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New thinking for alternative investments

Investing Through Inflation

A Series of Papers – The Compendium

April 2022

Investing Through Inflation

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Investing Through Inflation – Introduction to a Series of Papers

***Summary**: Inflation is of paramount importance because it affects the ability to maintain a lifestyle. But surprisingly, and not withstanding how much time is spent talking about it, it is not well understood. This is an introduction to a series of papers written to help understand and manage through an inflationary period.*

There's an important question investors are starting to ask – How do I invest through an inflationary period? My motivation in writing this series of papers is to help investors answer that question. It's a hard question to answer because the bald truth is if you're relying on conventional advice – you can't get there from here. Conventional investment management in an inflationary period will result in a loss of capital. The investment industry talks a lot about risk. The risk I'm talking about is loss of capital – permanent, non-recoverable loss of capital and purchasing power. Conventional advice will work again once we're through the inflationary period and you can revert to the tried and true methods that have worked in the past.

Let's first acknowledge that the inflation we're talking about is price inflation. Let's also acknowledge the reason we're concerned about inflation is because it raises the cost of living for the vast majority of society. That causes stress - in all forms. Stress creates anxiety - in all forms; personally, politically and economically. History provides enough examples to illustrate that when stressed by inflation, flawed political and fiscal decisions are made, often fueling further inflation or leading to new stresses.

Let's agree to ignore that we've been in a period of inflation since the Great Financial Crisis because we see it as "good" inflation – namely asset inflation. But it's still inflation and it still has a negative impact on parts of society. It's ignorable because it's stealthy in the way it affects us. The temporal positive reinforcement of seeing your wealth increase overrides concern about the future liabilities it's creating elsewhere. Case in point, inaccessible housing for the next generation.

In preparing an investment strategy for inflation and in challenging conventions you will have to step out of your comfort zone. This series of papers has as its objective to explain why inflation ~~is~~ was inevitable, why you will need to challenge conventions and if not the conventional way then what way? It's a tough task made tougher as we've trended towards shorter attention spans and 280 character missives. Each article will focus on a single topic. I'll try my best to stick to a format;

In aggregate the series of papers will attempt to explain the why, why not, what and how of investing through inflation. I'll take all feedback and comments and will attempt to answer any queries. I won't be accessible on Twitter, Discord, Slack, Clubhouse, Instagram or Facebook. I have all those accounts but find them to not mesh with how I prefer to communicate. I'll thank you in advance if you've taken any of your valuable time to read my thoughts. Feel free to let me know what you think, what's missing, or any questions.

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Meet the Writer - Biography

Summary: *Throughout this series of papers, I'll be challenging conventions. Given that, it may be helpful to offer the reader an introduction as to who I am and where I've been. Perhaps it will aid in understanding how I've come to my points of view and why.*

My entire career has been in the investment industry. I was fortunate to land a spot at Wood Gundy in 1980 right out of university. My formative years were spent at Burns Fry Limited, a Canadian investment dealer, working in equity research as a quant and subsequently on the institutional equity derivatives desk. I had one misspent year at a Canadian bank before I rejoined a former Burns partner who had just setup a hedge fund in the early 1990's. That two-person multi-strategy firm grew to twenty-five people with a decent internationally diversified asset base and a respectable track record notwithstanding one frightening period during the 1998 debacle. The firm and fund continue on today and would anecdotally be considered Canada's longest running hedge fund. After thirteen years I headed off on my own to continue to find new terrain working with partners to establish newer strategies and funds in the alternative space.

Over the arc of my career, I've had the opportunity to work buy side and sell side. I've done sales, trading and research. I've been a portfolio manager and a risk manager. I've managed active funds, passive funds, hedge funds and a carbon fund (before ESG was an acronym). I've worked in a large company, a mid-sized company, a start-up and on my own. All that to say I've covered a lot of ground, managed a lot of styles and traded a lot of instruments. I've had the opportunity to have multiple vantage points and multiple lenses through which to see problems and find solutions.

Some might suggest I'm not inclined to go with the flow. There's some truth to that. I'd say that my formative days on Burns' trade desk as an arbitrageur had some effect as well. Arbitrageurs see opportunity in the cracks between things. Initially I focused on the micro level – stock and index arbitrage. I've shifted to the macro level now. But it's the same skill. What are the pieces, how do they relate to each other, when are they not fitting together and where's the opportunity when they don't fit? That macro viewpoint has led me to be an unapologetic inflationist. I was taught early that inflation is a wealth destroyer. I've since taught myself that investing to protect against inflation requires skills not generally available in the industry. That's not widely known or discussed. I've written this series of papers to bring that to the fore and to provide answers and a solution.

A straight and smooth road could have been an option but I've chosen the curvy, bumpy career. It's led me to see inflation as a problem and an opportunity. The opportunity to work with others to manage through what looks to be a bumpy road.

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There's More Than One Type of Inflation – Broadening the Discussion

***Summary**: Inflation affects one's ability to maintain a lifestyle. To understand inflation and its affect on us individually and as a society the discussion needs to broaden beyond just the effect of rising prices. All types of inflation have an insidious effect.*

There's a problem with talking about inflation. It's the same problem that happens when talking about politics, religion, economics or sports, i.e., all the subjects we like to talk about. The problem is we all presume we have a common starting point. We don't. We rarely do.

Given we're all talking about it the definition should be easy. Look up the definition and the simple definition you'll find is, it's an increase in prices. Or, a fall in the purchasing value of money. Huh? Everybody gets prices rising. Who gets 'a fall in the purchasing value of money'? Ninety percent of inflation discussion is about rising prices. Ten percent about the fall in purchasing value. Already the discussion is too narrowly defined.

I'll give you a definition for inflation. All types of inflation affect the ability to maintain your lifestyle. Which is a problem because it causes household stress which becomes societal stress. Important note - I didn't mention prices. Because *price inflation* is only one of many types of inflation none of which is less impactful than the others. Let's broaden the discussion.

There's a book written in the 1930's often cited by economists as providing the basis for their inflation based research. Seven Kinds of Inflation was written by Richard Dana Skinner who had experienced the destruction of the 1919 – 1920 inflation and the crippling effect of the 1932 deflation crisis. As a frustrated bond analyst, he felt compelled to write "what the layman wants to know – what he *must* know if he is to conduct his business or his investments or his daily family affairs with any reasonable intelligence and soundness. First: Are we having *any* type of inflation? Second: If so, what type? Third: How can we detect and measure the course of this inflation?". Remember – this was written in the 1930's. Query how far have we advanced our knowledge of inflation?

The value of Skinner's writing is to raise awareness that "inflation" is not singularly defined. He notes seven kinds of inflation. I won't detail the full catalogue but will highlight components of his writings. Most interestingly he identifies absolute types of inflation and relative types.

The former, i.e. absolute, is what we generally talk about. Milk costs more today than it did yesterday. The relative version is what if the price of milk is constant but my income declines. The effect is the same. I, literally, can buy less milk. It's a relative form of inflation.

Focusing on the 'absolute' types of inflation Skinner identifies and notes bond price inflation and stock price inflation as important as price inflation. As we are currently experiencing, pensioners dependent on interest income have had their incomes drastically reduced by the reduction in interest rates (i.e., bond price increase). Asset price increases are overlooked because who doesn't like a 'wealth effect' but the real effect is currently being manifest in housing prices beyond the reach of home buyers. As per my definition of inflation each of these examples affects one's ability to maintain a lifestyle.

Skinner's window of experience ranged from 1917 through to 1936. He was able to identify periods where each of the seven types of inflation were experienced. He cautions that at times two or more types can occur concurrently. Prescient to today he wrote "Every so often we shall be engulfed by several forms at once and go through a true *general* inflation". I chose the word 'prescient' as I defy anyone to claim we are not currently in the grips of bond price inflation, equity price inflation, asset price inflation and general price inflation concurrently.

Skinner wasn't trying to forecast inflation. Nor am I. His objective was to help the layperson understand inflation to answer the question "Where are we now?". I'm not forecasting inflation because it need not be forecasted any more than standing in the rain requires a 'chance of rain' forecast. Skinner specifically states he wasn't answering the question "Where do we go from here?". Whereas I am.

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Why Inflation ~~Is~~ Was Inevitable

Summary: *An event occurred in 1971 that put us on a historically unprecedented path – fiat money. Fiat is money not backed by anything tangible and no restriction on how much money could be printed. The ultimate result of that decision has to be inflation.*

History doesn't repeat but it often rhymes is an aphorism. An aphorism is 'a pithy observation that contains a general truth'. Because an aphorism is by definition 'pithy' (an excellent word in its own right) people like using them. That doesn't make them right – it makes them pithy.

I reference this pithy quote to raise a cautionary yellow flag in terms of applying it to understanding the markets. Too often analysis resorts to 'this period looks like that period ergo this is how it will resolve'. There's a comfort in believing everything is a cycle or everything mean reverts. History has rhymed often enough to provide that comfort. Doesn't make it so, though.

I prefer to view history as a continuum. We're brought to a point where a decision needs to be made. The proverbial fork in the road. The choice is made, a path followed and eventually consequences ensue. And so on and so on. From a socio-economic perspective I believe there have been four forks-in-the-road that explain how and why we arrived as we are today. There is value in understanding what brought us to a particular fork, what were the choices and most importantly how and by whom was the decision made. It's not as pithy as the opening quote but "you can't understand where you're going if you don't understand how you got here".

The four socio-economic forks of interest to me are the 1919 Treaty of Versailles which in due course begat Bretton Woods which begat the US closing the gold window in 1971 which begat The Greenspan Central Banker. It's too myopic to start with the Greenspan era of central banking. The two earlier points are historically fascinating - one being a treaty and one being an agreement. But both of those have rhymed with past history. To provide context and texture to understand why we are where we are let's go back to 1971. What happened in 1971 set us on a path without historical precedent. An open road untraveled. The historical significance of this event, in my humble opinion, is devastatingly underestimated and overlooked.

Prior to 1971 and as far back as commerce is recorded, sovereign currency was backed by something tangible – usually gold. Bretton

Woods altered this arrangement slightly with a too clever for words adaptation whereby the US would hold the gold and everybody else would peg to the US hoard. In 1971 circumstances prevailed forcing the USofA to "no más" the agreement. They would no longer willingly exchange US dollars for gold. This effectively meant that no currency – anywhere – was tied to a tangible. So begat the fiat economy – currency not backed by anything. If there is no tether there is no limit. In the ensuing fifty years central bankers and policy makers have learned the value and utility of limitlessness. The quantitative easing in response to the Great Financial Crisis through to the $1.7 trillion fiscal package in response to COVID 19 are the mere manifestation of a fiat world.

Milton Friedman, renowned Nobel Prize winner, once famously and succinctly said "inflation is always and everywhere a monetary phenomenon … ". While I am not a monetarist nor a Friedman disciple, I find truth in his quote. The ever-expanding asset base of governments and central banks is equally offset by an ever-expanding debt load. You, me and corporations see debt as an obligation that needs to be repaid. Governments don't seem to need to see debt the same way. There is an understanding that as long as they can grow the economy faster than debt growth (they can't and they aren't) and as long as they can tax (they can but there's a limit before they don't get re-elected) and as long as they can print money (they can and they are) then the debt load is not consequential. Here's the catch. Because each of these three caveats are parenthetically qualified there is a limit. Nothing in the universe is limitless. Currency expansion is not the exception.

Why this matters is because as one sovereign buys another sovereign's debt there needs to be a trust they will be repaid. Trust is the limit. Breach that trust and the end game begins. Sovereigns posture and pose to present fiscal prudence and economic good standing such that the trust limit is not tested or breached. Obviously the most constructive approach is to grow the economy. However, as evidenced by a declining rate of global gross domestic product, that's proving illusory. Other tools of government policy include austerity, repression or taxation. All of which are either politically unacceptable or socially unacceptable. Leaving one last trick to be played – inflation. Paying today's debt with tomorrow's inflated dollars. A tale as old as time. That tale also rhymes with past history.

In summation, and at the risk of oversimplifying a complex notion, in a world where currency has no tangible grounding, there is no limit to its expansion and there is no limit to the offsetting debt load. Debt management tools are limited in scope with the exception being the introduction of inflation as the ultimate debt solution. The destination

is chosen. The route taken is being determined. I cannot state this often enough. Fiat is an unprecedented environment. There is no historical precedent, there is no history to rhyme with. Focus less on the path being taken, i.e., the day-to-day market gyrations, and prepare for the ultimate destination as we are currently experiencing – inflation.

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Why Isn't Gold an Inflation Hedge?

Summary: *Gold advocates believe that gold provides protection against inflation. Their belief can be supported by anecdotal evidence. An objective view suggests this anecdotal evidence is spotty and used conveniently. Gold has a role in a portfolio but perhaps not as an inflation hedge.*

If gold is an inflation hedge then my life as an investor concerned with inflation would be simple; buy gold. I can't, unfortunately, come to that conclusion. Gold has many virtues but its character does not reliably include inflation protection. This view is contrary to widely held beliefs. Where then do I differ?

Gold advocates generally espouse two points of view to support their position of gold as an inflation hedge;

First Point of View - The value of goods when priced against gold has been constant throughout history, which is to say 'a very long time'. This is commonly referred to as **The Golden Constant**. Anecdotally the price of a gentleman's finery costs the same in gold as the price of a good business suit today. Ergo, gold has held its value.

Second Point of View - The price of **gold is inversely correlated to real[1] interest rates**. A complicated way of saying – 'if an investor can't earn bond income greater than inflation what's the point of owning bonds?'. Further, falling real rates also suggests inflation is rising which could lead to oppressive monetary policies. In both cases capital flows to gold for its protection against the decline in real income and possible monetary debasement.

Don't get me wrong – both notions have some merit but they are misapplied to the current exercise of protecting against inflation.

The Golden Constant

Intuitively and anecdotally I believe in gold as a constant. I like the notion that something costs the same today as it did historically if paid in gold. And, if I was trying to hedge for the next century there could be an application of this thesis. Unfortunately, over short periods of

[1] Real is underlined throughout the paper to bring focus to the discussion of "real" rates vs "nominal" rates. "Real" rates are a more powerful driver than "nominal" rates.

time it is not a reliable hedge and ties up capital long term that could be better used elsewhere more opportunistically.

Worse still, true believers in The Golden Constant have to come to grips with the fact that the current real price of gold is historically high. The basis of the golden constant is that the long-term real return on gold is zero, i.e., the price of gold rises exactly as inflation rises. The 2021 year end real price of gold was $6.4 whereas the average real price of gold since 1978, i.e. the constant, has been $3.8. If the return on gold is to be constant over time the price of gold would need to drop 40% or the CPI index would need to rise 69%. The former alternative is disconcerting and the latter is hard to grasp even for an inflationist.

Inverse Correlation to Declining Real Interest Rates

There is strong quantitative evidence that there exists a negative relationship between the price of gold and declining real interest rates. At first blush one might hope this relationship would be useful in hedging against inflation. And it would have been if one had bought gold when real rates had begun to decline. For example, real 10-year yields declined from approximately 2% in 2009 to -1% on 2013 coincident with gold rallying from $870 to $1,204, i.e., 38%. Or again in 2019 when real 10-year rates declined from 1% to -1% over 18 months vs. gold rallying from $1,279 to $1,880, i.e., 47%. Here's the problem though. Since August 2020 the price of gold has been steady whereas real rates continued to stay in negative territory. The implication being that my assets continued to be debased by negative real rates but gold has not provided any further protection. My overarching investment thesis is that the oversized debt load requires fiscal and monetary authorities to promote a long period of low if not negative real yields. There may be evidence that gold offers protection while real rates are moving lower but there is a lack of evidence that gold can protect a portfolio thereafter through long periods of negative real rates.

If gold's role in a portfolio is to protect against a decline in real interest rates, then its job may be done. Otherwise, there is not enough evidence to support gold's role to provide gains offsetting a continued decline in real income from sustained negative real rates. Gold has been a constructive portfolio asset since the Great Financial Crisis. Going forward the strategic value of holding gold in a portfolio comes from its other characteristics – to be discussed in **Why Isn't Gold a Currency?**

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Why Isn't Gold a Currency?

***Summary**: In this era of fiat currency, where there is nothing tangible backing money, what is gold's role? It certainly has historically been a currency. Is it still a currency? What is its role in an investment portfolio?*

A podcaster I respect was interviewing his friend, an international investor of some renown. The investor was espousing his views on deep value investing, purchasing public equities through the lens of private ownership; long term, conservative investing tips from a seasoned, respected investor. The conversation turned to gold. The interviewer was a gold advocate and asked about gold's role in a portfolio at which point the interview took an interesting turn. Gold advocates generally have a view that a gold position should be 5% - 10% of a portfolio. At the time I was advocating 5%. The gentleman calmly disclosed his gold position was 30% of his portfolio. Wowzer! The interviewer had no idea his friend had such a significant gold weight. The explanation was that he views gold as a currency and a better store of value than other currencies which were being debased, in his opinion.

This was a new perspective for me and I chewed on it over the next few weeks. Ultimately, I liked how it fit my thesis and I committed to moving my allocation from 5% towards 10% (30% was way beyond my comfort zone). The short version of the story is I stopped at 7%. The volatility increase in my portfolio from the additional 2% was too much for me. While I was pausing at 7% I tried to understand how this conservative investor could tolerate a 30% weight if my 2% incremental increase was personally troublesome. Where I settled was, I came to the conclusion that gold is in fact <u>not</u> a currency. In my view gold is a commodity that <u>wants</u> to be a currency. Therefore, if I like gold it's because it's a hedge that fiat currency will one day be replaced by a currency tied to a hard asset. Gold's role in history makes it the most likely candidate.

What is a Currency?

Economists have a set of criteria that defines a currency. A currency has to have the following properties;

- Store of Value: it can be saved and used later
- Unit of Account: it can be used to quote prices
- Medium of Exchange: it can be used to buy goods and services

Let's examine each individually.

- **Store of value** – Gold has an annualized volatility of approximately 15%. That implies that within the span of a year the value of your gold could range up 15% or down 15% two thirds of the time. One has to determine one's personal tolerance. For me, that turned out to be too high a range to consider it a store of value.
- **Unit of Account** – we don't generally think of consumer goods in terms of the price of gold. No one values the price of a car in terms of ounces of gold. From time to time researchers will talk about the value of oil priced in gold but it's an intellectual exercise more than a practical exercise.
- **Medium of Exchange** – I'll admit that I keep a small amount of physical gold nearby. That's because I've watched Casablanca too many times and the image of Rick Blaine (Humphrey Bogart) giving Ilsa Lund (Ingrid Bergman) the letters of transit is ingrained in my nostalgic heart. Back in reality though, one doesn't generally transact in gold.

If gold's not a currency, then what is it? It's a commodity. Just as lumber, copper and silver are commodities. Liquid markets exist for where producers and buyers can meet and transact. Gold differs slightly from these other examples in that the price of gold is higher than its industrial or intrinsic value. What explains its premium? Gold is a commodity, like the others, except unlike the others it has airs and wants again to be a currency.

In a scenario whereby this era of fiat currency ends, gold could be restored as the tangible backing of a new currency regime. Gold's role in a portfolio is a call option on this scenario. That is, holding gold is an option on the breakdown of the fiat system. Once you come to see it as an option you realize you size it as you would size a long-term call option. Large enough to benefit from the leverage if your call is right but small enough that if the option expires without value you can sustain the complete loss of premium. Finger in the air comfort level: 5%.

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Why Gold Was the Bitcoin of the 1970's

***Summary**: The narrative that Bitcoin is "Digital Gold" has caught the imagination of the investing public. But is it? What does that even mean? This paper compares Bitcoin today to how gold similarly caught the public's imagination in 1980 when it was the shiny new object of the day.*

There's a theory that the market you enter at the beginning of your investment career is the market you will trade the rest of your career. If you enter in the midst of a crash you will forever be on guard for a crash. If you invest in the midst of a raging bull market you will forever presume that markets will always, eventually, be bullish. God help those who enter at the beginning of a parabolic market and are cursed to believe that if you can catch just one more wave all will be set right.

What if I had begun my investment career in 2017 right after graduating university? I'd have had a background in maths and computer science with enough business courses to be dangerous. In 2017, at that age with that background, I would most certainly have come across bitcoin. Right at the time when bitcoin was breaking out of the crypto-nerd crowd and into public view.

Bitcoin (BTC) was at the beginning of its parabolic move from $1,200 to $20,000. Maybe I would have seized the opportunity and positioned myself to be the go-to BTC expert given my age, my background and the innate ability of a 22-year-old to conflate being involved in the zeitgeist with actually knowing what was going on. Somewhere I would have heard "Bitcoin is Digital Gold" and it would have been a mic drop. Boom! I would have jumped on the wagon and gone for the ride.

I'd like to think my 2017 self wasn't a complete idiot so when BTC retraced 50% in a quick couple of months thereafter I would have kept my head down. But my commitment would not waiver. This shiny new object, this Digital Gold, would have its day again and I would be there to reap the rewards.

But I didn't start my career in 2017. I started in 1980. The shiny object of the day in those inflationary times? Gold. Real gold. The 79th element on the periodic table. But how could gold have been the 'new' shiny object? It had been used as a currency for a millennium. Why? Because between 1934 and 1974 it was illegal for Americans to own it. For forty years, two generations, nobody in the US knew how to use gold as an investment. Suddenly in 1974 it was released and coincidentally there was inflation and thankfully there was a narrative that gold was an inflation hedge. The fuse was lit but it was a slow fuse.

At year end 1974 the price of gold was around $100 / oz. Four years later it was roughly $200 / oz. Not exactly parabolic. Yet.

My career started in the midst of the 1980 great recession. That was when we knew how to do recessions. Deep and long. We didn't invent the word stagflation, the Brits had a decade earlier. But we popularized it. It was a combination that was not supposed to be possible; economic stagnation and inflation at the same time. The working person was squeezed at both ends and interest rates were rising. Enter the shiny new object – gold. The protector from inflation and the store of value. From 1979 to early 1980 the price of gold shot from $200'ish to $670'ish – more than a 240% increase. The mania was fed on the hope of riches that would offset the devastation in day-to-day life. It was fed on the historical narrative of inflation protection. There wasn't any recent history of gold to rely on so there was no debunking the narrative.

What's the learning lesson? Be wary of parabolic markets? No – well yes - but no. The lesson is be wary of narratives that cannot be substantiated by historical reason. Inflation in the 70's and 80's wasn't new. There had been bouts after both great wars. But gold wasn't a tradeable asset then. There was no history of freely traded gold during those inflationary periods and there certainly wasn't any history of gold's attribution to a diversified portfolio.

Does that provide a useful analog for understanding BTC? Is there a historical basis to understand if BTC's price is rich or cheap? Is there an understanding of its purpose and its attribution to a portfolio? Be wary of narratives that cannot be substantiated by historical reason.

I entered the industry when gold was going parabolic. Am I intrigued by today's shiny new object that has proven its ability to go parabolic? Absolutely. Yet I keep in mind that after gold's crash in 1980 it took 26 years before gold recovered to its prior peak and it didn't prove to be the inflation hedge the narrative predicted.

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What Is Bitcoin? a) Store of Value, b) Currency, c) Digital Gold, d) All or None of the Above

Summary: *The fact that we can't say with certainty what exactly Bitcoin is, is interesting. The following paper examines some options and comes to a conclusion – for now.*

What is Bitcoin (BTC)? At the time of writing BTC was trading at $37,700. Three months prior it was $59,000. Six months back it was $29,000. Store of value? Currency? Digital gold? How can these be open and valid questions yet someone is willing to use $37,000 of their US dollars to buy – what? And why?

a) Store of Value: One shouldn't need to rely on Justice Stewart Potter's pornography definition "*I know it when I see it*" to determine if something is a store of value. If it's worth today what it was worth yesterday, if it's worth yesterday what it was worth last week, then it's a store of value. How much variance am I willing to allow before I have to invoke Justice Potter's wisdom? Plus, or minus 5% in a day, a week, a month a year? *Will I know a store of value when I see it*?

Equities are a core position in a classic portfolio allocation. Why? Because equities provide growth. Not safety. Growth. Risk, as measured by volatility, is accepted as a trade-off for the growth potential. Equity risk is roughly plugged into models at 15% annualized. That is, 15% is one standard deviation of acceptable returns.

BTC currently trades with a volatility of 70%. It's a moving target but let's acknowledge that BTC is currently leagues more volatile than equities. I rhetorically ask, if nobody sees equities as a store of value and they trade at 15% risk, how can an asset trading at 70% risk be a store of value?

When advocates suggest BTC is a store of value I believe what they're saying is it will become a store of value. I might agree with that but semantics are important. What that translates to is that the current price of BTC is an option on BTC becoming a store of value. It categorically is not currently a store of value. Whether $37,700 is a fair value for the option is a separate question.

b) Currency: A search on the definition of currency will bring up a number of criteria. I'll focus on only two; 1) a store of value – the ability

to save it and use it later, and 2) supply is controlled or limited, i.e., certainty it can't be debased.

Those who advocate that BTC is a currency are convinced both are true. My point of view cannot abide the store of value test, as previously noted. Regarding the second criteria I have trouble accepting supply is controlled or limited. There's an act of faith that BTC advocates have accepted that I have trouble with. Their holy grail is that the amount of BTC that can be minted is known and fixed. To me, the open-source nature of the intellectual property convinces me that BTC is the first but not necessarily the last. They'll counter that it has first mover market advantage. I concede to that point and parry that is not an immutable advantage. We agree to disagree.

c) Digital Gold: Let's simplify this leg of the debate. Gold is a tangible. Irrefutable. BTC is an intangible. Irrefutable. Ergo claiming BTC is digital gold is saying BTC is an intangible tangible. I'm tempted to cheekily ask if you enjoyed your jumbo shrimp while I flip through the dictionary searching for the definition of oxymoron. I resist because cheeky doesn't play. Gold advocates are drawn to gold specifically because of its physical properties. Looking through the BTC lens bitcoiners would claim that tangibility is a quaint notion from a bygone time. That the world is digital and gold is an analog reference. I absolutely want to agree but can't get past what I outlined above re. the unlimited supply potential that arises from open-source intellectual property. Again, we agree to disagree.

d) All or None of the Above?

Where do I end up on all this? I want to agree it's a currency. I want to agree it's digital gold. I can't agree on either because I can't agree it's a store value. It may become a store of value. *Will I know it when I see it*? It's a risk. It's not the first risk of this nature I've faced in my career. (Will ESG change the markets? Will high frequency trading corrupt the markets? Was Alan Greenspan a maestro? Will Facebook and Twitter change how we socialize?) It's a risk that can be managed. Stay open minded. Challenge your base principles. Stay current. Do R&D. Be willing to lose money to learn. I'm not buying the option that BTC will be a store of value. But I reserve the option to change.

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What is an Intangible Intangible Asset?

Summary: *Intangible assets have value if they are tied to producing cashflows. That would be a tangible intangible such as a patent. There are intangible intangibles such as branding that prove to have valuation difficulties. When intangible intangibiles grow too large they can be ruinous. Fiat currency is an intangible intangible.*

In 2006 I had the opportunity to explore a new career direction. I reflected on my impression that the early days of hedge funds were interesting, exciting and fun because we were playing in a field where there were few players. To a certain degree we were sourcing advantageous returns because the securities we trafficked in weren't well understood and were therefore inefficiently priced leading to attractive and rewarding risk adjusted returns. As happens in markets, those opportunities waned as more capital, better models and higher IQ's came into the game. So I set upon the task to see if I could uncover another, or the next, opportunity that was likewise not well trafficked and offered the fun and excitement and, if properly executed, a new source of attractive returns.

What I settled on and chose to pursue was a line item on corporate balance sheets that was under serviced, under financed and misunderstood. The intangible asset. In particular the intangible asset of my choosing was intellectual property. I embarked on setting up an alternative investment fund to finance intellectual property. A long story to be told a different time, it has been an unrequited pursuit that I continue today. But along the way I learned a thing or two about intangibles. Germane to this paper is the valuation of intangibles and the difference between tangible intangibles and intangible intangibles. Akin to Rumsfeld's known unknowns and unknown unknowns.

The distinction between tangible and intangible intangibles is the former can be valued while that latter cannot. Examples of tangible intangibles include patents, software, customer lists, copyrights, trademarks, accounts receivables and mineral rights to name a few. Weighty tomes have been written on how to value these assets. Essentially, they all seem to revert to a complicated equivalent of a discounted cash flow model. Whereas intangible intangibles simply cannot be valued. You work backwards and plug in a number to solve for their value. For example, balance sheet assets have to equal liabilities. When there's a mismatch the balancing value gets plugged in as an intangible value on the asset side. All manner of unsolvable assets get bucketed into 'intangibles'; goodwill, brand value being two that easily come to mind.

Intangible intangibles, as an asset, can prove to be perilous to one's wealth. In small doses they can be ignored. They appear benign. However, as they grow on the balance sheet they take on the equivalent of that grain of sand being added to a sand pile. You can trust the sandpile is stable. Right up until you can't. With disastrous outcome. A sand slide as per the metaphor or a loss of capital as per an investment.

An illustrative example would be the once great Canadian company Nortel. Nortel grew rapidly in the late 1990's taking advantage of the parabolic growth of the fibre optic industry as the internet was developing. Nortel's CEO seized acquisition opportunities using its appreciating stock price as the currency for acquisitions. Here's where the intangible intangible comes into play. When the acquisition price was greater than the book value of the target company the difference was added into Nortel's 'goodwill' asset line. By fiscal year end 2000 Nortel's Intangible Asset line was $18 b of its $42 b billion asset total. It was the largest line item on the asset side of the balance sheet weighing in at 43% of the company's assets. Come the 2000 tech crash a write down of intangibles was required resulting in a write off of up to $14 b in asset value. Nortel's stock price collapsed from $124 to $0.47.

The takeaway point of Nortel is the illustration that an intangible intangible has no value. It's ignorable in small amounts but at an extreme it is destabilizing. The destabilization is triggered as soon as faith is lost. As soon as the unknown unknown is known to have no value. A reliance on an intangible intangible asset requires faith and trust and once breached there will be chaos and losses.

Where within our portfolios does an intangible intangible exist? Where are we relying on faith and trust? Shockingly it's the largest asset in the world. Currencies, specifically fiat currencies. I cannot over emphasize that the fiat world we exist in has no precedent. There is no time in history, of any relevance, in which the entire world's currency system was fiat, i.e., faith based. Why is a US dollar worth a dollar? As an intangible intangible it's only because we have faith it is. A country's fiat currency only has its value until that faith is lost.

Fiat currency exists on the belief in a sovereign's ability to grow its economy, tax or print more money. The eventual lack of confidence in growth and the ability to tax leaves only printing. History has not been kind to countries whose last resort is to print money with no limit.

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How the Fed is Forcing Investors to Take More Risk

***Summary**: Since the Great Financial Crisis short term interest rates have been controlled by central banks. Their objective has been to spur economic activity. Investors need to realize that these interest rates also serve to set market risk. If rates are artificially low, risk is artificially low. When risk resets asset prices will reset also – lower.*

Regrettably, I've never done acid. I say regrettably because I have a notion that a good acid trip would be the one time my conscious mind would be freed from the omnipresent calculation of risk vs. reward. Micro decisions every hour of every day. I've wondered what it would be like to be momentarily released from the burden. Yet our existence depends on the constant analysis of risk vs. reward. Usually the decisions are trivial, with obvious outcomes, but not always. Everybody has their own risk level. Your risk profile will be different than mine. We self-determine our risk. Personal risk isn't calibrated to a benchmark standard.

In the investing world risk is calibrated. The models we rely on require it. It's quaintly called the Risk Free Rate of return (RFR). It's the theoretical return on an investment with zero risk. For my entire investment career that has been the US 3-month t-bill. That is, until the Great Financial Crisis, thirteen years ago. More than half a generation ago. We've all but forgotten the heroic initiatives undertaken by Henry Paulson (Secretary of the Treasury), Ben Bernanke (Chair of the Federal Reserve) and Timothy Geithner (President of the Federal Reserve Bank of New York) to right the ship of the sinking global economy. What it took was setting the Risk Free Rate of return to nearly zero[1].

Essentially the RFR is the cost of money. It's the single most important price in the world. It was set at near zero and stayed at near zero for over seven years. Refer back to my earlier definition – the rate of return on an investment with zero risk was – zero. What do you think that does to one's sense of risk vs. reward? It forces you to reach for more reward by taking more risk. And so we have.

An investor builds an investment risk framework starting with the RFR. By taking more risk an investor would expect more return. Presuming nobody's happy with zero one steps out the risk curve. A six-month t-

[1] Technically the Federal Reserve sets the Fed Funds rate, i.e. the rate banks charge each other. But that rate influences the 3 month t-bill rate, the one I identified as the RFR.

bill should have a higher return than a 3-month t-bill. Longer term, more risk, higher reward. Likewise, a one-year bond should be higher than a 6-month bond. And onwards for 3 years, 7 years, 30 years. Maybe you like the 7-year term but not the interest rate. Well, investment grade corporate bonds pay more than government bonds. High yield bonds pay more than investment grade bonds. Private bonds might pay more than tradeable bonds albeit with less liquidity. Equities offer higher returns but are riskier than bonds. Growth stocks riskier than blue chips. Emerging markets vs. developed markets. And so on.

A well constructed investment portfolio is a blend of assets with varying risk/reward characteristics that average out to match an investor's risk/reward appetite. If you're targeting an overall 6% percent return you'll take some 3% expected return allocations with safety of principal and some 9% returns with higher risk and over time be happy with a blended 6%. That's the theory.

Here's the million dollar question. What if the base rate, the Risk Free Rate, is set too low? What if the Federal Reserve, for whatever reason, kept the RFR lower than natural market forces would have allowed? Wouldn't that make an investor pause and ponder if perhaps the risk of one's portfolio is understated and that one's reach for rewards is perhaps taking on more risk than the models or your investment advisor is suggesting? It's a leading question. I say YES, the investment industry, by and large, is saying Nah.

I started this article by cautioning that we can't suspend our instinctive notion of risk/reward. We individually determine our personal risk/reward framework constantly adjusting and calibrating it so we can live our lives. I'm cautioning investors to do the same with their portfolios. Question the validity of the risk/reward that the marketplace is implicitly stating. Calibrate your investment decisions and portfolios by questioning the validity of the Risk Free Rate and the risk/reward framework bootstrapped from that base. A variable as important as the Cost of Money can't be controlled by an agency (Federal Reserve) perpetually. When natural market forces prevail again risk premium will adjust upwards and asset prices will reset lower. Be ahead of that. Oh, and with regards to my opening statement – Don't Take Drugs.

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The Models Aren't Wrong – They're Just Not Always Valid

***Summary**: Investment management is built on a bedrock of quantitative models that have earned the originators Nobel Prizes. But it cannot be assumed that these models are infallible. Their underlying assumptions and nuances have to be taken into account before being used for real life purposes.*

There are giants in modern finance with unimpeachable reputations. Nobel winners such as William Sharpe, Harry Markowitz, Myron Scholes have helped define modern finance. Their models and formulas provide the structure and backbone on which we confidently manage our assets. To rail against these giants would equal the folly of Don Quixote charging at the windmills. And yet, I shall.

The arc of my career began as a quantitative equity analyst. In a time before the introduction of the IBM PC – the Precambrian period of personal computing. I studied the work of these future Nobel laureates and practiced the quantitative arts they defined. As time marched on I became an arbitrageur whose purpose and pay were dependent on exploiting the flaws either in the models themselves or exposed by the models. One's perception changes when tilting at windmills.

As the answer to every economic question is supply & demand the answer to any investment decision is risk vs. reward. I had come to believe that this identity could be oversimplified to art vs. science. The art of producing risk-adjusted returns vs. the science of controlling risk. Having worked long enough to have experienced more than my share of financial earthquakes teaches one that there is also an art to the science.

The formulas and models that have formed the bedrock of investment management assumes a stasis in the markets that does not exist. Stated simply, the markets of today are not the same as the markets when the models were created. It doesn't suggest the models are wrong it suggests their application has to be nuanced. An unwillingness to apply a qualitative lens to a quantitative approach will lead to missing the curve in the road. It can't be assumed the road is forever straight. There's a reason every car has a steering wheel.

What exactly is it that I'm questioning when examining the validity of a model? Three elements;

1) variables that are presumed to be independent but are not, and,
2) variables that are presumed constant but are not, and
3) the data backing the model

1) Independent Variables as Illustrated by the Sharpe Ratio

The American economist William Sharpe won the Nobel Prize in Economic Sciences in 1990. In 1966 he published the Sharpe Ratio. A ratio to measure the risk adjusted performance of an asset. In fairness to Professor Sharpe, he himself derides the overutilization of this formula. Nonetheless its continued use to compare assets requires attention. The formula is;

$$Sharpe\ Ratio = \frac{R_p - R_f}{\sigma_p}$$

where:

R_p = return of portfolio

R_f = risk-free rate

σ_p = standard deviation of the portfolio's excess return

I've highlighted the object of my consternation – the risk free rate. After the Great Financial Crisis the Federal Reserve had seen fit to set and control the risk free rate at or near zero. Professor Sharpe would have presumed that the risk free rate was a market determined variable. His model assumes that it reflects the true rate of return that an investment with no risk would earn. However, if it is not market determined and is controlled by an actor can one assume that the output of the formula accurately risk adjusts an asset's return? Answer – I think not.

2) Constancy of Variables as Illustrated by Portfolio Variance

Harry Markowitz, also an American economist, joined William Sharpe in receiving the Nobel Prize in 1990. He's known as the father of Modern Portfolio Theory, a theory that states a portfolio's variance (risk) can be reduced by selecting assets with low or negative correlations. Hence the calculation of portfolio variance warrants attention.

$$Portfolio\ variance = w_1^2\sigma_1^2 + w_2^2\sigma_2^2 + 2w_1w_2Cov_{1,2}$$

Where:

- w_1 = the portfolio weight of the first asset
- w_2 = the portfolio weight of the second asset
- σ_1 = the standard deviation of the first asset
- σ_2 = the standard deviation of the second asset
- $Cov_{1,2}$ = the covariance of the two assets, which can thus be expressed as $p_{(1,2)}\sigma_1\sigma_2$, where $p_{(1,2)}$ is the correlation coefficient between the two assets

The objective of Modern Portfolio Theory is to design an asset mix with maximum return while minimizing risk. The correlation of the assets is of paramount importance. The calculation is made at a point in time but the correlations between the two variables is not constant. Two variables might have been uncorrelated at the time of measurement and therefore risk minimizing but over time become highly correlated in effect raising risk. I once, when asked, cautioned Canada's bank regulator that correlation is the least understood variable in finance. I said that in 2007 just prior to the collateralized debt obligation (CDO) blow-up which was a model built on a flawed correlation assumption.

3) Data Sampling Out of Date as Illustrated by the 60/40 Portfolio

No Nobel prize has been awarded for the design of the 60/40 portfolio. In a further article I describe in painstaking, tedious detail this was an evolution as opposed to a breakthrough. The point I raise in this exercise is that the apparent and obvious success of the 60/40 portfolio is not the genius of the model but the effect of the times we live in. To assume its continued success is to assume the continued state of the markets. That requires you to believe that interest rates will not rise from the lows set after the Great Financial Crisis. A dangerous assumption on which to rely.

The book Don Quixote is considered by literary historians as one of the most important books of all time. Quixote became an archetype. I am no Don Quixote. I know the windmills aren't giants. But I also know the giants and their models aren't infallible. The models aren't wrong but they can be misapplied.

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The 60/40 Model – What Could Go Wrong

***Summary**: The 60% equity / 40% bond model portfolio has become the backbone of portfolio management. Its apparent success cannot be taken for granted going forward. Since its mass adoption the primary driver of its success has been the lowering of interest rates. Can that be assumed to continue?*

As a friend, what's your obligation if someone you care about is walking towards what appears to be a cliff? It might only be an indention or could be nothing? For further context your friend has been having a beautiful, enjoyable 40-year walk. There's been some rough terrain but well enough handled that it hasn't ruined the outing. Oh, and you might have yelled WATCH OUT a couple of times already.

The 60/40 portfolio is the metaphorical cliff. I work in an industry that is dependent on models and dependent on those models working. It's not that I see danger everywhere. But I've made my living understanding when the models are not going to work and why.

The 60% equities / 40% bond model portfolio is constructed to deliver consistent, moderate growth. The 60% weight in equities is the growth component. The 40% weight in bonds is the anchor. There's an expected interplay between these two assets. Difficult times in the equity markets are offset by stronger returns in the bond portfolio and vice versa. In technical terms the two assets are considered to be negatively correlated which creates the consistent, moderate growth.

In a separate paper I've described the 60/40 model portfolio as 'elegant'. Its elegance lies in its simplicity while still allowing flairs of creativity. The investment industry controls the inputs into the model in terms of products and services and the markets determine the output in terms of returns. To understand the model's weaknesses, you have to understand both the industry and the drivers of the market returns. Only then can you determine What Could Go Wrong and why.

It's logical to start with the market drivers. CNBC, BNN, WSJ, FT, the alphabet of overbearing, earnest coverage of all market issues wants you to know what they know is important. I'm going to be blunt and skip the usual supportive rhetoric. Bullishness sells. These are for-profit organizations and ad revenue is dependent on viewership/readership and that's dependent on wanting to be engaged. There's no malicious intent as it's been a justifiable stance. Since 1982 large cap US stocks have returned 10,427%. That's not a typo. Bonds? US 20 year government bond total return, 3,328%! I kid you not. It's not only been easy to be bullish, it's been right.

The underlying assumption of the 60% weight in equities is dependent on the upward sloping line of equity market returns. That's dependent on an upward sloping line of annual increases in gross domestic product (GDP). GDP measures the growth in the economy and over the period the 60/40 model has been utilized it's been a positive growth environment. The 60% equity weight is dependent on it and has gotten it.

The 40% bond weight has more than held up its end of the bargain. You wanted an anchor? Bonds have been your friend. But wait. Doesn't 3,328% over 40 years equal 9.2% per year compounded? How have bonds done that? In 1982 a bond investor earned 13% in interest from a 20-year US government bond. Last year, 2021, she/he earned only 1.7% in income. In between those two periods it was the price appreciation of the bonds that created the majority of the returns, not interest earned. Of the 3,328%, 75% of that return is from bond price increases as interest rates dropped from 13% to 1.7%.

The investment industry also plays a role in the success of the 60/40 portfolio. It pains me but it's necessary to quote Warren Buffet's partner Charlie Munger; "Show me the incentive and I'll show you the outcome". The investment advisory industry is a fee driven industry. Fees are earned by advising assets and selling products. I mentioned earlier that the 60/40 portfolio's elegance provides for flairs of creativity. That was code. What it provides is the opportunity for an investment advisor to add their own spice to the broth. Products are specially created to add the flair. The 60/40 portfolio provides a steady and steadily increasing asset base for fee revenue plus a steady stream of products to feed into the model each with the opportunity to earn more fees. It's not duplicitous. It's the way the world works.

No doubt about it the portfolio allocation of 60% equities and 40% bonds has been working. So why am I howling at the moon? If my specialty is knowing the why's and when's then why and when will it not work?

First, the non-correlation between stocks and bonds can't be assumed to continue. The performance of the equity market has been driven by the lowering of the risk free rate of return to almost zero. The performance of the bond market has been driven by interest rates being lowered to almost zero. I don't need to model it out for you, if interest rates can't go lower than zero (not necessarily a safe assumption) then these two assets can no longer act independently and non-correlation cannot be assumed. If interest rates increase the performance of the bond portfolio will be negative. The anchor will have detached. If a primary driver of

equity performance has been lower interest rates and interest rates don't go lower, the primary driver of equity returns will stall.

The Why? is because the assumptions underlying 60/40 model break in a rising rate environment. When? Rates rise in an inflationary environment as central bankers raise rates to stem further inflation. The 60/40 portfolio has been a stalwart. It is not designed for a rising rate environment. There hasn't been a rising rate environment since the model took root in investment portfolios. A new portfolio model is required but the investment industry is not prepared with the services and products to support a new model. Please, my friends, watch out for the cliff.

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The 60/40 Portfolio – Elegant but Potentially Fatal?

Summary: *The 60% equity / 40% bond model portfolio has become widely accepted. It appears to be an elegant model because it makes the complex task of portfolio management look easy. This paper discusses the foibles of this elegant model.*

Elegance – often sought, rarely achieved. To praise a mathematician's solution as 'elegant' is the highest praise. Elegance achieved is surprisingly simple and insightful yet effective and constructive. Throughout my career the investment industry has settled on a portfolio construct that rises to the definition of elegance. That which has become known as the 60/40 portfolio. Yet I write this article to bring to your attention that this elegant solution may be the equivalent of the equally beautiful and elegant Venus Fly Trap. Metaphorically the Venus Fly Trap is the 60/40 model and the unsuspecting investor is the soon to be terminal insect.

It's important to realize that the 60/40 portfolio (soon to be described fully) was not created to meet a specific need. It evolved as the industry and markets evolved and through the equivalency of natural selection the 60/40 model was derived. Remember though that natural selection created the lobster. Don't get me wrong, I love lobster. But seriously, what a freaky arthropod. Can anybody intuitively figure out how that evolved?

To understand how we got to this 60/40 elegant construct we have to follow three paths separately to where they converged.

- The first path is to follow how investors have interacted with the stock and bond markets over time.
- The second path is to follow how the investment advisory industry morphed.
- The third path is to follow how we individually became responsible for our financial freedom.

First Path: My career started in 1980 when I joined a brokerage firm. Not what we today call an investment dealer. I started at a broker. There was a retail division and an institutional division. The retail group serviced a few 'wealthies' but mostly it was speculative trading. Incented by commissions it was a churn and burn game. The institutional group, split between stocks and bonds, handled the trust accounts, pension plans, mutual funds and a few boutiques that were starting to sprout. The bond guys were king because bonds used to be the majority of a portfolio. The balance between the bond groups and

equity groups started to equalize shortly after the 1982 recession and the ensuing equity market recovery. Equities now play a larger role in a typical portfolio.

Second Path: The investment industry we know today has investment advisors and financial planners. The investment industry I started in had Wolf of Wall Street, Boiler Room brokers. In the early to mid-90's overseers and regulators came to grips and dealt with the inherent conflict of interest that arises from compensation tied to commissions. And so began the shift towards charging a flat management fee for services. Coincident with this development financial service companies (otherwise known as banks) began to diversify beyond deposit taking to offer the full suite of banking, insurance and investing. The banks bought the brokers. Sharks eating the chum. The banks had different objectives than the brokers they'd bought. If the old revenue model had been commissions that meant activity. If the new model was a flat fee that meant get big. Getting big meant getting conservative. Getting conservative meant a model that produced consistent returns with moderate volatility.

Third Path: My parents cautioned me early in my career not to jump around too much otherwise I'd never have a pension. They and their forebears relied on corporate pensions for their post working days. Come the 1980's corporations came to realize the burden of funding defined pension plans and began the shift of the responsibility onto the pensioners themselves. Governments aided with the introduction of tax incentives to encourage personal retirement savings. In Canada the Registered Retirement Savings Plan (401 k for Americans) was introduced in 1957 but had only $10 billion on deposit by 1991. It's eventual acceptance and uptake was coincident with banks entering the financial services game and selling investment advice and services to clients taking responsibility for their retirement savings.

Three Paths Converged: Three paths, albeit not entirely independent paths, converged to the superhighway of financial planning, servicing and the associated products that we know today. The overarching objective is to assist investors on their path to financial independence in their retirement years. Prudence and conservatism are the guiding principles. The basic building blocks of prudence are cash, bonds and stocks. The witches brew of ultimate conservatism has become the 60/40 portfolio; 60% equities and 40% bonds. Bonds for income and certainty of principal repayment, otherwise known as safety. Stocks for the sizzle, the growth the wealth creation.

Elegance can make something complex look surprisingly simple. Where does my cautionary Venus Fly Trap warning come in? The elegance of

the 60/40 model results from its appearance of effectiveness. That's cryptic – let me explain. It's easy to confuse something as effective because it has been working. We don't lift the hood of our cars until an engine warning light comes on. And even then, we peer inside with no knowledge of what to do.

Since the emergence of the 60/40 model the 40% allocation to bonds has benefited from an uninterrupted decline in interest rates – good for bonds. Simultaneously, the 60% allocation to equities has benefited from a lovely sloping upward trendline. Admittedly not always a smooth ride but with an accommodating central bank in times of crisis it's a trend we've come to rely on. When the bonds or the equities have sputtered the other piece of the portfolio covered the slack. A concept known as offsetting correlations. The stocks telling the bonds "I've got your back" and vice versa.

The stellar track record of 60/40 and unquestioned perceptions as to how and why it works changes in an inflationary environment. Ladies and gentlemen, the engine light is flashing.

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What's An Inflation Protected Portfolio?

***Summary**: There has not been an inflationary period in developed markets for over forty years. Which means there hasn't been a focus on managing a portfolio through an inflationary period. This paper illustrates an inflation protect portfolio.*

Try and act surprised when your grandchild comes home from school and asks "*did you know there was a time when interest rates were zero, like, for almost 12 years? And, like, the average person couldn't afford a house, like.".* Anybody who in the last five years has stuck their toe into the housing market can attest to the frustration that you can't buy what you want, you buy what you can get. The image of your dream home gets chiseled down to the house that is available at a price you and your banker could tolerate.

Building a portfolio that will protect your assets through an inflationary period is much the same process. You count on your investment advisor to be your eyes and ears on the market just as you rely on your real estate agent to make sure the full opportunity set of available homes are brought to you. Unfortunately, in the exercise of inflation protection your advisor may not have the full opportunity set available.

The investment industry has supported an education program that leads to a chartered designation, the Chartered Financial Analyst (CFA). I took the course in the early 1980's and surprisingly, given the mountainous tome of the body of knowledge, retained a thing or two. Germane to this exercise what I distinctly remember was the curriculum declaring that inflation is notoriously difficult to manage. The US centric program noted that countries such as the UK, Australia and Canada had inflation protected bonds but these were not yet available in the US. In fact, not until 1997 when the US treasury issued their first. Notoriously difficult stuck in my mind.

The investment management industry is by and large conventional. The convention of Modern Portfolio Theory (MPT) has served it well both in terms of investment returns and also as the platform on which to run a high margin business. But. But it won't work through inflation.

MPT seeks to build an efficient portfolio by diversifying amongst assets of differing risk, reward and offsetting correlations to create an optimum portfolio at a reduced risk. Conventionally today's investment advisor is typically limited to the building blocks of cash, bonds and equities. Bonds and equities are each dissected into further tranches, each offering further differentiated risk, rewards. Moving out the risk scale

from short dated US government bonds leads to longer dated governments, to investment grade corporate, to high yield corporate. The scope expands to international sovereign offerings and so on. Likewise, the equity offering expands to large cap vs small cap vs international to emerging markets, and again, and so on. There's a near infinite range of possibilities from which an optimum portfolio can be drawn.

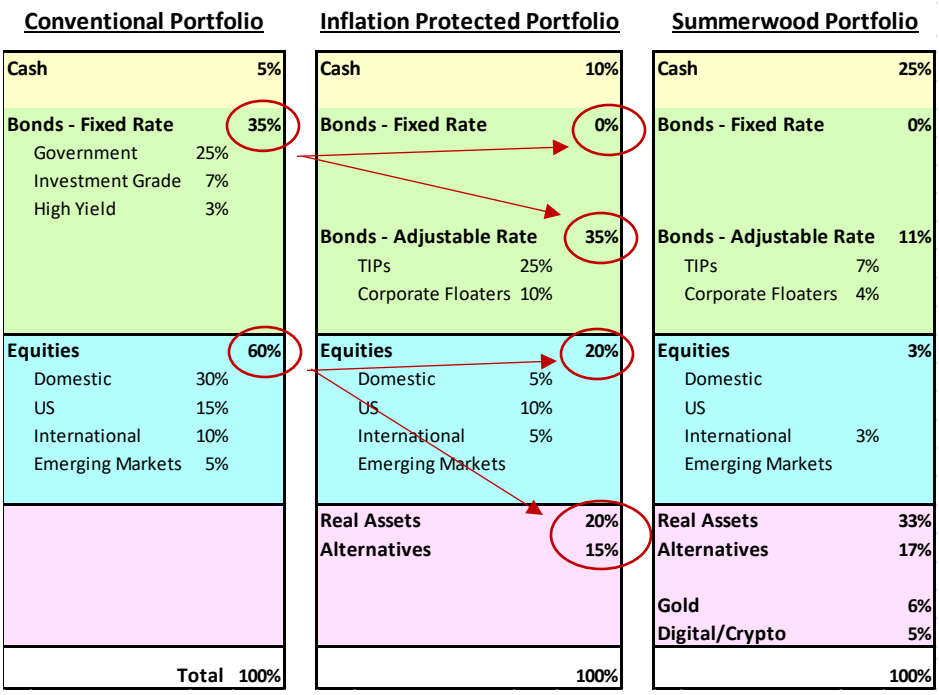
But. But the underlying assumption that diversification lowers risk through non-correlation is moot during inflation. The tool of choice for monetary authorities to tackle inflation has been to raise interest rates. The offsetting correlation assumption between bonds and equities is then no longer reliable making the theory of modern portfolio theory unstable.

You may counter that surely if domestic rates rise an international portfolio will provide protection. I parry with two observations; 1) any illusory gains made internationally will be scratched back by a currency effect, i.e. the foreign currency will likely depreciate against your domestic currency, and 2) notwithstanding recent developments suggesting the reversal of globalization, the developed world in aggregate has reached the same state of debt burden and money supply, i.e. there is no safe haven in the developed countries from inflation. In an inflationary environment the limited choices of cash, bonds and stocks is too limiting.

What then, if the conventional asset building blocks aren't up to the task? Start with the bond allocation. In order to preserve capital while earning income the fixed rate bond portfolio has to be converted to adjustable-rate income. The selection would include TIPs, floaters and swaps. Moving to equities the broad based fully diversified index approach has to become more focused. Focused on income earning businesses with real assets. It's not a time for passive broad index investing. It requires skillful active management to rotate through sectors and companies as the economy morphs through the inflation cycle.

New return sources outside of conventions need to be brought into the portfolio. Real assets in the broadest definition: natural resources, land, large scale heavy equipment, commodities. A finishing garnish would to add in a portfolio of alternative investments, i.e., hedge funds. The inflation battle will primarily be fought in the fixed income and currency worlds. Macro hedge funds are the apex predators in this terrain and will add diversifying value and returns through an inflation episode.

What does all this lead to? I've presented below three illustrative portfolios ranging from the conventional to an archetypal inflation portfolio and I've thrown Summerwood's current portfolio into the mix as well. The latter to show the degree of customization that can be brought to the exercise dependent on one's views and objectives.



It has been 40 years since the developed countries have experienced inflation. An entire generation of investment professionals have cycled through the industry without needing inflation management skills. The current crop of investment professionals has limited basis or grounding to protect a portfolio against inflation. The approach I have outlined is the investment equivalent to a house built for inflation. Once we're through the inflation cycle we can all move into the homes we dream of.

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Why a New Investment Firm is Needed For Inflation

Summary: *The investment industry has evolved over the years to provide conservative, reliable advice to investors. There have been market shocks but by and large the advice and products offered have not changed. To manage through inflation this will have to change.*

As a soon-to-be-teenager my parents took me downtown to meet a stockbroker they knew. I was being taught to save and invest and I bought a $100 Canada Savings Bond. Forget the life lesson. Once I saw the quote machine I was enthralled. That flashing grey cursor against the low resolution black screen with a bevy of blinking stock quotes spoke to me. It was the spark that drove me to want to work in the investment industry. Ten years later someone opened the door for me and I stepped into the business - sub-basement level but hey.

Forty plus years later the industry is still recognizable. As recognizable as your kids trying to guess which picture is yours in the high school year book. They'll find it but they will laugh. When I started the industry was made up of small independent firms where partners' capital was at risk. Excluding the corporate finance business revenue came from client commissions and bond trading. Firms are now large, publicly owned with a broad shareholder base. The revenue base has shifted to emphasize advisory fees and product management fees. These two new revenue sources have transformed the industry and the clients' relationship with the industry.

The business model for a fee driven business is scale and consistency. First job; attract assets, manage assets, retain assets. Second job; manufacture new fee earning products to attract, manage and keep – rinse and repeat. What has noticeably been missing in the past twelve years is innovation. In terms of innovation there is no comparison between the twenty years preceding the Great Financial Crisis and the twelve years since. Admittedly some of those innovations may have been seen at or near the scene of the 1987, 1998 and 2008 crashes but transformation and change sometimes involves cracking eggs.

The statis in the industry has occurred during a time when the central banks have collaborated to reduce market volatility and manage the business cycle. The investing clients haven't called for change and the industry hasn't offered it.

Change is needed because the investment climate is changing. Just as you change your outdoor clothing when the weather forecast changes, you'll need to change your investment approach. What's changing?

Only long-term global trends rooted in the 1980's such as globalization of trade, long term declining trends in interest rates, long term periods of disinflation and the long term decline in asset volatility. As Crash Davis (Kevin Costner) tells the Assistant Manager (Robert Wuhl) when he visits the mound in Bull Durham to find out "what the hell's going on", Crash tells him "we're dealing with a lot of shit".

What exactly is needed? The investment industry has three primary assets; 1) its people, 2) its services and 3) its products. The products pose no problem. Referring to the recommended asset mix in a prior paper all the necessary products currently exist. The service isn't an issue because ultimately the clients' objective of income, growth and capital preservation is the same. And lest you think I'm about to throw the people under the bus they're not the problem either. What then? I'd suggest it starts at the top where the culture and the direction is determined. A gap analysis of a conventional portfolio and the recommended inflation protected portfolio identifies strategies, products and tools that generally don't exist in conventional management firms. Management has to empower and train their advisors and portfolio managers to expand their repertoire and provide their people with additional degrees of freedom.

Consider the recommended fifteen percent allocation to alternative strategies. This could include allocating to external fund managers which requires a skill set to identify and evaluate the firms, strategies and traders. Alternatively, some strategies could be managed internally such as yield curve trades, breakeven strategies or outright real yields. This requires being licensed and comfortable with derivatives and leverage. Direct exposure to commodities is devilishly difficult and may require additional licensing. Real assets provide a final example. Exposure through publicly traded equities may be less than optimal depending on the premium paid for public market liquidity. Often, private and direct investment is optimal to isolate targeted real assets which requires the skill to structure private transactions.

Isn't the first step to identify the problem? This, and the related papers, is a voice deep in the woods yelling there's a problem. Summerwood is set to tackle the problem and seek solutions for investors to protect and grow assets through an inflationary period. What caught my eye when I was making my first investment still keeps me engaged. The ensuing 40^{+} years have Summerwood well positioned to manage inflationary challenges.

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A Series of Papers to Inform Investors the Program is Changing

***Summary**: It has been more than forty years since investors have had to concern themselves with inflation. This series of papers has been written to highlight that change is afoot and how best to prepare portfolios to protect against the effects of inflation.*

Maestro – an honorific title of the highest respect. Most often applied to a symphonic orchestra's leader, the Maestro's role is to unify the group, to keep the music moving at a steady pace, to fight the group's influence. Think of the central banker as the Maestro of the economy[1] - to keep the economy moving along steadily, at just the right tempo.

The natural flow of an economy is to cycle through expansions and contractions. The central banker attempts to control the tempo, to ensure the crescendos are allowed to build, the decrescendos allowed to fall, all within a range pleasing to the audience – society, businesses and politicians. A beautiful economic symphony – when it works.

The economic equivalents of the crescendos/decrescendos are inflation and deflation. Central bankers are ever vigilant to keep the push/pull of inflation/deflation in check. One might presume central bankers' concerns would be evenly balanced between inflation and deflation. I posit this is not the case. The next statement will attract counter arguments; I postulate that all Fed Chairs since the end of Paul Volker's era (circa 1987) have shown an over exuberance to avoid deflation versus a concern of invoking future inflation. Central bankers fear their inability to counteract deflation more than they fear their ability to control inflation. Simply put.

It's important for investors to recognize the policy imbalance. Inflation isn't a virus that can be eradicated. Investors will, in due course, need to be in a position to defend against inflation's effect. Central bankers, politicians, the fourth estate, none of these will "ring the bell" alerting investors ahead of inflation. Investors have to take it upon themselves to restructure their portfolios ahead of an inflationary environment or align themselves with investment professionals with a focus and understanding of inflation.

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[1] At the height of his central banking career Alan Greenspan was referred to as Maestro. Bob Woodward's 2000 biography of Greenspan was titled Maestro: Greenspan's Fed and the American Boom.

In the paper What's An Inflation Protected Portfolio? I wrote that classic investment theory recognizes that inflation protection is notoriously difficult to manage. In the pursuit of brevity what I omitted was that the assets and strategies used for inflation protection are scarce. Investors need to be positioned ahead of inflation just as home owners need to have home insurance in place prior to making a claim. The cost of inflation protection will rise as inflation becomes recognized. It will rise to the point where the cost of the protective assets and strategies will mitigate the benefits.

Throughout this series of papers, I have tried to not overtly plug Summerwood's services or capabilities. That being said I hereby countermand that directive. Summerwood has long held the view that inflation is inevitable and that the investment industry is ill prepared to manage through inflation. The argument that such a viewpoint has been early, or worse, wrong, needs to be addressed, briefly. My counterpoint to this critique is that by design the portfolio outlined in What's An Inflation Protected Portfolio? will protect assets through inflation while also providing risk adjusted returns in non-inflationary periods. To point, the bond portfolio is not eliminated but rather transformed from fixed rate interest payments to floating rate interest. Equities are not eliminated but are reduced and refocused on companies with real earnings. By design the highs and lows that accompany traditional portfolios due to the heavy equity weight are muted. All the while being in a position to protect assets when inflation begins its deleterious effect on the markets.

Summerwood has been singularly focused on the effect of inflation. Managing assets through inflation requires a breadth of knowledge and skills and exposure to a full suite of products and strategies. Summerwood has experience managing traditional assets and alternative assets. Bonds, equities, commodities, real assets and alternative strategies are all within its repertoire and experience. These are the tools that investors will need to avail themselves of in the days ahead.

A Maestro will have chosen the musical program before the audience arrives, before stepping up to the podium and before the baton is lifted. Investing Through Inflation – A Series of Papers was written to inform investors that the program will be changing from what they've been enjoying. The Overview papers alert investors to the inevitability of inflation. The Asset Building Blocks warns against relying on the illusion that gold and bitcoin can magically provide inflation protection. Finally, the Inflation Protected Portfolio Management papers provide investors with the basis for establishing an inflation protected portfolio.

To those who have read all or a portion of the series I want to thank you for your time and attention. They were written to help investors. If you would like to learn more about how Summerwood can help, please feel free to use the contact details below.

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