



## Views from the East Coast

Thursday 17<sup>th</sup> November 2005

### **The rationale**

Your intrepid investment managers recently ventured to New York and Boston. The intention was to kick the fat tyres of the US economy, obtain some grass roots views, and to research some key investment opportunities. Our list of rendezvous included an eclectic range of market participants, including long term equity fundamentalists, short term derivative strategists, private equity professionals, journalists, psychiatrists and transsexuals!

### **SUNDAY**

#### **Running through our minds**

In Central Park on a beautiful sunny autumnal Sunday afternoon, Simon and I enthusiastically jogged off our brunch of eggs benedict and waffles. On our second lap of the lake, we considered how our views on the US economy might be challenged over the coming days. As always, we approached the subject with an open mind.

### **MONDAY**

#### **The beautiful status quo**

It was a opportune time to be in New York on the Monday, as Alan Greenspan's successor was to be nominated by President Bush. The role of Chairman of the Fed is often seen as the second most powerful job in the US. So there was a fair amount of excitement when Ben Bernanke, widely seen as a safe pair of hands, was selected. On the day, Bernanke said "My first priority will be to maintain continuity with the policies and policy strategies established during the Greenspan years." Continuity of policy is paramount in today's US economy. As so often in financial markets, mild euphoria emerged from the suggestion that nothing was likely to change.



### **Rational exuberance**

Equity markets rose, the dollar held, and bond markets fell only slightly. This contrasts significantly with the experience when Greenspan was named as successor to Paul Volker in 1987. Stocks fell and the bond market had its worst day in 5 years. With the Bernanke nomination, clearly the market was relieved that Bush had selected a man with solid credentials. There had been concerns about a possible wildcard nomination after the ill conceived nomination of Harriet Miers for the Supreme Court.

### **Don't burst that bubble**

In our various meetings over the next three days, we discussed the more subtle inferences of the nomination. Bernanke is expected to follow Greenspan's hands off approach to potential asset price bubbles, allowing them to build until they burst, and then acting to shelter the economy from the impact through lower interest rates. We know this, because in October 2002, Bernanke said "It is rarely, if ever, advisable for the central bank to use its interest rate instrument to try to target or control asset price movements, thereby implicitly imposing its view of the proper level of asset prices on financial markets."

### **Ambiguity and volatility**

However, Bernanke is known to be vocal, with a much more direct approach than we have come to expect from the more ambiguous Greenspan. In addition, if asked a specific question, he is more likely to provide a direct answer. We wonder whether Bernanke will subconsciously add more insight to Fed policy over and above the level we have been used to over the last 20 years. It is too easy to come to the conclusion that markets will correct more rapidly, with the by-product of increased volatility or skittishness of the market. However, over time, the use of more words can only mean that those words become devalued. Hence the probability is that overall there will be very little change.

### **Tugging the beard**

Whatever the approach, Bernanke will face a significant test early on next year. With the Fed funds rate edging closer to a neutral level, the key challenge for any Fed Chairman will be how and when the FOMC changes the wording of its policy statements and communicates shifts in its stance to the market. The closer the Fed moves to a neutral stance, the more uncertain the market will be on the future direction of policy.

### **A disconcerting consensus**

Away from talk of Bernanke, somewhat surprisingly, there was an unsettling consensus of opinion among the market participants we met. The medium term future for US economy and indeed the stockmarket does not look great. The housing boom is showing signs of turning and there is renewed concern about levels of consumer indebtedness. In the corporate sector, although balance sheets are healthy, results are showing a squeeze on profits. Even the most optimistic analyst would have to admit that there can only be limited increases in profitability from current levels. The government budget deficit means that there is little scope for further fiscal boosts to prop up the slowing economy, and the trade deficit threatens to weaken the dollar. A weaker dollar would mean higher inflation. Moreover, the oil price is also adding upward pressure on prices, just when growth is slowing.

The concept of recession is defined by two consecutive quarters of economic contraction. In contrast, there are no precise criteria for dreaded stagflation, but this can be the only conclusion if slowing growth and rising inflation continue.

### **Equity investment and the Mosaic™ approach**

The above uncertainty leads us to believe that the well known US equity market indices are unlikely to produce double digit returns over the next few years. Hence we concentrated on searching for those fund managers who offer non-benchmarked forms of investment. We are always advocates of a non-



benchmarked approach, but the current environment means that stockpicking is more important than ever.

## TUESDAY

### **A question of behaviour**

Given the views stated above, there was initially cause for excitement when we interviewed a manager who runs a strategy almost purely based on behavioural finance. The strategy is unique, interesting and powerful. It focuses on the motivations and relationships between all the market participants that go into the fund management process, from sell side analyst to fund manager. Statistically this is based on concepts such as the fact that investors are much more likely to sell a winning trade than a losing trade. Overall the implication is that there is a lagged effect on what should be timely investment decisions. The concept is sound and robust.

### **The meaning of risk**

However the above manager views risk in a different way to the way we do. As we have alluded, we clearly see risk as that of holding the wrong stocks. However, many managers see risk as that of underperforming the benchmark. The concept of risk has in many cases become one of **career risk management** rather than **investment risk management**. Clearly the fund manager does not want to risk losing his tenure when running a fund. The manager therefore seeks to limit the risk of underperformance. Underperformance leads to the scrutiny of investors and senior management.

Therefore risk is addressed by placing limits on the degree to which a manager can deviate from reflecting the index constituent weightings in the portfolio. If large stocks in the index can only be under- or over-weighted, then the fund is inextricably tied to the performance of the market, reducing the performance potential of the fund. In many cases, therefore, really talented managers and sophisticated strategies are not given the freedom to perform as well as they could.

### **No shorts allowed**

Moreover, there is a further restriction on the fund we refer to. The fund cannot sell stocks short, key for this fund because half of the excellent behavioural theory cannot be utilised, further impacting potential return. On the day, we suggested that we would certainly be more interested in the fund if the restrictive shackles were removed.

### **Relief**

Our frustration was relieved when we met with a manager who runs small and micro cap strategies in the US. The manager uses a far more qualitative style, with very little benchmarking. Investment should be about investing in companies that deserve investment rather than for any other reason. Again, of course risk management is crucial, but we reiterate that risk should not be viewed as the risk of underperforming a benchmark. Rather it should be risk of investing in the wrong companies. The fund we analysed is consistent with this approach. There is a further benefit with this particular fund. Smaller companies often yield more interesting investment opportunities than their larger brethren, a function of fewer analysts and less money chasing limited opportunities.

## WEDNESDAY

### **Private but not unnoticed**

Finally, our search encouraged us to visit the private equity houses of Boston. Our Mosaic™ approach means that we are constantly on the search for alternative asset classes that add resilience to a portfolio. Moreover, in a market of low expected returns from equities, it is inevitable that we search even harder for better returns elsewhere. And there are clearly better returns to be made in private equity. Yes, money has been flooding into that area for quite some time, threatening to reduce returns. However,



most of the money has congregated at the upper end of the scale, focusing on large companies. This has left significant opportunities at the lower end for those with the right level of experience and connections.

### **Calm in the storm**

Hence, we braved the end of hurricane Katrina, comprising high winds and horizontal rain, to fly to Boston to visit two of the best private equity houses in the business, one generalist and one focused on the biotech industry. What is noticeable about the managers of really successful private equity funds is that they have all been involved in running companies within their career history. In addition, interests and motivations are always highly aligned. Here, the concept of investing involves more than just allocating capital. These private equity managers will usually insist on a board position in the companies they seek to invest in, enabling an efficient flow of information and advice. In addition, managers are likely to invest personal money to follow client funds into each investment, further aligning interests. The potential to achieve significant double digit returns over the medium term when stockmarkets are struggling highlights the attraction of this asset class. All of the above adds up to one of the strongest investment propositions available in the world today.

### **Conclusions**

So at the end of a productive four days, we contemplated our trip. As we treated ourselves to tea at the Four Seasons (our only real treat I hasten to add...), Simon and I felt that we had achieved much in a short period of time. The great and the good of NYC and Boston were as sceptical as we were about the state of the US economy. However, everyone also agreed that it has paid to be optimistic in recent US history. The remarkable resilience is unlikely to be dented any time in the near future.

As we mused, on a nearby table we overheard a well dressed American lady describing her chores for the afternoon: a meeting with her shrink followed by an appointment with her osteopath. Fix the mind and fix the body. This seemed somewhat synonymous with the state of the US economy. The body is in a fair amount of turmoil, and the imbalances cannot be ignored. And yet the mind continues to be cautiously optimistic, perhaps detached from reality, perhaps not.

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