

The Committee for Monetary Research & Education, Inc.

Fall Dinner Meeting – Thursday, October 21, 2010

The Union League Club 38 E. 37th St. New York City

The Federal Reserve Chairman has said “...the economic outlook remains unusually uncertain.” *But economic predictions are not uncertain, they portend serious woes. CMRE looks at problems, solutions, markets and deflation.*

Session III 8:15-9:15 pm The Essentials

Ben Davies, co-founder of Hinde Capital in London, which focuses on metals and commodities and covers gold and silver exchange-traded funds

Good evening, ladies and gentlemen. My name is Ben Davies and I co-founded Hinde Capital, a UK-based investment manager, with a gentleman called Mark Mahaffey.

They say you get invited to speak only twice in your career at the CMRE -- once on the way up and once on the way down. It's good to be back.

I've been invited here tonight primarily to convey my experiences in the markets. I see this section of the program is titled "The Essentials." I have taken that to mean I am here to talk about my experiences at the "coal face." For me the coal face is the marketplace -- the culmination of buyers and sellers. I would like to share my relationship and experiences with the coal face -- in particular the "gold face."

Undoubtedly, though, there is one other ingredient -- experience. My work partner once said to me, "Never trust with managing your money anyone under the age of 30, because they ain't seen nothing." I tend to agree with him. He expanded on this: "Markets go only two ways -- up or down -- so you've got a 50-50 shot."

A young man or woman could get lucky for five years and they and everyone will think he or she is good. Then they never make another dime.

I am not George Soros or Louis Bacon, nor do I want to be. I learned early on: Be your own man. I am also not under 30 years of age so I probably qualify to pass on some of my thoughts and experiences.

I want to address the title of the night because it's much more thought-provoking than one would assume on first glance.

The Federal Reserve chairman has said: "The economic outlook remains unusually uncertain." But economic predictions are not uncertain; they portend serious woes.

For once I agree with my namesake Ben -- the outlook remains unusually uncertain. A quite stunning observation, no less. But I would not just agree with the assertion that economic predictions are not uncertain. Note the double negative there.

Economics has sought to blend epistemology, physics, mathematics, and behavioral science to try to measure uncertainty. They aim to try to predict when we might have an economic collapse, but no model has been created that manages this with much confidence, if any at all. How do you measure a risk that is unmeasurable?

No, there is nothing certain about economic predictions. Donald Rumsfeld, the former U.S. defense secretary, unwittingly declared it so at a NATO press conference in 2002, when he responded to a question on intelligence gathering:

"It's not the certainties that make life interesting; it's the uncertainties. There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things we know we don't know. But there are also unknown unknowns -- the things we don't know we don't know."

"Unknown unknowns" -- at the time this was ridiculed as a piece of deliberate and meaningless obfuscation. Rumsfeld even won an award from the British Plain English Campaign for the most nonsensical remark made by a public figure. I would add that he narrowly pipped California Gov. Arnold Schwarzenegger, who commented, "I think that gay marriage is something that should be between a man and a woman."

Another stunning revelation. It's OK; we are clearly in safe hands with illustrious leaders like this.

Ridicule aside, I do think it was brilliant piece of polemic, irrespective of one's political persuasion. Without knowing it, Rumsfeld could actually be the poster child for a new line of economic thought that tries to draw parallels from physics -- the Heisenberg Uncertainty Principle.

In quantum physics this principle states that certain pairs of physical properties, such as position and momentum, cannot be simultaneously known to arbitrarily high accuracy.

The physical example Heisenberg used was the following. The more precisely you try to determine an electron's position, the less likely can you determine its momentum. A forecast of the electron's trajectory is therefore subject to unavoidable inaccuracy. And herein lies the issue with macroeconomics. One cannot be deterministic. Events are not causally determined by previous events alone. A known event does not predict a known outcome.

Although much can be learned from this theory, this is where the analogy ends. The act of experimenting with the electron and measuring position did not alter the outcome. In a human system the very act of forecasting or predicting an outcome actually influences that very outcome. This we call the feedback mechanism. It is encompassed in a theory many will know as "reflexivity."

Reflexivity refers to the circular relationships between cause and effect, what the philosopher Karl Popper referred to as the Oedipal effect (mothers, beware) -- an act of self-reference where examination or action bends back on itself.

Take the interaction between beliefs and observations in a marketplace. If traders believe that prices will fall, they will sell, thus driving down prices, whereas if they believe prices will rise, they will buy, thereby driving prices up. "Self-fulfilling prophecy" is another term you could ascribe this to.

If only markets were so simple.

Karl Popper believed that even scientific knowledge does not qualify as the ultimate truth. Rather, scientific theories should be accepted as provisionally true as no amount of corroborating evidence can rule out the possibility that some contradictory evidence will turn up in the future.

We are all capable of acquiring knowledge but we can never have enough knowledge to allow us to base all our decisions on knowledge. It follows that if a piece of knowledge has proved useful, we are liable to overexploit it and extend it to areas where it no longer applies so that it becomes a fallacy. One known fact today is that even in the age of information technology no society can have perfect information. No one person can likely understand everything. And even if they could, it would influence their interaction inside and outside the marketplace.

Maybe there is a predictive market model but we just don't know it. After all, we have imperfect knowledge.

I believe that George Soros -- him again -- coined the phrase a 'fertile fallacy' -- meaning that imperfect knowledge creates first a self-reinforcing cycle and then a self-defeating cycle. It is how bubbles are believed to manifest.

Market prices always distort the underlying fundamentals; mistakes can become "fertile fallacies" and change reality in a feedback loop, causing bubbles.

Cyclical behavior of boom-bust is understood by most now. Rational behavior becomes irrational in the thickening of the maddening crowd until the crash wakes us from the insanity. We understand it but we still can't predict when the cycle collapses. The very reality that we get it alters our fertile fallacy. It invalidates it.

Now if I haven't lost you all, I would like to say I believe that markets move in and out of balance on varying temporal horizons naturally. They overshoot and undershoot but become excessive in nature in a systemic way only when they are deliberately distorted.

Intervention in or manipulation of markets by the state is such a distortion. Its acts postpone the day of reckoning for years or even decades. It creates false sense of equilibrium that ultimately gives way to disequilibrium and heightened instability. We have not experienced free markets -- that is, the invisible hand -- for decades. The recent failure of markets to predict uncertainty was not a failure of free markets but a failure of fiat money and socialism.

Niall Ferguson, the monetary historian, eloquently wrote: "Financial markets are like the mirror of mankind, revealing every hour of every working day, the way we value ourselves and the resources of the world around us."

What he should have said is that financial markets are the mirror of state intervention, revealing our every hour of labor confiscated, our lack of personal ownership for our decisions, and the resources the state absolves us of.

I sound disillusioned. Well, I am. I still love the marketplace but one has to understand the beast. I would like to share with you some of the facets that I think make a great trader.

By the way, I am not there yet, and maybe it's inappropriate of me to muse on this topic, but I think it could be provide you with a useful insight into market behavior.

The most profound comment I ever read about markets was this: "Everyone ultimately gets what he wants from the market." This absolutely leapt out at me. I will repeat this: "Everyone ultimately gets what he wants from the market."

Ed Seykota was the name of the trader who made that comment in a famous trading book called "Market Wizards."

Ask any trader what he wants out of the market and the resounding answer would be "money," materialist heathens that we are. It's the product of our trade, so success is measured by how much money we make. It shouldn't be; it should be the return adjusted for least volatility. But Seykota was spot-on.

At a subconscious level every trader gets his just wants, and it usually isn't money. I have sat next to traders who love to trade feverishly. They like the excitement. They make lots of money really quickly, and then become inured to the rush of making it and then they lose it. I would say they lose it deliberately, but at a subconscious level. They need the thrill and angst of making it back. Others like to make it and lose it and then wallow in pity because they receive more attention. Then they repeat the process. What they crave is excitement and attention, not the money.

My Achilles' heel, among many, is that I am ambivalent about money. I know that for me nature, friends, and family are ultimately worth more. I constantly juggle this conflict. But if I didn't enjoy it I would stop.

To be a great trader, at a generic level, the truth is: Do what works for you and not what anyone else does and thinks. Take responsibility for all your actions, good and bad.

Specifically, four points that work for me:

- Patience. Patience to wait for the right trade and then stay in the trend.**
- Impatience. Cut your losers early.**
- Intuition. Know if you have it (listen to your inner self) and trust it.**

-- Flexibility.

I helped develop a system model we employ at Hinde, and, if truth be told, it's not perfect for me as it's not my model alone, but what it has done is help generate good money management. Survive to live another day is the key.

I believe that trading takes a peculiar mixture of conviction and flexibility. Conviction to know you are right and flexibility to say no, I am wrong. Bear in mind most traders' win-loss ratios are 55-45. That is a lot of wrongs you have to deal with. It illustrates how risk management is key.

Like all human endeavours it taps into the creative element, which is why I want to mention Michael Steinhardt. I have never met him but he is considered a legendary investor, again immortalised in the book "Market Wizards."

He returned more than 24 percent annualised over some three decades, with, I assume, low volatility of returns. He developed the concept of "variant perception." I want to share his concept of "variant perception" and his ability to challenge the status quo.

The theory of variant perception is best explained when I recount Steinhardt's own words. He said:

"A summer intern reminded me years later of the advice I had given him on his first day at work. I told him that ideally he should be able to tell me, in two minutes, four things:

"1. The idea.

"2. The consensus view.

"3. His variant perception (a well-rounded view that is meaningfully different from consensus view).

"4. A trigger event.

"No mean feat. In those instances where there was no variant perception I generally had no interest and would discourage investing."

Financial markets are truly beguiling and as I have mentioned they have an equally beguiling end product -- money, which affects us all. It shapes our lives, for many of us our every waking thought. If asked, most people will always say, "I want more money." Even popular music today captures the wishes of the masses. Travie McCoy's opening line to his song "Billionaire" says it all:

*I wanna be a billionaire so fricking bad,
Buy all of the things I never had.
Uh, I wanna be on the cover of Forbes magazine,
Smiling next to Oprah and the Queen.*

Twenty years ago, according to the Forbes Rich List, there were 140 billionaires. Three years ago there were almost 500. This year there are close to 800, each with an average

net worth of \$3.3 billion. Why the surge? The "invisible hand"? No. Animal spirits? I doubt it. Did the world just get eight times more get-up-and-go? Hardly. So what then?

Money -- that's what.

Globally, living standards and wealth have been on the rise even for the poor, primarily based on "cheap" or "easy" money. Debt has been offered at low interest rates. All this debt is money -- money that has funded an illusion. No wonder people are buying gold.

And what should you make of the recent stampede to own gold? A detached observer might be puzzled by the obsession to own the yellow, shiny stuff. Warren Buffett once wryly observed, "It gets dug out of the ground in Africa or someplace. Then we melt it down, dig another hole, bury it again, and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head."

Buffett's response is too smart by half. A Martian would be equally puzzled to see humans cut down a hundred-dollar tree in order to pulp it, turn it into paper, print numbers on the paper, and pass it off as bills worth \$1 billion.

Gold's antagonists claim that gold is a Ponzi scheme. Its value continuing to rise, they say, depends on people willing to buy it at higher prices from previous buyers.

This is to misunderstand the nature of gold. It is not just another commodity. Gold was once money and no doubt will be again. The last four decades are the blip in time when money has not been backed by gold.

All this you know, but now you know I know. We're back to those "unknown knowns," aren't we now?

People always say to me gold has gone up a lot and so it's too high. I always reply that gold has a price and a value. These two constructs are not interchangeable. Price is a level at which you make an exchange, and value is whether it is worth it. Right now gold is at a high price, but when examined in the context of other assets, it remains undervalued -- primarily against paper money.

As gold's value rises -- or, more accurately -- as paper money's value falls, what we are seeing is an incremental return of gold to a monetary asset. The fact remains that the subtle confiscation of your day's labour by issuing printed money has only begun to dawn on the populace. They are only just waking up to gold as money.

Governments today are struggling with thumping budget deficits and unfunded liabilities, so the risk of further money printing looms large. With gold already undervalued, its outperformance will only accelerate.

A German banker once said that gold normally trades like a commodity. But he also said that when investors lose confidence in currencies, because the pool of gold is so much smaller than the pool of currencies, demand for gold can effectively become unlimited.

He is spot-on. When individuals obsess about the validity of money, they lose faith in government. Their discarding of money in such a situation is akin to an increase in the

money supply, which is an inflationary event. Hyperinflations such as these are thus a political event, not only as government will be deficit-financing but because people have made a statement about government. After all, fiat money is by decree of government, not free markets.

I am also often asked how high I think gold will go -- as if I had answered the riddle to the uncertainty model. My prediction is: How low can money go? How many zeros can you put on a piece of paper -- that is how high gold can go. In Hungary the pengo was denominated in 100 quintillion. That's a lot of noughts per ounce of gold.

My personal framework is that we are experiencing the invisible signs of inflation, which manifests from the issuance of global sovereign debt. Professional pundits like to polarize the world between deflationists and inflationists Richard Cantillon noted that the supply of credit and money does not work its way uniformly into the economy. Government cannot control where the money flows.

I predict with uncertainty that encumbered asset classes such as housing will in real terms go nowhere. In nominal terms they may even rise. But areas with a small float of stock -- certain commodities -- such as silver, gold, small-cap emerging-market stocks -- will rise in nominal terms tremendously. My only concern is that the market is embracing this concept, but far from me taking a contrarian position here, I believe that the feedback loop will self-fulfill this eventuality.

On that note: On the way over I read a great little book by Gustav Le Bon called "The Crowd" where he observes the behaviour of the masses. He introduced the Law of Mass Action or Mentality: When it comes to the effect of social behaviour on the intelligence of individuals, $1 + 1$ is often less than 2 and sometimes considerably less than zero. People are unpredictable.

Nonetheless I want to give you my variant themes:

-- Japanese stocks are the most unloved in the world. Small-cap stocks in Japan will skyrocket in years to come, but then they would, as I see hyperinflation there in the next five years. Question: What was the best-performing stock market in 2008? It was the Zim Industrials in Zimbabwe -- up more than 30,000 percent in nominal terms, initially far outstripping inflation.

-- The Swiss Franc as a bastion of safety is a fallacy. They too are debasing their currency.

-- Turkey: the Ottoman Empire will return. Great enduring demographics and entrepreneurial spirit.

-- Mongolia will surpass Japan in GDP on a PPP basis.

Not since the arrival of the Gutenberg printing press has humanity been so challenged by the printing of notes. Oh, the irony -- Gutenberg was himself a goldsmith by training. I am sure that he could never have envisaged the abuse the financial printing presses would have on mankind's development.

***Ex scientia pecuniae libertas.* "Out of knowledge of money comes freedom." I echo these sentiments but it is the duty of all of us to create more awareness of monetary theory and with it of markets. The CMRE and GATA are wonderful forums for truth and action, but they both will need to broaden their audience. I hope I can help.**

Remember: Just because the sun rises in the east and sets in the west doesn't mean it always will. That, I know, is unknown.