The wisdom of markets and the madness of crowds

Money maxims in turbulent times

John Nugée

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First edition 2020

Cover: New Stock Exchange by Thomas Rowlandson, 1809
Published by OMFIF Press

For more information about this and other OMFIF Press publications, please contact:

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Printed by CPI

9780995563698

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FOREWORD

Guidance to the fields of gold

David Marsh

If markets are a manuscript, John Nugée is the man who can illuminate them. In assembling this highly personal, at times whimsical, collection of precepts and principles on the theory and practice of investment, Nugée brings matchless acumen and a singular perspective. He has viewed the workings of the financial system from multiple vantage points, all connected to the arena of international money that for many years has been his intellectual and professional home. Markets are mysterious; they are capricious; they are mercurial. They can lead right- and wrong-minded people astray, up false trails, past wrong turnings and, occasionally, to fields of gold. Nugée combines culture and capitalism. He exploits his knowledge of human nature, psychological insights and experience of buying and selling financial instruments to shepherd us on this journey. We travel with him as he explores the random walks and the rational avenues of investment ideology and performance.

Few like Nugée, in his day-to-day life, can so copiously, convincingly and apparently spontaneously take a compilation of arbitrary events and indicators, and fashion them into a seamless body of scientific thought. Reading these insights and aphorisms on the wisdom and follies of monetary dealings, one envisions Nugée declaiming in one of his natural habitats. An oak-panelled parlour of the Bank of England. The well-scrubbed concrete and glass of post-war Frankfurt. An antique Latin American accounting hall bustling with portraitures of moustachioed money men. The fastidiously understated boardroom of an official Asian institution that has entrusted its reserves to the asset manager for which he worked for many years, State Street Global Advisors.

None of these vistas, however beguiling, adequately does justice to the broader panoramas of this volume. Nugée takes the span of human instinct and endeavour, and weaves these elements into a comprehensive fabric enclosing, shaping and guiding market patterns that, for better or worse, govern our lives and our livelihoods. Light-, heavy- or sure-footed, whether venal, vexatious or vainglorious, from the rational to the reckless, investors of every hue will find tenets that inspire emotions, fears and fancies.

This is not a book that lays down commandments for convertibles or decrees directives for green bonds. Readers will search in vain for advice on how to balance risk in multi-asset portfolios or to hedge the euro against the dollar. Those seeking guidance to the renminbi's role, the future of the European Union, or the influence of geopolitics on currency constellations must look elsewhere. But seekers after a judgemental framework on when and where to invest – and when to hesitate – will find a compendium of axioms that will channel spirits, excite curiosity, calm nerves and fan passions.

Like an old wine or a new book, there is something for every mood. Some of the messages are mellifluous, some melancholic, some messianic. For a lexicon of investment opportunities, inquire of Warren Buffet. For a philosophical road-map conducting you across byways and pastures of the investment landscape, turn to Nugée. Not all the meadows and the uplands are verdant, some may be unstable ground. Yet in steering you between the spiritual and pecuniary worlds, Nugée builds a bridge from values to value – a path to pleasure and, perhaps, profit.

Introduction

This book is about markets – financial markets, mainly – and how people have tried to describe, understand and survive them. It is an old, old subject and I am far from the first to write about it: indeed, this volume's very title echoes that of one of the earliest books to examine markets and the psychology of those investing in them. That was a tome from 1841 entitled *Extraordinary Popular Delusions and the Madness of Crowds*, by Scottish journalist Charles Mackay. It was a seminal study of mass movements and crazes, including several market bubbles and crashes.

Mackay's book was one of the first to detail how markets work, and how occasionally they can be gripped by collective insanity. Most of what he wrote remains valid and worth reading. In some senses it remains not just worthwhile but essential reading, as for all our modern systems, we seem to be just as susceptible to market madnesses as our forebears. This should be unsurprising, given the central role that psychology and human emotions play in markets.

Markets dominate our lives, and it is impossible to imagine anything other than the most primitive of societies functioning without them. In our modern world, there are many markets: the market for goods, for services, for labour. We are so familiar with the concept that we use the word as a metaphor, as in the marriage market, or the market for ideas.

But one market above all has come to symbolise a modern economy, and that is the financial or capital market – the market for money. It is not an exaggeration to say that for a society to prosper, it needs vibrant financial markets. There is much evidence to show that the larger the financial sector is as a proportion of an economy, the more prosperous that economy will be.

It is therefore remarkable that, despite markets' centrality to our lives and their being among civilisation's earliest features, they remain far from fully understood, and even in our modern era can run out of control with devastating results, as the 2008 financial crisis once again reminded us.

This lack of understanding of exactly how markets work is not for shortage of analysis. Ancient Egypt, with its highly developed food distribution systems and labour markets, studied the financial markets, and in the latter years of the pharaohs their financial system embraced many innovations such as savings accounts, money lenders and even cheques. The Romans also scrutinised how markets operated and their role in society – they were clearly necessary, but could not be ordered or controlled, and this puzzled and frustrated the methodical Roman mind. They concluded that there was something disreputable about markets and trade, and the ruling senatorial class largely avoided the matter, focusing instead on agriculture and land-owning, administration and government, and the military.

This hostility to the financial trade persisted. Religions routinely denounced those active in finance, and by the Middle Ages both Christianity and Islam had strong strictures against lending money. Both faiths were happy to leave it to the Jews, as immortalised by Shakespeare's Shylock in The Merchant of Venice.

To this day, Islam maintains strict rules regarding the conduct of finance.

"Trusting others with your money?
That will never catch on."

But even when Christianity relented and embraced financial markets, there remained an air of insalubriousness about the art of making money from money. One can see vestiges of this whenever modern politicians denounce the City of London and lament the decline of manufacturing or "the real economy", as if money earned by making something tangible is innately more honest than money made in finance.

And yet we need financial markets; in fact we need them more than ever. Credit markets enable our consumption; capital markets fund huge infrastructure and development projects; and the investment opportunities markets provide enable us to save money and provide for our retirement.

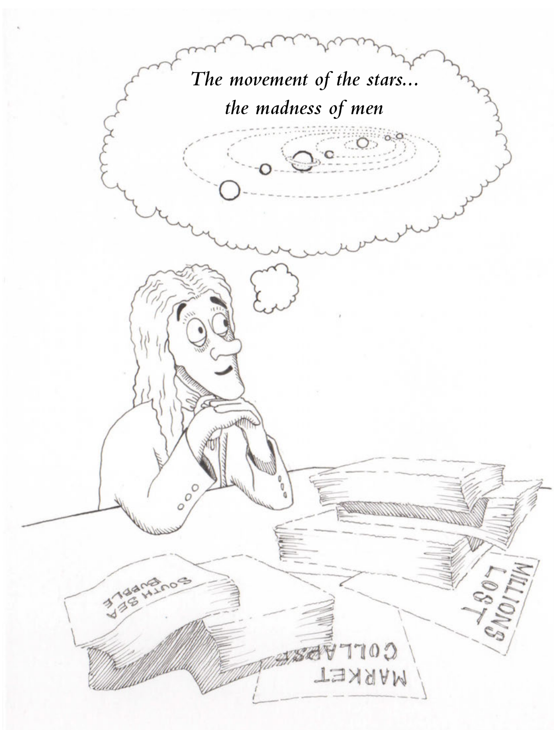
So the markets, as well as being one of civilisation's oldest inventions, are among the most indispensable for our modern way of life. And yet, as I observed earlier, they are still not fully understood. Markets almost stand alone for their capacity to confound us: our ancestors may have lived in an uncertain and often-little-understood world, but we are accustomed to there being scientific explanations for things and for all aspects of our lives to be under human control.

It is this combination of the financial markets being both critically important to our lives but still cryptic that makes them so captivating, and which has led so many to analyse them. The Chinese, who were the first to invent and use paper money – the Tang Dynasty (618-907 AD) created the first banknotes as long ago as the 7th century – were thereby the first to invent over-issuance, inflation and the loss of public confidence in paper promises. One can see in treatises from the period that they probed and deliberated why this was so, and there is a mournful comment from one senior mandarin asking, "Why do the people not trust the emperor's word?", as the imperial notes were being rejected by the populace.

In England, the Tudor period saw huge financial disruptions and inflation, leading Sir Thomas Gresham (1519-1579) to coin his well-known phrase, "Bad money drives out good" – which, as popular financial sayings go, is probably more widely quoted and less properly understood than almost any other. The financial chaos continued intermittently throughout the 17th century, leading to no less a person than Sir Isaac Newton (1642-1727) to be asked to undertake the restoration of the coinage.

As warden and later master of the Royal Mint from 1696 until his death, Newton had considerable success with the mechanical side of coining a wholly new circulation coinage, as well as with the judicial side of pursuing counterfeiters and bringing them to justice (and the gallows). But even he was undone by the markets, and the man who determined the course of the planets in the heavens was still wholly taken in by the speculation fever of the 1720 South Sea Bubble. Though he never publicly admitted the full scale of his involvement, it is widely believed that Newton lost more than £20,000 (several millions today) in the collapse. As he later commented, "I can calculate the movement of the stars, but not the madness of men."

Approaching our current era, the number of market commentators and analysts rises inexorably. Among 19th century writers, Walter Bagehot is the most acclaimed, and although his famous work Lombard Street (from 1873) is better known for the advice he gives in it to the Bank of England on the duties of a central bank, most of the book is a study of banking and markets in general, and especially what causes crises and panics. A measure of the timelessness of Bagehot's analysis is that it is still referred to, quoted and indeed followed today. In the early 20th century, Edwin Lefèvre stands



out as a commentator whose insights have also stood the test of time. His book Reminiscences of a Stock Operator (from 1923) is the distillation of a lifetime's experience of working in the markets, and was just as valid and read just as well after the 1929 Wall Street Crash as before it.

Today, the number of market commentators has multiplied beyond measure, analysts abound and there is a plethora of theories seeking to explain how markets work – usually with only limited or transient success. This is unsurprising: markets combine the hard science of data and mathematics with the softer studies of psychology and power. They are intimately concerned with the human mind, being the combination of two very powerful emotions: how people react to money, and how people react to other people. The challenge of addressing both in the same theory is immense.

Those who trade in the markets for their living cannot afford the luxury of theoretical analyses that may or may not hold true in practice. They know that, like the weather, the world of investment is unavoidably full of uncertainties, and they have always sought their own guides to help them presage the future and plot their way through the permutations of their profession. A veritable library of market sayings has been amassed, with a pithy piece of wisdom for every possible situation.

I have worked in financial markets for almost all my career, starting in 1974 in a small investment management company and working since then in both public and private sectors. I have run portfolios myself ranging from the moderate to the very large and also overseen others doing so (which is far more stressful). I have advised clients and offered my own market commentaries and analysis. I have even tried my hand at forecasting (in which I did not excel; the best forecast I gave by some margin was that forecasting markets wasn't going to be my niche). In the process I have seen my share of hope and disappointment, fear and greed, surprises and shocks.

Before I continue, though, an important disclaimer and a word of warning. There are so many sayings about markets that, almost whatever happens, one can find a piece of lore after the event that would have predicted it. As prognostic tools, therefore, what follows is perhaps less than entirely reliable, and nothing herein is infallible – the sayings are offered as one guide among many, and I accept no responsibility for any losses that might result from following them. But if you want to sound wise after the event when your stockbroker explains why his sure-fire tip has lost you a fortune, read on.

Meet the family

As we explore the various axioms in this book, it is important to remember one thing above all others, and that is the human element in markets, investments and the like. Markets are made up of people, and their movements reflect individuals' emotions, hopes and fears. So, to guide us through and explain markets, we will be accompanied by four everyday people. You will meet them in any market in which you invest…

Christopher Courageous is a self-made man. He had considerable success in his career, and is enjoying a well-earned and comfortable retirement. He took a few risks, and suffered more than a few losses, but as he always says, "The man who never made a mistake, never made anything." Actually, he has made rather a lot of mistakes in his time. But, as well as more than his fair share of good fortune, he also has a well-tuned ability to forget most of his more costly errors.

Penelope Prudence wouldn't change her happy-go-lucky husband for the world. True, she has rather lost count of the number of financial scrapes he has got them into, and she suspects their current finances owe slightly more to her careful management behind the scenes than he realises. But that's all part of life, and meanwhile she's got enough set aside for any grandchildren that might come along.

Duncan Dependable is Christopher and Penelope's son. He is fond of his father, but very much takes after his mother. "Better safe than sorry" is his motto – but he is not entirely without a more adventurous side, and latterly he has been surprising everyone, including himself, by showing it rather more.

Fiona Frivolity is Duncan's girlfriend. She has two ambitions in life – to have fun, and to stop Duncan being so boringly serious. This latter goal is important, because while she has many projects on the go, none ever quite seem to generate the money she would like. Which makes Duncan's solid job and solid bank account terribly useful – if only he can be persuaded to spend it on her.

CHAPTER ONE

On Trading & Risks

Almost all active investment in the market involves trading, i.e. buying and selling. And almost all investment involves risk, or uncertainty about the final outcome. This is inevitable, because when one invests in the market one invests in the future, and the future cannot be known with certainty.

Even the most reliable investments, such as government securities, can rise and fall in value before their redemption – and even the redemption value itself may not be 100% guaranteed, as Europe has recently found to its cost. One of the first lessons an investor must learn is that, for most investments, success or return cannot be guaranteed, and the occasional loss is as much part of investing as the reward from calling the market right.

Trading might seem the most basic element of operating in markets, indeed of interacting with our fellow men and women. In some form or other, trading takes place in almost all societies, however primitive – there is barely a society worthy of the name that does not involve some form of trading. So one might think it is a basic, almost instinctive skill we all possess. But this is far from the case. Some people are seemingly born better traders, and some seem to revel in it whereas for others it is a chore. Consider haggling – it is a basic part of life in much of the world, but few people from societies where haggling is not common find it easy and many find it unnerving.

Trading in the markets requires two skills – buying and selling. And the skills are not at all similar. There are many people who can find a bargain and unearth an undervalued stock, but who find it extremely difficult to sell anything. This could be because they are hoarders, or because to sell something implies it was wrong to have bought it. Whatever it is, investment houses know that whereas a trader who knows when to buy is valuable, one who knows when to sell is far rarer and worth far more. If you are among the many who find it easier to buy than sell, stick to assets that one can buy and hold (for example, assets that generate an income, be it coupon, dividend, interest or rent), and forego any strategy that relies on selling to realise value.

Of course, when you do start selling assets, you face the possibility of making or realising losses. People are affected differently by losses, and no individual can predict in advance how they will react. But in time you will discover what sort of losses you are comfortable with and what represents "a loss too far". In short, you will have discovered your tolerance of risk. From that, the sensible investor will work out which assets are suitable for him or her and which markets he or she can comfortably trade in.

This opening chapter therefore looks at these two basic components of operating in the markets: the art of trading, and how to assess how much risk you should take.

The keys to calling the market correctly are skill, judgement, bravery, luck… and hindsight

Investors are always looking for ways to forecast what a market will do, and an industry of market analysts has grown up offering their prognostications. Some are better than others at this, and to succeed in predicting or "calling" the market, you need skill, judgement and – at times – bravery to stand by your convictions when others are ridiculing them.

Skill, judgement and bravery are essential to becoming a good forecaster. But they alone are not enough – one, also, undoubtedly needs luck. There was once an analyst for a London stockbroking firm who always issued a weekly buying recommendation list. He was known for finding something worth buying even when the outlook was dire and the market was plummeting. One week he was unexpectedly very sick, and at short

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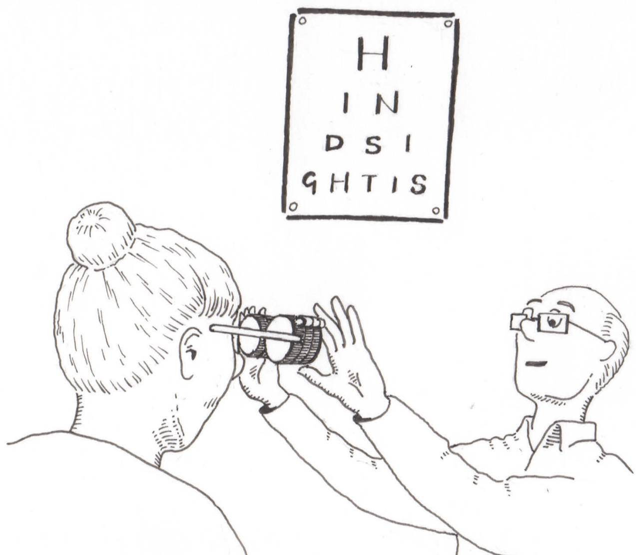

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