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A View from the Bridge

"It's not rising prices that worry me – it's falling ones"

As the summer draws to a close, we hope that those of you who require an annual fix of sunshine but have yet to fly off in search of the sun, have at least already brought your euros or dollars as the falling price of sterling is making those evening cocktails, rather more expensive.

Our first article perhaps focuses more on rising prices but in the longer term the inflation/deflation debate remains alive. In our second article, we return to the subject of 'behavioural finance' and consider why a focus on fundamental analysis can, in the short term, be blown off course. Our third article is rather less serious and even contains a tip or two which might help you win your next game of Monopoly!

Some of you may have noticed an increase in the number of unsolicited investment-related letters, telephone calls and emails. Known in the industry as 'Boiler Rooms' the organisations behind these communications are scamming people in the UK to the tune of between £200m and £500m a year. Once on the phone, they can sound highly professional so please be on the look out and do contact the FSA or Taylor Young if you have any doubts.

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Three views on inflation

"Answer me this one guv. If inflation is about rising prices, why is the price of my house going down, the price of my car going down and the value of my pension fund going down? It's not rising prices that worry me – it's falling ones." *London cab driver*

Amid news of a rise in inflation, with the level of the Retail Price Index rising over 5% in the year to the end of July, it may be odd to focus on falling prices. Nevertheless, the cab driver has a point. Some prices are indeed falling – it is just that for most people, they are the wrong prices.
A rising housing market and a rising stock market provide a warm feeling of increasing affluence to householders and investors whilst higher gas bills, council tax and petrol produce precisely the reverse effect. The annual rate of increase in the category of utilities, which encompasses energy and water bills, was a massive 17.2%, with food price inflation the second biggest riser, up by over 12%.

If such increases were limited to areas such as household goods or electricals, consumers could easily defer purchases until market conditions became more benign – it is the fact that **essential** goods and services are the fastest risers that renders the current inflationary situation particularly miserable.

But what if the taxi driver was right, and that the inflation that we are currently experiencing is just a temporary phenomenon? Interestingly, in the United States there has recently been a large swing in longer-term inflationary expectations. At the beginning of July, the market expectation for average inflation over the next 10 years was over 2.6%. It has now fallen, in a matter of a few weeks, to below 2.2% – the lowest level since 2003. A major factor in this change in sentiment has been the rapid decline in the price of oil from a peak of $147 per barrel; indeed, if a bear market can be defined as a fall of over 20% from

a peak then oil is currently in such a bear market – not a commonly held view recently.

Could this also be true in the UK? It is certainly the case that although there are inflationary pressures from rising input and energy costs, there is currently little upward pressure on wage-rates – the so-called 'demand pull' component of inflation. This is to some extent a factor of the weakening power of organised labour within the economy. Trade Union membership peaked in 1979 at over 13 million but, since that time, numbers have been falling steadily to around half the peak figure, with the major concentration of membership in the public sector. It is thus more difficult to envisage a 'wage-price' spiral, where higher wage demands chase higher prices, developing in the way that was seen in the early 1970s. What may be seen as a throwback to those days is a rise in unrest in the public sector as the government seeks to clamp down on the annual pay round review. Cost of living related pay increases at current inflation levels will place an even greater strain on an already stretched exchequer but any attempt to impose a pay round at less than cost of living will undoubtedly encounter severe union hostility. The ball is very much in the government's court here, and it will be interesting to see whether much attention is paid to a second view on inflation:

"Inflation is always, and everywhere, a monetary phenomenon" *Friedman and Schwartz: 'A Monetary History of the United States 1867–1960'*

As long ago as the early 1960s, Milton Friedman was arguing that only governments, who have control over credit and monetary creation, can cause inflation. Excess monetary growth, where too much money chases too few physical goods results in inflation whilst deflation and depression, as experienced in 1930s, resulted from the failures of central banks to boost money supply during a severe downturn. At the moment, central banks and governments are walking on a financial tightrope – wanting to curb the monetary excesses of the past few years but fearful of provoking too fierce a 'credit crunch' that would tip the major developed economies into a recession.

In some ways, a recession is harder to deal with than inflation – Japan's economy has been struggling with depressionary tendencies since the early 1990s – as once interest rates have been cut to minimal levels to help boost economic sentiment, they can be cut no further. This is the 'liquidity trap' mentioned by Keynes, which has been likened to trying to push on a piece of string. Consumers and businesses cannot be compelled to invest and spend – economic recovery requires governments to take the lead in 'priming the pump' to stimulate growth which will encourage consumers and the private sector to follow suit.

So, in theory, governments and central banks could contain inflation through a fierce monetary squeeze which would have the effect of dampening down growth and causing unemployment to rise, neither of which are likely to be popular measures. Deflation, or falling price levels, produces difficult decisions such as those related to benefit payments related to the cost of living – can any government **cut** pension payments if prices fall? Probably not. Although it may seem unlikely, it is possible that deflation rather than inflation will be the problem that will need to be tackled some time next year; after all who, six months ago, was forecasting inflation at 5%? In that case, our London cab driver's fears could be well-founded and falling prices and sharply rising unemployment may be the dominant concerns later in 2009.

This has all been rather depressing, so for a rather more upbeat comment on inflation the third view comes from the well-known politician and diarist Alan Clark:

"all the indicators were bad for this year, and inflation would still be at 8% in November. Personally I wonder if it matters all that much. It's still a million percent, or whatever, in Brazil and you can still get taxis and delicious meals. Sex doesn't stop." *Alan Clark diary 20/2/1990*

Now **that** makes for a more interesting view.

Why do market participants overpay?

What drives market prices? Is it their fundamental value or does human behaviour play a major role? These questions are more timely than ever in the light of the volatility that has been endemic in capital markets over the past year. The massive 'consensus trade' consisting of an overweight position in mining stocks and a large underweight in financial companies suddenly unwound in the middle of July, wrong-footing a substantial number of major global trading funds. In today's markets, where 'short selling' of shares dominates the headlines we take a step back and attempt to analyse two questions. The first is whether it is possible to identify and measure the fundamental value of a financial asset; the second, slightly more controversial question is to examine how human behaviour can potentially influence asset prices. In other words, assuming that we knew the theoretical fundamental value of a financial asset, would this mean that market participants armed with this information could still be tempted into overpaying?

Let us first focus on the views of a very successful practitioner towards our first question – whether it is possible to establish the fundamental value of a financial asset. George Soros, best known for 'breaking the Bank of England' on Black Wednesday in 1992 has, since then, written a series of books and developed his own theory about how the markets operate. In some cases, Soros rejects the existence of a theoretical fair equilibrium price; his approach is based on the idea that individuals introduce their own bias into the markets in which they operate and are thus partially responsible for changing the fundamentals of both the economy and market prices as a result. He replaces the assertion that the markets are always right with the concept of 'reflexivity', arguing that the thinking and actions of market participants are not independently given but are contingent on their own decisions.

If we now turn to our second question, the issue arises that even if we knew the fundamental value of an asset, would this necessarily deter us, as human beings, from overpaying? In an early edition of the 'View from the Bridge' we introduced the concept of herd-like or 'behavioural' investing. It has been alleged that human behaviour has an impact on the overreaction of financial asset prices versus their fundamental values, but, since economics has been viewed as a 'non-experimental' science, performing so-called 'controlled' experiments and making specific deductions from them has traditionally been considered invalid. The argument was simple in that it had been thought impossible to reproduce in a 'laboratory like' environment all the factors that affect the financial decision-making process. Whilst it is true that financial markets are very complicated, experimental economists proved that by allowing a relatively small number of individuals to transact, basing their decisions on a known set of 'predesigned' laboratory-like rules, one can perform experiments and gain useful insights into the behavioural aspects of trading. A pioneer in that field, Vernon Smith (who together with Daniel Kahneman won the Nobel Prize in 2002) focused on the mechanisms that induce financial bubbles and drew some very interesting conclusions.

Firstly, the behaviour of financial participants can have a material impact on traded prices. So-called asset price 'bubbles' are assumed to form since it is difficult for market participants fully to assess the fundamental value of any particular asset or groups of assets. But what should happen if the fundamental value of an asset is known? One should, theoretically, anticipate that the price of the asset will always trade fairly near its fundamental value, with an allowance being made for small random 'noise' or non-correlated market movements. If an asset is worth $15 now and pays $1 at the end of each of 15 periods, this should mean that the value of the asset will trade close to the straight line connecting $15 now to $1 at period 15. Amazingly enough this is not the case. In his experiments Smith showed that traders sometimes pay $12 for an asset that, by construction, will pay them at most $7. Why is that? Given the lack of uncertainty regarding the intrinsic value of the asset, the overshooting in the price the traders are willing to pay has to do with the anticipated behaviour of their counterparties.

Secondly, 'practice makes perfect'. Using the same types of experiments, economists showed that a group of 'experienced' traders consisting of people who participated in two previous experiments were less keen to overpay or underpay substantially and thus less likely to exhibit behaviour which would lead to busts or bubbles. It can be argued that the high turnover in personnel in many financial institutions and the resulting lack of trading experience is one of the reasons why markets may tend to overreact both on the upside and the downside.

Thirdly, excess liquidity is a key component in 'inflating' bubbles – and possibly also 'deflating' them. Intuitively it makes sense that a bubble may develop if more money is competing for the same amount of financial assets. These days we read a lot about the amount of money shorting stocks in the market. More and more market participants are using short positions to profit from their 'negative' views. According to data compiled by the financial news system Bloomberg in the middle of August, investors worldwide were betting more than $1 trillion on a collapse in stock prices. This is a new factor in capital markets and is possibly a major factor in explaining why the stock market has seen such a marked bounce since the middle of July.

In conclusion, where does this leave us? We cannot ignore the behaviour of market participants when we seek to allocate assets between the various asset classes on behalf of our clients. At the same time however, we need to make sure that we are not carried away with the latest short-term market trends. Our thematic approach, whereby we focus on long-term fundamental market drivers, serves as a useful compass and barometer which greatly assists us in navigating our way through volatile markets, whatever their conditions.

Monopoly – past, present and future

No, this article hasn't escaped from the 'Economic Journal' or some other worthy and learned publication. It arises from the fact that Hasbro, the manufacturers of the well-known board game, now offer a bespoke facility where it is possible, for a payment, to customise your own board and use your own selection of property, utilities and stations. It has been estimated that perhaps 750 million people have played Monopoly since it appeared in the mid-1930s, making it arguably the most popular commercial board game in the world. After over 70 years, however, it is perhaps worth

speculating on how much London, on which the original John Waddington version was based, has changed and what a more up-to-date version might feature.

On the original board, the configuration of London is most curious. It extends a little in all directions except the west, where the outer perimeter is bounded by Park Lane. There is also, apart from Liverpool and Fenchurch Street Stations, no property at all in the Square Mile – an obvious omission in so entrepreneurial a game. A modern version would surely redress this with sites such as the Barbican, Broadgate and – a prized square surely – Canary Wharf. Another throwback to a past age is the existence of the Electricity Company and Water Works – perhaps the introduction of RWE and EDF, the respective owners of Thames Water and London Electricity would emphasise London's position as a dominant European Capital?

The days of 'Free Parking' in the capital are long over, so a 'Congestion Charge' payment – with some offsets – would be appropriate. The player with the racing car might also suffer a specific penalty by drawing a specially targeted 'Chance' or 'Community Chest' card with a swingeing fine for overlooking daily payment. Given the overcrowded state of the jail system today, three doubles in a row might not now mean immediate incarceration – a 'tagging' order missing three or four rounds of play could be an option.

There must be many such ideas for bringing so popular a game into the 21st Century. However, if only the site names change and the rest of the game remains broadly unchanged, the key strategies for successful play should remain the same. Here is where the investment analysis comes in, for which I am most grateful to Mr Jim Slater, one of the founders of Slater Walker, who has made a profound study of the game.

The key sites for a player to obtain are the Orange trio in the top left corner of the board, where the returns on hotels relative to capital invested is 141%. The next most attractive set is the light blues, next to the 'Jail' square at the bottom of the board which has a higher return at 159%, but which are somewhat less likely to be landed on. The four stations as a group are also a compelling investment, but the utilities in general should be avoided. The worst set is the green set – Regent Street, Oxford Street and Bond Street in the old format, where the comparable returns are just 101%.

Perhaps, though, Monopoly is just an instinctive game for a natural businessman. Jim Slater relates the story of the high profile Monopoly game in which he participated which was easily won by Sir Jack Cohen, the founder of Tesco. The rules were only explained to him the night before by his chauffeur!

Please send your views and comments on any of the articles above to Nick Rundle at:

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