

Perspective Changes with Distance

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In our school days it was orthodox to treat the periods 1901-1914, 1914-1933 and 1933-1945 as discontinuous and distinct periods of history. Today historians regard the end of the Edwardian period in the UK to the fall of Germany in 1945 as a continuous period of great power competition with Versailles and Weimar the pivot points between the two halves of the period.

Distance provides a different perspective on cause and effect that is often indiscernible to the people of the time.

Some of our team started their working lives back in 1981, a time which is likely to be seen by future historians as the beginning of the great period of financialisation, globalisation, international capital mobility and trade that may be drawing to an end right now with the primacy of Donald Trump in the Whitehouse and Boris Johnson in No.10.

In the UK, the period started with the highest interest rates and bond yields since records began at the foundation of the Bank of England 300 years ago. UK 10-year bond yields peaked at 14.88% in 1981, mortgages were offered at 14.18% (Bank Rate had reached 17% some time earlier) and inflation expectations were running at 10%.

As of today, inflation expectations are barely 2% (target), 10-year gilts pay their owners 0.232% and mortgagors routinely pay less than 2%. Interestingly, the population of the UK in 1981 was just over 56M, today it is 65M representing a growth rate of just 0.37% per annum in the period.

Whether future historians will see the period as a continuous episode beginning in 1981 and ending in 2021 is clearly for the future but what is important to us as investors is that the period has changed utterly profoundly the mathematics of investment appraisal and current political change amplifies the risks around investment appraisal.

The central point is that the present value of a stream of income into the future rises as the discount rate (the rate at which other investments would be more, or less attractive than the current one) falls.

To put that into plainer English, the present value of a stream of income payments of £10 per annum on a £100 investment would be £75.40. That is what you would pay for it at the gilt yield prevailing in 1981. Today the cost of the same investment discounted at the current gilt yield of 0.232% would be £196.45. More than 2 ½ times as much.

Gilt investors have had a great time just riding the interest cycle down all the way from 14.88% to 0.232% (This phenomenon is the reason why so many pension schemes are in trouble. The present value of their future liabilities has exploded simply as a function of the maths).

The problem for investors, including pension trustees, is that this process works in both directions. Should discount rates begin to reverse their forty year decline because we are entering what may be seen as a break period with our immediate past then present values will fall which is to say the price of gilts and other fixed income investment (including property) will fall.

The interesting thing about business is that businesses are uniquely placed to deal with change. Companies are dynamic; they can cut costs (in effect socialise the cost of excess labour) but more positively they can develop new products, open new markets, extend existing product lines and flex their capital structure. Most importantly of all, they can adapt to change to maintain profit growth under different circumstances. Cash deposits, gilts, fixed income securities and property

can't do that.

Margaret Thatcher was the architect of the single market; Boris Johnson is withdrawing the UK from it. Keith Joseph was deeply opposed to state intervention and picking industrial winners; Dominic Cummings wants to withdraw from the EU rules on state aid and competition to do precisely the opposite.

Whichever side you align with, we will see very significant change. If, as a result, discount rates change, all asset prices will be affected.

Paul Krugman used to say that at the zero-interest rate bound, "vice is virtue and prudence is folly." As we move away from the zero bound, assets that can grow future income streams will be much more valuable than those that cannot.

In that case, what is regarded as safe and what is regarded as risky is a question that will take on a whole new significance for investors across all the asset classes.

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