

Missing The Cut

'Who would have thought it... Mr Darcy... ten thousand a year! Oh, my dear Lizzy! Pray apologise for my having disliked him so much before.'

When Jane Austen wrote 'Pride and Prejudice' in 1813, an annual income of £10,000 compared to an average salary of just over 30 pounds. In today's money, Mr. Darcy's annual income would have been £10 million. No wonder Mrs. Bennet was so excited!

The welfare state, as we know it, did not exist in nineteenth century Britain. The fear of literally running out of money was, therefore, prevalent across society, and with good reason. In the UK, a strong and relatively stable economy has long since supported services such as the widely applauded National Health Service. The welfare state is, however, dependent on a sustainable tax system largely financed by employment or savings. More recently, and less impressively, it has been subsidised by an unprecedented splurge of government borrowing. 'On the tick' as our farmers like to say. Expect governments to dip into your pockets before too long to pay for all of this. Because somebody has to.

Whilst zero interest rates can artificially resuscitate an economy, the impact on savers is calamitous. £1 million invested in cash (with a reputable borrower) will today generate less than £5,000 in annual income. A portfolio of UK government bonds will generate £10,000, before tax. This is half of the UK national living wage and 40% below the minimum wage. Who wants to be a millionaire?

For many investors, the fear of spending capital to subsidise income goes back, if not to the days of Fitzwilliam Darcy, then certainly to Victorian times. Historically, pension portfolios – representing the classic income investment mandate - have contained a balance of cash, bonds, property and equities to generate a reasonable income with, hopefully, some scope for capital growth. Not too long ago, a sterling income yield of 5% was considered sensible. These days, it looks outlandish.

There are alternatives, but they are rare. Sensibly invested property collectives such as our own **First World Hybrid Real Estate Fund** can still produce an inflation-busting yield. Infrastructure funds have a strong income bias and are frequently invested into government-backed projects, improving quality. On the whole, however, income producing assets of this nature are hard to find without sacrificing diversity, liquidity, or both.



Breaking news: You are the money tree.

In a bygone era, the contents of this next paragraph might have been to explain the attractions of the UK market as a one-stop-shop for dividend-hungry investors. In the depths of the COVID-19 crisis, however, over 400 listed UK companies cut or cancelled their dividends at an estimated cost to investors of £32 billion. Whilst some of these businesses have since resumed payouts, the cat is well and truly out of the bag. At the first sign of trouble, the default reaction was to bunker down at investors' expense, wilfully encouraged by regulators and the government. No doubt dividend cover was scanty in many cases anyway, but trust has been lost and it is no surprise that UK equity market returns have been generally dire in 2020, in both relative and absolute terms.

The approach to this income shortfall is and has been for some while, to design a low cost portfolio containing the finest quality international equities where total returns can support regular withdrawals over time. This requires a leap of faith for those raised on a diet of coupon clipping and dividend cheques. Equity returns are, of course, anything but linear. But this approach is absolutely necessary to avoid being trapped in the fading light of low interest rates, zero growth and creeping inflation. Doing nothing is not an option, either. Left uninvested, Mr Darcy's annual £10,000 income would today have deflated to £108. Hardly enough to buy a round of six drinks before Boris and his scientists, the likes of whom once thought the earth to be flat, turn the lights out.

Russell Collister

CHIEF INVESTMENT OFFICER - OCTOBER 2020

For The Love Of Joe

'Coffee, (which makes the politician wise, And see through all things with his half-shut eyes)...'
(The Rape of the Lock, Canto 3, Alexander Pope, 1712)

In our days of (splendid) isolation in the Isle of Man, I can but reminisce of stolen moments between London meetings, nipping out of the rain into a local Costa to buy a double-espresso and catch up on emails, with a smidgin of espresso crema settling absent-mindedly on my top lip. Accompanying my iPad tap-tapping might be the high-pitched steam-hiss of an enormous coffee machine behind the counter and the glorious smell of roasted 'coffea' seeds, a legal drug which lies in second place to crude oil as the world's most traded commodity. Since America's Boston Tea Party in 1773, coffee has been the hot beverage of choice across the Atlantic, eulogised by Thomas Jefferson as 'the favourite drink of the civilised world'. It certainly occupies pole position in the Tait household; our Nespresso machine dominates the kitchen, accompanied by a cafetière (for emergencies). I have fond memories of visiting my late great-uncle's delicatessen in Antwerp as a youngster and drinking in the aromas emanating from huge brass containers of 'Jespers koffiebranderij', his family business established in 1920. While the brand survives on Facebook, it's not quite the same as being eye-level with the counter and smelling those beans.

England now has to comply with 'rule of six' social-distancing restrictions, introduced in early September. One could almost hear the collective exasperation of Joe Public, as communal events were subsequently postponed or binned. Daily deaths from COVID-19 remain modest in the UK (cases are rising but mainly among the young and healthy, due to greater testing, while the sick are increasingly saved by improved treatment). One must wonder whether the UK government is drinking enough coffee by half. Surely it understands that the cure is increasingly worse than the disease? The Whitty & Vallance Show occasionally showers us with speculative graphs and 'big ifs' predicting winter-time disaster, failing to offer any real science. Lockdowns do not beat viruses unless we plan to hide from them forever (and a viable vaccine, produced at significant volume, is probably not just around the corner). As the journalist and novelist, Lionel Shriver, recently suggested, if this is the UK Government's default policy, we might as well all 'procure a mercifully deadly dose of cyanide' and get it over with.

A tad too grim, perhaps. As the nights close in, the great British people might alternatively vote with their feet (and with what's left of their hearts and minds). As my encouragement, I take the example of coffee's European history. This beloved beverage made its way to the continent in the 17th century and despite instant popularity, there were some less secularly-minded individuals who labelled it as the 'bitter invention of Satan' (even before Starbucks or the 'skinny latte' hit the scene). Arriving in Venice by 1615, coffee was condemned by the local clergy but the backlash forced Pope Clement XIII to intervene, bestowing upon it his papal benediction. In England, sixty years later, King Charles II declared that coffee houses caused 'evil and dangerous effects'. In other words, undesirable opposition, such as Thomas Harrington's republican Rota Club, which was known to meet at Miles' Coffeehouse in London. These establishments were also promulgators of the 'fake news' du jour, such as Alexander Pope's poem, 'The Rape of the Lock', seemingly born of a coffee-house rumour. Both Charles II and James II made their own attempt at politically-driven social distancing, regulating exchanges which took place in coffee houses, a move which extended (in the case



of Charles II) to the banning all sales of coffee, tea and chocolate, both public and private (gasp). That decision lasted all of two weeks.

Perhaps 17th century intellectuals realised what their 21st century counterparts have since forgotten. With the supposed panacea of Zoom, Teams and other video-streaming services at our beck and call, my contemporaries have largely concluded that face-to-face meetings are superfluous to requirements. Apart from Andi Owen, that is. The CEO of US furniture giant, Herman Miller recently highlighted the key shortfalls of social-distancing: *'That unplanned kind of interaction that contributes so much to how we build relationships with people and how we build culture, those things are what are missing'*. By the middle of the 17th century, over 300 coffee houses in London played an important role in the development of the City's newspapers and financial markets. Lloyds of London had its origins in Edward Lloyd's Coffee House in Tower Street while the City's stockbrokers spent a century meeting at Jonathan's Coffee House in Exchange Alley (see picture). Despite the laboured death of the UK high street, it is our coffee houses which survive. No wonder **Coca-Cola** bought **Costa Coffee** from the UK hotel chain, **Whitbread**, for £3.9 billion in 2018. Humans are social animals and while Zoom is useful for seminars and presentations, it just doesn't quite cut the mustard when natural interaction and putting your trust (or your money) with someone is the order of the day.

Helped greatly by the Scandinavians (as the world's biggest coffeephiles), the world lowers away 1.6 billion cups of Joe each day, many of which are consumed in cafés, meeting rooms and office kitchens. Whether we call it Joe, java or jet fuel, it offers me solace to observe the failure of those erstwhile killjoys attempting to ban coffee by decree (just as COVID lockdown rules are declared, currently undebated in the House of Commons). The failure of any misguided state decree is something to celebrate rather than dread, illustrating our innate hunger for social intelligence and, perhaps, the love of Joe.

Mary Tait
INVESTMENT DIRECTOR

Life After Taxes

'It's easy to depict a discovery, once made, as resulting from a logical, and linear process, but that does not mean that science should progress according to neat, linear and sequential rules.' (Rory Sutherland)

In the earlier stages of the coronavirus pandemic, populations across the world were emboldened by a sense of national unity, as they were told to stay at home. This partly explains the many parallels made to wartime Britain and the clamouring of pots and pans in city streets in gratitude to front-line workers, as it instilled a sense of a common purpose and comfort, in the hope that it would all be over soon. The eye-watering expense of the UK government's furlough scheme was widely applauded, even as the debt-to-GDP ratio was pushed above 100% for the first time in more than 50 years, because industries which needed it most would ultimately form the bedrock of any V-shaped economic recovery.

Several months later, however, the UK has taken steps to thwart a second wave of infections and this sense of unity has started to fracture. Whilst some refuse to leave their homes until the virus has been eradicated entirely, others have become increasingly frustrated that a seemingly harmless virus (relative to their demographic) has forced them to shut down their lives to protect a smaller group of particularly vulnerable people. A ballooning sovereign debt will likely be the next source of negative frustration, as the Government starts tightening purse strings to repay its obligations, one of the reasons why the prospect of a wealth tax has resurfaced. This is an alluring idea to many, since it is seen as applicable to a minority whose assets have appreciated disproportionately relative to those of numerous misfortunates. This is even more pertinent while Britain faces a huge potential spike in job losses as the furlough scheme tapers off. Likewise, the crisis has highlighted key differences between various economic sectors. Whilst a wide range of industries have been brought to their knees in the face of stringent lockdown measures and global tourism decimated, the share prices of **Amazon**, **Apple**, and **Microsoft** have all reached record levels. Consumers around the world have been enabled by the services these firms provide, but these same people resent them not paying their fair share of tax. Therefore, policies which force companies to contribute more to state coffers may be a popular way of garnering support.

Unfortunately, society is generally not great at visualising large numbers and subsequently, may be disappointed when the government does a lot more than adjust the fringes of the tax code. Journalist Merryn Somerset Webb recently offered us some numbers on the subject of wealth taxes, noting that doubling the rate of IHT and CGT would (all other things being equal) raise just £16bn and £10bn, respectively. This falls far short of estimates provided by the Office for Budget Responsibility, that the UK needs about £60bn in additional tax revenues each year. Increasing tax liabilities for the world's largest companies is also not that easy. For example, Amazon is a multinational corporation with a global presence and is often criticised for its meagre UK tax contribution. However, with statements such as 'Amazon paid about 2.1 per cent of its revenues in tax'¹, media pundits offer a misleading and unhelpful view because this fails to address how much tax should be paid, nor does it acknowledge the fact that: a) Amazon doesn't report its UK revenues, and b) companies don't pay tax on revenues, but on profits. As such, a fiscal solution remains elusive while a lot of damage is done to public perception of a corporation's worldly contributions. Instead, it feeds an idea that such companies serve only to extract wealth from society whilst returning little of substance.



Procter & Gamble: The power of corporate innovation.

In defence of the idea-generating nature of capitalist enterprise, it's worth taking a look at **Procter & Gamble**. A lack of clean drinking water across much of the developing world is responsible for millions of deaths each year, and the UN estimates that it would cost about \$150bn annually to ensure global access to clean water by the end of the decade. Although a clean water source is always the ideal solution, in the early 2000s, P&G developed a way of turning 10 litres of potentially life-threatening water into something clean and drinkable. This was a by-product of the company's attempts to clean dirty laundry water and was only made possible by generations of research and development². Microsoft's Bill Gates, a world-renowned capitalist-turned-philanthropist, used the Gates Foundation to dangle a prize for the development of a vaccine for pneumococcus, which acted as a form of price top-up, rather than a financial lump sum award to pharmaceutical companies. This approach was very agnostic to the process, but the results speak for themselves, as three-quarters of a million lives were ultimately saved.

This brings us to where we are now. It could be that a disproportionate amount of emphasis is placed on the production of a COVID vaccine, as the world's only escape from this crisis. However, as with the breakout of HIV in the 1980s, research into a vaccine may not lead to anything fruitful in the near term and in the meantime we have become more efficient at dealing with the symptoms. If a fracturing public sentiment grows into abject refusal to follow the rules (something Mary Tait considers in her article), the UK may be left with little choice when the time comes to repay COVID debts; a force unassailable by capitalist innovation.

Michael Craine
INVESTMENT MANAGER

¹ Ashley Armstrong in The Times (9th September 2020) ² More information can be found at csdw.org.



Jackknifing

A lucrative autumn job for a teenager was spud-picking and for me this included a free trailer-load of rejects which could be used as animal feed, another project to divert me from study. In the same way that pigs seem incapable of knowing when to stop eating, I failed to appreciate the dangers of overloading a trailer. Driving down a long, steep and everlasting bend, the weight of the trailer started to push the car, but I delayed braking. By the time I did, the trailer was swinging violently and I made a bad situation worse. After a 180-degree spin, my car stopped dead, straddling the road. With the trailer on its side, I was completely mesmerised by thousands of potatoes slowly rolling down the hill in the peaceful evening light. Wasting no time, I jumped out of the car, heaved the trailer back onto its wheels and headed off...but waited anxiously all evening for a knock at the door. It never came and I said nothing, but I did learn that applying brakes too late does not prevent the inevitable.

On the 27th August, the Fed Chairman Jerome Powell announced an important policy shift towards 'average inflation targeting'. This means that the US central bank will allow inflation to run higher than its 2% target before increasing rates, their objective being to avoid a Japanese-style deflationary spiral. The fear of inflation which persisted up to the 1980s has long since passed, but it may show signs of life next year when a collapsing oil price falls out of the data and one must wonder if this new policy will provide much-needed oxygen for inflation, with widespread consequences.

A successful investment should achieve a return greater than inflation and this is not difficult when the latter is almost non-existent. Summing up the past thirty years in this environment, equities have been re-rated onto higher multiples whilst fixed interest stocks benefited from a falling interest rate environment. Success becomes more elusive when these factors reverse and this is the risk associated with the Fed's new policy, should inflation find a new lease of life. In the midst of a global pandemic, deflation is a natural concern, explaining why this policy change has not attracted the attention one might expect. Yet, the virus period will eventually end and there is little harmony, either domestically or internationally, putting pressure on governments to be radical in their attempts to retain power.

Inflation can be either 'cost-push' or 'demand-pull' and in the case of the former, this could be due to the implementation of green taxes to curtail climate change, import tariffs from trade wars, a falling exchange rate or rising wage costs, as described in the book, 'The Great Demographic Reversal' published in September. Demand-pull inflation could arise due to a lack of supply (companies folding due to COVID), rising house prices, tax cuts or even increased government spending, which could move to a new level if central banks revert to Modern Monetary Theory (MMT). Otherwise referred to as the 'magic money tree', this is perhaps a last resort, if everything else fails and unemployment becomes the scourge of society.

MMT is a back-door method of greater state control which, given the precarious position of airlines, hospitality, sports and leisure, may be inevitable, but it is a leap beyond quantitative easing. To enact such



The potato-spillage equivalent of Modern Monetary Theory.

a policy, a change in central banks remits may be required, where the goal becomes full employment, creating unlimited amounts of new money. It could be highly inflationary, especially if a country did this in isolation. Pushing rates higher to control inflation would subsequently undermine the policy itself. Inflation control would need to be directed at those who have benefited the most (the asset rich) whilst protecting zombie households and businesses. Given the levels of inequality across society, however, the definition of 'asset rich' may have a much lower threshold than we expect. It was recently reported that the median salary for a working-age American man was just \$36,000, less, in real terms, than four decades ago and less than the UK equivalent. Subsequently, it's not unreasonable to assume that the tax burden won't fall here. What about an income of \$50,000 however? Or a wealth tax - a policy becoming popular in Europe?

The global reaction to the virus has changed considerably, with both wealth-destroying and wealth-creating consequences, but there are other headwinds to consider. Twelve months ago, governments were declaring climate emergencies, while advances in technology were destroying jobs, but are these trends moving faster than changing demographics? Trade wars are escalating, societies are becoming polarised and these challenges must be addressed before they become that jackknifing trailer, where a delayed reaction spells disaster. To do this, however, countries need leadership and vision, qualities which are in short supply. Investors and savers face potential headwinds that previous generations might struggle to imagine and the option of putting your capital at risk or earning a zero (or negative) return is not morally fair. The global economy has reached a point where there is no room to manoeuvre without radical change and MMT remains an option, as indeed does the reengineering of inflation to erode debt. Whatever direction this takes, the backdrop will be equally challenging for savers, investors, house buyers, retirees and those considering careers. Discussing and sharing these challenges with an investment manager will help to identify a more resilient solution, as there are always opportunities to create wealth.

Paul Crocker

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