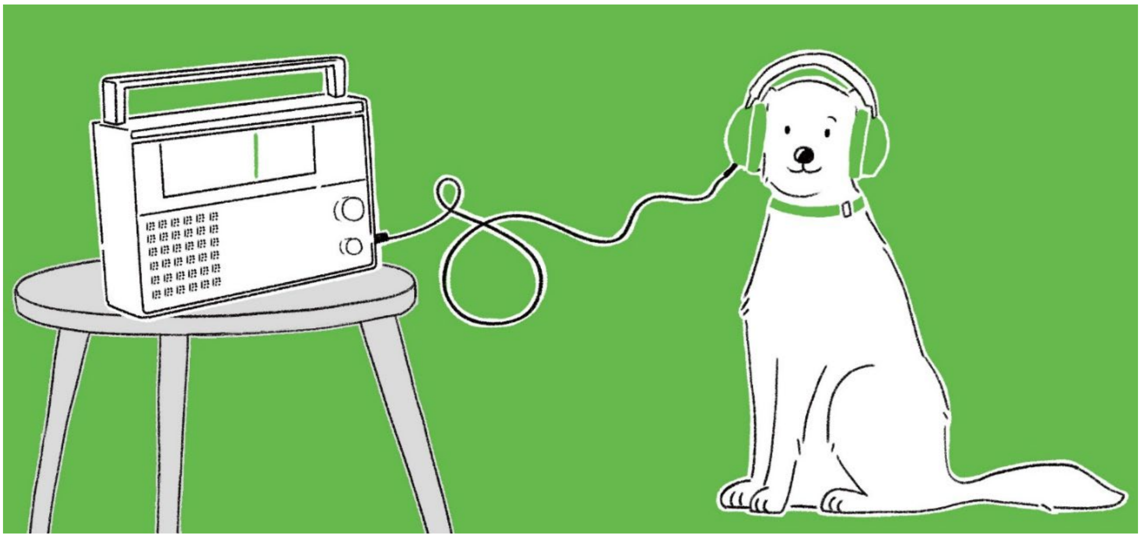
Ruffer Radio

Episode 22 – Leaving the pack



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Rory McIvor, Director – Markets and Communications

Welcome to Ruffer Radio, a series of podcasts in which we explore the investment universe and share our interpretation of what's going on. At this time of the year, we are spoilt for choice when it comes to sporting events, from which we can derive some vaguely illustrative analogies to help explain market dynamics. So, as we're approaching the midpoint of this year's Tour de France, let's see if we can get something out of that. Now, there's the obvious lesson about stamina and endurance, essential traits undoubtedly for the long-term investor. Then there's something more tactical altogether, which boils down to the decision to either stick with the peloton or ride out alone in the hope of avoiding those terrible pile ups. Now, for much of the past 18 months, the Ruffer portfolio appears to have been riding out on its own. Certainly, it has owned assets very different to the herd and it's been riding into some strong headwinds. So is now the time to rejoin the pack or to keep pedalling, keeping faith in the tactics and in the toolkit? Today I'm joined by Fund Manager Jasmine Yeo, who's going to share her thoughts on Ruffer's ride in the year to date. So, Jas, what have we actually learned in the first six months of the year? It feels like quite a lot has happened, but not a lot has changed.

Jasmine Yeo, Fund Manager

Well, we've learned that, I guess, markets are still hugely sensitive to inflation. That definitely remains a key driver for investors, clearly because of the knock-on implications that's going to have interest rate policy. Basically, how quickly can central banks start cutting interest rates? If we go back to the start of the year, investors were so confident about disinflation that they expected six or seven interest rate cuts in the US this year. But as time has gone on, there's been a bit of reality check, so the expectation is still disinflation, but slower. Progress than initially thought. And there's now just two interest rate cuts in the US price for 2024.

Rory

And that is a remarkable rethink. And for it to have happened without causing any real market turmoil is even more remarkable still.

Jasmine

Well, it didn't really happen in a straight line. So the first few months of the year, you had a great sort of Goldilocks just right scenario of robust US economic growth, but not persistent inflation. And that's really why you saw risk assets rally pretty strongly at the start of the year. Then in April, you had a much less friendly market backdrop. So there weren't any signs that the US economy was actually going to slow down. And then you had also geopolitical escalation in the Middle East, and that had an impact on the oil price and that led to greater concern around inflation and the impact being higher for longer interest rates, potentially. And that was an interesting reminder of how painful it can be when you have bond and equities falling together, because that's what happened.

Bond yields went up, their prices went down, and the S&P fell about 5% in three weeks at the start of Q2. And that was a bit of a hark back to 2022. And it reminded investors, I think, of the need for uncorrelated return streams. In the case of the Ruffer portfolio, we look to our derivative protections. I guess the other thing is that the market found its feet quite quickly after that April wobble, basically because the Fed came out and said they're not going to raise interest rates. You also had some help from good corporate earnings, calmer geopolitics, eventually better inflation data. But without rambling on, bringing that all together, what's interesting, I think, is despite the fact that markets think you'll have fewer rate cuts this year than you did at the start.

So that kind of wobbly journey from seven to two rate cuts. Equity markets, particularly in the US, have powered on. And the S&P, the Nasdaq, they're all at record highs at the moment. And that's despite still ongoing geopolitical uncertainty. The announcement of snap elections on both sides of the channel, which we've now had, volatility is at record lows. And it all comes back to why we continue to be concerned that asset prices are yet to adjust for this higher interest rate environment.

Rory

So the portfolio is a living and breathing thing in a constant state of adaption. What practical things have you changed in the portfolio? And how is the portfolio adapted to all of the new information that we've learned in the last six months or?

Jasmine

So, year to date, for example, we've been quite dynamic in our precious metals exposure. So trading between gold bullion, which also hit record highs this year, between that and gold mining equities, for example, we've also had some silver exposure this year in our inflation linked bond exposure. We've switched some of our UK inflation linked bonds into US inflation linked bonds because of an attractive relative inflation adjusted yield there. And the portfolio has been much better at delivering balance this year. So we're currently carrying very similar, if not more, actually protection in the portfolio than we did last year which is certainly a better outcome than 2023. Part of that is because we've had a slightly higher equity exposure. But crucially, it's because protection is a lot cheaper at the moment.

So investors are far less fearful than they were at the start of last year. And as I mentioned, some measures of stock market volatility are all time lows. And that's important here, because volatility is a key input into the price of some of that protection. The other thing is that our offsets have been working nicely. So in an environment where some of the core protective assets in the portfolio are vulnerable, typically that's been in a rising bond yield environment. When you have a stronger economic backdrop, which we've discussed, that's been good for things like oil, copper and other commodities that we've got exposure to, that's worked well this year. So if we want to keep going down this analogy track, the portfolio is going a bit faster, but we're confident to do it because we've got a good crash helmet.

Rory

Always pleased to extend the analogy and let's see just how far we can take it over the course of the next six or seven minutes. So, Jasmine, the view remains that this is very much a market worth insuring against, and you've touched on some of those protections. But is there anything else that really bolsters the portfolio in the moment?

Jasmine

So, a key protection, for sure, is the yen. Jonathan mentioned this on his most recent review. We continue to think that currency is undervalued and it's an attractive way to profit from lower interest rates in the US. That too should benefit the Japanese currency, as the relative gap in terms of interest rates closes between those two economies. And we think it's a dynamic that could be accelerated if you get a shift in the policy stance from the bank of Japan, who recently been making a lot more noise about their concern for a weak yen. So, politics driving some of that, there's certainly some motivation there. I also think the yen is going to work well in the portfolio against a period of financial stress if we get one. Japanese investors own huge amounts of us assets, particularly us credit.

So if you do get some sort of concern there, you're likely to see those investors become sellers. So selling those assets, it means they're selling dollars and therefore buyers of yen in a crisis type scenario, that's in and amongst credit protection, which we talked about before, basically assets that will benefit from corporate borrowing cost rising, which are very likely to see if you either get just a period of market stress or deteriorating fundamentals. Real bang for your buck in this type of protection at the moment, credit spreads, which are sort of a measure of corporate borrowing costs, they're at the narrowest end of their range over the last decade, really. And that's alongside the equity protection S&P puts, volatility, call options.

All in all, a whole basket of protections that really emphasises the importance of having lots of different exposures of this type in the portfolio. We're not just relying one. We've got sort of various tools in our puncture kit.

Rory

Now with markets, equity markets in particular, having done what they've done certainly over the course of the last six months. But actually over the course of the last two years, there's been an opportunity cost to being invested in Ruffer. And I know very few investors hold Ruffer for beta or just market exposure. But I guess the question for me, Jasmine, is will it be worth the opportunity cost for those investors who have held onto Ruffer and missed out on what looks to be relatively easy equity market gains?

Jasmine

Our history and our track record suggests yes. It's clearly been painful in the run up, but we've always been too early. So Ruffer has been running this strategy for 30 years now. There's been several periods where that prudence has ultimately been rewarded. But in 2000, were about 14 months early, as Jonathan again points out in his Review, 2008 so the global financial crisis, I think about two years early, Covid 2020, at least two years. And clearly at this stage, we're 18 months at a minimum ahead of time. But as I say, that has ultimately been rewarded. But it's not just in the moments of crisis, it's also the aftermath. We expect the portfolio to deliver very attractive returns in a risk off environment.

But then, crucially, we're going to want to pivot the portfolio and drive a second leg of returns by capturing the opportunities that any type of sell off potentially represents. And I guess it just comes back to our aim, which is to offer something truly differentiated, something beyond or certainly different to market risk. And if our caution ultimately is unwarranted, we have got 25% in equities, we've got an oil and commodity exposure, which we've touched on. We've got lots of interest rate sensitive assets which ultimately are going to benefit if we do get interest rate cuts in the US in that more benign scenario. And of course, we've got plenty of cash to redeploy. I think the trouble, though, is that large parts of the equity market, and certainly investor portfolios, are already positioned for that benign outcome. Where we see much more exciting opportunity is in some of those uncertainties breaking.

Rory

Now, without a doubt, the Ruffer portfolio seems to have strayed a long way from consensus, both in the actual portfolio positioning, but also in the views that you're expressing. Jasmine, what are you saying that the world isn't?

Jasmine

It's not that we've got x-ray vision. In fact, lots of investors are seeing and discussing the same risks that we see. It's just that it's not really yet reflected in their positioning. So what's a tangible example of that Bank of America fund manager survey great insight on a quarterly basis into what global fund managers are thinking, but crucially, what they're actually doing now. The most recent survey found that 70% of the global fund managers thought that the magnificent seven was the most crowded trade. So there's definitely a lot of concern out there. And yet half of those same participants expect the large US growth stock, so basically the same companies to lead the market higher still. So you've definitely got an indication of unease and uncertainty.

Yet there's also a lot of confidence in a benign outcome, so much so that these global fund managers are willing to position their portfolio that way. And I do think that combination of uncertainty, plus the fact that we're still in this higher interest rate world, albeit dependent on the path of inflation, you have now certainly got some very lofty valuations in the case of the US, plus some extreme positioning in certain areas. That's all a pretty dangerous combination, I would say.

Rory

Now, the cynic in me, Jasmine, would say that you and Ruffer more broadly, are permanently bearish, and this view of a market collapse is entrenched in the investment approach and indeed the investment process. Is that the case?

Jasmine

My friends call me a realist. Is that the same as being a bear?

Rory

Yes, I'm sure they call you a realist to your face.

Jasmine

I don't want to hear the truth. No, look. So I think it comes down to a different starting point. For most investment managers, the starting point is typically a conventionally taking risk to maximise opportunity, and then as a secondary layer, thinking about hedging or some sort of protection as an afterthought to mitigate potentially some of those risks, we invert that traditional approach. So the starting point for us is always, what are the dangers? What are the risks out there that we need to protect investor capital against? What assets can we own that will deliver returns if those risks do occur, and only once we've built a portfolio we think can achieve that, do we start to think about maximising returns. If we're scanning the horizon constantly for risks, for dangers in the investment landscape, some of them actually aren't that difficult to spot.

But it is why we're very often talking about these dangers and these risks. I also think, though, it comes down to a belief that this starting point or this lens does drive an attractive long-term return profile in the fullness of a market cycle, it also delivers a much smoother journey. If we're looking to spot and mitigate those risks, we don't suffer the same large drawdowns. And that's particularly valuable for investors who perhaps need access to those funds. But it also provides a lot of optionality in an environment where assets are falling because we can become buyers when others are fearful. And that's really a key part of what's driven our returns over the long term.

Rory

Just to finish, Jasmine, looking out into the second half of this year, what are you casting around for? Whether that be opportunities or risks? And how are you thinking about the rest of 2024?

Jasmine

There's lots of things that clearly we're looking at definitely the path of inflation. Do we get this immaculate disinflation that investors are hoping for, that kind of goldilocks of falling inflation, but without recession, I think our bias is disinflation does continue, but not all the way back to 2% so easily. Or if it does get there or even below 2%, it's going to because of economic weakness. To that point, can the us consumer hold up? They've been remarkably strong, but we are starting to see bifurcation now, where sort of the top end of US consumers, those that have asset portfolios own their houses, are experiencing above inflation increases in pay. They're doing very well still, but at the lower end, you are starting to see interest rates bite.

And you can evidence that by looking at credit card delinquencies, auto loan repayments, for example, liquidity, which is another lens through which we analyse sort of the market environment, effectively the amount of money available to financial market participants. That was a massive driver for good asset price returns last year. It was in abundance, I think an absence of positive news here, which is pretty likely given ongoing quantitative tightening. Elections this year are going to limit the ability for a significant amount of fiscal support. That's basically unlikely to provide the release valve that it did throughout last year, and really any of those things. So inflation, economic fundamentals, liquidity, or indeed a macro shock from any other vulnerability like geopolitics, maybe that's the rider that causes the wobble and costs you the yellow jersey. I don't know, but we're certainly thinking it's worth insuring against.

Rory

Jasmine, thanks very much for joining us today.

Jasmine

Thank you.

Rory

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