

Managing Portfolio Risks

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Any functioning market is comprised of two groups: willing buyers and willing sellers. That might seem an obvious point but the complexity behind the apparently obvious has sustained decades of academic research and Nobel prizes awarded. Information asymmetry is always a problem; the chap selling you that car always knows more about it than you do when you part with your money.

It is always worth asking yourself about the motivations of participants in markets. At one level it is clear; if you visit the open outcry market of Ludlow, for example, producers of lamb gather in the ring with consumers of lamb and by a bidding process every bit as rapid fire as anything in the City, the two groups reach an acceptable price for lamb on that day. Both groups need a transparent market with clear rules to satisfy their need to buy and sell.

The market for money is many times bigger. The key point though, as Warren Buffett has mentioned many times, is that as investors, we are not suppliers of the meat, but we are suppliers of capital to produce it. Thus, the most important question for us is what price can we extract from the market for the use of our client capital when we enter the metaphorical ring on behalf of our clients.

Sometimes markets can be distorted: there may be a drought; a shortage of DRAM chips; there may be a war. The most recent distortion in our financial markets has been quantitative easing, or QE.

The function of any market is to balance supply with demand at a market clearing price. But, in the global financial market in recent times there has been a **glut of money**, and as a result the market clearing price of money has been zero – zero interest rates.

For any serious investor that is a worry because it is totally unprecedented. It means that we must be extra careful.

That brings us back to motivations.

As an investor in businesses, we want our chief executives to Hoover up cheap money, lowering their cost of capital, raising their operating margins and the returns to us, the shareholders. Company treasurers should be lengthening their balance sheets, retiring short-term debt and locking-in (almost) “free” capital, often for decades.

Indeed, we do see company treasurers coming to market because the cost of money is “too low to resist.” Amazon recently borrowed \$18bn for 40 years fixed at just 0.95% over the Treasury yield.

The motivation **to sell** debt at that rate over that term is obvious. But, on the other side, why would we want to **buy** it as an investment? Our motivation is to extract a high price to use “our” capital, and this just isn't it.

There is a third point.

There is a great deal of angst in markets about a resurgence of inflation. As everybody knows inflation destroys the purchasing power of money.

We think current market fears are overdone but it is likely that inflation will rise, if only because central banks want it to. The market clearing price of money is too low, pointing to a dysfunctional market economy.

What that means is that Amazon and other companies are selling a hugely expensive investment, seen from our perspective as an investor. We expect the price of corporate debt issued at these yields to decline because we expect inflation rates to rise and we expect interest rates to rise, albeit modestly, as recovery from the pandemic takes hold.

In practice, that makes for a very delicate balance in portfolio construction. We don't want to hold cash, but we don't want to hold corporate debt that is exposed to a change in inflation expectations. Equally, a change in the cost of money will impact companies in different sectors in different ways as the mathematics of a change in discount rates works its way through valuations.

Our approach to managing this is via a 'barbell' of very high quality short-dated sovereign debt with inflation protection, married to a portfolio of equity in high-quality international businesses.

In the short run, we are accepting a lower return on our fixed interest investments in exchange for safety. The distortion of QE in our markets makes longer-dated sovereign and corporate debt risky and unattractive. We are relying on the cash flows and dividends attributable to equity investors for future returns, and we favour companies which have pricing power and can mitigate most of the effects of any inflation which is to come.

As Warren Buffett has also noted, "Every day, Mr Market will come to you and offer you a price." Ask yourself why, you don't have to take it.

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