

Identifying the Food Chain of the Market

Predator or Prey ?

Market Wildlife

Hunter, Gambler and Parasite

- Hunter- Identifying inefficiencies and systematically stalking them. Remains acutely sensitive to the possibility of being stalked by a yet more powerful predator. Relies on constant “hypothesis testing” to be forewarned of changing conditions.
- Gambler- typically a “Black Box” investor hoping the recent past can be projected into the future. Failures of VAR etc.
- Parasite- typically a “Modern Portfolio Theorist, who believes Markets are efficient yet tries to charge active fees for nearly passive management.

Market Inefficiencies

- Structural – Some market participants are innately better informed.
- Time frame- Market participants do not have the same investment horizons.
- Analytical- Mean Reversion is a definition of price history not one of innate value.

Structural Inefficiencies

Why are some investors better informed?

- “Being in the Flow”, whether of Primary or Secondary market Key.
- Quality of Research.
- The Power of an Institution is reflected both in its access to information, and also via “reflexivity”, its power to create information.
- Shifts in “Business Model” paradigm are reflected in shifts in the “Food Chain”.

Understanding one's Position in the Food Chain Key.

- When markets are inefficient some participants inevitably benefit to the cost of others participants.
- Are you Prey or Predator?
- Seek Market Places and Environments which play to ones structural strengths.
- Be aware of, and expect changes in the Market Places over time, altering the “Food Chain”.

The Changing Environment for Macro Investors 1945-2009

	Bretton Woods -1971	1972- 1990	1990-1998	1998-2007	2007-Future
Government Economic Policy	Keynesian demand management. Fixed Exchange rates.	Floating FX & Gold Price. Shift to Supply side Economics	Supply side Economics and de-regulation	Supply Side + Global competition lowers tax rates	Coping with de-leveraging financial system. Crisis Management
Global Political Environment	Cold War. Military Stand-off	Cold War. Re-cycling of Oil Surpluses leads to internationalisation of the US Dollar	End of Cold War birth of Globalisation	Globalisation, Finished goods in excess supply + growing competition for raw material resources	National economic salvation paramount. "Closet" Protectionism likely to re-emerge
Political Environment for Markets	Fixed Exchange rates and managed devaluations	Implicit promotion of Free Markets globally by the USA	Salomon Affair ending of market Free for All	Increasingly managed Markets. Central Bank Interventions succeed against Hedge Funds	Dirigiste model as many Banks become State-dependent
Role of Financial Markets	M&A. Agency Broker	Principal position taker Salomon Model Investment Bank	Leveraged Position taking Emergence of the Hedge Funds	Securitisation turns the Financial industry into Commission Salesmen	De-leveraging Balance sheets. Agency Broker
Place of End Investor (Fund Manager) in food chain	Low. Amortised book accounting creates passive victim FM	High, providing proactive and aggressive	Hedge Fund Dominant, Long only FM now a scavenger	Bottom of Food chain the designated holder of high fee earning Securitized Products	Top of Food Chain, able to charge for putting Capital at risk and to dictate prices..
Conclusion	PRE-HISTORIC ERA	GOLDEN ERA	SILVER ERA	BRONZE ERA	DIAMOND ERA

Particular Examples

- The “Salomon” Investment Bank model 1972-1997, followed by the “pass the parcel” Banking model 1998-2006.
- Capital Markets used as a weapon in the “Cold War” fighting for US\$ Hegemony 1973-1991.
- The Growing and malign influence of “Consultants” has undermined independent decision making of Fund Managers. Structural asset allocation decisions are made which consign clients to the bottom of the “Food Chain”, and to the role of “Gamblers” and “Parasites”.
- Rigid adherence to “Indices Culture” promotes “Herd Mentality” and victim behaviour.

Conclusions

- The future is rosy for unleveraged independent managers of Capital. As a very scarce resource, a significant premium should be extracted for its deployment.
- Free Capital will become a price maker rather than price taker.
- An essential component of success will be to think and act like a Predator.

Further Conclusions

- Traditional “Risk management” is of second order importance to a prime predator. VAR is a fig leaf too insubstantial to keep Market Participants off a “Financial Sex Offenders Register” for poor practice. Constant “Hypothesis Generating and Testing” is the only “Scientific” approach. Benchmarks should be largely abandoned in favour of looking directly at each clients liabilities, risk tolerance and financial aspirations.
- “MPT” should be ridiculed for promoting mediocrity. Understanding how to seek Strategic advantage and to avoid disadvantage is the only way forward. Understanding that advantage is subject to alteration over time means that Fund Managers need to have sufficient Structural flexibility to change their methods and value propositions over time. Bring Back “Balanced Mandates” and understand the decision making dead end of bureaucratic dirigism on investment decision making.