portfolio construction forum

Central banks encourage irrational hedonism

Christopher Joye | Smarter Money Investments | 29 July 2016

In 1648, a Dutch water authority issued a bearer bond inscribed on goatskin to Niclaes de Meijer that promised to pay him 5% in perpetuity to finance improvements to a local dike. The bond is now owned by Yale and, 368 years later, is still paying interest, even though the rate halved to 2.5% in the 17th century.

Yale professors Geert Rouwenhorst and Will Goetzmann write that the life of such perpetual loans has typically been "cut short by imprudent financing, government recall or the misfortunes of wars and revolutions".

Here in Australia, we see perpetual notes in the form of the preferred equity issued by banks, called hybrids, that have no legal maturity (only optional refinancing periods or mandatory equity conversion dates).

These hybrids lost 40% of their value during the 2008 to 2009 crisis. But mark-to-market investors, which represent most of us, are told to ignore this volatility and focus on the claim that the major banks will never go bust.

> "There have been many instances in history when institutions issued debt with very long tenure," Rouwenhorst says. "But it is very rare that there is an uninterrupted history when governments or other entities have not defaulted on those debts."

A financial instrument active after nearly 400 years reminds us of the ephemeral nature of our own life spans and the contrasting time horizons over which we make decisions.

How does one think about, indeed define, the "short" and "long" term, and is there a legitimate distinction between the two? Is it just one continuum that demands consistency?

An institutional investor recently asked for trade-by-trade analysis on one of my portfolios, which was a revealing exercise. In this pool, there were more than 1,727 purchases and sales over the previous 1,606 days. One-third of positions were held for less than 35 days; another third for between one month and six months; and, the final third retained for more than half a year.

PRICING ERRORS

This reflects discrete trading horizons: the first sub-portfolio exploits near-term mispricings, often related to specific events, which are promptly exited; the longer-term holdings are motivated by more value-based or "fundamental" bottom-up decisions that identify asset-pricing errors that can take many months, if not years, to converge back to fair value.

Managing these disparate durations inevitably encourages one to think about how recent technology and policy changes have affected the way investors - savers and the delegated portfolio managers that service them - behave over the immediate and longer term.

Throughout history there have been innovations - coffee houses (1600s), railways (1800s), telegraphs (1800s), cars (1900s), telephones (1800s), faxes (1960s), mobile phones (1990s) and that most ubiquitous technology invention, the Internet (1990s) - that have radically altered interconnectedness and compressed perceptions of time.

Every second, we are faced with choices regarding whether we consume resources in the present or save them to facilitate subsequent consumption.

And with 10-year global risk-free (or "discount") rates hitting unprecedented lows around the world, governments have artificially debased the opportunity cost of consumption to the cheapest levels ever observed - if you believe that market pricing has not been heinously distorted by the tens of trillions of dollars governments have spent bidding up privately traded asset prices to lower yields.

An alternative view is that this has stimulated irrational human hedonism and inflated the prices of government bonds, US shares and Australian housing to the craziest levels on record.

UNWIND DISTORTIONS

So, how do we survive when liquid and safe asset classes, including many cash and fixed-income investments, fail to offer income that covers our cost of living? Do we speculate today or wait for risk-free rates to normalise and unwind these distortions at some unknowable distant juncture?

One concern is that the availability of real-time information on anything we desire is contributing to an evolutionary rewiring of our neurology that heightens expectations of instant gratification to the detriment of our capacity to make over-the-horizon decisions that incur contemporary costs. Witness the secular inability of governments to balance their budgets or the never-ending rise in household debt, which borrows from the future to pay for pleasure in the present.

Central banks blithely ignore the threat of asset price imbalances and inflation - even with core consumer price appreciation in the US above the Federal Reserve's 2% target -in the name of pushing unemployment rates below their full-employment thresholds.

Nobody seems worried that the cheapest money in history is poisoning capital allocation decisions in a manner that will destroy the productive capacity and growth experienced by the next generation.

Contradictions between government-determined asset prices and those that would prevail if markets were left to their own devices, exacerbated by the growing emphasis placed by all stakeholders on high-frequency performance, make responsible money management more difficult than ever before. Recall the plight of the value funds that tried to resist the 1990s "tech boom"?

SHORTER CYCLES

Thankfully, the complex issues surrounding "the long and the short of it" will be addressed by Australia's pre-eminent annual gathering of high-end advisers, researchers and fund managers, the PortfolioConstruction Forum, on August 24.

> "The world seems to operate on ever shorter cycles," says its chief, Graham Rich, who founded Morningstar in Australia.
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> "Politicians promise lower taxes (or union deals) to boost their election prospects, instead of the infrastructure projects that could provide multi-decade economic and social benefits. Companies pay higher dividends and buy back their shares, rather than reinvest profits for future growth.
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> "Public outrage flares and dissipates within hours, driven by the constant churn of social media. Meanwhile, commentators bemoan the inability of governments, corporations and the general public to focus on what truly matters."

Rich defines "investing" as the process by which we turn our human capital into financial capital to provide for post-retirement spending needs and contends that "while the speed freaks and go-slow brigade continue to slug it out, a more nuanced debate is needed on time horizons". Too right.

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