

# HindeSight

## Part I: Pensions

### A Tipping Point in Sight

As we enter into February we would like to wish all our readers a Happy Chinese New Year - despite the sobering topic of this month's HindeSight letter.

In Part I of this letter, we will look at a brief history of the pension, from its modern-day origins in the Royal Navy to David Lloyd George's introduction of the state pension in the UK in the early 1900s. We will look at the inexorable mathematics of pensions and the astounding effects compound interest has on the annuity a pension pays out.

This leads us on to Part II, in which we discuss how pension managers will find it increasingly difficult to manage their portfolios in order to provide retirees with a decent pension. We look at Modern Portfolio Theory and some of its flaws, ie how it disregards valuations and economic conditions, which should be key when making investment decisions. Finally, we posit what we believe should be the 'best' portfolio going forward, in order to achieve smooth, linear returns with low volatility.

This letter is intended for pension/wealth managers, and individual investors alike, to highlight the paradigm-shift that will be required in attitudes to investing in the aftermath of the financial crisis. Hopefully, if we achieve anything, we can help people in the future to avoid the potential outcome of . . . THIS!



#### **A Royal Pension: The earliest pensions**

*As he looked back from the shore at the outline of the Sovereign of the Seas, or the Golden Devil as the Dutch called her, he thought she was still the most magnificent ship of her era. The construction of the Sovereign was part of Charles I's plan to overawe his enemies, including the Dutch and Spanish, with England's naval power. John Tylande well remembered her first engagement at the Battle of Kentish Knock during the First Dutch War on 28 September 1652 when she destroyed a Dutch ship with a single broadside, as it was his baptism of fire as well.*

*It was still fifty years before John Harrison would solve the longitude problem allowing sailors more hope on their long Atlantic voyages, and one hundred and thirty odd years before Nelson met his fate at Trafalgar.*

*On the eve of his fortieth birthday in the year of our Lord 1672, John Tylande had served his last day in the Royal Navy of England. The caulker's mate from Chatham had survived numerous sea battles, recovered*

from two bouts of scurvy and had watched many a man flogged. It had been a harsh life since joining the Service at the age of sixteen, but after twenty-three years his aged body was now looking forward to a new life. They had promised him something called a pension, consisting of £8 a year for his services to King and country.

He wasn't convinced it would last but he had the first year's note payment in his hand and that was a good enough start.

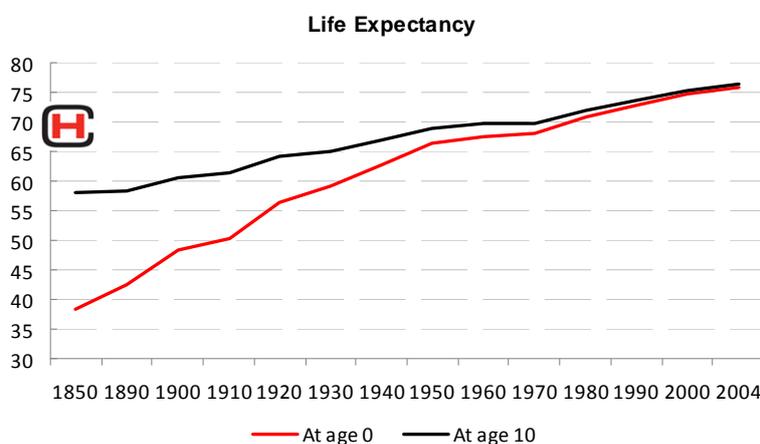
Although the Royal Navy's pension scheme, along with that of East India Company, is one of the earliest in England, there is documented evidence that Roman soldiers, after a twenty five year tour of colonizing and empire building, received a pension which was often land to cultivate as they wished.

With life expectancy - without the rigours of twenty or so years of brutal military life - not much greater than fifty years, even in the late seventeenth century, this doesn't seem like the deal of a lifetime.

**Pension: Origin** 1325–75; ME (< OF *pension*) < L *pēnsiōn-* (s. of *pēnsiō*) a weighing out, hence, a paying out, instalment paying, equiv. to *pēns* ( *us* ) (ptp. of *pendere* to weigh out, pay by weight, equiv. to *pend-* v. s. + *-tus* ptp. suffix, with *dt* > *s*) + *-iōn-* *-iōn*

Despite the aforementioned pensions, Georgian/Victorian Britain was a harsh place for many of its older inhabitants. The divide between rich landowners and industrialists and the workers made pensions irrelevant for some and a dream for the masses. The lower classes worked until they dropped - literally.

The chart below shows the life expectancy for the period through to the present day. The difference in life expectancy in the 19<sup>th</sup> and early 20<sup>th</sup> centuries for a child just born, and for a child who makes it to 10 years old, is stark. Infant mortality was very high in this period, and this skewed life expectancy statistics lower. Now, the gap has been almost eliminated; there is almost no difference in the life expectancy for someone just born and a 10 year old child.



*“This is a war Budget. It is for raising money to wage implacable warfare against poverty and squalidness. I cannot help hoping and believing that before this generation has passed away, we shall have advanced a great step towards that good time, when poverty, and the wretchedness and human degradation which always follows in its camp, will be as remote to the people of this country as the wolves which once infested its forests.”* David Lloyd George, April 1909

With the spectacle of European MEPs guzzling from the public trough (or any politicians, for that matter), or Tony Blair making millions from his “advisory” road shows, it is hardly surprising that the phrase “the common good of socialism” leaves a sour taste in one’s mouth.

History is littered with many “great men”, who were usually wartime or religious leaders. Indeed, there was a popular 19<sup>th</sup> century idea, “The Great Man Theory”, which posited that history can be explained by the impact of those men alone.

David Lloyd George is one who should appear on any scroll for great men. While he is remembered often as a leader during the Great War, it is his service before that is the most important. The only Welsh politician to hold the office of Prime Minister of Great Britain, he spent a lifetime in the House of Commons. He served in the Liberal party and campaigned tirelessly for action against the poverty in the masses he saw.

Between 1908-1910 David Lloyd George, as Chancellor of the Exchequer, and Herbert Asquith as Prime Minister, introduced wide-reaching reforms for the welfare state, paid for by unprecedented taxes on the wealthy, including a ‘super tax’ of almost 8% on incomes greater than £5000 (almost £400,000 in today’s money).

Despite a long struggle with the House of Lords, dominated by Conservatives representing the rich landowners, the ‘Peoples’ Budget’ was passed and the reforms, including the Pensions Act of the previous year, could be funded by government revenue.

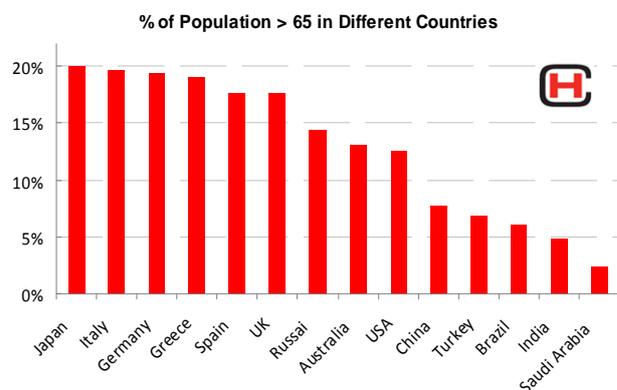
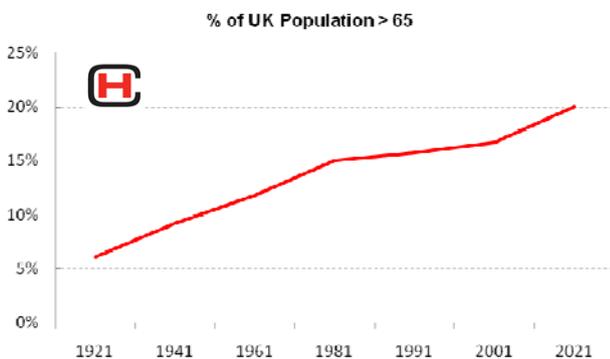
‘Pensions Day’, January 1<sup>st</sup> 1909, commenced the general old age payment, paying a non-contributory weekly sum of between 1 and 5 shillings (5p - 25p) from the age of 70 on a means-tested basis. On that day half a million people were eligible, and £16million (£1.2bln today) had to be raised for this purpose.

Although the relief for the poor in the workhouses was immense, the level of benefit was actually set low to encourage workers to make provision for their own retirement. Eligibility would make a mockery of today’s rules. It included ‘a character test’: only those of good character could receive a pension. Those who had habitually refused work or been convicted under the Inebriates Act received nothing from the scheme.

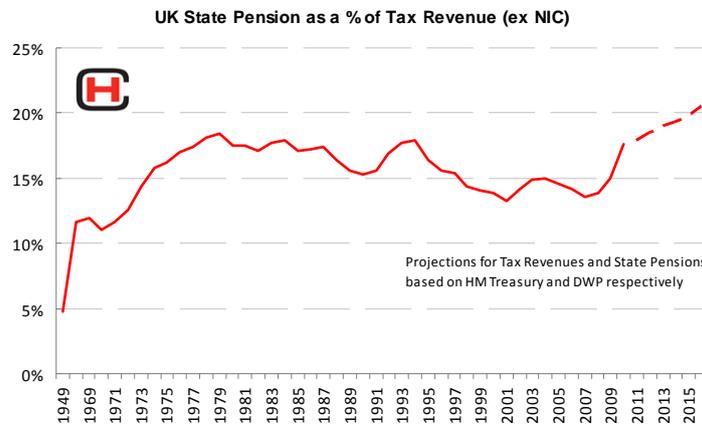
(The National Insurance Act of 1911 was passed to provide monies for the unemployed and infirm. For many years afterwards the saying “on the Lloyd-George” was used to describe people who were collecting the benefit.)

There have been numerous changes to the pension laws in the 100 years since but the basic facts remain. Whether it is a state, company or personal pension the costs involved in providing for a continued level of income after the end of employment is never easy. While Lloyd-George struggled to get his £16million funding through, a quick look back at the life expectancy chart, and the table below, will show how few people really were eligible to claim the new benefit.

As medical advances and improvements in lifestyle prolong life (a recent study predicted that 1 in 5 people alive today in the UK will reach 100), the pension issue will be never be far away. The inevitability of the pension age for state pensions rising to 75 and beyond is there for all to see. The problem is that, although we are living longer, it is not obvious that we are any better equipped to work in our old age than we were at the turn of the last century.



And indeed, we are far less equipped to pay for it, as the chart below illustrates.



Source: Department of Work and Pensions

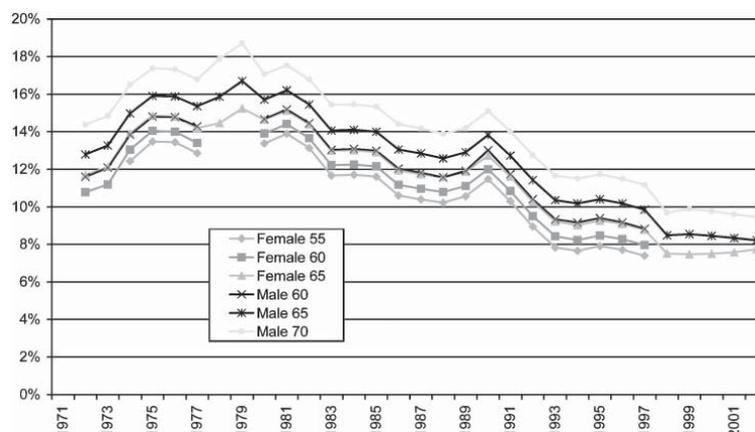
## Pension Maths

Let's do some very elementary maths on the ability to provide a pension from the savings of a person, company or state.

For simplicity we will assume the worker pays into a saving plan that accrues no investment yield above an assumed zero percent inflation, no taxation, and no salary change through the saving period, at age 25 through to 65, with a yearly wage of £30,000.

It is usual on retirement to take a quarter of the monies saved as a lump sum and then purchase an annuity with the residual. If we have an imaginary target to provide us with 10 years' retirement at the same salary as when we were working, we need a sum of £300,000 on retirement. Clearly, to have that we need to save 25% of our yearly wage for 40 years ( $25\% \times £30,000 \times 40 = £300,000$ ).

This would usually then come as £75,000 lump sum (one quarter of £300,000), and £22,500 a year from an annuity bought at 10% ( $[\£300,000 - \£75,000] \times 10\% = \£22,500$ ). However, with interest rates ultra-low, receiving a 10% annuity is very unlikely these days. The chart below shows the declining levels of purchased annuities in recent times.



Of course, in retirement we will likely have less outgoing expenses, hopefully the mortgage will have been paid (but not the fashionable interest-only ones), and the kids will have flown the nest (although with it becoming increasingly difficult for first-time buyers to get on the housing ladder, this is becoming less likely). With the mortgage paid, most retirees will also have the ability to extract equity from their house, but to enjoy 10 years of retirement, you might need to extract it all!

Nevertheless, who saves 25% of their salary for 40 years? We live in a ‘consumer-now’ society: we want to enjoy today and to hell with tomorrow. The subject of economics could probably be summed up in a few paragraphs, one of which might be: “you cannot hope to spend your future income today and still have it tomorrow”.

Not exactly rocket science but try telling that to the people who are calling the ‘debt Samaritans’, or to the deficit-plagued governments. Of course, if you are the government you can print money to cover your debts, for a time at least. However, the individual ends up in debt, with no savings for later use at any age. A disaster when you are past retirement age as you can’t even work any more!

In fact, the reason we have not needed to save 25% of our salary for the last 40 years is down to a concept from economic investment theory 101: compound returns. Richard Russell of Dow Theory Letters has been publishing a compounding table reminder for many years, similar to the one below:

AGE	Contributions		Balances	
	SAVER A	SAVER B	SAVER A	SAVER B
25	2000	0	2,000	0
26	2000	0	4,200	0
27	2000	0	6,620	0
28	2000	0	9,282	0
29	2000	0	12,210	0
30	2000	0	15,431	0
31	2000	0	18,974	0
32	0	2000	20,872	2,000
33	0	2000	22,959	4,200
34	0	2000	25,255	6,620
35	0	2000	27,780	9,282
36	0	2000	30,558	12,210
37	0	2000	33,614	15,431
38	0	2000	36,976	18,974
39	0	2000	40,673	22,872
40	0	2000	44,741	27,159
41	0	2000	49,215	31,875
42	0	2000	54,136	37,062
43	0	2000	59,550	42,769
44	0	2000	65,505	49,045
45	0	2000	72,055	55,950
46	0	2000	79,261	63,545
47	0	2000	87,187	71,899
48	0	2000	95,905	81,089
49	0	2000	105,496	91,198
50	0	2000	116,045	102,318
51	0	2000	127,650	114,550
52	0	2000	140,415	128,005
53	0	2000	154,456	142,805
54	0	2000	169,902	159,086
55	0	2000	186,892	176,995
56	0	2000	205,581	196,694
57	0	2000	226,140	218,364
58	0	2000	248,754	242,200
59	0	2000	273,629	268,420
60	0	2000	300,992	297,262
61	0	2000	331,091	328,988
62	0	2000	364,200	363,887
63	0	2000	400,620	402,276
64	0	2000	440,682	444,503
<b>65</b>	<b>0</b>	<b>2000</b>	<b>484,750</b>	<b>490,953</b>

The basic observation is that at 10% annual compounding rate, saver A only has to save for 7 years to get X amount at 65, while saver B, who starts saving later, has to save for 34 years to get the same pension pot on retirement. Amazing.

If we go back to our original example, we have to save 25% of our salary for 40 years to get the desired target of 10 years retirement at the same income. With the power of compounding we might have the following scenarios:

**At a compounding rate of 3% p.a. we need to save 13% of our salary.**

**At a compounding rate of 5% p.a. we need to save 8% of our salary.**

**And at a compounding rate of 7% we only need to save less than 5% of our salary.**

Clearly, the latter is the highly desired target. The old financial advisor yardstick of ‘how much do I save for my pension?’ question, generally had the answer: take your age, halve it, and save that percentage of your salary. This rule of thumb, is roughly the first scenario, ie saving 13% of your salary under the assumption of a 3% compounding rate.

It must be made clear here that the compounding rate required is a real rate of return (*above* the underlying inflation rate). For instance, if your compounded investment returns are 5% pa but inflation is also running at 5%, you will be back to the first example of having to save 25% in order to have the same purchasing power.

The problems we face to today have manifested from the two main issues:

- 1) We are not saving enough, early enough to provide for a comfortable retirement.
- 2) We have overestimated potential real compound returns due to un-optimal asset allocations and the generally low yields of many investments.

In this current extended period of negative real rates, all the problems are coming home to roost quickly. The extent of unfunded state and company pension liabilities is so huge that the only sensible course of action is ‘stick your head in the sand’. This is the tactic currently being employed by policymakers. Personal pensions are massively inadequate to provide a retirement that is anywhere close to comfortable, in the environment we are in today of declining annuity rates and rising inflation.

Unfortunately, in the short-term, there is not enough time to fix these issues. The problems are real, and at a tipping point.

In the long run we need to focus on many parts to the equation, but the three most fundamental in our eyes are:

- 1) As the life expectancy increases and the pension age increases, the need to work for longer will become paramount. Obesity and dementia are but a few of the health concerns that must be addressed.
- 2) Encouraging people and governments to save more, and do so earlier. Obviously in a time of declining real wages and lower real tax revenues this is easier said than done. Despite all the talk of austerity, we have seen nothing of that yet at all.
- 3) Focus on improving the real compounded returns on savings by recognising the need for having exposure to additional asset classes, and more optimal allocations among asset classes.

This section would be incomplete without a quick look at the retirement table below for different countries in Europe. Clearly, if there is to be any hope for Europe to save itself from total destruction, having people retire in Greece at 57, while Germans have to work another 10 years, is patently ludicrous.

Country	Early retirement age	Normal retirement age	Employed, 55–59	Employed, 60–64	Employed, 65–69	Employed, 70+
Austria	60 (57)	65 (60)	39%	7%	1%	0%
Belgium	60	65	45%	12%	1%	0%
Denmark	none	65	77%	35%	9%	1%
France	62*	65*	51%	12%	1%	0%
Germany	65	67	64%	23%	3%	0%
Greece	57	65	51%	31%	8%	1%
Italy	57	65 (60)	34%	12%	1%	0%
Netherlands	60	65	53%	22%	3%	0%
Norway	62	67	?	?	?	?
Spain	60	65	46%	22%	0%	0%
Sweden	61	65	78%	58%	5%	1%
Switzerland	63 (61), [58]	65 (64)	77%	46%	7%	2%
United Kingdom	none	65	69%	40%	10%	2%
United States	62	67	66%	43%	20%	5%

The conclusions that hopefully can be drawn from this basic analysis should be obvious no matter how worrying they might seem. As the demographic pyramids in most countries are rapidly inverting, the growing percentages of total tax revenue needed to provide the basic state pension is ballooning, and will soon reach a tipping point. **With the only real option being to increase the pension age or decrease the payment level via increased taxation, people will be have to do a much better job of saving and investing to avoid working through ill health until death.**

## Part II: The Holy Grail of Investment Returns

*“I’ve made 10% returns for 20 years and I’ve never had a down month.”*

Sadly these comments were made in 2007 by an investor in the now infamous Bernie Madoff fund.

As the old saying goes, “if it sounds too good to be true, it probably is”. Producing high returns in the financial markets (without being a market maker or broker) above the underlying inflation rate on a long-term basis, with virtually no drawdowns, is nigh-on impossible. While in the world of leveraged trading, the professionals who constantly make double-digit returns are few and far between, even they often have large swings month-to-month. Market wizards like Paul Tudor Jones or Louis Bacon, who do actually have that elusive long-term track record, deserve all the credit they get. As the markets go only two ways - up or down - it is easy for many people to delude themselves in the short run that they are masters of the universe. Bull markets have a habit of making geniuses out of idiots.

Unfortunately just as high, leveraged returns are extremely difficult to obtain in recent times, so have been reasonable, real, non-leveraged investment returns. The days of following the advice of investment firms to alter your 59.2% equity/40.8% bond portfolio to 58.1% and 41.9% to achieve those average 9% returns are long gone. Today’s manager or investor will have to get smarter and be more diversified if he is to achieve those sort of returns.

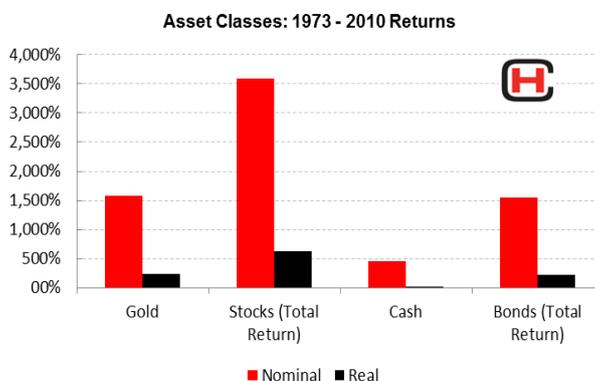
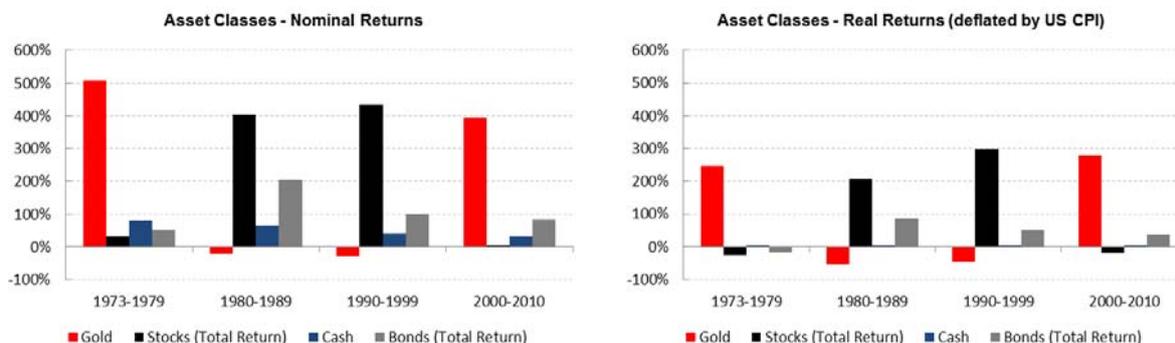
There is no such thing as a bad investment class (ruling out cigar bars and fraud), just poor timing. Every asset class has had periods of great returns and periods of poor returns. To enjoy the success of good returns often boils down to two basic determinants:

- 1) Current valuation with regards to the historic valuation
  - a) Relative to other asset classes
  - b) Relative to simple metrics within the sector
- 2) Assessment of the stage in the business/credit cycle and the prevailing economic conditions.

The importance of both should be clear, but the lower the valuation the less you have to rely on your forecast of the cycle. The cheapness helps with a lot of the work.

We look here at the performance of the main asset class types. What we are trying to achieve is the portfolio with the optimum weightings so that it generates positive real returns, with low volatility. While the historical time series of any investment class is always going to be too short, for the purposes of this analysis we are going to look at the last 40 years, since that is when we left the gold standard and a somewhat more disciplined global monetary policy.

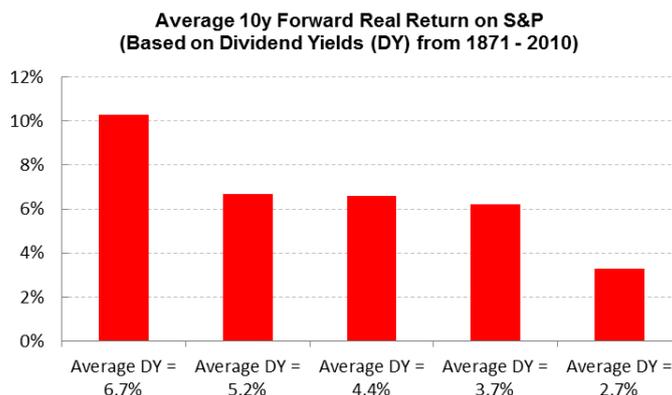
The following three charts show the real and nominal returns of bonds, stocks, cash and gold since 1973 (since this was as far back we could get data for a total return bond index).



(Stock and bond returns are with dividends or coupons reinvested, and cash is compounded on a 12 month rolling basis.)

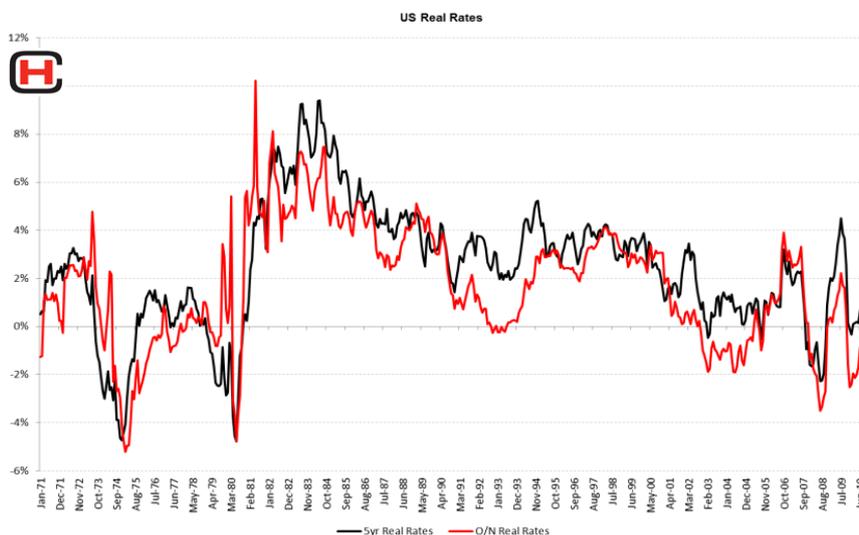
While the returns for these assets in nominal terms look stellar for most of our timeline, the real returns tell a different story. Stocks may have nominally made 3,500% over the last 40 years or so, but in real terms it is not much over 500%. Similarly for the other assets. The point is making *real* returns is not easy.

But, if you buy into an asset at an opportune time, ie when valuations are good and economic conditions are favourable, this can make a huge difference. The chart below shows the average 10y real returns in US equities depending on what the dividend yield is when you buy. As is clear, buying at historically rich levels severely hampers subsequent returns.

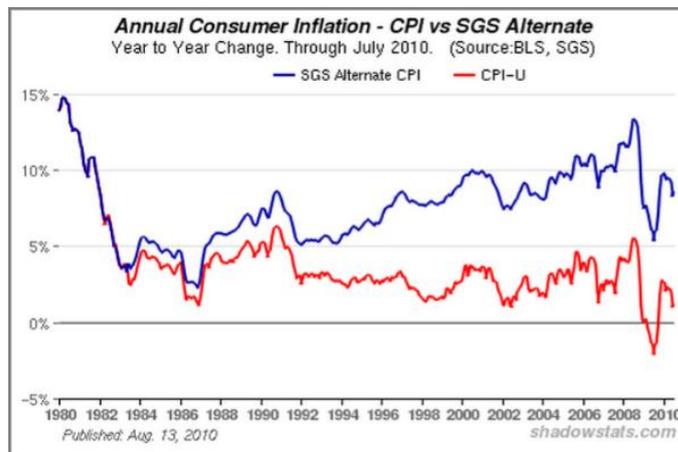


Source: Plexus Asset Management

Buying bonds in the early 1980s when real rates were extremely positive led to excellent returns over the next 2 decades. Now real rates are negative, bonds are highly unlikely to deliver decent returns in the coming years absolutely, or relative to other assets.



Moreover, the above chart calculates real rates using the official US CPI rate. However, CPI has been subject to many adjustments (hedonic adjustments, calculation changes, etc) over the years that it is debateable it is a true reflection of inflation any more. John Williams of Shadow Government Statistics compiles the “shadow” CPI. Essentially, he has continued calculating CPI using a much older methodology, ie before all the hedonic adjustments and so on. It tells a different picture.

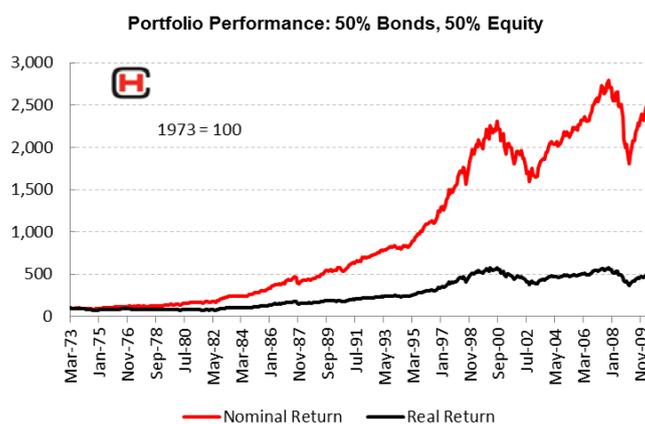


Source: ShadowStats.com

Thus, it is likely real rates are actually much lower than the chart earlier indicates, and bonds are an even worse buy than official measures indicate.

## Difficulties to come

Pension managers were generally very successful in the period 1980-2000. If we look at the typical portfolio of a pension manager of 50% equities and 50% bonds, between 1980 and 2000 in both nominal and real terms, we can see it was combination that worked well. Going forward, however, things are likely to become more difficult. Negative real rates and increased volatility of the business cycle will conspire to make investing more difficult; the old techniques will likely not work nearly as well. The halcyon days of positive real rates producing great bond returns, and declining bond yields fuelling stock prices, will likely not return for a decade, or even longer.



The last 10 years have certainly been a more trying time for the equity investor but the bond investor has on the whole has been well compensated over the last 30 years.

This leads us to the topic of modern portfolio theory and the diversification of risk.

## Modern Portfolio Theory

Harry Markowitz introduced Modern Portfolio Theory (MPT) in a 1952 article and a 1959 book and classed it as 'Portfolio Theory' because "there's nothing modern about it". The fundamental idea of MPT is that assets in an investment portfolio should be viewed not only on their individual merit but on how each asset changes in price relative to one another.

Investing should always be a trade-off between risk and return. In general, assets with higher expected returns are riskier than assets with lower expected returns. The portfolio manager today is fully signed up to the following assertion: higher risk with higher volatility is necessary for higher returns, and lower returns have lower risk and lower volatility profiles.

MPT describes how to select a portfolio with the highest possible expected return for a given amount of risk, or for a given amount of return how to select a portfolio with the lowest possible risk.

For the geeks, some of the maths of the theory are below:

- Expected return:

$$E(R_p) = \sum_i w_i E(R_i)$$

where  $R_p$  is the return on the portfolio,  $R_i$  is the return on asset  $i$  and  $w_i$  is the weighting of component asset  $i$  (that is, the share of asset  $i$  in the portfolio).

- Portfolio return variance:

$$\sigma_p^2 = \sum_i w_i^2 \sigma_i^2 + \sum_i \sum_{j \neq i} w_i w_j \sigma_i \sigma_j \rho_{ij}$$

where  $\rho_{ij}$  is the correlation coefficient between the returns on assets  $i$  and  $j$ . Alternatively the expression can be written as:

$$\sigma_p^2 = \sum_i \sum_j w_i w_j \sigma_i \sigma_j \rho_{ij}$$

where  $\rho_{ij} = 1$  for  $i=j$ .

- Portfolio return volatility (standard deviation):

$$\sigma_p = \sqrt{\sigma_p^2}$$

For a two asset portfolio:

- Portfolio return:  

$$E(R_p) = w_A E(R_A) + w_B E(R_B) = w_A E(R_A) + (1 - w_A) E(R_B).$$
- Portfolio variance: 
$$\sigma_p^2 = w_A^2 \sigma_A^2 + w_B^2 \sigma_B^2 + 2w_A w_B \sigma_A \sigma_B \rho_{AB}$$

For a three asset portfolio:

- Portfolio return:  $w_A E(R_A) + w_B E(R_B) + w_C E(R_C)$

- Portfolio

variance:

$$\sigma_P^2 = w_A^2 \sigma_A^2 + w_B^2 \sigma_B^2 + w_C^2 \sigma_C^2 + 2w_A w_B \sigma_A \sigma_B \rho_{AB} + 2w_A w_C \sigma_A \sigma_C \rho_{AC} + 2w_B w_C \sigma_B \sigma_C \rho_{BC}$$

MPT assumes that investors are risk-averse, or risk aware, meaning that an investor will always chose the less risky portfolio if given two portfolios that offer the same return. An investor would only take on increased risk if adequately compensated by increased returns, and conversely an investor who wants higher expected returns must accept more risk.

NB: The assumptions that all investors will act rationally and that the asset returns are normally distributed are reasonable, but unfortunately while all investors think they are investing rationally, often they are not. They are not all intelligent investors and have not invested on the basis of valuation and economic conditions but perhaps on a whim, hope or fad (see behavioural economics). It is better to believe that different investors will evaluate the trade-off differently based on individual risk-aversion characteristics, but it usually comes down to a poor and incorrect analysis of risk vs reward. (Think Fred Goodwin, former chairman of RBS, buying ABN for £100bln in 2007. Error.)

Some of the drawbacks of MPT in its use as a global portfolio allocation tool have been addressed in recent times. The Black-Litterman model developed in 1990 at Goldman Sachs by Fisher Black and Robert Litterman is a good place to start.

Unfortunately both Black-Litterman, MPT, and indeed all portfolio theories do not take account of valuation - ie timing - and economic conditions in the conclusions that they draw. **If one enters into an asset class at a low valuation, then it is possible to achieve high returns with low risk and low volatility, contrary to the theories' conclusions. Buying at a low valuation gives you a much higher margin of safety in your analyses that MPT and its offshoots do not take account of.**

However, the concept of a diversified portfolio is important. An investor can reduce portfolio risk by holding more than one asset class that is not perfectly positively correlated with other asset classes, and still have the same expected return as holding the asset class on its own. Asset pairs can have varying positive or negative correlations over different time periods, and it is this analysis that will determine the differing return horizons. The standard 50% equity, 50% bond portfolio has benefitted from the oft-occurring negative correlation between the two assets, especially in times of crisis.

## Investing With a Crystal Ball

The legendary investor Jim Rogers used to say that you only had to make a decision on one asset class every ten years to enjoy unbelievably high investment returns and that diversification and over-trading were the way to ruin. The table below emphasises this.

1970-1979	100% invested in gold	1,363% return
1980-1989	Switched from gold to Japanese Equities	493% return
1990-1999	Switched from Japanese equities to US equities	317% return
2000-2010	Switched from US equities into gold again	391% return
<b>1970-2010</b>	<b>Total compounded return of above strategy</b>	<b>177,530% return</b>

Now this is of course with the benefit of Hind(e)sight, but one would have only needed to make 4 investment decisions over the last 40 years to make a mind-blowing return of over 175,000%. Undoubtedly the volatility and drawdowns of this strategy would have at times been unbearable, **but it illustrates the point that all that is needed to make superior returns is to be in the right asset class at the right time (and make sure you're not in the wrong asset class at the wrong time).**

The better informed you are, and the more knowledge you have of valuation and economic conditions, the more you can then aspire to trade with the gods. For mere mortals, it still shows some diversification is certainly wise.

Yet, despite Markowitz's work being over half a century old, diversification has not taken place as much as one might think. While we are bombarded daily with new products, from Vietnam stocks to Rare Earth metals (usually in the form of Exchange Traded Funds (ETFs), which come with their own often unrecognized risks, especially in the case of gold – see a presentation we did on the subject, link [here](#)), the typical pension or investment manager probably still has a very high percentage in developed equity and bond markets. Old habits die hard but the belief that high returns and high risk always go together is still dyed-in-the-wool for many, much to the detriment of today's pensioners (remember the annuity chart from part I of this letter).

As a current example of this, think of the UK gilt market. Today, we have the Bank of England pursuing an ultra-low interest rate policy, actively debasing the currency, which has led to the very negative real rates we now have. When we add in the huge unfunded liabilities (pensions, public-private partnerships, etc) and a tax-take that will struggle to grow as the UK experiences a stuttering recovery and sluggish growth, the picture becomes desolate. All this will put further strains on the UK's fiscal situation and thus its creditworthiness as a sovereign.

So, are gilts a good thing to own? Given the growing risks and negative real rates, we think decisively not. Yet pension funds still have an exposure to gilts that is too high. (Part of this is unavoidable, there are a limited number of income-generating sterling assets that are sufficiently liquid, but we contend there is some leeway, and a reduction in exposure right now would be the prudent thing to do.)

Investing in the UK gilt market, for domestic and foreigner alike, must be one of the surest ways to the poor house in history. You will likely not be surprised to hear, however, that this is still a large percentage of any typical wealth manager's portfolio.

## Why Not Diversify More?

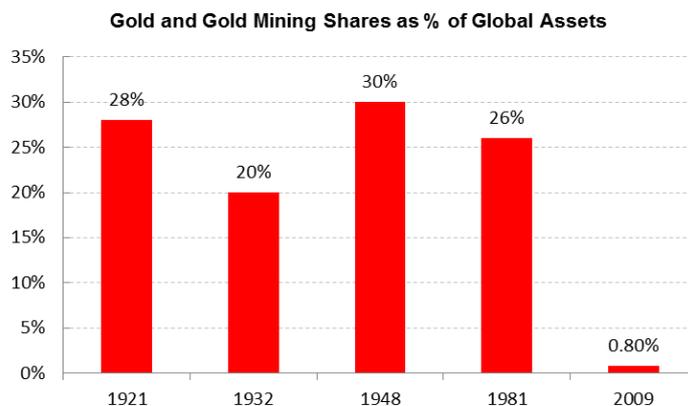
In the last decade or so, despite the reluctance of the majority of our wealth managers to invest more than a fraction of their portfolios in gold and precious metals, it has been clear that some asset classes have enjoyed very high returns in that period. These include: emerging market equities from China to Brazil; emerging market bonds; gold and silver; oil and copper; and most agricultural commodities, eg wheat, sugar and rice.

While emerging equities, bonds and cash come as subsets of the original portfolio choices (ie asset classes), where often there is a positive correlation, it is an astute manager who realises that a heavier weighting is warranted for fast-growing new economies relative to the debt-burdened old economies.

## Gold – An Excellent Portfolio Diversifier

Writing from the desk of Hinde Capital, as investment manager of Hinde Gold Fund, we often write on the subject and attributes of gold. Such is our bias, so we are pleased that we are several pages into this letter before we self-plug.

Gold has returned almost 400% since the beginning of the millennium, making it one of the most outstanding investments of the period. However, despite the roughly 20% annualized return it has delivered, it still remains only a very small part – if a part at all - of most wealth managers’ portfolios. Indeed, as the chart below shows, a combination of the explosion in new assets over the past 30 years (securitized products, derivatives, etc), and a lack of enthusiasm for gold and those who produce it, has led to gold and gold shares being less than 1% of all assets globally. Miniscule to what it has been for most of the last 100 years or so.



*Source: Erste Group Research*

We cannot tell you why gold remains unloved and underowned by the masses, despite its meteoric rise. Maybe the “barbaric relic” smear lives on. Perhaps the asset with no cash flow, coupon or dividend has no right to demand any real value in today's modern world?

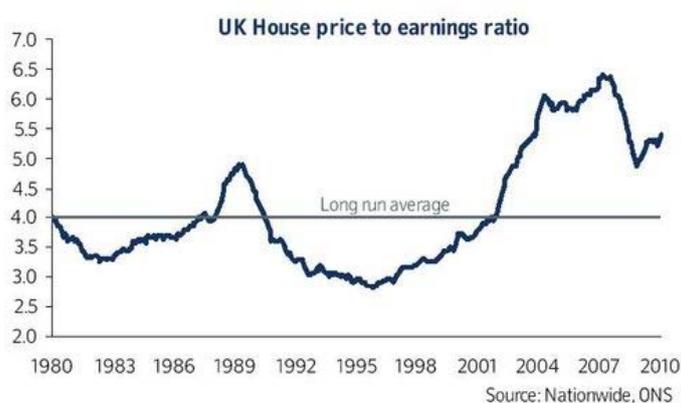
Perhaps it is its “meteoric rise” itself that is putting people off, convincing them they have missed the move? Clearly gold in nominal terms was at a lower price in 2000 than it is today, but if we value gold relative to the global money supply we could reasonably argue that gold today remains as cheap as it was then.

The negative real rates that have fuelled the rise of many real assets over the last decade are still in play today. The fundamentals haven’t changed. Indeed, we could argue that real rates are becoming more negative, and are probably incorrectly reported anyway as actual inflation is likely far higher than what official statistics say, as we alluded to earlier.

So, before we move on to the main point of this letter, how best to diversify your portfolio, we want to make the briefest case that gold is not in the price bubble that some fear.

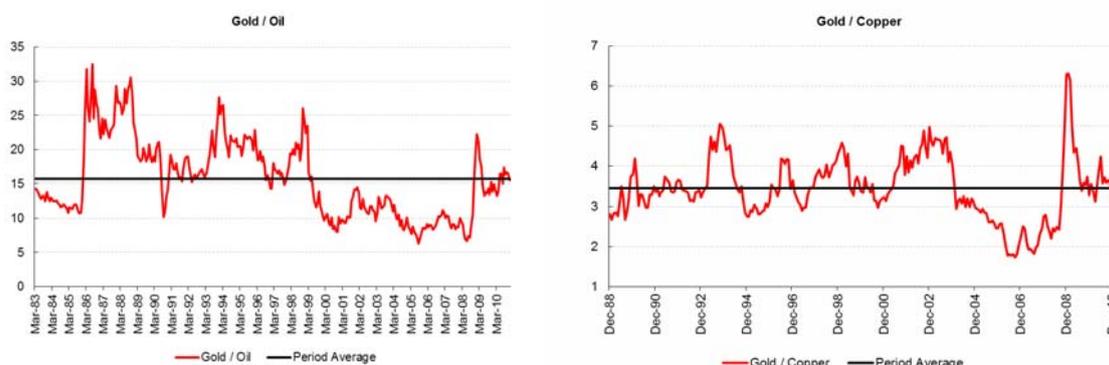
Firstly, in every other price bubble, irrational as they may be, the asset class has been hugely owned, discussed, and loved by the masses. Charlie Munger, Warren Buffet's sidekick, is still describing gold as "stupid". We often read more bearish articles on gold than bullish on any given day. Indeed, only recently did we read an article by Giles Turner in the FT. He wrote that gold bugs were going to get "swatted" when the Bank of England raised rates, completely neglecting to mention the guaranteed catastrophic collapse that would occur in the UK housing market if this were to happen. In a situation of another potential financial meltdown, investors are likely to hold on to their gold rather than dump it. Nil points for joined up thinking, Mr Turner.

Furthermore, the conservative level of the average income/average house price would suggest that valuations in the property sector remain in nosebleed territory (and we won't even discuss how over-owned this asset class is!)



In time maybe we will read more bullish articles on gold, and the proverbial shoe-shine boy will advise us what gold stocks to own. Real rates will have started their return to positive levels, to counter high inflation, and long bond rates will yield double digits once again. Come that day, gold will not be the great investment it has been in the last decade and remains today. But we are a long way off that just now.

Secondly, the relative valuation of gold versus the other real assets shows that many of the long-term mean reverting ratios are still very much in line.



The average ratio for the last 40 years of barrels of oil to ounces of gold is 16. Today it is 15.5!

If gold is in a bubble, then it would suggest that oil, copper, silver, corn, palladium are also in bubbles. It is a little more likely that the purchasing power of the currency that these real assets are priced in - the US dollar - is declining as the supply of dollars increases exponentially, is it not?

**We believe that all investors and asset managers should average a 20% weighting of gold and other precious metals in their portfolio. A good starting point would be closer to 25%, as today's economic conditions warrant it.**

There, we've said it. Whenever we even hint at this number, or less, in discussions we are often laughed out of the room. Never mind that anyone who has done this over the last 10 years is decidedly better off than the average investor.

## A Unique Purpose

The reason why we don't believe that we are insane, despite the 10 year track record, is that in our search for the perfect portfolio gold serves a unique purpose.

- 1) Gold over many time periods has a negative correlation to equities and bonds.
- 2) Gold serves as the medium for real assets.

A “perfect” portfolio, in our opinion, should have as a smooth as possible returns over time, such that an investor is able to commence investing at any point with impunity. They are not unduly penalised for getting in at the wrong time. Constructing such a portfolio benefits from a smoothing factor such as gold.

From earlier, we saw that a portfolio of 50% bonds and 50% equities has delivered a solid set of returns over the past 30 to 40 years. However, as we discussed, it is unlikely to do so in the future. In a period of negative real rates, official or unofficial, the likely beneficiaries are equities, property and real assets, including gold. While valuations for equities and property on individual metrics are still on the higher side, valuations for gold look fair to cheap.

As Markowitz explained, if we can add an asset with negative correlation which would provide the same expected return as the original asset on its own, we could smooth out the volatility of the drawdowns. This should be the true purpose of diversification. A well-known investor is quoted as saying, “Diversity is the way to mediocrity”. If by that he means the mediocrity of compounding a yearly 7% real return with limited drawdowns, we are all for it.

Another unique factor of gold is its money-like status, and its proven ability to be a long-term store of value. This makes gold the best candidate as a medium for all real assets. Gold should not be looked at as a single investment class but rather the currency of the real assets.

If the long-term ratios of gold to oil, copper and wheat mean-revert over a period of time, by investing in gold you are also investing in all the other real assets. Thus having 25% in gold in actual fact means having 25% in real assets. Although a fund manager who has 5% in gold, oil, copper, wheat and corn would probably be seen as more prudent, this allocation is unlikely to produce returns that are much different than holding gold alone. Of course if the ratio of oil to gold is at 30, the astute investor should invest in oil over gold but for the majority of investors, just gold will well serve their purpose. Nevertheless, as mentioned above, gold in relation to most other hard assets is near its long-term average, therefore gold should give a similar exposure to these assets, in aggregate, over the long term.

## 'Best' Portfolios

We have put together a few portfolios. We believe that a portfolio consisting of:

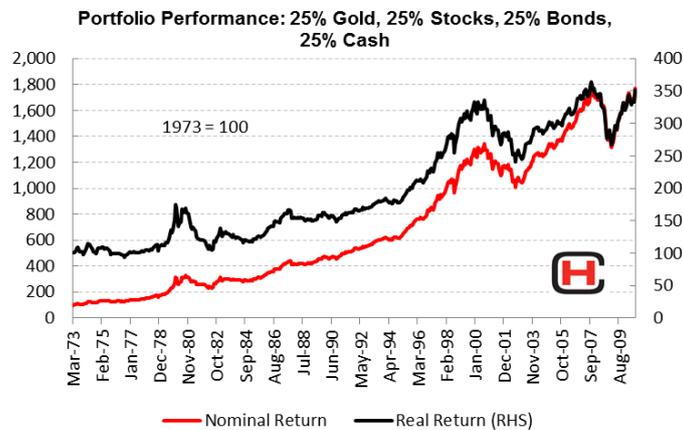
- 25% 12m US cash
- 25% intermediate duration US Treasuries
- 25% US equities
- 25% gold

has given and will continue to give a smooth return structure with a very low volatility in (monthly) returns, while delivering excellent returns.

This is a very good starting point for any investor or investment manager. All asset classes have the ability to lose in different economic conditions. Cash and bonds will lose purchasing power or capital in any inflationary scenario. Equities and gold will lose in any deflationary period of monetary contraction. A diverse portfolio helps address these issues.

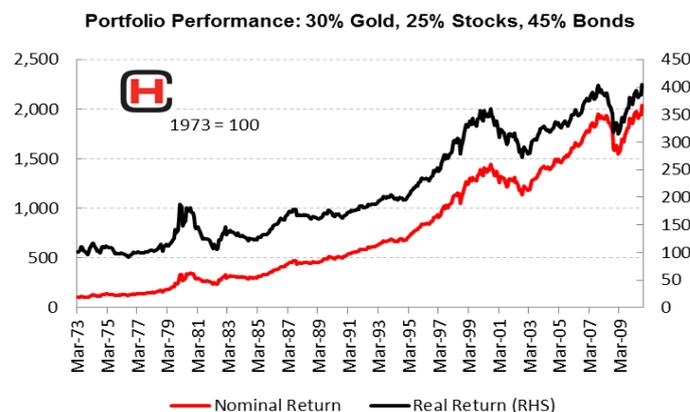
**Key to this type of portfolio's success is an ongoing assessment of valuations and economic conditions.** This is the approach we emphasised earlier, that portfolio theory neglects. The investor varies the weightings marginally based on this assessment. For instance, if real rates are positive, increase bonds by eg 5%, and decrease gold by the same amount. Or if P/E ratios are less than 10, increase equities, decrease cash. There are many possibilities for the active manager. The point is, small rules and small adjustments can make all the difference.

The chart below shows the performance of this portfolio since 1973 in both real and nominal terms.



This portfolio has given an annualized return of 7.9% (3.4% in real terms), with an annualized volatility 6.6%, much lower than a portfolio of gold (20.1%) or stocks (15.9%) alone. \$100 invested in this portfolio in 1973 would be worth almost \$1800 today. The worst drawdown is less severe than holding just stocks or gold on their own, with the largest peak-to-trough fall over almost 40 years of 25% (in, you guessed it, early 2009), with much larger 50% and 60% drawdowns respectively for stocks and gold.

We also ran an optimization routine to try to discover which portfolio (of bonds, stocks, cash and gold) would give you the closest to smooth, 4% real returns each year over the last 40 years or so. A 30% weighting of gold, a 45% weighting of bonds and a 25% weighting in stocks achieves a 3.8% annualized real return, with a low volatility of 7.7%. \$100 invested in this portfolio in 1973 would be worth \$2171 today.

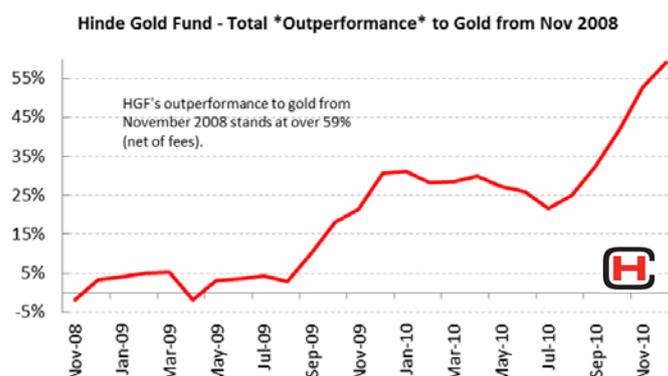


We are not necessarily advocating this portfolio, but it is instructive to note that in trying to construct portfolios that have a smooth, *real* annualized return of around 4%-5%, gold needs to be a reasonably high constituent. This makes sense as we know gold tends to do well in a negative real rate environment (as is the case at the moment). Bonds would have helped keep the portfolio growing through the 80s and 90s when real rates were mainly positive (and gold underperformed). As real rates are now negative, decreasing the bond allocation and increasing the gold and equity allocations (especially to sectors exposed to real assets), would be a smart move.

Alternatively, or in addition, to timely allocation shifts, an investor should investigate the ability to increase his returns by choosing fund managers who can outperform the benchmark of the portfolio allocation. Success in this venture will not only provide higher returns but also enable more margin of safety in the event of a mis-timed major allocation shift.

## Hinde Gold Fund As Your Gold Allocation

Hinde Gold Fund began trading on 19<sup>th</sup> October 2007 using a 50% gold equity, 50% spot gold bullion benchmark. In November 2008 the Fund's mandate changed to a 100% spot gold bullion benchmark. **Since then, Hinde Gold Fund has outperformed the gold price by 59% - net of all fees - with an absolute return of 156% in the same period (to end of 2010).** HGF targets a rolling 12 month outperformance of 15% net of fees by timely allocation shifts in gold and silver and a small portfolio of well-researched junior mining stocks.



In time, Hinde Capital aims to bring the other investment classes to market in fund structures that target an outperformance to the respective benchmark that investors can benefit from. This will enable us to offer our clients the ability to shift allocations to other asset classes, while remaining under the umbrella of Hinde Capital funds.

We began this letter with a discussion on pensions and have ended with a proposed 'best' portfolio. At no time in recent history will the need for correct allocations be more necessary than now. The need to save and compound at a good rate will be the difference between being wealthy and very poor in the coming years. **If one starts with this portfolio – 25% gold, 25% equities, 25% bonds, 25% cash - and follows some basic rules in observing valuations and economic conditions, and investing with fund managers who outperform in their respective asset classes, you will be well primed to avoid the workhouse in your old age.**

## **DISCLAIMER**

*Hinde Gold Fund Ltd is an open-ended multi-class investment company incorporated in the British Virgin Islands.*

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