



May 2017

Investment Rules

“The stock market is filled with individuals who know the price of everything, but the value of nothing.”

– Phillip Fisher

Back in 2013, Harriman House published a book called *Professional Investor Rules*, which covered ... guess what ... self-imposed investment rules set by a selected number of professional investors (exhibit 1). Cutting a long story short, back in February, one of the editors of Harriman House suddenly called and asked me if I would be interested in writing a chapter for the follow-up to *Professional Investor Rules* that they are planning to publish later this year.

The very first thing I did was to check who contributed to the first book. When realising that investment midgets like Marc Faber, Bill Gross and Niall Ferguson (plus more than 20 other highly esteemed professional investors) had contributed, I said to myself: “Well, if they can do it, so can I.”



Exhibit 1: Professional Investor Rules by Jonathan Davis

Source: Harriman House, 2013

The following is, with only a handful of adjustments, my contribution to the second rule book. It is admittedly a little different from the typical Absolute Return Letter, but I enjoy not always writing about the same topics, and I hope you'll find it equally enjoyable to read. I will let you know when the book is published. All I know at this stage is that it should come out later this year.

Rules about Rules

Investment rules shouldn't be static. Investors should adapt their rules per the environment they are in. From experience, I can confirm that those who don't adapt usually get into trouble sooner or later. My first and most important rule when investing is therefore a rule that defines the rules I should adhere to.

What exactly do I mean by that? How can I possibly have a rule about rules? Allow me to explain. As I see things, there are rules and then there are rules. The most important ones always apply; those are my first frontier rules. There are not many of them, but they are all critically important.

The second layer of rules – the second frontier – are strictly speaking not rules but principles. I treat them as rules, though, because I follow them almost whatever happens.

Warren Buffett once uttered the now famous words: "If you aren't willing to own a stock for 10 years, don't even think about owning it for 10 minutes." From my 30+ years of investment experience, I can confidently say that those who lose their shirt on investments are almost always those who don't stick to their principles; those who get carried away when an opportunity presents itself.

I have a less than outstanding short term track record (as most investors do) but, over the years, I have found that my track record over the long term is better than just good, so I stick to the long term – just like Warren Buffett does. The four rules that I will present to you today have worked very well for me over the years, but don't expect them to work particularly well if your time horizon is only until next week. Now to the first of my rules.

#1: Adapt the investment principles you follow to the environment you are in

Let me give you a very simple example why my investment principles change subject to the environment we are in.

Many investors are in love with growth stocks, and it is not difficult to understand why. Growth stocks have outperformed value stocks for many years but, if you do your homework properly, you find a close link between bond yields and the relative performance between growth and value stocks.

When bond yields decline, growth stocks outperform value stocks, and vice versa when bond yields rise. With declining bond yields for most of the last 35 years, it is easy to understand why many investors are infatuated with growth stocks. An entire generation of investors have never seen value stocks outperform growth stocks, and those who have hardly remember because it is more than 35 years ago.

Now, assuming we stand in front of a multi-year rise in interest rates, even if it is of modest proportions (as I think it will be), all that could be about to change. Investors who are wedded to their growth stock rule may be disappointed, while those who are prepared to adapt to the changing regime are more likely to outperform.

Another example is the wider performance of equity markets. At the very highest level, I divide equity markets into secular bull and secular bear markets. Over the last 150 years or so, the US has enjoyed six secular bull markets and only five secular bear markets (exhibit 2).

A secular bull market is characterised by rising earnings multiples, whereas earnings multiples decline in secular bear markets. Falling earnings multiples lead to the sharply lower returns that characterise secular bear markets. As you can see, the difference in total returns between secular bull and bear markets is quite dramatic.

Year	Market Milestone	Percent Change	Number of Years	Annualized Return, No Dividends	Annualized Return with Dividends
1877	Low	-	-	-	-
1906	High	396%	29.3	5.1%	10.1%
1921	Low	-69%	14.9	-7.5%	-2.0%
1929	High	396%	8.1	21.9%	28.4%
1932	Low	-81%	2.7	-44.9%	-41.2%
1937	High	266%	4.7	32.1%	38.7%
1949	Low	-54%	12.3	-6.2%	-0.8%
1968	High	413%	19.5	8.8%	13.3%
1982	Low	-63%	13.6	-7.0%	-3.0%
2000	High	666%	18.1	11.9%	15.3%
2009	Low	-59%	8.5	-9.8%	-8.1%
Now	-	172%	7.9	N/A	N/A

Based on inflation-adjusted S&P Composite monthly averages of daily closes.

Exhibit 2: Secular US equity bull and bear markets since 1877

Source: Jill Mislinski, Advisor Perspectives, March 2017.
www.advisorperspectives.com.

There are no rules as to how long a secular bull or bear market should last for, but history provides some guidelines. Only one has run for more than 20 years, and both bull and bear markets tend to stay in a relatively predictable channel – at least they have done so for the past 150 years (exhibit 3).

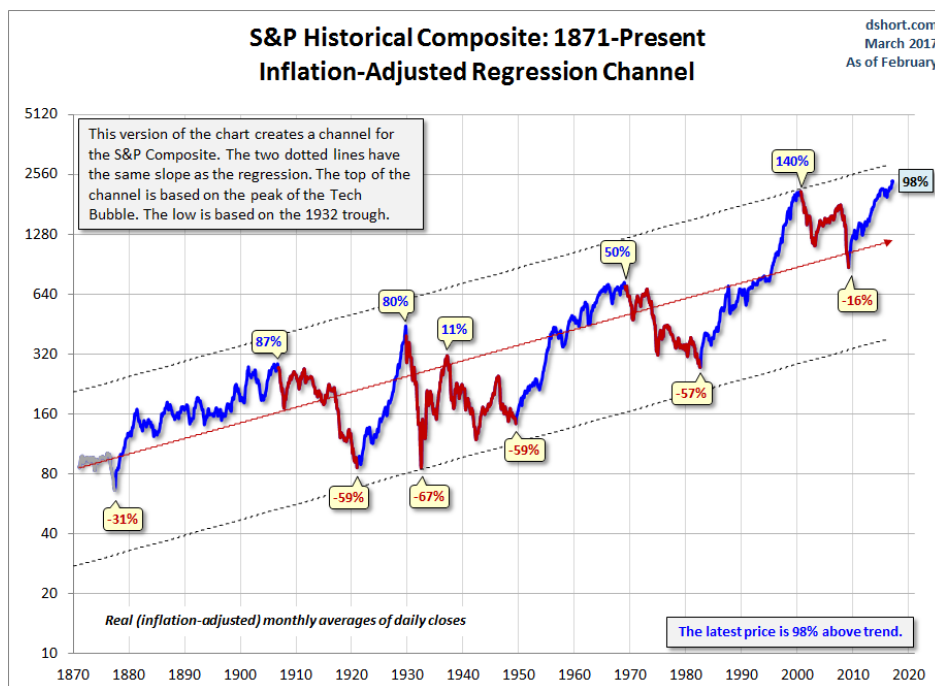


Exhibit 3: S&P Composite - 1877 to present (inflation-adjusted regression channel)

Source: Jill Mislinski, Advisor Perspectives, March 2017.
www.advisorperspectives.com.

As is also apparent from exhibit 3, the secular bull market we have been in since 2009 is (at the time of writing) 98% above the long-term trend line but, when secular bear markets take charge, equity markets rarely 'just' go back to the trend line. Most of them go all the way back to the bottom of the channel.

This leads me to conclude that equities in general, and US equities in particular, are priced for problems in the years to come; hence I would allocate only a limited amount to this asset class at present.

Having done my very best to dampen your expectations, let's kill another sacred cow. There appears to be a firmly entrenched view amongst investors - probably driven by the so-called Fed Put (aka the Greenspan Put) - that, whenever the going gets tough, the Fed will bail you out, and it won't take long before equities are back on track.

For that very reason, many investors have chosen to sit out most storms in recent years. If you subscribe to that philosophy, let me remind you that equities sometimes spend *decades* under water before they finally come back with a vengeance (exhibit 4).

	Real Return	Period	Number of Years
US	-7%	1905-20	16
UK	-4%	1900-21	22
France	-8%	1900-52	53
Germany	-8%	1900-54	55
Japan	-1%	1900-50	51
World	-9%	1901-20	20
World ex US	-11%	1928-50	23

Exhibit 4: Longest runs of negative real equity returns since 1900

Source: Dimson, Marsh and Staunton, London Business School

I could mention many more principles that investors should adhere to, but time doesn't allow me to go too much into detail. One in particular deserves at least a mention, though. With interest rates hovering not far from all-time lows, and with a growing number of people retiring every year, the demand for alternative sources of income is on the rise.

Investment grade government bonds simply don't yield enough to meet the growing demand for income from the elderly, so the search for income is becoming ever more creative. The simplest way to find that extra bit of income would probably drive you towards higher yielding equities (European more so than US equities) and non-investment grade bonds, but many investors think those asset classes are already too expensive.

Before you write them off, though, bear in mind that circumstances have changed. As the number of elderly with a need for regular income has already risen substantially, and will only grow further in the years to come, it is not entirely impossible that assets offering a decent yield will become even more expensively priced.

In other words, one needs to incorporate changing demographics, and the effect such changes are likely to have on various asset classes, into one's investment principles. One cannot assume that just because 15 times has been the average earnings multiple in the past (which it has – at least in the US), 15 is also a fair earnings multiple going forward.

In that context - one word of caution. I have assumed that earnings multiples on higher yielding equities can be expected to remain relatively high for many years to come, but I have established a principle that a company should not only pay an attractive dividend. It should also generate enough cash from operating earnings to finance that dividend internally. Too many high dividend companies resort to borrowing when paying dividends, and that will come back and bite them at some point.

#2: Never let short term trends drive your portfolio construction

Different sorts of trends and themes set the tone in financial markets, and I divide those trends into tactical trends and structural trends. Tactical trends are either cyclical in nature or they are behavioural, and most of them are short to medium term in length. Structural trends are very long term (as in many years), and they are mostly unaffected by investor behaviour; they unfold regardless.

Cyclical trends refer to the economic cycle, and how they are likely to affect financial markets. Behavioural trends are a tad more complex. Investor behaviour changes over time, and financial markets are affected accordingly.

One simple example – following the financial crisis, investors have typically been in either 'risk-on' or 'risk-off' mode. When risk is on, virtually all risk assets rise, and when risk is off only 'risk-off' assets do so. US Treasuries and gold have been the primary 'risk-off' assets since the financial crisis, but JPY has also stood out as a solid performer in 'risk-off' times.

This has had rather dramatic implications for investors, as reducing risk through portfolio diversification has become a great deal more complicated post 2008.

Now to the structural trends – by far the most important in my approach to portfolio construction. I have identified a total of six of those, but I would not recommend letting any of those trends dictate your investment strategy, if your investment horizon is only until next week.

However, if you invest like me, I can virtually guarantee you that those six trends will shape the world we live in, and the markets we invest in, for many years to come. The six trends – which I call structural mega-trends – are as follows:

1. The end of the debt super-cycle.
2. The retirement of the baby boomers.
3. The declining spending power of the middle classes.
4. The rise of the East and the decline of the West.
5. The new energy regime.
6. Mean reversion of wealth-to-GDP.

In addition to those six mega-trends, I have identified several structural sub-trends, all of which are driven by one or more of the six mega-trends, and those sub-trends again drive my portfolio construction.

A good example would be the first of ‘my’ structural mega-trends – *the end of the debt super-cycle*. Debt super-cycles run for 50+ years on average, and the one we are in at present was established in the late 1940s. Europe was in need of major reconstruction, following six years of devastating warfare, and much of it was financed with debt.

Debt-to-GDP has risen ever since, but only since the early 1980s has the pace of debt growth gained substantial momentum – so much that financial regulators are now seriously concerned and want to curb bank lending. The European banking regulator is particularly hostile, and banks all over the EU are being forced to reduce their loan books. I call that structural sub-trend *regulatory arbitrage*, as it has opened the door for a myriad of investment opportunities in the alternative space.

It never ceases to amaze me how little time the average investor allocates to structural trends when constructing his portfolio. It is probably mostly a function of impatience, as many investors find it hard to look beyond next Monday.

That said, constructing your portfolio based on longer term structural trends makes long term success quite likely, but there are no safety valves you can rely on in the short to medium term. Because of that, I never use financial leverage. Back in 2008, I learned that leverage can do substantial damage, even if your strategy is perfectly suitable for the long term.

When I say *never let short term trends drive your investment strategy*, I need to explain exactly what I mean. I construct portfolios so that there is a structural core – which is the key driver of returns – and a tactical overlay. In other words, the core of the portfolio is constructed on the back of the six structural mega-trends I have just mentioned, and the tactical overlay is designed to take advantage of shorter term opportunities. The tactical overlay’s contribution to total returns is usually quite modest, though.

Let me give you an example as to how it all works. As I just explained, *the end of the debt super-cycle* leads to plenty of *regulatory arbitrage* opportunities, and many of those are denominated in US dollars, as the Americans are a step (or two) ahead of us Europeans in terms of providing alternative finance to corporates away from commercial banks.

Because the US economic cycle is further advanced than the European cycle is, it is only fair to expect a more dramatic rise in US interest rates in the short to medium term and, for that reason, a simple cyclical analysis would lead one to expect USD/EUR to appreciate further in value. European investors should therefore leave any US dollar investments unhedged, and US investors should hedge any investments they have in euros.

An approach, where the structural analysis is combined with a tactical/cyclical overlay, would undoubtedly lead to that conclusion, but things are not always that simple. Some of the most

powerful short-term trends are behavioural in nature, and various studies suggest that being long USD is already a very crowded trade (exhibit 5).

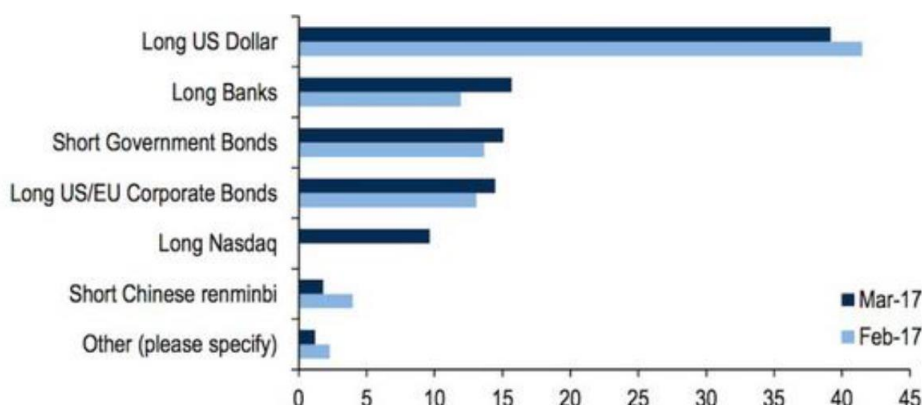


Exhibit 5: What do you think is currently the most crowded trade?

Source: BofAML, Business Insider, March 2017

Although behavioural trends can, and do, change at short notice, they are extremely powerful, and ignoring them when constructing portfolios can be very expensive indeed. Consequently, they form a critical part of my tactical overlay, but they never drive the portfolio construction process. Only structural trends do.

#3: Pick your moments to be contrarian

My third rule is the one that has made me the most money over the years, but it is admittedly also the trickiest one. *Be contrarian, but pick your moments carefully.* Don't be a contrarian just for the sake of being contrarian.

Many moons ago, my then boss taught me the art of making the right noise at the right time. Go long and get loud, was his simple advice, and that advice has followed me ever since. His philosophy was simple. Smart investors *never* express what they truly believe in, until they have positioned themselves accordingly. When somebody goes on TV and claims to be bullish (bearish), he/she is already *very* long (short), he told me, and he was, and still is, spot on.

If long USD is already a very crowded trade, where is the buying power going to come from? Experience has taught me that these sorts of issues *must* be taken into consideration when engaged in portfolio construction.

Here is the tricky part. Being a contrarian doesn't always work. I have learned over the years that is not enough to have a majority of investors subscribing to a certain view. You need a *substantial* majority to be behind that consensus for the contrarian strategy to work.

Secondly, it also makes a difference where you are in the cycle. I have found that, the earlier in the cycle you are, the less likely it is that the contrarian view will work. Going back to the USD example from before, the USD index started to form a bull trend in mid-2014. Following a very powerful bull run that lasted about nine months, the USD index began to consolidate, and has moved sideways ever since.

The combination of large gains, more recent consolidation and a marketplace that is very crowded turns my contrarian instincts on. The only reason I haven't made any moves yet is the overwhelming likelihood of a more hostile Federal Reserve Bank, as the US output gap continues to shrink.

Going back to my trend model, my current reading on USD is as follows:

- Structurally: NEUTRAL to BULLISH
- Cyclically: BULLISH
- Behaviourally: BEARISH

Most of my structural trends are not particularly bullish or bearish for USD with one noticeable exception. The US workforce will grow by 0.5-0.6% per annum between now and 2050,

whereas the European workforce will actually fall - by about 0.4-0.5% annually to be precise. All that is because of ageing – or because of the retirement of the baby boomers, as I call that structural trend.

This will lead to trend GDP growth in the US that is about 1% higher than that of Europe, assuming productivity gains are broadly the same on the two continents (which is a fair assumption). All other things being equal, that will lead to higher interest rates in the US and a stronger USD.

That said, in a perfect world, and for me to go head-on into a contrarian trade, I need at least two, and if at all possible all three, trend models to send the same signal, but they don't in this case, which is why I continue to sit on my hands.

#4: Never fight the Fed

Now to my bonus for readers of the Absolute Return Letter. My fourth and final rule will (most likely) not show up in the book, as I have used my allocated space already. Excluding it from the book doesn't imply it is not important, though. I simply ran out of space.

As you can see from exhibit 6, when the actual rate of unemployment dips below NAIRU (as it does now) the FOMC always reacts. *Always!* The obvious implication is that recent US interest rate hikes are likely to be only the beginning of something much bigger to come. A hostile Fed combined with almost no earnings growth (as is the case in the US at present) has never been the best cocktail for equity markets.

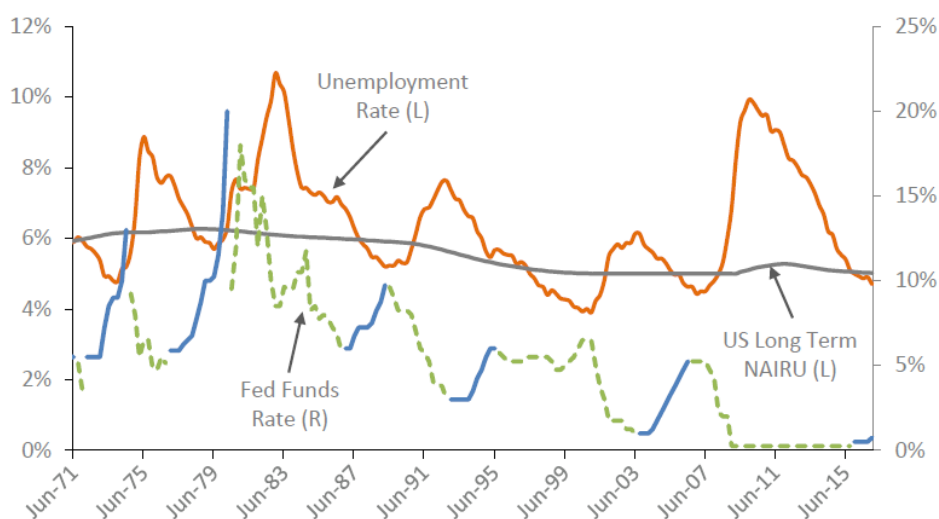


Exhibit 6: Unemployment rate, non-accelerating inflation rate of unemployment (NAIRU) & Fed Funds rate

Source: PhaseCapital, OECD, Bloomberg, April 2017

Consequently, I am a seller of US equities. Having been intimately involved with US equities for many years (which is what I did when I first moved to London), I know that it rarely pays off to stand up against the Fed.

The implications for equities in other parts of the world are not so straightforward, though. On the negative side, a US bear market will certainly have at least some negative effect on the investor appetite for equities in other countries. On the other hand, the US economy is at a much more advanced stage of the economic cycle than most other countries are, and US equity valuations are ridiculously high at present. For those reasons, a no to US equities doesn't necessarily imply a no to all equities.

Final comments

I haven't told you this before, but there was a good reason I got that phone call from Harriman House. It wasn't just because they think I am as smart as Bill Gross (which I am sure they don't).

About 18 months ago I was approached by them, asking if I would like to write a book. They had been reading the Absolute Return Letter for a while and thought I could possibly come up with something that wouldn't put everyone to sleep.

Fast forward 18 months and the book is almost ready to go to print. I have a (self-imposed) deadline around the 1st June, when I must submit the manuscript to Harriman House, and I bring it up in this context because the six structural mega-trends mentioned above are reviewed in much more detail, including an elaborate assessment of how each of them is likely to impact financial markets in the years to come.

I call the book (and it is only a working title) ***An Economy in Decay** – What is happening & where might it lead?* If everything goes to plan, it should come out either late this year or early next, but I will keep you posted.

Niels C. Jensen

3 May 2017

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