Canso

MARKET OBSERVER

July 2014

"The Biology of Boom and Bust"

This is the kind of financial market that we at Canso despair of. Stupid money looks smart and smart money looks stupid.

What, you are thinking? Things are great. My portfolio is going up and I am happy, if not euphoric. The problem is that I can't find enough new investments. Yup, that bank loan ETF with an inverse yen hedge and a call on the Kamchatka stock index looks good.

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It's not your fault that you now think this way. You are in the grips of a clinical mania, thanks to Janet Yellen and her chums at the Federal Reserve. Excess money begets excess optimism. A mania, you ask? Yes, due to your success in the markets, you now have chemicals coursing through your body that urge you to take on even more risks.

This means bigger and more risky bets if you are a trader and almost every so-called investor is now a trader fixated on the short-term. By the peak of the cycle you will actually believe you are invincible and can do no wrong. You will begin to believe that your insight and skill will allow you to make money in all markets.

Under the Influence

Now you might also believe that Canso has truly lost it. They're talking technical mumbo jumbo. As someone who has been well schooled in modern portfolio theory, you are completely confident that markets are efficient and all attempts to time markets or add value by security selection are utterly worthless. Human beings are rational in a Cartesian sense. We have shed our emotions and have embraced clinical and dispassionate thinking. Financial markets are data sets of numbers in spreadsheets and trading platforms, waiting to be harvested by those in possession of coding skills.

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Preachy Keen

The "preachy" tone of the rough draft of this newsletter met with some consternation among the volunteer editors who also are those tasked with dealing with the outside of Canso world. They felt that the liberal use of "you" and highlighting investment foibles risked alienating our loyal readers and clients. Well, our anonymous authors' collective has considered this and decided that preaching was exactly what was intended. It's not quite, "FALL ON YOUR KNEES INVESTMENT SINNERS AND REPENT!!" but that's not too far from the tone we sought.

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Unfortunately, the rationality of investors is now demonstrated to be quite lacking. The historical number trail of the financial markets reflects human activity. Biological research is now proving human behavior to be anything but rational, dispassionate or even conscious! It shows that we humans are under the influence of powerful chemicals created by our bodies, honed by evolutionary forces which allowed us to succeed and pass on our genes in an often hostile environment.

Your trusty Canso correspondents truly despaired of writing another diatribe against financial excess this quarter. Luckily, we picked up an excellent book for summer reading entitled *"The Hour between Dog and Wolf"* by John Coates. The sub-title is telling: *"Risk-Taking, Gut Feelings and the Biology of Boom and Bust".* Not only did the book prove a great read, it also validated many of the "founding beliefs" of Canso. What we will address in this newsletter is the reason for the average investor's propensity for financial self-destruction.

The Everything Bubble

Coates' book is quite timely, given the current state of the global financial markets. A recent New York Times article discussed how inflated financial asset prices have now become:

> *"Around the world, nearly every asset class is expensive by historical standards. Stocks and bonds; emerging markets and advanced economies; urban office towers and Iowa farmland; you name it, and it is trading at prices that are high by historical standards relative to fundamentals. The inverse of that is relatively low returns for investors…*
>
> *The phenomenon is rooted in two interrelated forces. Worldwide, more money is piling into savings than businesses believe they can use to make productive investments. At the same time, the world's major central banks have been on a six-year campaign of holding down interest rates and creating more money from thin air to try to stimulate stronger growth in the wake of the financial crisis."* Welcome to the Everything Boom, or Maybe the Everything Bubble, Neil Irwin, New York Times, July 7th 2014

Since Coates once ran a trading operation, this is an excellent vehicle to explain his neurological concepts.

The Biology of Trading

Coates is a neuroscientist and a former derivatives trader with Goldman Sachs, Deutsche Bank and Merrill Lynch. He delves into the biology of trading and the financial markets using the example of a fictional trading floor. Since Coates once ran a trading operation, this is an excellent vehicle to explain his neurological concepts. Without going into great detail and spoiling your reading of this excellent book, we will summarize his important points. Coates starts with a look at the human brain and the biology of the evolutionary mechanisms that have developed to allow Homo sapiens to move and survive in our dangerous world.

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Where economists and philosophers believe in human rationality, Coates points out that our bodies react subconsciously to external stimuli. This happens because conscious human reaction times are too slow to deal with the external threats and danger that we once faced in the wild. You might think that this is another take on another favourite Canso book, *"Thinking Fast and Slow"*, but Coates delves much deeper into the physical and chemical reactions of the body to stress and danger.

Coates explains that trading success floods the body, especially males, with testosterone and steroidal compounds that cause ever increasing risks to be assumed.

Testy Traders

Coates explains that trading success floods the body, especially males, with testosterone and steroidal compounds that cause ever increasing risks to be assumed. These chemicals are necessary for male animals to engage in dangerous physical activities like mating rituals and combat. The victorious gain even higher levels of these self-administered drugs but the vanquished see increases in natural depressives like cortisol that cause the loser to flee rather than fight! These changes prepared winners for further combat and encouraged losers to leave the field of battle to mend and recuperate.

While these drugs were effective in the natural world to keep us alive, Coates makes the point that they have become quite counter-productive in our modern financial system:

> *"Indeed, under the influence of pathologically elevated hormones, the trading community at the peak of a bubble or in the pit of a crash may effectively become a clinical population. In this state it may become price and interest-rate insensitive, and contribute greatly to the violence and intractability of runaway markets, to what Nassim Taleb has called "Black Swan" events. Perhaps this is why central banks have met with such little success in arresting a bull market or placing a safety net under a crashing one. When building models of the risks facing a bank or economy, risk managers and policy makers should therefore bear in mind the likely clinical state of the trading community under extreme scenarios."*

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Animal Spirits

At Canso, despite our modern portfolio theory educations, we have never been a big believer in efficient, rational and dispassionate markets. We have always believed that markets impound human nature and that they tend towards excess. We are not alone in this view. John Maynard Keynes, perhaps the greatest economist of all time and a very successful investor in his own right, talked about "animal spirits" in the economy and financial markets. As we often say, humans "herd" towards the consensus view and it is much more comfortable for the average investor to be part of the crowd than to expose themselves to the risk of "being wrong". The acceptable risk is that which is in fashion, be it CDOs or commercial real estate, and usually involves leverage.

It is the role of value investors to insulate themselves from the "Madness of Crowds" and rely on valuation metrics to find desirable investments. Benjamin

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Graham developed the value investment methodology after being wiped out in the great market crash of 1929. Warren Buffett famously closed his original fund when the "Nifty Fifty" euphoric markets departed from reality in the late 1960s. The late John Templeton bought his investments at "the point of maximum pessimism".

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Strictly Value

We at Canso have a strict valuation discipline and an investment culture that emphasizes long term thinking. From 2003 to 2007, we found ourselves marveling at the euphoric financial markets. This very letter discussed the "credit mania" in securitization many times. Our independent credit research and valuation discipline forced us into safer investments as time passed and we went into the Credit Crisis in 2008 with the highest quality portfolio that we had ever owned. The opposite occurred during the Credit Crisis from 2008 to 2009 when valuations encouraged us into buying many excellent investments trading at very low prices. In 2011, during the Euro Debt Crisis, we had the discipline to hold onto and add to our European financial bond holdings based on our long-term normalized valuations.

Investment Disabled

What is it that causes Canso "to go against the grain" when others are euphoric and buying overpriced investments or depressed and sitting on their hands? John Coates concludes that the "clinical state" of traders and its negative effects on financial markets could be remedied by a long-term focus and lessening reliance on the testosterone-fueled young males of bank trading floors. Coates points out that asset managers seem to take a longer term view and have many more female employees who are not as "disabled" by testosterone as their male peers.

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Canso's "Investment Philosophy" provided to prospective clients in the 17 years since 1997 is replete with the words "long" and "term". We also have had a very high percentage of female staff so perhaps we have unconsciously adopted many of Coates' prescriptions for investment success. Our compensation structure does not depend on short term results which meets another of Coates' suggestions. He also makes the point that where trading is a young man's game, asset management seems more suited to those with experience of many economic and market cycles. Politically incorrect Coates speaks of "older men" to which we admit to having a few! When we started Canso, we had watched the short term trading and "closet indexing" of many portfolio managers fail to add value so we relied on our buy and hold and bottom up focus to create value added. After three credit cycles at Canso and substantial proven value added, we think we have proven our methods.

Gut Feelings

Another main point we found interesting in Coates' book is that "gut feel" results from the biological reaction to a change of circumstance. Our unconscious minds recognize changing circumstances well before we consciously react. In

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this spirit, we have been telling you for some time that our investment instincts are on high alert. Like a rustle in the forest that signals danger, we see the signs in the current financial markets that suggest caution is warranted. We have focused in past editions on the danger in the bank loan and high yield markets as yield spreads and absolute yields have plunged to historical lows. We have also warned that the very low historical level of real yields, artificially suppressed by monetary policy, make long duration assets very expensive.

Paid to be Ignorant

In terms of "never again" for credit markets, we are now seeing a new crop of CDOs (Collateralized Debt Obligations) being sold to investors hungry for extra yield, despite all the investigations, mea culpas and regulatory angst over the Credit Crisis. It has always amazed us that investors refuse to learn the lessons of investment history, but then they are paid very well to be ignorant of the risks they are assuming. Thanks to Coates, we also now know that they are literally drunk with their recent investment successes.

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In the past three years since the depths of the Euro Debt Crisis, we have seen the credit cycle move from sheer terror to the current euphoria. As Coates points out, it doesn't take too much in the way of mayhem for an investor mood swing to occur. We believe the next "market panic" will not be a banking or government debt crisis. It will be a traditional market rout where the selling of assets overwhelms buying. Shadow banking will have an unfortunate spotlight shone on it. There are few more diabolical instruments than a bank loan or high yield ETF that buys illiquid long term assets and funds them money that can be redeemed on a daily basis! This is perhaps why the Federal Reserve has been musing about restricting withdrawals from ETFs and mutual funds in times of "financial stress".

Backing Out of Forward Guidance

Coates also makes a very important point which has important implications for the recent vogue in central banking circles of broadcasting monetary policy intentions through "forward guidance". The idea was that central banks would assure investors and markets of their policy going forward with clear benchmarks and timing for policy action. It all seemed so logical. The problem became that when conditions changed, the Federal Reserve in the U.S. and Bank of England in the U.K. and the Bank of Canada were all forced to "amend and extend" their guidance. The Fed has revised down their unemployment rate trigger several times. Now that U.S. unemployment has obviously fallen below the level where interest rate policy would be "normalized", the Fed has now adopted growth in wages as its new best friend benchmark. As we've said before, the current timing for when interest rate policy will be normalized is "when the cows come home!" A CNBC article captured the central banking conundrum:

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> *"The world's major central banks are returning to a more opaque and artful approach to policymaking, ending a crisis-era experiment with explicit promises that they found risked their credibility and did not substitute for action. From Washington to London to Tokyo, the glob-*

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al shift from transparency to flexibility underscores the challenges central bankers face as they test the limits of what monetary policy can achieve… The return to a more traditional policymaking approach and nuanced statements will challenge the communication skills of central bankers who have been chastened in the last year after some too-specific messages confused and disrupted financial markets." Central banks ending era of clear promises, return to 'artful' policy, CNBC, Monday, 7 Jul 2014

When traders are in a certain environment, they tend to take on even more risk, as their "gut feel" and unconscious assures them that conditions are propitious for greater risk and success.

Certain and Risky?

Perhaps the central banking fraternity has read Coates' book at one of its shindigs. Coates makes the observation that humans are much more cautious when exposed to "unexpected" conditions and uncertainty. When traders are in a certain environment, they tend to take on even more risk, as their "gut feel" and unconscious assures them that conditions are propitious for greater risk and success. This is the very opposite of what forward guidance was supposed to achieve. Central bankers tried to assure business that it could make capital expenditures and consumers that they could spend. What the central bankers might have achieved is an increase in risky behavior in the financial markets!

Cycling Fear and Greed

Before reading Coates' book, our approach to monetary policy was really quite simple. We believed in a credit cycle. When money was plentiful and capital cheap, people would squander it on ill-advised investments. When money became less plentiful and capital more expensive, then the stuff would hit the proverbial fan as "speculative balances were liquidated". Now that we understand the high-octane nature of the chemicals fueling the speculative peaks and panics, we are even more convinced of the existence of a credit cycle.

What scares us now is that the inevitable return to more normal monetary policy will see massive liquidation of speculative and levered investments. We are not particularly worried about our portfolios, which tend to take care of themselves. We make our investments without assuming that we can sell them when we want to. Liquidity is an ephemeral thing. You can have it and then see it disappear in a heartbeat. Our investment research and valuation discipline means that we have sturdy portfolios where we are compensated for the risks we have assumed.

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Moving Towards Safety

Currently, we are finding that the compensation for many investments does not justify their risks. This means our portfolios have been moving slowly towards higher quality. This has occurred by active management decision but also by improvement in the underlying fundamentals of the issuers. This is not necessarily reflected in the credit rating of some bonds that we hold. The credit rating agencies, fighting the last war of financial institution risk, have downgraded many issuers that are now in far superior condition than before the Credit Crisis. We also have had many issues mature and reduce in term. We bought many 10

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year financial bonds issued in 2006 and 2007 during the Credit Crisis in 2008. These bonds of 2016 and 2017 maturity are now 2 or 3 year bonds which have much less downside. As equities become substantially overvalued versus our normalized values, we have also been selling.

Is our caution "clinical" as Coates would say? Well, given our strong performance and success of the past few years, we should really be euphoric and believing in our investment super powers. However, we are not beating our chests in triumph; we are contrarily becoming quite cautious. We would much rather reduce our yield and prospective return slightly and our risk substantially than try to beat the "stupid money" over the next year or two.

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