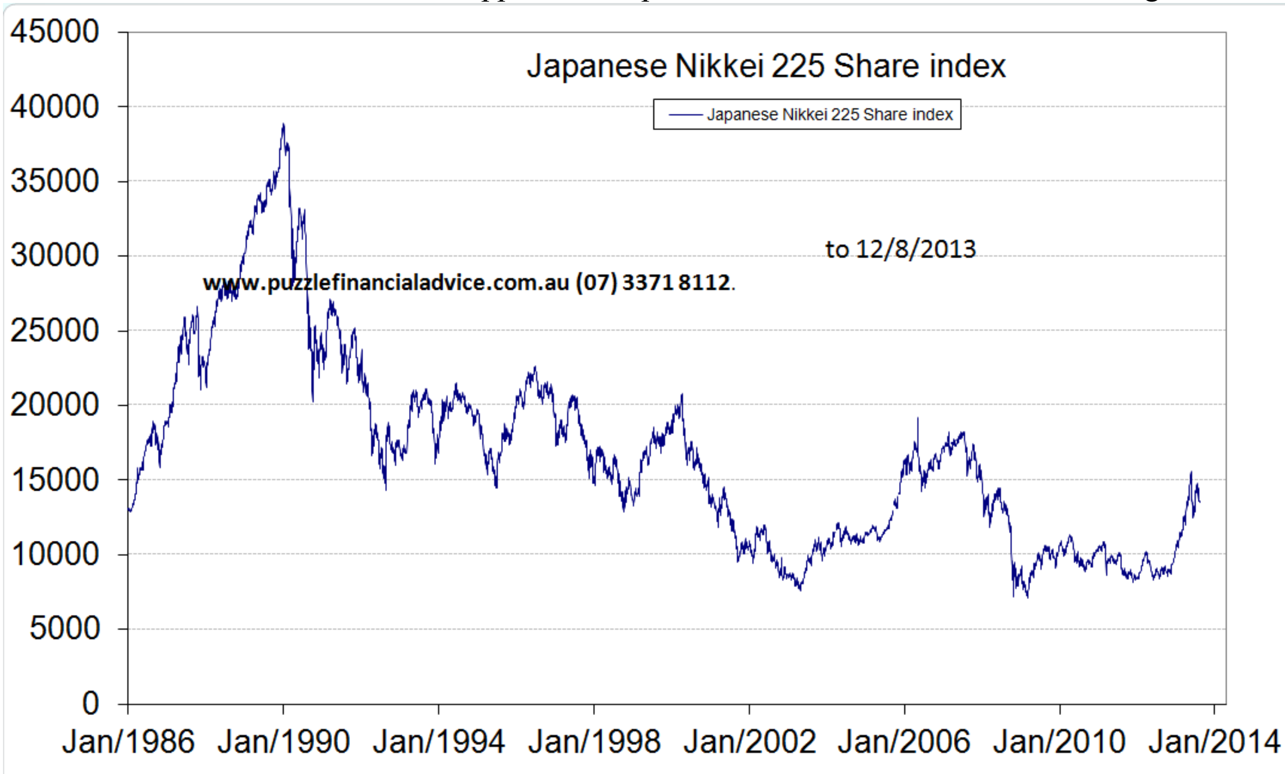
- **Opportunities from a broad sector perspective:**-
  - **Emerging markets.**
    - We are in the biggest emergence event in history. This means that played well, it has the potential to deliver very high returns for us over the next decade – but that does not have to be done through investments directly in those markets. However, I would note that at this time, China and India are at a very cheap P/E of about 10 after being in a cyclical bear share market over the last 3 years. This sector can be played through:-
      - **Companies well positioned to supply the biggest boom in middle class consumers in history**. Typically these are large multi-nationals with strong brands. We are currently in the biggest expansion in the global middle-class in history, as many in the emerging world become middle-class consumers.
      - **We mainly rely on carefully selected fund managers to invest in international markets** that will benefit from this emergence event – including funds that invest in emerging markets and funds that invest in international shares that might benefit from this emergence event. Note:

Currently there are a lot of cheaper shares outside Australia than inside Australia, and the falling A$ also makes this a good time to be investing in carefully selected international shares.
        - Precious metals – China & India are the biggest consumers/buyers of gold in the world, and as they get wealthier, it is reasonable to expect that that appetite will grow.
    - **One-off special situations**.
    - **Falling A$** - will benefit exporters more generally. Yes, sentiment is ebbing and flowing on the A$ - but it is already about 15% below its peaks. If I am right about the impact of the debt bubble on Australia over the next few years, I suspect the A$ could fall a lot further.
    - **Precious metals** – the beneficiary of massive money printing in USA, Europe (incl UK) and Japan. I don't think the major part of the inflationary impact of this has been seen yet.
    - **Cash does well in periods of deflation**. One of the risk factors is also a potential opportunity. We face deflationary risk from debt bubbles, asset price bubbles and also wage price competition with the emerging world. However, developed world central banks have shown that they are prepared to take historically-extreme measures to try to prevent deflation. That being said, this is a factor we need to continue to monitor.
    - **Technology**.
        - One of the key-themes that Kerr Neilson likes is Internet portals. In fact, Kerr describes the Internet as a theme that keeps on giving, just like railways did in the 1800s in the USA.
        - Big multinationals should be one the big winners from the current rapid technological advance because they have the resources to gain rapid productivity and product advancements. Typically, these big multinationals are also well-positioned to benefit from the rapid development in the emerging world.
        - 2nd wave of robotisation, automation. Cheap (and getting rapidly cheaper) networked computing devices and cheap telecommunication. I think this is going to drive a second wave of competition from the developing world over the next 5 & 10 years – and in fact over the next 50 years, as we get **price convergence** between developing and developed markets. We are in a phase where **employment from manufacturing will shrink rapidly** over the next few decades – just like what happened in the agricultural revolution. But where will these displaced employees go to get replacement employment?
        - Rapidly falling solar energy prices.
        - More generally unconventional oil & gas technologies. Shale, tight gas, coal seam gas. The effects of these are only just beginning.
        - 3D printing – and resultant distributed (rather than centralised) manufacturing.
- **<u>Risks</u>**.
    - **Expensive western markets.**
        - A lot of Western share markets on broad averages – particularly US & Australia. Most at risk are yield stocks, which I believe have formed a bubble of sorts over the last 12 months or so. You might recall the charts I prepared a few months ago (approx July 2013) supporting my view that we currently have an inverse of the bubble of 2000. In 2000, investors sold value (yield stocks) to buy growth stocks. Over the last 18 months, the reverse has

happened. When all investors get on the same boat, that boat gets expensive – this is one of the most reliable things I have found in investing.

- Mind you ….. among all this, specific stock or sector stories will appear in these markets, from time to time, for astute stock pickers.

- **Rising bond yields.** This will be a head-wind for share markets (particularly yield stocks at this time), but also asset classes in general.
  - Also bond funds have been fantastic investments from 1982 to May 2013. (The biggest bond bull market in history). It is likely that a bond bear market has commenced, set to last many years.
- **Rising unemployment** in the face of competition from the developing world and rapid technology change. Other than large social problems this might create, **this seems likely to create large structural problems for developed world governments.**
- **West debt bubbles.** This will cause (on broad averages) at best, comparatively tepid growth over the next 10-20 years compared with the last 60-year averages.
  - In Australia, I expect this to bring a residential property crash (and probably credit freeze) – with severe secondary effects likely.
  - This is what happened to Japan after its debt bubble started crashing in 1989.



- Now let us divide Western countries into those with huge (by historical standards as & % GDP) government debt (US, UK, France & Southern Europe), and those without huge government debt but with historically huge private debt as a percentage of GDP (Australia).
  - I highlight that the main difference between these 2 groups is that the 1st group had an economic crisis in 2008, that triggered governments to take over massive debt from the private sector.
- Note: Historically, governments have "solved" government debt problems by either default or financial repression (Reinhart & Rogoff). Currently, it is generally expected that USA, UK and most of Europe will not default on debt but rather will/are implementing some form of financial repression. Now financial repression involves 2 key elements:-

- Being able to generate consumer price inflation AND
- Repression – keeping interest rates negative in real terms over a few decades.
- Normally consumer price inflation – leads to higher wages, which leads to greater tax revenue, which leads to government debt being lower relative to government revenue over time.
    - BUT now, with extreme competition for jobs between the developing world and the developed world, developed world wages seem likely to fall (at least in real terms) over the next few decades. So traditional, "inflation your way out of debt" strategies may not work.
    - So the governments may need a revised strategy. Higher wealth taxes and consumption taxes seem likely – as a way of paying off the debt. Lower social security and government services seems also likely – as a way of making budgets more sustainable over the longer term.