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Conference Roundup: The Annotated Russell Napier

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On April 5, 2018, I attended the Foundation Financial Officers Group (FFOG) joint conference with a European foundation group, EFFIO, in Milan, Italy. The most engaging and erudite speaker was Russell Napier, a former asset manager with Baillie Gifford, Foreign & Colonial, and CLSA, and now independent.

Napier founded Electronic Research Interchange (ERIC), a platform for independent investment research; and edits "The Solid Ground," a "global macro report originally published by CLSA and now published independently." He presides over a business and financial history library, the Library of Mistakes, in Edinburgh; and is the author of *Anatomy of the Bear: Lessons from Wall Street's Four Great Bottoms.*

Napier presented "Twenty-One Lessons from Financial History For the Way We Live Now." While his lessons stand very nicely on their own, it's also fun to poke at them and see where I agree and where I disagree.

In an article about Napier's speech at a CFA Institute conference, Ron Rimkus, a content director at that organization and former colleague of mine at Ibbotson Associates/Morningstar, writes:

> [Napier] shared a lengthy list of his favorite lessons from history. "The best lessons," he observed, "come from stupid people." Where to find stupid people? The front pages of newspapers are good places to start, he said. After all, one gets on the front page by, first, having been right in the past and, second, by expressing certainty about the future — both of which sell newspapers yet fail to provide accurate forecasts.
>
> Nowadays, when investors distill the art of investing into models and equations, they necessarily leave out philosophy, sociology, politics, and history, among other disciplines, Napier said. He urged investors to put back what their regimented and equation- and model-based processes filtered out.[1]

In the discussion below, the numbered, italicized statements are Napier's 21 lessons. The subsequent, indented paragraphs are my restatements, explanations, comments, and opinions.

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[1] Rimkus, Ron. 2017. "Russell Napier, ASIP: 21 Lessons from History." *Enterprising Investor,* CFA Institute, https://blogs.cfainstitute.org/investor/2017/08/29/russell-napier-asip-21-lessons-from-history/.

1. Spend as much time analyzing supply as you spend analyzing demand.

No kidding! First of all, it's possible to learn more about supply than about demand. Supply is all about changes in technology, whether the technology is electronics, manufacturing processes, delivery mechanisms, marketing practices, or what-have-you. (Technology is the economist's shorthand for "whatever makes it possible to do more with less.") Learning a little science and a little engineering will make you a better forecaster of technological trends than most people will ever hope to be.

Demand, in contrast, is about what's in people's heads. Studying that can be an interesting application of psychology and sociology, but is not always possible. With most basic needs fulfilled, it's hard to predict what people will want to buy, and in what proportions. Fifty years ago, computers were room-sized devices that were used to print bank statements and process tax returns; who would have guessed that *personal computers* would become one of the two or three dominant consumer products a couple of decades later? As late as 1977, Ken Olson, the CEO of Digital Equipment Corporation, said, "There is no reason anyone would want a computer in their home."

On the other hand, mobile phones should have caught on much sooner — Maxwell Smart had one in his shoe, in 1965.

2. There is no relationship between GDP growth and the return from equities.

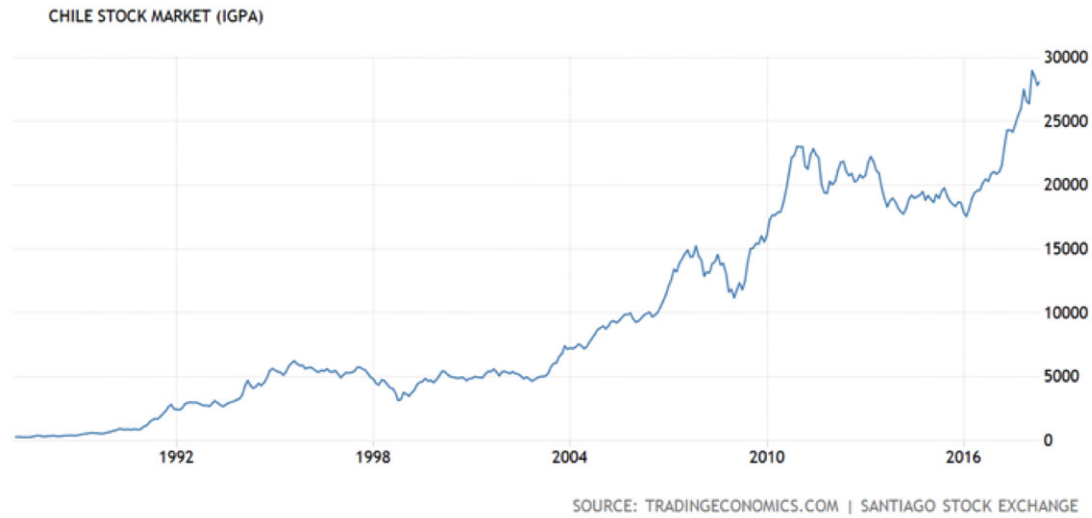
In the short and even intermediate run, that's right: GDP growth affects the stock market with a long and variable lag, and with a large error term — and only the unexpected part of GDP growth "counts," the expected part being impounded in the going-in price.

However, in the truly long run, stock market returns in the best-performing countries have been spectacular. You only need to capture such returns once in a lifetime to make a fortune. Below are some examples. (The chart for Germany doesn't even capture that country's best years, but the chart for Japan, the granddaddy of high-flying markets from 1950 to 1989, does.)[2]

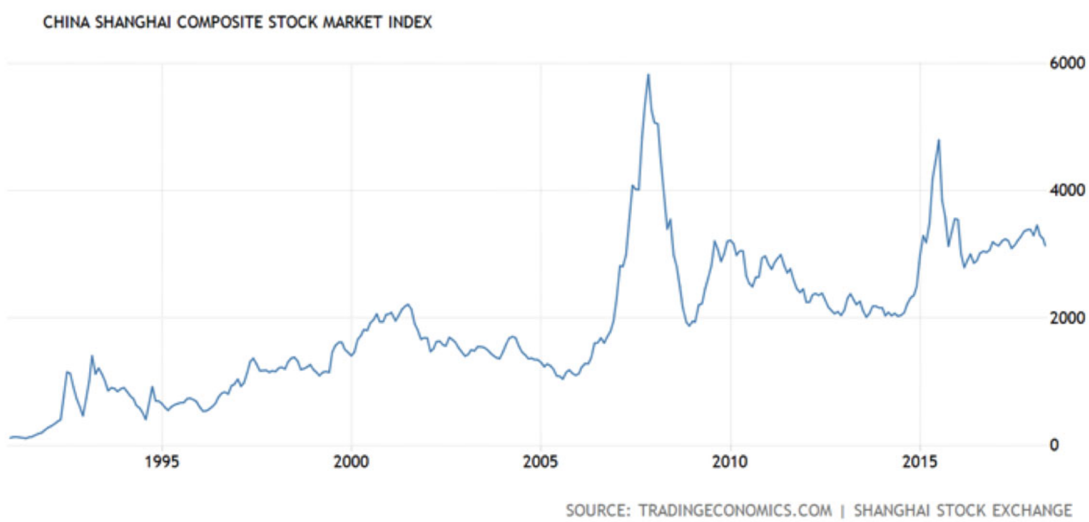
[2] As far as I know, the returns shown are price-only and are nominal (in local currency). To make them directly comparable, they would have to be converted to U.S. dollars and then adjusted for inflation using U.S. inflation rates; and dividends would have to be added. (The graphs would also look better in log scale, but, except for Japan, I don't have the data.)

Data sources: http://www.tradingeconomics.com, except for Japan (http://www.macrotrends.net).

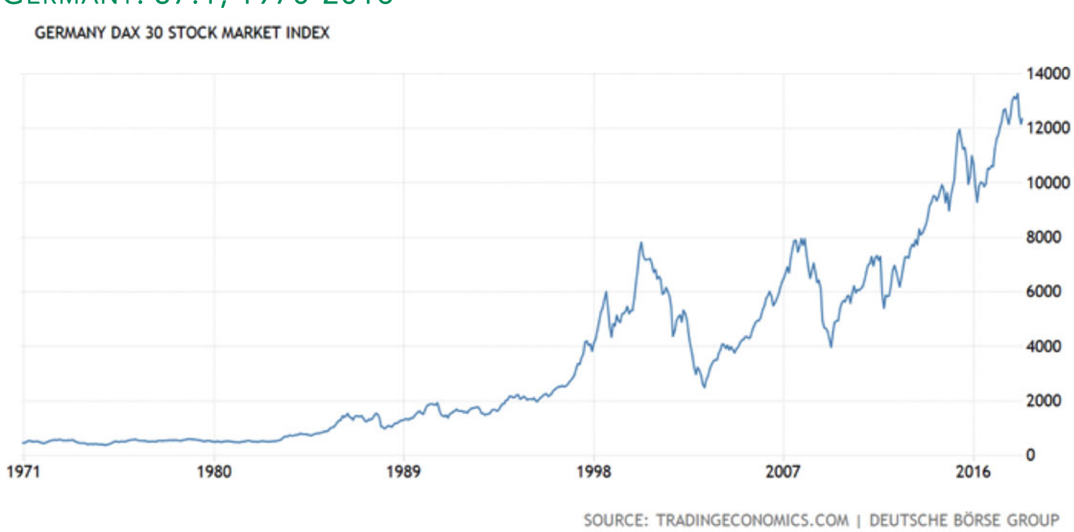
Chile: 112:1, 1987-2018



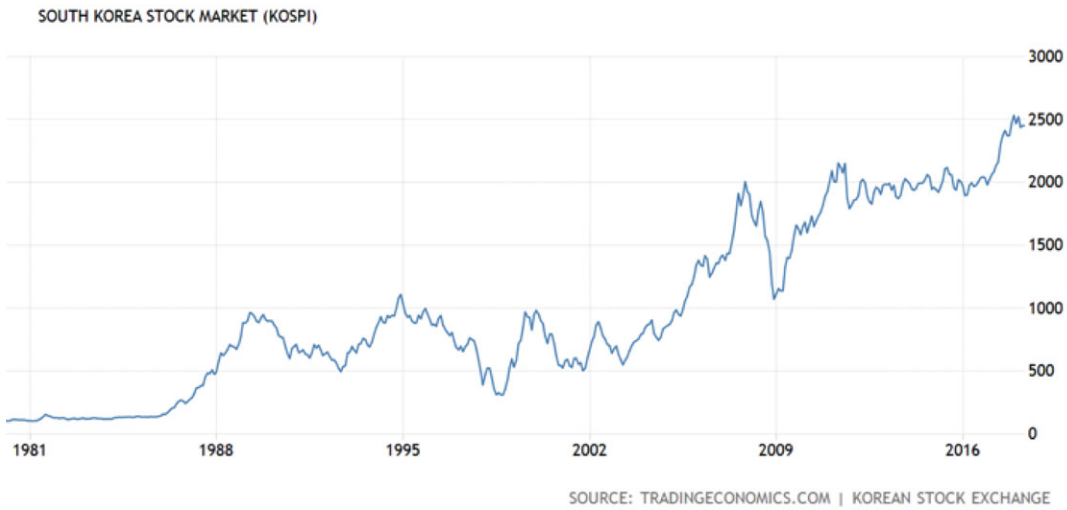
China: 30:1, 1990-2018



Germany: 37:1, 1970-2018



SOUTH KOREA: 25:1, 1980-2018



INDIA: 17:1, 1992-2018

JAPAN: 380:1, 1950-1989

Of course, this is not a proper study — it's just a collection of cherry-picked anecdotes. There may be countries with terrific growth and disappointing stock returns (China was in that category for a while), and/or countries with poor growth and great returns. We also haven't compared these countries' results to a benchmark; the U.S. and world indices did well over these periods too. But the data shown are pretty convincing evidence that picking future GDP winners can be a very rewarding long-term strategy.

3. Gordon Pepper's law — estimate how long the unsustainable can be sustained, double it, and take off a month.

(Gordon Pepper is a writer, economic historian, and author of, among other works, *Inside Thatcher's Monetarist Revolution*.)

Yes. This is a corollary of Stein's law (anything that cannot go on forever will stop) but with a twist. It can go on much longer than you think, then will collapse much faster than you were expecting. The housing bubble was a case in point.

4. Follow Charlie Munger's advice: "Never, ever, think about anything else when you should be thinking about the power of incentives."

As Rimkus said in his writeup of Napier's speech, "the world is run by agents. And when agents have the wrong incentives, you get the wrong result." Nassim Taleb would say they need skin in the game to be properly positioned to make good decisions, and they rarely have it.[3]

5. Governments like markets only when they deliver the prices they want.

"Governments aren't neutral — they take sides," writes Rimkus.

6. The ratio of corporate profits to GDP ratio must mean revert in a free society.

But revert to what? The ratio of corporate profits to GDP depends on the marginal productivity of capital versus the marginal productivity of other factors of production, such as labor, "land" (natural resources), and entrepreneurship. The mean from the equilibrium that has been achieved in the past reflects the contributions, on average, of each of these factors *in the past*. There's no special reason to believe that the conditions in the past will persist without modification in the future.

I think Napier is just saying is that the other factors, say, labor, will demand greater rewards through the political process. Surely they will. But, if those rewards are significantly greater than the marginal contributions, an equilibrium will not be reached and the pendulum will swing back the other way.

I'd be very careful about drawing conclusions about future capital and labor shares of income from the past, when huge armies of low-priced labor were needed to man the factories, staff the clerkships in offices, and grow food on farms. It's a rapidly changing world and the past is not always a reliable guide to the future.

7. In assessing the appropriateness of monetary policy assess the quantity of money as well as the price of money.

Yes! Many of today's "monetarists" are basically Fed watchers and interest rate forecasters. That's not what a monetarist is.

A monetarist believes that the money supply is an important economic variable. When too much money is chasing too few goods, you get inflation; when there's too little money to facilitate transactions, you get depression.

But monetary institutions have changed since Milton Friedman enunciated these principles in the 1950s. So the money supply is no longer rigidly controlled by central banks but is affected by the actions of other players, such as regular

[3] See Nassim Taleb's book, *Skin in the Game*, and my review of it at https://www.advisorperspectives.com/articles/2018/04/02/why-nassim-taleb-thinks-leaders-make-poor-decisions.

banks, non-bank credit grantors, money market funds, and hedge funds. Thoughtful scholars such as John Cochrane and Eric Leeper are rethinking what it means to be a monetarist in today's environment.[4] They don't have all the answers yet, and I surely don't.

8. The most dangerous form of speculation is the search for yield. 'John Bull can stand many things but he cannot stand 2%.' – Walter Bagehot

What Bagehot, the late 19th century editor of *The Economist*, meant is that "virtually everyone in the world, particularly those outside of finance, believes they have a moral right to 5% yield," as Napier explained. "If they can't get 5% in a high-quality security, they will try to find it in a low-quality security" at their peril.

9. The real danger for investors from populism depends upon the strength of the constitution and the rule of law.

That's right. In the long run, populism will hurt the U.S. and the U.K. much less than it will hurt Argentina — or South Africa.

10. The countries most likely to default on their debt are those that have defaulted on their debt.

It's like college admissions: you don't want to believe it, but the best forecaster of college performance is high school performance. There are always exceptions.

11. High equity valuations fall slowly when the surprise is inflation and quickly when it is deflation.

We haven't had much deflation to test this hypothesis. It worked in 1920 and 1929-1932 but that was under a different monetary regime.

The brief spat of deflation in 2008 came from the fact that the asset bubble that burst the worst, housing, is also a large component of the CPI. Declines in the price of housing from the lofty 2006-2007 high brought the housing affordability index back to earth and helped many home buyers even as it hurt those who had made leveraged purchases at or near the top. I don't worry much about deflation.

12. Never buy emerging market equities if the exchange rate is overvalued.

I don't know much about this, so I'll cast my lot with Napier.

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[4] See my article, http://larrysiegel.org/milton-friedman-and-monetarism-through-the-looking-glass/.

13. Tourism is the best guide to whether an exchange rate is over-valued or under-valued.

It might be a canary in the coal mine, but it's far from a hard-and-fast rule. Napier cites, as an example, the large number of Chinese tourists shopping at expensive stores in New York. This is a clue that the U.S. dollar is undervalued relative to the renminbi . . . or that Chinese shoppers have so much money that they'll shop enthusiastically wherever they are, and they like to visit New York. Economic decisions are part of the tourism equation, but they're not all of it.

Americans also find many parts of the world to be cheap, but don't go there much, or shop there, for other reasons — they find Latin America dangerous, eastern Europe colorless, Asia and Africa too different. When Americans shop abroad, they mostly do so in western Europe, which is expensive but *interesting*. It's a cultural thing.

14. Always buy equities below a CAPE ratio of 10 unless the future [of a country] holds communism, war, or a surrender of monetary independence with an overvalued exchange rate.

You might have a long wait. The last time U.S. equities were below a 10 CAPE was in January 1985. Since then the U.S. market is up 3,411%.[5] I agree that emerging and frontier markets selling below a CAPE of 10 are attractive, but they can stay attractive longer than you can remain patient (a "good deal" sometimes becomes a "better deal"). Moreover, waiting has an opportunity cost.

15. Democracy is more suited to the operation of capital controls than the free movement of capital.

If democratic processes favor solutions with short-term benefits and long-term costs, then they could favor capital controls. This is mostly a concern in emerging economies.

16. When private savings are exhausted, monetization of government debt and high inflation/hyperinflation follow.

I would have phrased this as, "When there is a lot of government debt, monetization of government debt and high inflation/hyperinflation follow." The inflation is what later exhausts private savings.

We can regard inflation as a tax on savings. If private savings are already low, there is nothing for the government to "tax" by devaluing the currency — although there is always *some* private savings, and desperate governments will tax anything they can.

[5] Nominal total return on the S&P 500 through December 31, 2017.

17. Technology never ultimately defeats inflation.

Improvements in technology push prices down; expansion of the money supply pushes prices up. Which effect "wins" depends on how hard each side "tries." From 1870 to 1914, technology won — we had deflation in a period of high growth — because the U.S. government didn't have much debt so it didn't have much reason to lower the real value of the debt through inflation. After two world wars and a Great Society, there was plenty of incentive to debase the currency, so monetary policy was designed to make inflation win. Today, technology seems to have regained the edge, pushing inflation down to 2% in a world awash in debt; don't get used to it.

Other countries have other stories to tell regarding the war between technology and the money supply.

18. Monetary systems fail about every 30 years.

Rimkus writes, "In 1914, the monetary system fell apart as World War I pushed many countries off the gold standard. In 1931, the Bank of England left the gold standard. In the early 1970s, the Bretton Woods system collapsed. Today, the monetary system is once again crumbling. Any cyclical analysis is invalid during such structural shifts."

19. Money is almost always in disequilibrium.

Napier asked us to remember this statement from the 1810 Bullion Committee's report to Parliament: "The most detailed knowledge of the actual trade of the Country, combined with the profound science in all the principles of Money and Circulation, would not enable any man or set of men to adjust, and keep always adjusted, the right proportions of circulating medium in a country to the wants of trade."[6] In essence, the committee said that central banking was impossible. Consequently, money is always in disequilibrium.

I don't really agree. Equilibrium means that the amount of an asset supplied equals the amount demanded. If that is not the case, there is a surplus or shortage of the asset and its price must change such that the asset moves into equilibrium.

The price of money is the interest rate. Except for the shortest-term interest rates, which are set by central banks, interest rates are generally free to change as market circumstances require. Now, traditional monetary theory says that only "zero maturity" funds are money, but the financial system has evolved so there's a continuum between zero-maturity and other short, safe maturities – so the definition of money has expanded greatly. (This has caused central banks to lose some of their effectiveness in controlling the money supply.)

[6] http://www.lbma.org.uk/assets/alc57_200_anniversary.pdf

Therefore, assets used as money, if they trade freely at market-determined prices (interest rates), can usually be presumed to be in equilibrium, not disequilibrium.

20. Never trust a forecast with a decimal point — especially your own [forecast].

"Economists put decimal points in their forecasts to show they have a sense of humor." – attributed to William Gilmore Simms, 1806-1870[7]

21. Extrapolation is the opiate of the people

No kidding! Even those of "the people" who are considered to be wise students of the markets and astute forecasters mostly just extrapolate recent trends.

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[7] I find it difficult to believe he said this. A Southern partisan during the U.S. Civil War era, Simms lived at a time when there were few economists and essentially no economic forecasters.