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investing ON THE go

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. Today we're discussing genuine protection in times of market stress with the LF Ruffer Diversified Return fund, an extension of the wider Ruffer investment strategy.

Chris Salih (CS): I'm Chris Salih and today we're joined by Ian Rees and Duncan MacInnes manager of the Elite Radar LF Ruffer Diversified Return fund. Thank you both for joining us today.

Duncan MacInnes (DM): Thanks for having us.

Ian Rees (IR): Yeah, likewise, good morning.

[INTERVIEW]

CS: Ruffer as a firm has a sort of safety first approach to investing and you guys often use the analogy of being like a tractor on the motorway plotting through the slow lane, which is a very good analogy if I might add one in there, but could you maybe explain that philosophy a bit further for us?

DM: Yeah, I'll start with that one. So the Ruffer philosophy is one of what I call all weather investing. So what does that mean? It means trying to deliver consistent positive returns regardless of what's going on in the market or the economy. And I always think of this old quote from the economist John Maynard Keynes, who said it's about trying to be roughly right than precisely wrong. And I think that's the way that we think about building portfolios.

Now, the tractor on the motorway metaphor is from Jonathan Ruffer, our founder. I think it's a little bit like the old tortoise and the hare fable that we all know. And the idea is that sometimes investing with Ruffer can feel like being a tractor on a motorway, and you're being overtaken by flashy sports cars on occasion. But when the weather turns in climate and the road is icy and dangerous, you often find that the sports car ends up in the ditch and actually the tractor sort of floods along unperturbed. So really it's about consistent positive returns compounding over a long period of time. And that actually often, or almost certainly ends up with a better outcome than higher flashy, more volatile returns that are occasionally punctuated by large losses.

CS: Okay. And this is a sort of a new fund launch, the Ruffer Diversified Return fund. It's an extension however of the wider Ruffer strategy, which goes back the best part of three decades. Could you maybe talk us through that and why an absolute return fund was the best fit?

DM: Yeah, so it is an extension of the Ruffer strategy that's been going since the mid-nineties. So Jonathan Ruffer was the chief investment officer of Rathbones before he set up the firm and he had a couple of insights back then that I think now appear quite obvious, but they were quite novel at the time. The first one is that the investment industry is obsessed with benchmarking and relative returns. So we are deliberately un-benchmarked and we try to keep the menu of what we can own as wide as possible. We go anywhere. We invest in almost anything. We invest across asset classes and all geographies.

And the second insight that I think Jonathan had is what's now known as prospect theory, just Daniel Kahneman's idea that I think he want a Nobel prize for [in 2002], but the way that Jonathan sort of phrased that was clients like making money, but they hate losing it more. There is a real asymmetry to the way that we experience losses. You're much happier losing a hundred pounds than you are happy gaining a hundred pounds. So back in 1995, the phrase absolute return didn't really exist. But it has become much more popular especially post financial crisis. And then it fell out of fashion again, in the last few years because of some of the higher/larger funds feeling to deliver. But ultimately we've always been doing this idea of absolute return.

CS: OK. And then back when you launched the fund, you said that sort of traditional asset allocation models, and for those listening, that's the idea of having 60% in equities and 40% in bonds, will come under renewed stress, as inflationary volatility were rises, and portfolio construction is ultimately challenging. Could you maybe elaborate a bit more on that for our listeners and how that works in practice and what we should be sort of wary of going forward from here?

IR: Sure. I think what's important before we look forward, let's consider the world or the investment landscape that we're leading behind for the past three decades or so we've been in a world of what economists would call disinflation. So you have positive inflation, but the annual rate of change has been falling. And this has allowed interest rates to fall around the world. And it's created a very fertile ground for asset prices. Just look at the performance of bonds and equities amongst others over the last 30 years. But what's more important perhaps is not just the performance it's been that bonds and equities have been negatively correlated. And that negative correlation is what gives balance to that sort of 60/40 style equity/bond portfolio. But we think a period of higher inflation and more just the return of more uncertainty and economic volatility will provide a number of headaches for investors to consider.

We think that that higher inflation will end the three decade long bull market. And perhaps unsurprisingly conventional fixed income will struggle when inflation is rising, but we also think equities will face much stronger pressure than they have in the past. But the real key, again, from our perspective is the role of diversification. Looking back through time when inflation has been above 3-3.5%, the correlation between bonds and equities has actually been positive. So we're not talking about extreme levels of inflation. We're just talking what I would consider a bit of above target, really what we and other investors need to consider in this world is where are you going to find diversification if your bonds and equities are moving in tandem and as we fear falling at the same time.

CS: Okay. I guess we'll sort of take a step on from that. So how does this fund sort of fit into this new type of environment? You mentioned the diversification there, does that mean more asset classes? Just give us a bit more insight on how that works in practice within sort of under the bonnet of the fund?

IR: Sure. I mean, look at a very simple level, the fund we're aiming to provide low correlation to wider financial markets and provide investors with genuine diversification. That's what we're trying.

What are we doing? Well, our real concern when we talk about higher inflation is actually a period of financial repression. It's where inflation runs above the level of interest rates. So the real value of your capital is eroded. We think that would be a very, very difficult period for financial markets to absorb and to protect against this. We have holdings in inflation link bonds in the United Kingdom and via the United States, and also gold for a mix of bullion and gold mining equities.

I've spoken a lot already about the need for new sources of negative correlation or an offset. And here we're making use of less conventional assets, such as derivatives. And these can be very helpful from a portfolio construction perspective. We've used them in the past and continue to use them to reduce our interest rate risk, for example. And also we use them to protect against equity market weakness. These have been an evolution if you like that, you know, they are relative in new additions to our strategy over the last decade or so. And that's come out of a real need to find a new protective assets. We think that traditional havens, if you like, such as conventional government bonds, no longer provide investors with the protection. And we're needing to look for less conventional or common assets to provide that for the portfolio to appreciate. I went off of it now.

Also, you know, I might have sounded already that we some more bearish or pessimistic whilst, you know, that that may be the overarching tone. We do think there are opportunities within equities. The portfolio today has about 35% exposure to the asset class, but we think there'll be particular winners. We think those such as, you know, commodity companies, industrial financials will probably far better in a world where inflation is higher and we're seeing faster nominal economic activity.

And just one final point, Chris, if I may, we think it's as important to consider what you don't own in this world in a world where interest rates are held below the rate of inflation. We think the epicenter of where not to be invested is the conventional bond market. So government bonds, although we've seen yields move slightly higher in the last few months, we think, very much deserve the title of return free risk.

CS: Let let's try and sort of bring everything together then. So obviously we always hear on all these podcasts about managers, the importance of process and risk, but you guys sort of try to do something unique. You sort of look at the previous 100 years of data, I believe. And how does that work in practice? I mean, for example, things like wars or, I mean, the COVID sell off in 2020 the fastest in history. How does the fund sort of work to counter those sort of scenarios?

DM: Yeah, I think that, that's an interesting question because lots of the fund management is industry looks at historical data. I don't think many do go as far back we do. And one good example of that actually is to do with the bond equity correlation that Ian was talking about. Much of today's portfolio construction is based, on an assumption that stocks and bonds are negatively correlated. And that's because that's what the data says, but that's what the data says, if you go back only to the eighties, if you go back of the 1880s, if you include an additional century of data, actually most of the time in the last 140 years, stocks and bonds have been positively correlated. And that's the environment that we've moved back into. We think in the last, in the last little while, but more broadly than that scenario analysis is an important part of our investment process, it is important to state that it is, it is just one input into discussions. You know, it informs our discussions and decisions, but it doesn't drive them.

And I think what we do, how would I describe what we do? We stress test today's portfolio, but by running it through this analysis and seeing how today's portfolio would've performed in every major market event in the last hundred years or so. So hypothetically, how would today's portfolio have performed in the 1929 crash or in on black Monday in 1987 and, or in positive shocks, like the NASDAQ melt up in the late nineties or the commodities boom, in the early to mid-two thousands. And you can also do a sort of create your own disaster. So what would happen if the Fed raised interest rates by 200 basis points overnight and the oil price…

CS: Or a global pandemic?

DM: Well, exactly, exactly. Yeah. and, and what would the, the sort of consequences in that be? So you can, you can stress test the portfolio in all these different ways. And then we use that as a jumping off point for discussions. So for example, if today's portfolio would have an what we deem an unacceptably, large drawdown and the max drawdown on the strategy over the last 27 years is less than 10%. So that's sort of what we're talking about. If today's portfolio, would've had an unacceptably large loss in a scenario. So in a repeat of the Nikkei crash of 1989, you know, when Japan had its bust then we can talk about it and say, well, what do we think the likelihood of a rerun of that event is? And in that instance, for example, it's pretty unlikely because even today, the Nikkei is still down about 40% from where it was in 1989. And the valuations are completely different back then. It was the most expensive equity market the world had ever seen today. It's the cheapest, major global equity market in the world. So seems pretty unlikely. It's going to have the same type of crash, but so we can discuss the likelihood of a repeat of that scenario. And then from there we can discuss what we might want to do in the portfolio to protect or insulate or change the portfolio. So that we're no longer exposed to those risks.

CS: And just quickly, Duncan, you did mention it there. You do look at positive scenarios as well. And I want to emphasize that, this one isn't sort of just, the eternal pessimist fund, it does look for opportunities when they do arise.

DM: Thank you. Thank you very much for mentioning that, Chris. Yeah, we're sort of, yeah. I said to someone in a meeting yesterday, you know, same old Ruffer, always boring, always bearish. And I think that that's the stereotype and it's totally unfair. We are known as bears, as bear market operators, and that's because we've made money in the three big crises since the firm began the dot com, financial crisis and then the COVID crash, but we've made money in 26 of the other, you know, 26 of the 27 years that we've been around. So yeah, most years, nothing bad happened. Markets are positive and hopefully Ruffer is positive too.

CS: And just to lastly, obviously you are supported by a big team of 30 analysts covering both macro and micro focus or security selection. Obviously that's a lot of sort of potential options and voices. How does the team make decisions on where to invest in, to take advantage of opportunities? And maybe give us an example if you can.

IR: So really Chris, the key driver of returns at Ruffer is our asset allocation. It was the setting of that allowed us to deliver a positive return during the, you know, the dot com bust, the financial crisis, and actually make money in March of 2020. That is the key for, and this is set by a team of senior fund managers and members of the research team. And it's led by our chief investment officer, Henry Maxey and our chairman and founder Jonathan Ruffer building on what Duncan has said, really what we're looking for here in this meeting, what are the key risks? What do we need to protect our clients and investors capital against, you know, what are the assets for that?

But also what are the opportunities that we see, where can we make money more often than not at least in my financial lifetime, your times have been good and we need to participate in that.

You know, we're not hiding, waiting away. There's always a balance between sort of growth and protection in our asset allocation. So keep it at a high level once that, you know, portfolio structure is sort of set from the top, we then make use of our internal research team, quite 30 analysts give or take who are tasked with finding ideas to fill the portfolio. There's a mix between what you would call bottom up and top down decisions. So bottom up for, for anyone who who's not familiar is very much an idea, which is not driven by a sort of macroeconomic or, you know, a strategy view. For example, the bottom up idea today would be something like American Express, where our analyst has high conviction on what we think, the recovery of the economy will be, and the company's earnings growth potential.

So we'll always have some of those ideas, but the top down ideas are where the, some more closely connected to the asset allocation. So for example, today we have a preference to own economically sensitive equities, and, you know, a specific example, if you like, proof, how that's come to fruition would be where, we've tasked the research team or the analysts define what we think are the best expressions of playing the energy sector. So we think that energy will be a beneficiary in this new world, you know, rising demand, but also constrain supply. And we want to participate in that and the analysts, the tasks to go away also considering your ESG factors, what think are the best expressions to play that?

I think, you know, a couple of key points if you like, we have one strategy. So the analysts, all of their focus is just on that one approach. There are no conflicts in that regard. And also just the analysts always need to be mindful of the house view. So if you were an analyst pitching a UK banking stock in 2007, that wouldn't have made it into the portfolio.

CS: Ian, Duncan, thank you very much for joining us today.

IR: Thank you very much for having us Chris.

SW: The LF Ruffer Diversified Return fund is an absolute return vehicle which has the protection of investor capital at the heart of its process. As the managers have explained, asset allocation is a key driver of returns in the portfolio with a strong emphasis on capital protection at the core of their philosophy. To learn more about the LF Ruffer Diversified Return fund visit fundcalibre.com – and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.

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