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Invest from a platform of knowledge

STIRLING LARKIN THE AUSTRALIAN JUNE 14, 2014 12:00AM

US president Ronald Reagan greets Austrian-born economist Friedrich Hayek at the White House in 1981 Source: Supplied

EVERY investor holds a worldview and, whether they are aware of it or not, each of those views is shaped by the basic principles of economics.

Successful investing therefore requires us to understand these principles so that we can better appreciate both their strengths and weaknesses.

This is particularly true in the current environment when markets are uncertain and indicators are behaving ambiguously, as this understanding will help the astute investor find the best way forward.

Like discussing religion or politics at social gatherings, discussing economics in Australia has become a faux pas, often frowned upon and even considered a taboo.

This is very unfortunate, as the global investors who successfully build wealth and contribute to society are those who ground their worldviews from the smart ideas of the great economists of the past three centuries.

These global investors seek out good advice, which then helps them decide whether the role of bottom-up analysis — “stock picking” — or the top-down approach — “macro” — is the better way forward at that time.

Probably the greatest advocate for the bottom-up approach was the British economist John Maynard Keynes.

Keynes believed that people priced shares not based on what they thought their fundamental value was, but rather on what they thought everyone else thought their value was or what everybody else would predict the average assessment of that value to be.

His famous analogy likened this to picking the winner in a beauty pageant, where you choose not the person you think the most attractive, but the person you think others will choose as the most likely winner.

According to Keynes, “As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes.”

Many Australian retail funds today tell their clients the same things — they have good information and aim to outperform the market.

However, one of the best ways to see whether an economist or money manager believes their own contentions is to look at their own personal investments.

For example, Keynes lost a good deal of money in the 1929 crash — he was, of course, not alone in this — a clear example of why the top-down approach should never be overlooked.

His investment performance in the 1930s managing the Queens College Endowment Fund reflected his willingness to take on risk more than any real stock-picking ability.

Alternatively, the top-down approach or “sound money” explanation is associated with what is referred to as the Austrian school of economics.

The Austrians believe that it is the cycle of credit expansion and contraction from the banking sector that drives the business cycle and then consequentially the markets.

Especially, they believe, if you are in a contractionary phase, stock picking is a waste of time, as everything is going down.

Only in the event that money is sound is stock picking useful, as otherwise the cycle drives prices.

Many of the world’s most successful global investors and money managers, such as Ray Dalio of Bridgewater Associates or George Soros of Soros Funds Management, are advocates of this worldview. Their performances, over time, speak for themselves.

As with most aspects of life, in economics there is no clear black or white and no path forward is really assured.

This is particularly important, because in the past few years neither approach appears to have worked; as governments have been driving the whole show and a new set of rules have been introduced.

This is evidenced by the peculiar combination of current record stock and bond market highs, illogical foreign exchange movements, relatively weak fundamentals and possibly a glut of “bad money” in the system. UHNW investors now treat good advice from those “in the know” as crucial, as they recognise that the old rules no longer apply in these conditions.

In light of this, a more recent view suggests that markets are adaptive and there is a time to pick stocks and individual assets and a time to take the top-down approach and look at markets in their entirety.

They listen to specialists such as Andrew Lo, a hedge fund and financial engineering professor at MIT who coined the term “adaptive markets hypothesis”, which describes the way in which markets can swing between rational and irrational.

UHNW investors recognise that contemporary contributors are particularly important, because they link economic history with modern-day conditions.

A case in point is the controversial French economist Thomas Piketty, who is receiving huge publicity and worldwide attention for his recently published Capital in the Twenty-First Century, which attempts to connect this history with fresh ideas.

The greatest Austrian economist of the 20th century, Friedrich Hayek, believed that "the more the state (government) plans, the more difficult planning becomes for the individual".

Hayek and the Austrians examined the sensitive relationship between the long and short term debt cycles and productivity growth.

The concept of reflation — discussed regularly in this column — then bases itself on enhancing this relationship in an effort to re-stoke the global economic machine.

In the US, this has been via quantitative easing; in Japan through "Abenomics"; in Europe and China through structural reforms, and in Australia by reducing the government's fiscal drag.

We also know that the relationship between economists and the people who pull the strings can often be very intimate and simply looking closer at those relationships can be crucial in understanding which direction our investments may likely head.

"Reaganomics" and "Thatcherism" were interpretations of such relationships.

Equally, the relationship between Federal Reserve chairman Alan Greenspan and the libertarian-minded author Ayn Rand is important as her influence over how modern day monetary policy has been crafted has become abundantly clear.

So, too, is the influence of Milton Friedman's "Monetarism" school. These modern-day policies are continued to be driven forward today by chairman Ben Bernanke and most recently chairwoman Janet Yellen.

Following any one paradigm may not assure an investor success, but one thing is certain — undervaluing the importance of economics altogether during uncertain times can guarantee failure.

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(Editor's note: Last week's article by Stirling Larkin contained a number of typographical errors such as "iliquidity" for "liquidity" that were introduced during the editing process.)

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