36 South Views

BY RICHARD "JERRY" HAWORTH

Underpinnings

Coming to the end of the year we tend to get more reflective, especially this year where chasing performance has been like trying to guess the visible colours of a Rubik's cube in a tumble dryer.

And we all revert to the assumptions or 'underpinnings' of what we believe to ensure that we are synchronised with reality – because if we are not, we will get ground down until we are.

The raw beauty of reality – when someone calls: "Lunch!", don't automatically assume you are the one doing the eating!

So what are the underpinnings of the current asset valuations? We believe they are as follows:

1) Inflation is contained.
2) Everybody is searching for yield at the expense of risk.
3) Interest rates are permanently low.
4) Social inequality won't impact geopolitics.
5) Volatility is low and the VIX won't breach 30.
6) Property is safe.
7) No war on the horizon in western countries.
8) Commodities are in a structural bear market.
9) Central banks have our back.
10) Structured credit is safe. Investing in debt is safe.
11) China is growing its GDP at 6.9% and is financially solid as it has massive reserves.
12) Levels of debt are sustainable.

The problem with these underpinnings? They are all correlated… if one turns out to be false, the others become inherently unstable. It is not a robust environment but a fragile one.

Let us take one at random and falsify it: inflation is not contained, for instance.

In this scenario…

1) interest rates will have to go up to provide a relative yield
2) asset prices will go down to provide a higher matching yield
3) social inequality becomes more pronounced
4) volatility will rise
5) property prices will fall initially while yields are rising
6) prospect for war will increase as economics get worse and resources get scarce
7) commodities will boom
8) central banks will respond by printing more money, effectively putting petrol on the fire.

Take any underpinning and falsify it and the others get swept away with it.

We face not correlation "potholes" but a correlation "trench". ALL underpinnings fall in together!

You cannot diversify away any of the risk as they are too correlated.

The most important thing we have learnt this year is that you get a NON-LINEAR reduction in risk by putting non-correlated investments in your portfolio. Ditto for underpinnings.

You can get a NON-LINEAR reduction in risk by putting investments in your portfolio which benefit when one of the underpinnings fails, and like we said before it doesn't matter which one you cover by "proxy" because they are highly correlated.

So look for investments which benefit when….

Commodities boom;
or
volatility rises;
or
interest rates rise;
or
war starts in a western country;
or
property or equity prices fall.

We have settled on volatility rising because it is convex and scales as the deviation from normal gets more extreme. It is also much uncrowded at the moment, like commodities, and therefore is priced attractively.

DISCLAIMER

36 South Capital Advisors LLP is authorised and regulated by the Financial Conduct Authority (FCA).

This document is for professional investors and qualifying investors only and no other person should rely upon the information contained within it. Prospective investors will be required to certify they are qualified investors upon application and certify their awareness of the risks involved in the investment and, in particular, the inherent risk of losing sums invested. Offering documentation and fund literature is only available upon request and not available on the 36 South Capital Advisors LLP's website. As part of the subscription process the fund administrators check the eligibility of investors.

Unless otherwise stated, the statements, views and opinions expressed in this document are those solely of 36 South Capital Advisors LLP.

An investment with 36 South Capital Advisors LLP will involve a significant degree of risk, which each prospective investor must carefully consider.

Past performance is not necessarily indicative of future results.

This document concerns certain investment strategies and does not purport to disclose details about any particular existing funds. This document is accordingly provided for informational purposes only and does not constitute investment advice. The information herein is not intended to provide, and should not be relied upon for, accounting, legal or tax advice or investment recommendations. Please consult independent tax, legal, accounting or other advisors in the course of assessing any strategies mentioned in this document.