I N V E S T M E N T   L E T T E R   Nr.1 June 1994

1. Back To Normality

It may sound somewhat cynical to one or the other when an investment bank speaks of "normality "in the face of the unfavourable circumstances in the financial markets of the last four months. Losses were inevitable for any investor who did not have the prophetic foresight to convert all bond and stock holdings to term deposits. All elements were against him: interest rates rose - although this was expected in the short term dollar area, it was unexpected at the long term end, and completely unexpected in the previously unconnected European currencies. Simultaneously, the stock indices began to plummet, and here also the connection between the European exchanges and various emerging markets, and Wall Street proved to be a disappointment to the diversified investor. Those investing in Swiss francs had the additional misfortune of an unfavourable exchange rate, as the franc has such strong tendencies.

Is this normality? - No and yes. No first of all, because even in hindsight it is not fully clear why the relatively small interest rate increases of the American Federal Reserve precipitated such a drastic drop in the American bond markets. Previously, of course, there was talk of the necessity of such a step. This drop must be in connection with an extremely speculative angle of the balance sheet of American banks and other financial intermediaries (such as pension funds, hedge funds), who, during the years of generous liquidity supply by the Fed, profited after the principle "from short make long" and were still surprised by the eventual reversal of the trend. A respected New York brokerage house in January still prognosticated "significantly lower short term rates". Events proved to be otherwise, and as a result liquidity was required to be obtained in extreme fashion world-wide. This would also explain why the European stock and bond markets were detrimentally affected. The extent of this sell wave was surprising.

Surprise - therein lies the affirmative of the question regarding normality. The market developments of the last months clearly demonstrated that in the long run, financial market dealings are never without risk. "Risk" is synonymous with "surprise". The more one-sided the prior expectations of a different development, the greater the impact of the surprise, and the more unpleasant its result. The unison choir of consensus of the American analysts with regards to dollar interest rates led to the extreme disequilibrium between assets and liabilities in the interest rate change risk. One must ask why this one-sidedness of opinions did not raise suspicions earlier.

2. The Enigma of the Fundamental Data

In the last months, the big problem of the commentators who orient themselves by the overall economic climate was that while radical changes were in the works in the financial markets, economic indicators changed only minimally. It was known already in January that a broadly supported economic upswing was in the works in the USA. There was also an awareness that Europe would rise from the economic trough near the end of 1994. The framework of monetary policy was clear, and it was known that America had just experienced three years of extremely generous liquidity supply through the Fed. The market was also familiar with the expansion of the money supply in the Federal Republic of Germany and the uncertainty with respect to the aggregate money supply M3 in the aftermath of the reunification.

Movements in the financial markets since then have been primarily justified with reference to "inflationary fears". Modified inflationary expectations and the associated modified interest rate expectations are indeed to be taken seriously, and would certainly be grounds enough to set off declines of significant magnitude on stock and bond markets. But even relative to inflation, the economic data has not materially changed since January. Thus, while a few commodity prices like coffee, copper and silver have increased, the singularly relevant commodity price of oil still remains under $20 per barrel in non-inflationary regions. Another early indicator of an economic upswing is capacity utilisation. In the USA, it has effectively increased, which may manifest itself in the form of more tenacious wage negotiations, for example. It would, however, be exaggerated to infer from that a virulent inflationary danger. This is even more applicable to Europe, where the inflation rates have declined to historic levels, and where a certain upswing is within reach, but where for the time being businesses are still plagued by recessionary problems, and unemployment persists at high levels.

3. "Everything is Psychology."

When a commentator of business and stock market happenings reaches an impasse, there is a simple and, at the first glance, generally enlightening way out: a reference to psychology. The advantage of the psychology argument is that it cannot be wrong. For it is truly a possibility that in the case of the financial markets, which indeed are dependent on human nature and human dealing and are therefore determined by psychic decision making, that "psychology" is at work. The disadvantage of the argument is its inability to produce evidence. It is similar to a doctor, who, when dealing with symptoms he cannot explain, claims that "endogenous factors" are at work. It would be better, or at least more honest, to admit that it is a mystery. And then one could in all modesty attempt to lift a part of the veil which shrouds the mystery.

Even the reference to "market operations" is unfortunately insufficient. As enlightening as it may seem to explain falling market prices through the liquidity procurement of mispositioned market participants, it is still unsatisfactory when the price correction results in a longer-term slump. The miscalculation, that is, the speculative assumption of a risky position was not made without consideration, or without corresponding expectations. When no new buyers enter in the course of position clearing, then a fundamental change has occurred. The cause of this change must be ascertained.

4. Higher Real Interest Rates as a New Fact

A subsequent analysis of the economic indicators reveals that the only materially relevant difference in the month of January is a markedly higher interest rate. In all relevant currencies, interest rates have increased by up to 1 1/2% higher at the long end in comparison to the end of 1993. This is a clear and unequivocal fact, and due to its global and lasting significance, cannot be explained by market operations.

When the price demanded for a longer-term loan increases, it points to an increased uneasiness on the part of the lender with regards to possible occurrences during the term of the loan. Formulated economically: a risk premium is demanded. This risk premium is based on an altered estimation of certain elements. Which elements could these be?

We could, for example, be dealing with increased scepticism with regards to global political developments. The hopelessness of the Yugoslavia conflict leads to the insight that the impotence of the international community could again become painfully evident in the majority of similar tensions. The outbreak of a civil war in Yemen arouses unpleasant memories of the Gulf war, the Cashmere conflict, and Afghanistan. And history has already seen one Crimean war, although it was in an era without nuclear weapons...

The risk premium could also be linked to a growing awareness of the weaknesses of the Clinton administration. These weaknesses should, however, already have been noticeable as the still-fresh president appointed his spouse to head a study of the thorny problem of health care: a leadership style that could possibly be characterised as sympathetic, but conceivably unprofessional, is hardly appropriate for a world power. It appears that on the financial markets, the first and last term of office for Clinton is underway.

It is highly probable that the elections in the Federal Republic of Germany are also casting dark shadows on the economic horizon. A renewed, even if close, victory of the existing coalition is difficult to imagine. And the alternatives create headaches. It is difficult to speculate where a large coalition, or even a red-green alliance, would obtain the means for a larger income redistribution exercise given the existing tight financial situation.

The risk premium, however, primarily indicates higher inflationary expectations. And such expectations apparently orient themselves not by "hard" factors such as oil prices and wage negotiations, but by "softer" factors. A such element is, for example, the appointment of the economics professor Alan Blinder by the Clinton administration to a recently-vacated seat in the Fed (cf. Wall Street Journal, 28 April 1994). Blinder is a proponent of a "constant, predictable" high inflation rate, and maintains that this will lead to an increased rate of economic growth that will primarily benefit the poorer classes. Inflation may well be a "cruel tax - but only for those who derive their income from interest, dividends and capital gains". The financial markets have evidently understood this gospel - and manifest themselves in the form of higher real interest rates, which choke off the Blinderian ideal in the bud.

5. ...but the Punishment Follows Immediately!

With this, we have reached an important point for the evaluation of the present situation. The global increase in real interest rates has surprised not only the majority of investors, but also the central banks and political agencies by its magnitude. It is as if the financial markets are giving a clear signal, warning against even the smallest step in an inflationary direction. In actuality, the hands of the Fed have been effectively tied since February: the bond markets dictate when short term rates are to be increased. If the play between foreign exchange rates is taken into consideration, then similar observations can be made for virtually all central banks. Improper conduct is immediately punished, be it through a weaker foreign exchange rate, through a weaker bond market, or through both.

This is comforting and confidence-building: it appears that the much closer connection of the international financial markets has created a type of "competition of the systems". This competition evidences itself in reduced latitude of the central banks, and a decreased ability to follow political whims. And thus someone like Alan Blinder should prove to be wearing Keynesian blinders.

Our prognoses are therefore also relatively optimistic. We do not believe that a reflationisation is inevitable. This also means that there is little grounds for fear of a renewed interest rate increase. It is even thinkable that a calming of the markets, both in the dollar and in the European currencies, can once again create room for long term interest rates to decline. This would then also have the consequence of recovery in the stock markets, with interest rate sensitive equities which have taken the greatest hit in the past months showing the most potential for gain.

6. Is It Worth The Risk?

In phases of declining market values, it is often asked if it is worthwhile to assume the risk of stock market activities, or even of bond portfolios with their imminent interest rate risks. In the last months, term deposits were the only investments which were not money losers. In hindsight, it is easy to say that "a properly-timed switch should have been made". This is based on the opinion that it should be possible for a specialist to anticipate the movements of the financial markets. That is, after all, their job.

It is interesting that the majority of market participants agree, at least implicitly, with the truth of this assumption. The ranking of so-called "performance" in trade journals and the most popular investment newsletters confirms this. In these publications, the "best" investment managers are periodically celebrated, ranking lists made, and "cellar dwellers" disgraced. All this, even though finance theory has conclusively proven in a majority of studies that it is highly unlikely, over a longer period of time, to systematically and consistently prognosticate accurately. The development of financial market values is stochastic and follows a random walk.

Fundamentally, only two statements can be made which can be easily justified economically:

Statement 1: In the long run, stocks earn higher returns on average than bonds, and in the long run bonds earn higher returns on average than liquidity. The reason for this lies in the reward for the higher risk which the stockholder and the bondholder must bear.

Statement 2: A diversification of investments is generally worthwhile. This is because the price fluctuations of various investments at least partially cancel each other out.

(A graphical representation of these two statements with respect to empirical data can be found in the section of this commentary entitled "Investment Politics")

Beyond what was discussed above, very little meaningful can be said either with a clear conscience - and every investment manager should have this, since he is entrusted with money - or with more than an extremely small probability of accuracy. (We freely admit that our profession would lose much of its glamour if it did away with the fortune-telling and alchemy.)

7. Balance Sheet Risks as Advisory Items

At this point, the gentle reader and investor is with all likelihood questioning the need for investment advisors and wealth specialists, if not for improved prognostication with respect to developments in the financial markets. This is, after all, what they are paid for!

The question is a result of a misunderstanding of the actual role of the investment advisor. Those who regard him as a guru are mistaken. His function is to undertake the right, or at least the justifiable, course of action on behalf of his client, taking into consideration the random nature of the markets. And this has nothing to do with alchemy, but is very much related to intensive economic work.

The majority of this work is to determine an appropriate level of risk for each individual client, and to eliminate certain risks as much as possible. The meaning of this is best illustrated with an example. Let's assume that an investor who, until the present, has happily participated in the stock market with due regard for its inherent risks, is now close to retirement. And let's assume that his pension provides for ordinary living expenses, and his insurance for any health care costs. His accumulated savings must provide for extraordinary expenses or for an eventual stay of unknown length in a retirement or old-age home. Beyond this, the client would also like to leave a significant portion of his accumulated wealth as an eventual inheritance for his children.

That which is described here is economically not different from the liability side of a balance sheet; the "obligations" side. There are numerous clearly defined requirements, several possible needs, as well as a few wants. The maintenance of purchasing power in regards to a stay in the retirement home would be a significant accomplishment. In any case, a higher return would be imminently desirable, so that total consumption of the accumulated wealth can be avoided.

8. First the Analysis, Then the Action!

The asset side of the balance sheet must now be matched to the sketchy definition of the economic requirements of the liability side. It must be determined which financial components will provide the highest probability of achieving the desired economic wealth goals. Only after this task can effective investment activities be begun. Both the asset and liability sides require a periodic adjustment to reflect changing circumstances.

In practice it is common to find liabilities that are exposed to risks which are relatively similar to those on the investment side. For example, the "contingency fund" of a car dealer would probably be required when an increase in gasoline prices causes the demand for new cars to decline. It would be negligent to carry Chrysler and BMW stocks on the asset side. Or: demands on the welfare fund of a company would be made if social assistance cases among its pensioners or employees began to accumulate. This in turn would probably be the case when the company itself is be experiencing difficulties. Investments should therefore be found which are as weakly correlated with that particular industry as possible. It may even be worthwhile to tolerate "underperformance" for years to ensure an ability to pay out when required. - More examples could easily be cited. It is critical to recognise the importance of balancing the economic needs of the liability side with appropriate economic answers on the asset side.

Investment consulting understood in this manner requires an in-depth understanding of the specific circumstances of each client, and a corresponding relationship of trust. This type of investment consulting cannot simply be purchased "off the rack", and cannot be viewed as a commodity. This type of investment consulting is not as simple to evaluate as "performance" in accordance with "balance sheets" or "statements of cash flows". This type of investment consulting is not something for agile Yuppies with colourful braces, since it does not evaluate fast-tracking dynamics, but rather the correctness of long-term calculations. This type of investment consulting can endure the weak phases of stock and bond markets, because it does not promise that which no one can promise.