ALTERNATIVE VIEW

The Last Popular Delusions

Cockroaches for the long run!

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All good things come to an end, sadly. So it is with my time here alongside Albert, Andy and the rest of the gang at SG. I'm signing off, checking out, moving on to pastures new. It's been a wonderful time. But after three years of trying to sound clever it's time for me to do something altogether more difficult, and actually *be* clever. So early next year, I will join a small but outstanding investment practice. Naturally, I hope it will be a great success. But what makes a great success? Since there are few more accomplished species on earth than the lowly cockroach where better to start looking for an answer?

Cockroaches get a bad press. They're pests. We don't want them in our houses. Mainly, we want to kill them. If you call someone a cockroach, like Tony Montana did to Frank Lopez in Scarface, it's not meant as a compliment. You might think that one of the most successful species in the long and colourful history of life on earth would enjoy more respect. But no…

Of course, you have to be careful in how you define success. Cockroaches don't have iPhones, space stations or edible underwear. They don't have any of the nick-nacks we have that make us think we're so clever. They're not ingenious, like we think we are.

But ingeniousness is over-rated. Cockroaches may not be able to build nuclear bombs, but they can withstand nuclear war. They *survive*. Don't get me wrong. Thriving is great. Prospering isn't bad either. But neither mean much if you're unable to survive. To my mind, therefore, capacity to survive has to be the starting point when thinking about success. It's all about robustness really, and on this metric cockroaches are tops.

The oldest cockroach fossil is 350 million years old, which is quite remarkable when you think about it. We humans have been around for around for a mere fifty thousand years (so we're one seven thousandth as successful as cockroaches). According to the record of the rocks, cockroaches first appeared just after the second of the earth's five mass extinctions (defined as the loss of 75% of all species). In other words, that means they survived the third, fourth and fifth mass extinctions which followed, the last one being the Cretaceous event which wiped out the dinosaurs. They can go without air for 45 minutes, survive submerged underwater for half an hour, survive freezing temperatures and withstand fifteen times more radiation than humans. They eat pretty much anything, including the glue on the back of stamps. And when that runs out, they can last a month without anything at all before finally starving.

But what I like best about cockroaches isn't just their physical hardiness, it's the simple algorithm they use to survive. According to Richard Bookstaber, that algorithm is *"singularly simple and seemingly suboptimal: it moves in the opposite direction of gusts of wind that might signal an approaching predator."* And that's it. Simple, suboptimal, but *spectacularly* robust ….

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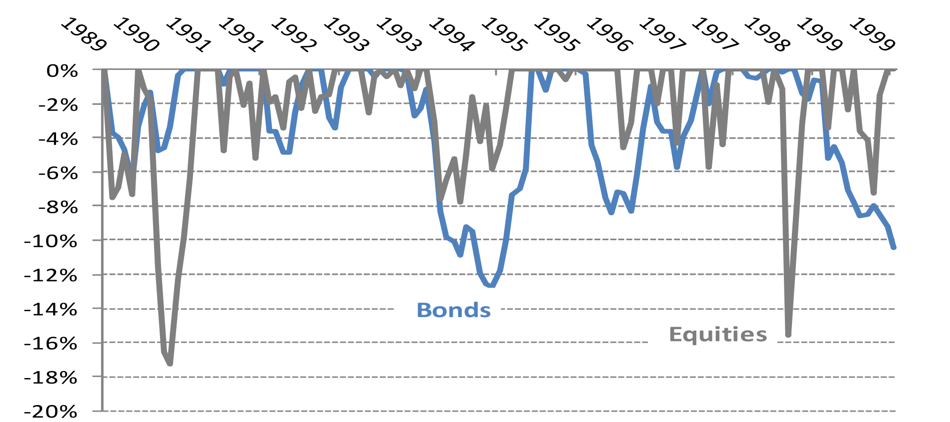
Cockroaches prove that what is optimal isn't necessarily robust, that there is such a thing as being too clever, and that you can thrive with very simple underlying algorithms. As you can imagine, this is an inspiring and reassuring idea for someone as limited me. And it's got me thinking about what a cockroach portfolio would look like.

When I started work in 1997 equities were the only place to be. The mantra was that in the long run, you couldn't lose money in stocks. The tech bubble was just beginning to inflate. Two financial writers, James Glassman and Kevin Hassett, were conceiving of a book called "Dow 36,000" which would be published a few years later, in 1999. This would be close to the peak of the bubble.

In a sense it's easy to see why. The following chart compares the real drawdowns (peak to trough movements adjusted for CPI inflation) of bonds and equities during the 1990s bull market. The maximum real drawdown was 17% in the equity market (in 1990) and 13% in the bond market (1994). These downsides weren't a million miles away, but the returns on equities were much higher. So only idiots would own bonds. This all sounds quaint today. But it happened and it was real. Institutional investors, pension funds and insurance companies held about 85% of their assets in equities. They thought it was the prudent thing to do.

Real 1990s drawdowns between bonds and equities compared (% peak to trough in real return)

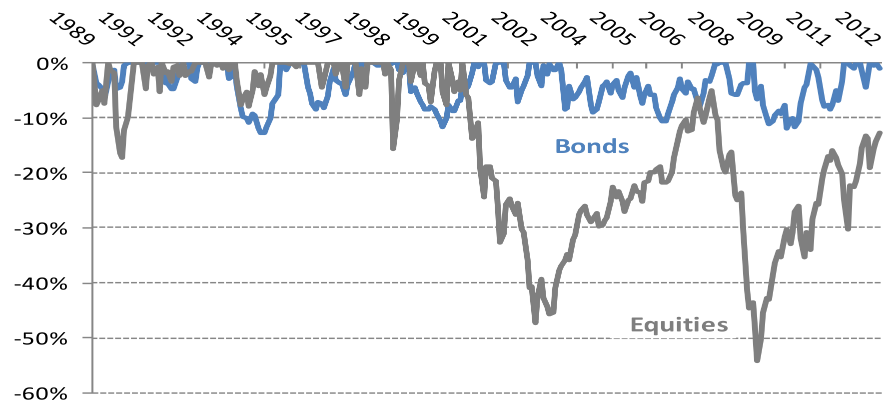


Source: SG Cross Asset Research

As the market rose to the heady valuation peak of the late 1990s, equity investors felt very pleased with themselves. They understood all the fancy new ideas like collapsing equity risk premia and productivity miracles. They marvelled at tantalizingly delphic central bankers, and on good days they thought they were nearly as clever. It would all have been lost on a lowly and limited cockroach …

Over a decade later, and we're in a similar place today. Insurance companies have almost completely sold their equity holdings and they own large bond portfolios instead. The FT reports that UK pension funds also now own more bonds than equities. In real terms, equities have suffered real drawdowns of nearly 50% on two occasions in ten years while bonds have held firm (chart below). Worse, equity returns have been negative over that period.

Equity market drawdowns were savage in the 2000s, bonds trucked along



Source: SG Cross Asset Research

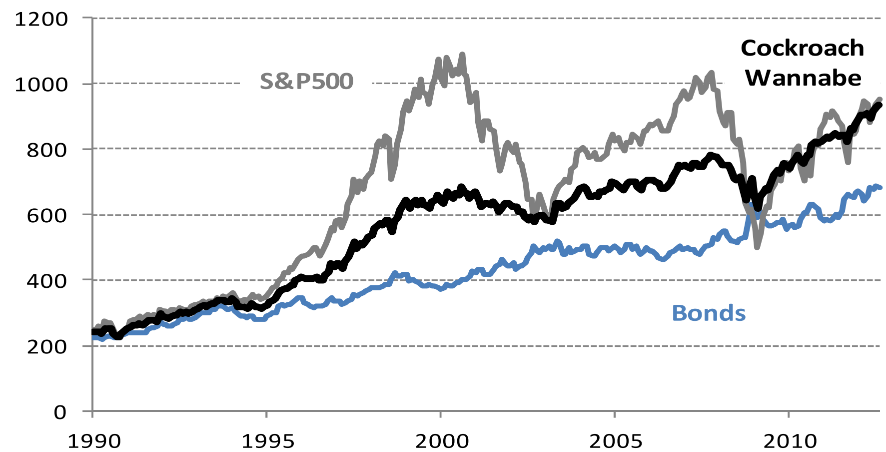
So .... now everyone knows that only an idiot would want to own equities. It's true that bonds don't offer much return with yields down here … *"but at least you don't lose your capital."* They've had 10% maximum real drawdown, after all. They're risk-free. Some economists even tell us that governments can't go broke if they are in control of the printing press. "*That your only risk with bonds is inflation, but let's face it deflation is the risk here. Look around, we're deleveraging! Central banks couldn't create inflation even if they wanted to!! We'll be lucky to emulate Japan!!!*" … according to Nobel Prize winning clever-clogs. I happen to think the clever-clogs wrong. But I don't really know. Maybe it's me that's wrong. What I do know is that it's all beyond the lowly cockroach.

Of course, if you'd been clever (or lucky) you'd have owned equities in the 1990s and bonds in the 2000s. You'd have switched out at the top. But how many did? Some managed to be right in timing as well as thought and so kept their jobs. But most didn't. For the overwhelming majority, timing these events is a mug's game. Yet today everyone asks what the trigger will be for a bond rout. They need to know so they know when to get out of bonds. It's what they're paid to do. Again though, it's all beyond the lowly cockroach.

A cockroach would avoid playing the game in the first place. He'd accept that he wasn't clever enough to know when to switch out of one asset class and into another. He'd probably do everything he could to avoid having to make such horrible decisions. He'd buy bonds and equities together, ensuring that each year he held them in equal proportion.

The following chart shows what his returns would have looked like, using such a strategy from the 1990s onward. Not bad in fact.

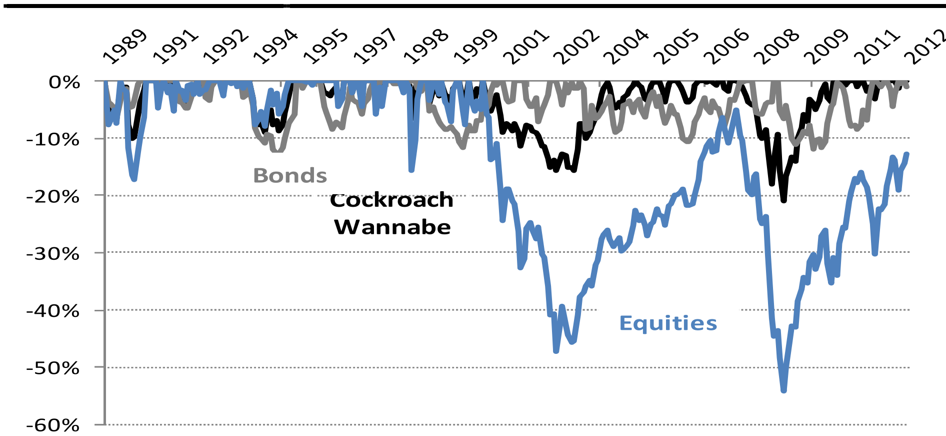
Real returns compared: bonds, equities and 50/50 bonds/equities



Source: SG Cross Asset Research

The picture looks even better when you compare the drawdowns. Not only does the cockroach wannabe combine bonds and equities, giving a much better risk profile than each one individually, it removes the need for a crystal ball.

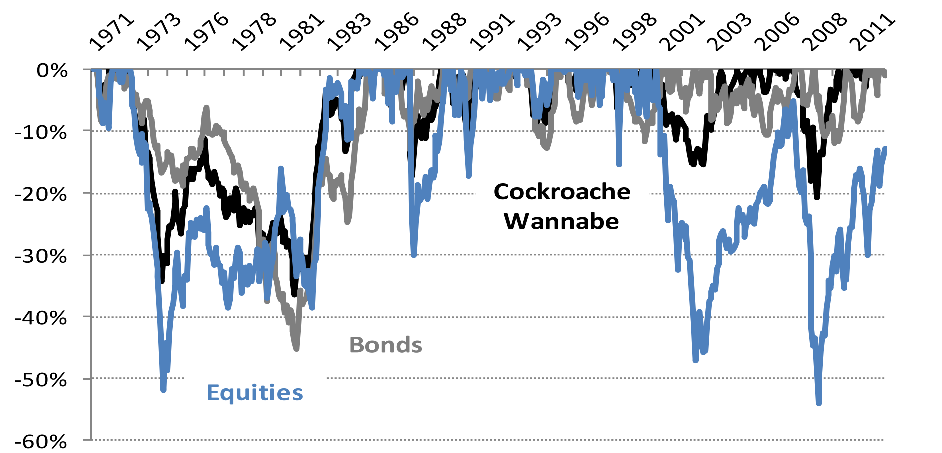
Real drawdowns compared



Source: SG Cross Asset Research

But … how cockroach-like is this strategy really? If we go back to the 1970s and compare real drawdowns from then, we get a very different picture. We see that during that inflationary decade the bonds/equity combo didn't really do much to mitigate the potential for capital loss.

Why the wannabe isn't a real cockroach: huge drawdown in the 1970s

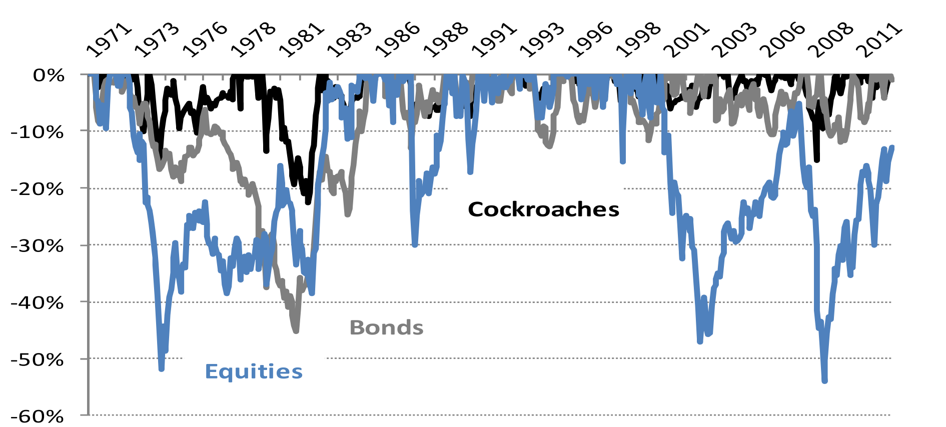


Source: SG Cross Asset Research

A real cockroach would survive the 1970s. It would be inflation resistant, deflation resistant, credit inflation resistant, credit deflation resistant … despite having "no view" on which scenario was more likely at any point in time. So let's assume our cockroach has no view. It doesn't know what's around the corner so it doesn't make any bets. It holds half of its capital in real assets, the other half in nominal. Of course, being a cockroach, it doesn't know if capitalism is about to collapse or flourish. So it divides its nominal and real buckets further into productive and unproductive assets. It puts 25% of its portfolio in equities, 25% of its portfolio in gold, 25% of its portfolio in government bonds and 25% in cash.

The following chart shows that such a portfolio offers some very real protection against the vagaries of an unknown future. Real drawdowns during each regime were significantly mitigated with the cockroach-like strategy of simplicity, agnosticism and robustness.

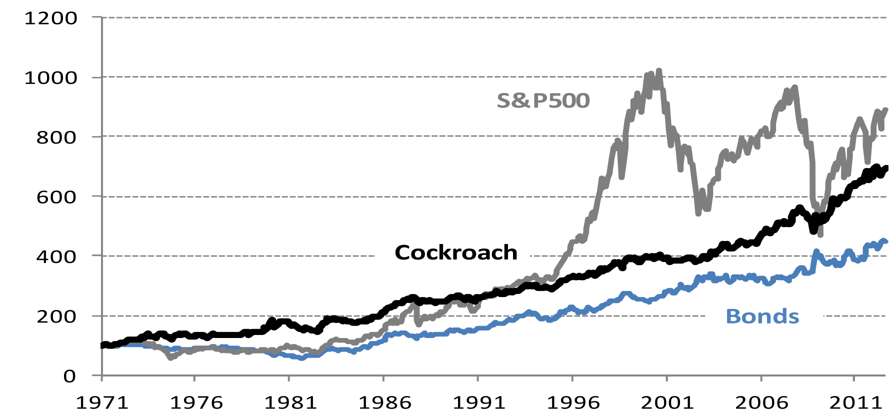
A true cockroach portfolio survived the 1970s



Source: SG Cross Asset Research

And the returns haven't been bad either: 5% real since 1971, versus 5.5% in equities and 4% in government bonds.

Cockroaches for the long run!



Source: SG Cross Asset Research

In 1975 Charles D Ellis wrote about investment being a “losers’ game.” He was using the distinction Simon Ramo drew in his book *“Extraordinary Tennis for the Ordinary Tennis Player”* who observed that the game of tennis was in fact, two games. After extensive statistical analysis, he concluded that professional players *win* points, while amateurs *lose* them. Professional players put the ball wherever they like, at whatever pace they like, with a precision and consistency which the overwhelming majority of players could never hope for. The winner of a professional tennis match is the one who makes the most winning shots.

For most tennis players the game is different. Each player tries to make those special shots. They try to win points. But in doing so they double-fault, miss the baseline, hit the net … In other words, they lose points because they keep trying to hit winning points they’re not capable of. The winner of the losers’ game is the one who loses the least points.

I like Ellis’ categorisation of investment as a losers’ game. We spend so much time and energy trying to be clever: what the Fed will do next; what it should do next; where oil prices will go; what the effect will be on the economy; when the recovery will come; *if* the recovery will come; will China see a revolution; will Russia revolt against ‘Tsar’ Putin; *et cetera, et cetera.* It may be better to focus instead on not being dumb. How good are we at making these predictions? Of course there is a time for going on the offensive, and the occasional opportunity to play winning shots. In moving to an investment practice I guess I’m trying to make one now. Time will tell on how sound my judgement is. But I think the principle is a sound one.

So … it’s an odd feeling to be drawing the curtain on my time here with Albert and Andy at SG. The three years have flown and it’s been both educational and entertaining working with them. But I’ve known them both for years and been close friends with them for years. So while I’ll miss the day-to-day contact, we won’t stop being close friends.

But I’m going to miss SG too. I know it’s customary to thank everyone everywhere when you leave, but in all sincerity, my time at SG has also been memorable because of SG. It’s not been an easy time for banks. Eurozone banks have had a particularly rough time and SG has copped its fair share of the flak. But I’ve met some fine and honourable people here who will be life-long friends.

I've come across wonderful people outside of the bank too: readers, clients, journalists. But the most common question I've been asked in my time here has been *"how do you get away with writing what you write, while working inside a bank?"* Lurking beneath the question is the implicit understanding that other banks don't allow their analysts freedom of thought and expression. Yet SG has given us exactly that freedom, along with trust that we won't abuse it. Such trust is unusual indeed in this industry and without it I wouldn't have had the fun, the personal growth, the readership, or relationships that the readership has fostered over time. I am truly grateful and I will always be very fond of this place.

When I resurface on the buy side early next year I will continue to write from my new perch. Before then I will be presenting at Albert and Andy's January conferences in London and Edinburgh. Hopefully I'll get to catch up with some of you personally then. In the meantime, anyone who's corresponded with me, met me, or even just enjoyed reading the odd Popular Delusions and would like to stay in touch, feel free to drop me a line here. To the rest of you, thank you and farewell!