PRICE**VALUE**PARTNERS

All change, please **26th July 2021**

"Life is what happens to you while you're busy making other plans."

- John Lennon.

There are times when flexibility is everything. In his book *The New Market Wizards* (incidentally one of the best books on trading ever written), author Jack Schwager tells the story of how Stanley Druckenmiller, a colleague of George Soros, changed his mind entirely the day before the 1987 Black Monday market crash, only to change his mind ***again*** when it looked like he was initially wrong:

> Druckenmiller made the incredible error of shifting from short to 130 percent long on the very day before the massive October 19, 1987 crash, yet he finished the month with a net gain. How? When he realized he was dead wrong, he liquidated his entire long position during the first hour of trading on October 19 and actually went short. Had he been less open-minded, defending his original position when confronted with contrary evidence, or had he procrastinated to see if the market would recover, he would have suffered a tremendous loss. Instead, he actually made a small profit. The ability to accept unpleasant truths (i.e., market action or events counter to one's position) and respond decisively and without hesitation is the mark of a great trader.

Many investors will have been completely blindsided by the fast-unfolding events of early 2020, for example, when the rapid spread of coronavirus changed ***everything***. (And then the grotesque governmental overreaction changed everything, ***again***.) But as the saying goes, you don't have to make it back the same way you lost it.

As investors either triage their portfolios or look for opportunities amid the volatility and selective wreckage of the financial markets in July 2021, it feels appropriate to reiterate some generalised advice.

First and foremost, as most financial advisers and wealth managers will tell you, asset allocation – how you elect to divide up your investible pie between the various investible asset types and vehicles open to you – will probably have a far more meaningful impact on your portfolio's performance over time than which specific stocks you elect to own.

Within our own business (and our own portfolios, for that matter, which mirror those of our clients in every respect) we split the investible market up into three distinct asset types, namely:

- High quality value stocks
- Uncorrelated assets, notably systematic trend-following funds
- Real assets, notably the monetary metals, gold and silver.

You may well notice that there is a standout omission here. Bonds. For several years our exposure to fixed income and credit investments has been *de minimis*, for the straightforward reason that bonds even before the coronavirus crisis were grotesquely expensive, and now they even more closely resemble what the hedge fund manager Kyle Bass once referred to as a bug in search of a windshield.

During a question and answer session on the social media platform Reddit last April, Ray Dalio, the founder of hedge fund Bridgewater Associates, issued a similar warning about the supposed attractions of bonds as investible instruments:

> I believe that increasingly there will be questions by bondholders who are receiving negative real and nominal interest rates, while there is a lot of printing of money, about whether the debt assets they are holding are good storeholds of wealth.

A few weeks beforehand, as the likely economic impact of the coronavirus pandemic was becoming clearer, Mario Draghi, the former head of the European Central Bank, issued a similarly blunt warning about the demerits of fixed income investments. In an op-ed for the *Financial Times*, Draghi wrote that

> Much higher public debt levels will become a permanent feature of our economies and will be accompanied by private debt cancellation.

When he refers to "public debt", he means government bonds. And when he refers to "private debt cancellation", we interpret him to mean that corporate debt will end up defaulting or being "jubileed". That will be potentially great news for borrowers, but it will be positively disastrous for any investors unlucky or unintelligent enough to be caught holding this stuff, because its value will be vaporised.

As if on schedule, the *Financial Times* duly reported that $90 billion of corporate debt fell to "junk bond" status during March last year. Credit ratings agency Moody's ended March by downgrading its outlook on $6.6 ***trillion*** of US corporate debt to 'negative'.

So at the risk of stating the blindingly obvious, if you do not need to own debt, particularly when it carries either an extremely derisory yield or a negative one, it probably makes sense not to. That is not to say that government bonds aren't capable of trading at even more absurd levels as the market wakes up to the deflationary scale of the coronavirus crisis, only that we will not be joining investors at that particular party. Investors who are not constrained by regulatory fiat or habit to own bonds may feel similarly wary of the entire asset class.

As to equity markets, further extreme volatility seems certain. But having never owned "markets" per se – as opposed to individual, high quality companies run by principled, shareholder-friendly management, with little or no associated debt, and only when the shares of those companies can be purchased at a meaningful discount to their inherent worth – we are not about to start now. Not every market or sector enters this crisis in the same shape. We think specifically about the opportunity called Japan. Japanese companies, by and large, have spent the last 25 years hoarding cash while they deal with their own domestic deflationary depression. As a result, they now have the healthiest balance sheets in the world. Japanese dividend yields have roughly tripled over the last six years. Compare the situation of corporate Japan to that of corporate North America, where companies are entering this crisis having never issued so much debt in their lifetimes, and with both dividends and share buybacks likely to be severely curtailed. We know which market we would rather own. (And on a point of order, Mister Speaker, Japan now yields more than the US; Topix's dividend yield stands at 2.03%; the S&P 500's stands at a miserly 1.35%. Choose wisely, grasshopper !)

Which is why we stress the requirement to keep an open, flexible mind. What has worked, for the last decade at least, may well not work in the future over the medium term. The game has simply changed. The market strategist Anton Tonev, in his excellent 'Beyond Overton' blog, writes that

> The sudden crash in the US stock market in March 2020, caused by the realization that Covid-19 might not only freeze economic activity for much longer than first expected, but also change profoundly the way we work and consume, and cause a rethink of financial regulations, may herald such a new reality. **I expect the US stock market to post negative annualized returns, in both nominal and real terms, as well as including dividends, for at least the next decade.**

[Emphasis his.]

Stock markets buoyed by years of accommodating monetary stimulus, easy money, indiscriminate share buybacks and index-tracking may find the new reality challenging on multiple levels. The seemingly effortless rise of exchange-traded funds may struggle to adapt to this new reality. Perhaps in the future, underlying valuations might actually matter once again.

And then there are the seismic shifts that may well come at a cultural and political level in response to the economic damage caused by Covid-19. The British philosopher John Gray, writing for the New Statesman, hints at what may be to come:

> The era of peak globalisation is over. An economic system that relied on worldwide production and long supply chains is morphing into one that will be less interconnected. A way of life driven by unceasing mobility is shuddering to a stop. Our lives are going to be more physically constrained and more virtual than they were. A more fragmented world is coming into being that in some ways may be more resilient..
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> A situation in which so many of the world's essential medical supplies originate in China – or any other single country – will not be tolerated. Production in these and

other sensitive areas will be re-shored as a matter of national security. The notion that a country such as Britain could phase out farming and depend on imports for food will be dismissed as the nonsense it always has been. The airline industry will shrink as people travel less. Harder borders are going to be an enduring feature of the global landscape. A narrow goal of economic efficiency will no longer be practicable for governments..

Nobody has a perfect crystal ball. Our best guess is that having a mind open to the possibilities of dramatic change – open to investment opportunities as well as threats – will serve investors well. That, together with a commitment to genuine asset diversification, an acknowledgment that we are at a turning point in history, and a healthy allocation to gold.

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 listen to our regular 'State of the Markets' podcasts, with Paul Rodriguez of ThinkTrading.com, here. Email us: info@pricevaluepartners.com.

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