LONDON BOROUGH OF TOWER HAMLETS PENSION FUND

report to

31 March 2015

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Period under review 31 December 2014 – 31 March 2015

Portfolio value	**£50,618,734**

Performance (net of fees) to 31 March	**%**
3 months	+4.8
12 months	+12.4
Since inception (28 February 2011)	+26.5

Summary

Even by post crisis standards the first quarter of 2015 proved eventful. January saw the Swiss National Bank abandon the Sisyphean task of holding down the Swiss franc against the euro, and also witnessed the dawn of full-blown quantitative easing (QE) by the European Central Bank (ECB). This latter move added further fuel to the continuing leitmotif of plummeting global bonds yields, with negative nominal rates spreading further along the German yield curve and ten year eurozone government borrowing rates outside of Greece collapsing. Global equities rose over 7% on the quarter, led by Japanese equities and European equities, with the FTSE All-Share Index up slightly below 5%.

Against this at times surreal backdrop the portfolio performed well. Falling yields meant that UK index-linked bonds surged even as inflation readings dipped. European equities rose sharply, and the euro commensurately dipped, on the reality of QE and hopes of economic recovery. Japanese equities continued their rehabilitation, boosted by ongoing asset allocation changes towards equities by the Government Pension Scheme (GPIF). Meanwhile with hopes high for the US economy, and a tightening in US monetary policy therefore in prospect, the US dollar continued to rise against most comers.

At the portfolio level the quarter saw us taking some profits in equities and more significantly in currencies. The US dollar exposure was further reduced as its increasing correlation to equities reduced our belief that it would act as a protection. Elsewhere we continue to worry about the state of the corporate bond market, where risk is not being rewarded and liquidity may prove to be lower than the number first thought of, thus we have initiated a position to protect against a possible dislocation in this area.

Factors that helped performance

Japanese equities Asset allocation shifts towards equities and an improved corporate performance combined to drive Japanese equities higher.

Inflation-linked bonds Asset purchases by the ECB caused a further sharp drop in bond yields, extending gains in the price of longer duration inflation-linked bonds.

US dollar A sharply falling euro and expectations of tighter US monetary policy took the US currency higher against sterling, prompting us to take profits and cut the US dollar exposure to 5%.

Factors that hurt performance

Options With most of the portfolio's option positions being protection against higher interest rates they generally lost value as bond yields fell.

US technology Small losses were sustained in the portfolio's US 'old technology' stocks as investors factored in the effect of the rising US dollar on their overseas earnings.

Summary performance attribution

Five largest positive contributions	%
Japanese equities	+1.2
Index-linked bonds	+1.0
US dollar	+0.9
Volkswagen	+0.4
TAG Immobilien	+0.3

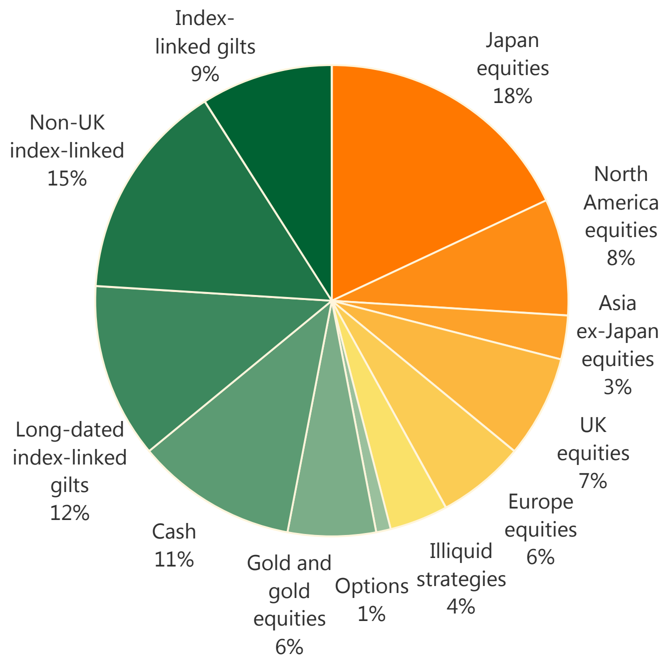
Five largest negative contributions	%
Options	-0.4
Microsoft	-0.2
Viacom	-0.1
Oracle	-0.1
Antofagasta	-0.1

Current investment strategy

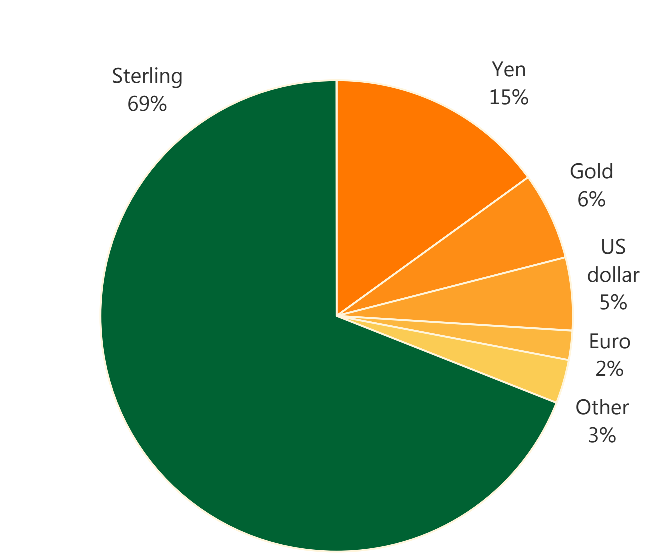
In the accompanying investment review Jonathan Ruffer seeks to encapsulate the present dilemmas and difficulties facing central banks. Six years of quantitative easing and cheap money may have inflated asset values but have had much less success in reigniting economic activity. As the clamour for nominal economic growth increases, the next stage will have to involve fiscal policy creating ‘real’ money, capable in Keynesian language of creating ‘effective demand’, rather than ‘voucher’ money usable only in the closed system that is the financial sector. This will have inflationary consequences. As we have often said inflation and deflation are two sides of the same coin of monetary instability, and the journey towards the inflationary outturn that we expect was always going include deflationary lurches along the way. To the charge that we have made strong returns out of inflation-linked bonds while inflation has been notable by its absence, our response is to point out that right from the dark days of autumn 2008 we were very firm in our view that an integral part of the landscape during that journey would be official interest rates, and thus bond yields, remaining at rock-bottom levels for some considerable time. In fairness we might not have foreseen the negative nominal interest rates now visible in parts of the eurozone, (who did?), but our forecasts of negative real interest rates have been longstanding and resolute. If asset prices inflation has formed the prologue to the unfolding drama, then CPI-ish inflation will surely follow as Act 2 or 3. Inflation-linked bonds appear expensive on traditional metrics but they remain central to our asset mix; thus we have resisted the siren voices urging us to take profits, choosing instead to put into the portfolio protections against a backup in bond yields.

This phenomenon of interest rates nailed to the floor is the major distortion in the present investment world. If discount rates are held close to zero, then do asset values travel towards infinity? Yet the stark reality is that central banks have become one-club golfers, where the confidence-enhancing effects of asset price inflation represent the only route by which they can shepherd the world to economic salvation. Equity market levels already owe much of their present state to central bank actions rather than the everyday realities of economic growth, profits and dividends. Add in the Indian rope-trick of share buybacks funded by increased corporate leverage and one can see that as markets have risen fundamental supports have diminished. Our recent moves have therefore been to take profits in equities, mainly in the US, selling out of General Dynamics, and reducing Lockheed Martin and some of our ‘old technology’ stocks, all on handsome gains. We have also crystallised our gains in our US dollar position, replacing that with some exposure to the yen, where we have greater faith in its protective potential. In contrast we have left our exposure to Japanese equities largely unchanged, as we find Japanese equities continue to provide a compelling opportunity. The market exhibits a pleasing convergence between supportive government policy, changing domestic asset allocation and more equity-friendly corporate performance, fuelling our optimism that it can build further on its 10% gain achieved in the past quarter.

Asset allocation



Currency allocation



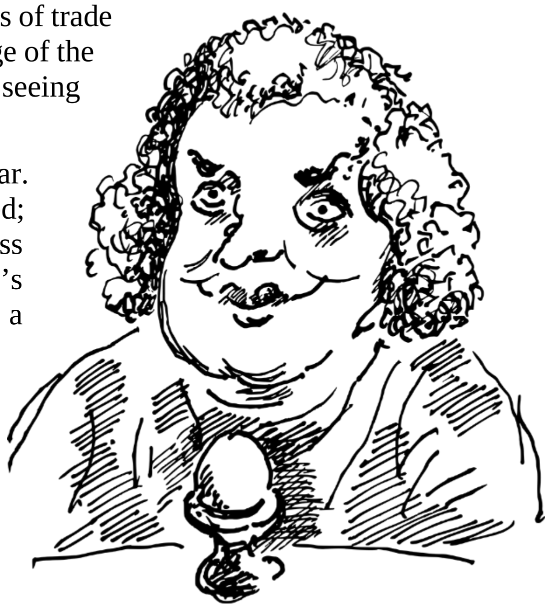
This review is more ambitious in scope than many quarterly offerings from Ruffer. It will cover more ground than is perhaps wise, and the reason for doing this is that we are looking at the many elements which will determine whether we face a deflationary crisis (to which the answer is a near-certain 'yes'), and whether the response of the central authorities will result in our long-predicted high inflation coupled with low interest rates (our answer to this is 'indubitably'). These seemingly inconsistent conclusions arise from our long-held understanding that both inflation and deflation are manifestations of the same thing: monetary instability.

The fall in the CPI inflation figure is important only if it's a herald of true deflation. Ignore talk of 'good deflation' and 'bad deflation', and the far-fetched idea that with deflation running at 0.1% a year, consumers will hold off buying stuff until it has dropped in price – presumably by a penny per £10. The issue is whether it is a messenger of mischief to come: the albatross of the Ancient Mariner, the receding of the tide before the tsunami: a harbinger – not the real thing. It does not need publication of a low CPI inflation figure to establish that there are powerful deflationary forces at work in the world's economies. Where there are deflationary forces, falling asset prices are never far away, and if central bank response to deflationary forces has driven them to high levels ahead of it, then the reversal of this becomes hard to avoid.

We may look back and see that the present phase in the worldwide economy is in a cross-current: the deflationary forces offset by the exuberance engendered by rising asset prices. Remove the latter, and you are left not only with existing deflationary forces, but also with the superimposition of the migraine imposed by financial pressures and thwarted hope. This can be seen in historical example. The fall in Wall Street in October 1929 is the best example of it. The Wall Street Crash was indeed the cause of the Great Depression – something which was obvious to its victims, but which was declared 'wrong' in the rewriting of its causation when viewed through monetarist eyes a generation later. Well, here we are again; it's not a theological debate. It is a matter of deep concern.

This is certainly the way the central banks themselves see it. They are far from complacent about the fall in inflation, concerned that it might be worrisome in its own right, and that they 'let it happen', even though they had been at great pains to seek to avoid it. The idea of quantitative easing was a resounding success for policy management, but it was more than six years ago. The cadre of economists feel it is time for another triumph, but are split on a solution and are proposing increasingly radical and divergent solutions.

Prices go down for two separate – indeed, opposite – reasons, something observed by that fine economic expert of the eighteenth century, Dr Johnson. On a trip to the poverty-stricken Shetlands, he found that eggs there cost only a ha'penny, rather than the going-rate of a penny on the mainland. He observed that the reason for this was not the abundance of eggs, but the shortage of ha'pennies. This is a crucial distinction, since a falling price can come from a change in the terms of trade either through a glut of the commodity for sale, or through a shortage of the money to acquire it. Without this distinction, one can end up seeing opposites as the same thing.



In the days when money held its value, the distinction was clear. Throughout the Victorian age, prices fell as industrialisation occurred; we see the same process today in digital cameras, in cars, and across a wide range of computer and other technologies. This is Dr Johnson's abundance of eggs. But there are times – and places – when a fundamental lack of prosperity is the driver: I see it at first hand in County Durham, where I am striving to lift spirits, lift economic activity and to lift prices. Why can one buy a four-bedroomed house in Bishop Auckland for two-thirds of the price of a two-bedroomed Oxford flat? The answer is the shortage of ha'pennies that comes with economic prostration. Across the globe, there are many economic deserts which have nothing to do with abundance, and everything to do with shortage.

We no longer live in a world where money is an absolute. When a pound sterling was made of gold, it was easy to tell whether prices were really going up or down: the rise or fall in the cost of living gave the answer. But when sterling is a token, made of paper, or by a computer entry on a bank screen, there are two moving objects. Prices have two opposite forces in a modern recession: a tendency to fall because of the economic malaise, and a tendency to go up because there is more paper money in circulation. As times get harder, the 'more paper money' overwhelms the economic malaise. That is clearly manifest in Russia: low oil prices, a flight of confidence, of capital, are all symptoms of hardship, of shortage. But the rouble is being created in big volume, so there is inflation in Russia, although the forces are exclusively deflationary. At least Russia is able to create new roubles – the essential problem for Europe is that Greece, Portugal and many other countries suffer the deflationary forces of a widespread loss of confidence, but have the euro, which they cannot manipulate downwards, as they would have done with their own currency in the last century.

Pausing there, we see deflationary forces throughout the world, which are being scarcely held at bay by the bull market in assets, itself the result of a rush from safety by conservative investors despairing of getting an adequate return on their money. The bull market is now a fundamental part of the health of the world economics, as a bear market would be – will be – if it comes about. And then the world's economics will darken quickly.

In this circumstance, the question is: will the central banks at the centre of the world's economy follow Russia and allow the partial default of their currency? In this world, the deflationary shortage of ha'pennies masquerades as an abundance.

Quantitative easing was such an initiative and it has been a resounding success – largely due to a fluke. We described in the last investment review that the money-creation was voucher-like, in that, acting as money, it transformed the balance sheet of the financial system, but it was a voucher not usable by the consumer or corporation for spending on goods and services. The inflation was seen, therefore, in asset prices, not retail prices. It bought time for those central banks, but the time has run out – will they create consumer demand with CPI-sensitive money, as a reprise?

It is an important question. If we see inflation, it is the saver who suffers. If we see deflation, it is the borrower. There is a lot of debt about following the debt explosion which came to an abrupt end in 2008. The ensuing years have seen a re-arranging of that debt – basically from the financial world to governments – but it is pretty much as high as it has ever been. There is a huge asymmetry of risk between an inflation (one less holiday a year for the victims with savings) and deflation, which threatens to bankrupt every debtor, beginning with governments. It will be inflation which will redistribute the wealth away from the saver, and keep stable the equilibrium of the borrower.

The surprise – it shouldn't have been – is that the creation of 'somewhat inflation' by the 'somewhat destruction' of a nation's currency isn't as easy as it sounds. This observation would have created hollow laughter in the days of high inflation a generation ago, but the reality is that once a trend is in place – Japan since 1995 – it is very hard to reverse. But there's an increasing realisation that the only way of extinguishing the amount of debt in the world is to penalise savers – the same dynamic, of course, as subsiding borrowing rates. Thus, when RPI peaked at 5.2% in Britain in 2011, base rates were already down to 0.5%. Now that inflation has disappeared, that subsidy has disappeared, but it tells investors what we could only surmise (as we did) a few years ago, that the solution which governments will choose is interest rates much lower than the rate of inflation. While asset prices hold up, deflation is a paper dragon. Central bankers will worry, but the rest of the world will go happily or unhappily about its business. If asset prices fall, and fall seriously, the phoney war will be over, and we will indeed be facing true deflation: a deflation which is one step on this journey to currency-compromised inflation. If that happens, expect the central authorities to respond. Expect them to target inflation. Expect them to learn from the old Japanese experience that a desire to replace deflation with a bit of inflation with some vague attempts at monetary expansion, is like attacking an enemy with a pair of scissors. Currency destruction – partial, of course, as in the UK during the 1970s and 1980s – is achieved through fiscal profligacy. In these extreme circumstances, that is the course which they will adopt. We expect to see interest rates up to 4% in the next cycle – when inflation is 10%. The next boom, on the back of prostrated savers, will be a mere five years after that.

Jonathan Ruffer
April 2015

About Ruffer

Who we are

Ruffer is a privately-owned investment management firm. We currently manage over £18 billion for pension funds, charities, companies and private clients, and employ over 200 people, with offices in London, Edinburgh and Hong Kong. We have a single investment strategy that has followed the same tried and tested investment approach since the firm started in 1994.

Our investment objectives

Our goal is to deliver consistent positive returns, regardless of how the financial markets perform. We define this through two investment aims

- not to lose money in any rolling twelve-month period
- to generate returns meaningfully ahead of the ‘risk-free’ alternative of placing money on deposit

Since Ruffer started, this approach has produced returns ahead of equity markets, but with much lower volatility and risk. Over shorter time periods, if equity markets are rising, our returns are likely to be lower than those of equity indices, since we will always hold protective assets as well.

Although these are our aims there is always the chance that we may lose money because of the nature of the investments involved and it is possible that individual constituents of the portfolio lose all their value.

How we invest

Ruffer portfolios are predominantly invested in conventional assets, such as equities, bonds, commodities and currencies; we also will make use of derivatives. Part or all of your portfolio may be invested in Ruffer in-house funds.

At the heart of our investment approach is an asset allocation which always maintains a balance of ‘greed’ and ‘fear’ investments. Protective assets, such as bonds, should perform well in a market downturn and defend the portfolio value; those in growth, principally equities, should deliver good returns in favourable market conditions. This blend of offsetting investments reflects the prevailing risks and opportunities that we see in financial markets, rather than any pre-determined allocation. We operate without the constraints of benchmarks that institutional investors have historically been tied to.

The asset allocation is fulfilled through specific stock selections. We invest only in companies that reflect the themes we seek to benefit from in portfolios. We never simply invest in a stock market index.

Our investment team

Ruffer’s investment team and strategy are led by Jonathan Ruffer (Chairman) and Henry Maxey (Chief Executive). They are supported by a Research Team of over 20 analysts, focussing on economic and market trends, company analysis and developing investment ideas. These are used by portfolio managers on the Fund Management Team to construct portfolios in line with the investment strategy. The average experience of Ruffer’s investment team is over 15 years.