Intelligent Investor
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INTERVIEW SERIES: **Paul Thursby and Peter Geikie-Cobb (Thames River Capital)**

Making the most of global bonds

Peter Geikie-Cobb (left) and Paul Thursby

Thames River Capital, the fast growing hedge fund boutique, hired two of the City's best global bond fund managers last year in order to launch its new Global Bond Fund. The two also manage a smaller long-short fund. Paul Thursby ran top-ranked bond funds for more than a decade at Baring Asset Management while Peter Geikie-Cobb did the same at Merrill Lynch Investment Management (formerly Mercury Asset Management).

In this interview they explain why they moved to their new firm, how they see the bond and currency markets developing and why they see investment grade government bonds as an infinitely better bet than investment grade corporate bonds in the current environment

Why did you decide to leave your old firms and come here?

PT There were two main reasons. On the one hand there were some personal factors, including a sense of dissatisfaction with the way the industry has moved, towards big companies and central control, and lack of freedom and lack of intelligence in the way that people manage money. Secondly we suspected that the industry was badly equipped to help people at a time when we think there is going to be a sea change in interest rates and bond markets. Having lived through the late 1990s, and seen the fallout from the TMT bust in equities, our concern now is how to help investors stay alive in the difficult period that is coming in the bond market.

Where has the industry been going wrong in your view?

PT Many companies have opted to give their bond investors a much greater exposure to corporate bonds, or credit, whereas we are through and through government bond managers, for whom cash, not credit, is the logical alternative to 10-year bonds in a bear market. What other firms are saying to people is "Okay, we know bonds are not very exciting, but here's a bit of corporate paper yielding 50 basis points more – why not buy some of that because it'll be a bit more yield?" We feel that is the completely wrong direction to go for clients' investment health.

The risks in corporate bonds have not been fully appreciated?

PT What corporate bond managers have done to their clients is exactly what the equity guys did in the late 1990s. Then it was TMT (telecoms, media and technology stocks). TMT went from being nothing to 35% of the benchmark, and of course the managers said "Great, we have got to be in this. It is the market". The same thing exactly has now happened in investment grade bond credit. Gilts used to be 100% of the available bond universe in the UK. Now it's now less than 50%. There's been a huge supply of new investment grade corporate debt, and it has come to trade on increasingly tight spreads to government paper.

PGC In the UK for example, there has been a huge growth in bond issuance, but it has all been in investment grade corporate bonds. The bond universe in the UK unit trust/OIEC universe is now worth £37 billion pounds, but

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of that only £2 billion is governments and £35 billion is corporate bonds. Our worry is that the investors who are buying corporate bond funds see them as the anchor in their overall portfolio. They are not taking on board the underlying equity risk that's involved. You have seen many examples recently of how things can go wrong – Parmalat, obviously, and before that the whole Enron debacle – which should bring the equity risk element closer to home.

PT Of course, it is logical that bonds should have been a growing feature of people's portfolios. Everyone has to have some bonds in their portfolios as a balancing element. The older you are, the more bonds you have in your portfolio, and the more secure the income stream you need for the future. But we feel very strongly that people should be investing in the highest quality bonds to be sure that they can protect their capital and generate a reasonable income stream in the future.

What can you do here that is different then?

PGC The ability to protect capital is now the big issue in all financial asset classes. The ability to protect capital is where boutiques such as Thames River with their absolute return focus can score heavily. Our aim is to preserve capital while adding some incremental return even in the difficult times. In my experience, which goes back 20 years, we saw how investors got caught in the mid-1990s, the last time yields hit 4.5%, by chasing yield in places such as Mexico. It's not hard to see how it could all go wrong again. We don't wish to be part of that – and we won't be, given the quality and liquidity of the markets we trade in.

Why should a global macro approach such as yours work better in today's markets?

PGC The last decade has been difficult for macro bond fund managers. We've been in a very friendly bond market. It didn't really matter whether you were in a gilt or a treasury or a German bund. As long as you were long on interest rate risk, in general you would make good returns. Active management in a global macro sense, rotating around the world, looking for added value – which is what we do - was difficult to sell. That incidentally is why we think you've seen the big houses migrating into credit, with the emphasis on credit analysts adding value to a bond portfolio through a bottom up approach.

PT Our view is that the world is changing and that all the correlations we've seen in the markets in the past are going to start breaking down. We are beginning to see different parts of the world following different policy agendas, both in politics and macroeconomics. That means we can add value through macro strategies, moving round the world looking for macro opportunities in the new environment. Credit managers, on the other hand, are not going to find life as easy as before.

Given how difficult it is for active managers to beat the bond market index, you have to make a strong case for active management of government bonds, don't you?

PT Certainly in a straightforward bull market, just as in an equity bull market, you will do pretty well if you just own the market. But it is not the same in periods of greater volatility where there's less certainty around. Don't forget that we are coming to the end of a 20-year period of ever-declining levels of inflation. You couldn't have had a better environment for financial assets than that. Every time anybody took a profit, they underperformed the market! Our feeling is that this is one reason why people have been conditioned to stay very close to their benchmarks. That isn't going to work any more.

Why has active management not produced better results?

PT The big trend in the UK institutional market in the last few years has been to adjust mandates to bring in corporate debt. If you're a largish pension fund in the UK, you went from having a benchmark made up of 100% gilts to one that is now 50% gilts, 50% credit. What that means in practice is that you have to run lots of little positions. Because you don't want to get caught by a Parmalat, you have to have say 10 gilts and 300 other positions. That is difficult to manage and very expensive because the dealing costs are so high. Liquidity is difficult in the market and so nobody outperforms. That is not the way we want to go.

PGC In the larger investment houses the style is also very much benchmark-driven. In the environment we are now in, when people are looking for absolute return, and we are at the bottom of the interest rate cycle, how much can a large firm do to protect its clients money if it is constrained by having to follow the benchmark? You might be say two years short of duration, but you are never going to be 100% in cash, keeping your powder dry, waiting for an opportunity to get back into the market. That is what we are able to do.

What is different about the structure at Thames River?

PGC The most refreshing thing is being able to focus 100% on markets. Thames River provides all the infrastructure. That takes away all the things that distract fund managers from focusing on the markets and making decisions. My experience in recent years is that the larger the organisation, the more distraction there is, and the more emphasis there is on business rather than market risk. So that if for example you went off for the weekend on a Friday and there had been no breaches of the fund's guidelines, that was a successful week.

PT The success of the formula here is that as fund managers we can spend 100% of our time thinking about markets and managing money. We have just one meeting a month on

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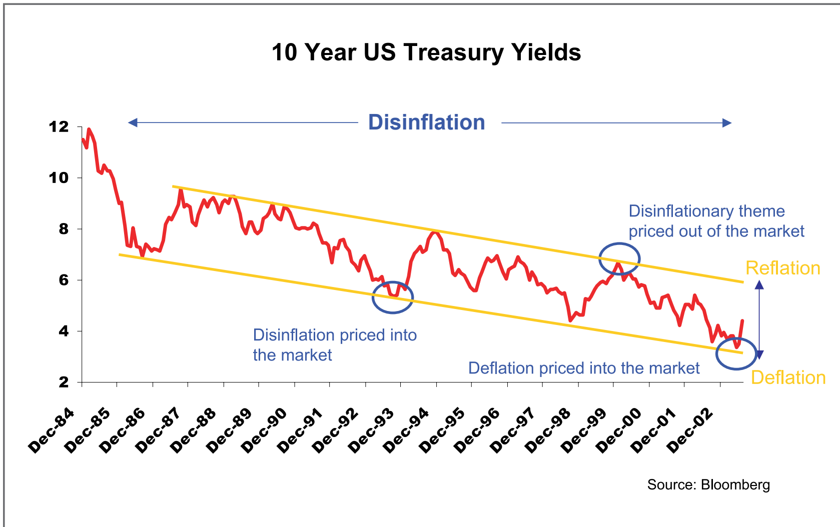
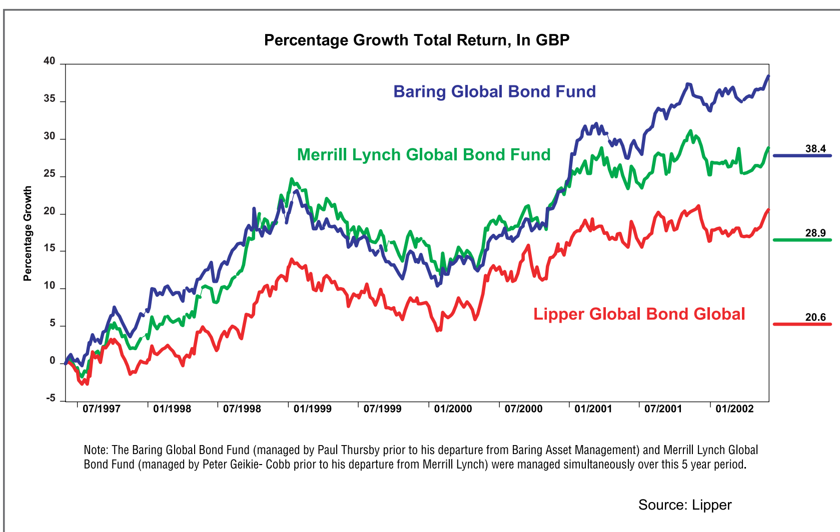


BOND YIELDS IN PERSPECTIVE

10-year US Treasury yields 1984–2004

The past 20 years have been marked by falling inflation and a relentless decline in bond yields. Yields could reach at least 6.5% before breaking out of the long term downward trend, according to Thursby.



TRACK RECORD IN BONDS

(Performance 1997–2002)

Thursby (at Barings) and Geikie-Cobb (at Merrill Lynch Investment Management) both managed global bond funds that outperformed the Lipper's global bond index in the five years from May 1997 to May 2002.

our accounts, for example and no other administration. The second important thing is that we only have two products, a long-only fund and a hedge fund, to worry about. Both Peter and I used to run multiple funds with 10 or 15 different mandates at our old firms. When you made a decision to buy or sell something, it could take three days to work out the implications for each account. You also had to persuade 10 people in a meeting before you could agree to do something. Here, by contrast, we can make and execute decisions instantly.

What is distinctive about your investment approach?

PGC We're value managers, so our job is to value bonds. That means looking at real returns, risk premiums, worrying about inflation, the balance of payments and all the things that we've always done. Apart from being able to execute immediately, the other big difference is that we don't have to track the benchmarks. With a benchmark you spend your time worrying about tracking error, which is not relevant to anything except the benchmark itself. For us cash is always available as an alternative. Right now the maturity structure of our fund is two months! A notional benchmark would be 6.5 years. Our most aggressive competitor has a duration of four years, and he's very bearish. That underlines the degree of freedom we have.

PT The frustration we had before was always trying to persuade other people to focus on the things we thought mattered most. For example TIPs – US index-linked government bonds - have been very good performers over the last two years. Yet three years ago you couldn't give them away on a yield of 3.5% simply because they weren't in the benchmark. At one point I remember being told that it was a career decision if I put any TIPs in my portfolio. That is a good example of what shouldn't happen and what doesn't happen here.

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Spending more time doesn't mean you are guaranteed to be right, though, does it?

PT No. We could be wrong. Anybody can. We've been bearish on markets since we joined last year, but it is only since March 2004 that we have started to see the bond market start to produce negative returns. So even though we are prepared to be aggressive, we still need to finesse our timing so that we are not too far out of line with the way the market is going. That is part of the job. We're fund managers, not economists. You have to have a sense of where the market consensus is going. You can't afford to be too early. Even if you're right in the end, if you're a year or two too early and you start to lose money, then your investors simply lose interest.

PGC We are always looking to confirm our understanding of the market, in the sense of seeing how markets react when the data comes out. Are we predicting the data and the market reactions well? The more confident you are that you are in tune with the way the market's going, and if you think you have a good understanding of the fundamentals, the more ready you are to build positions. For example, we've been short treasuries in our hedge fund, and the market has now pushed yields to the highest they've been in this recent run. So we've been adding to our positions, because we sense that the market is now confirming the story that we have been working with.

What is the universe you are choosing from?

PT Our universe consists of the world's investment grade government bonds. That means in theory we are following 33 markets and their respective currencies, from G7 countries, the big liquid markets, through Europe and on to growing countries in Asia. We have a limit of 80% in OECD countries, which leaves us with up to 20% for other investment grade countries. The point is that all our markets are liquid ones. Our job is to rotate around the world and cherry pick whatever we think is the best value at the time.

PGC Unlike most asset management companies/firms, we have made a conscious decision to widen the range of countries we can invest in. Most people don't do that, and that's odd because often the countries have just achieved investment grade status are undervalued by the rating agencies. They didn't want to get caught again after the Asian crises back in the 1970s and 1997/98. In our view a single A rating for a government bond now is the equivalent of at least a double A in corporate land.

You are particularly keen on Asia? Why is that?

PGC Yes. The credit standing is huge, they have huge reserves, and there's real growth there. These are hugely improved economies and will be competing with our economies for bond money at some stage in the future, because their credit dynamics are very strong, and under-recognised by the Western investment community. Investors here have shied away from JGBs (Japanese Government Bonds) because they're so expensive, and in the main they've not bothered to get involved in the other Asian markets.

PT Admittedly, it's a bit more complicated getting involved. There's lots of rules and regulations you've got to work round, but the markets are liquid and deep and will grow. The Asian economies will need capital markets to develop in order to control their economies. The problem in China now, for example, is they haven't got the depth of capital markets to bring about the monetary tightening they need. They need to be much bigger to give the central banks some ability to manipulate interest rate structures and control excesses within the economy, just as we do with our economies. That will happen. We are early into that.

Your fund is also chasing currency opportunities?

PGC Yes. The core part of what we do is managing bond risk. But there are also a whole spectrum of potential currency opportunities in the world that we feel have also been underplayed by the big fund management houses. Of course currencies are risky too, but in the end currency markets are driven by value just as much as bond markets are. Sure, they tend to overreact more because of speculative influences. They always have done. Our view is that whereas the world in the 1990s was driven by capital flows, and basically by the dollar, in the future the game will be more traditional. Current account imbalances are much more likely to have a greater impact on currency relationships than in the last decade.

PT If you look at currency as a form of economic management, it has become a very competitive arena. The Americans need a weak currency to restructure their current account imbalance. The Japanese have tried to keep a weak currency to allow their economy to grow. The Asians have done the same. Europe we think also wants to have a weaker currency going forward because of the problems they having with lack of growth. The ECB is still concerned that a weak Euro is a sign that the single currency is failing, but recently they've woken up to the idea that a weak currency could be quite good for them. All these competitive currency relationships create volatility and opportunities for us.

How do you see the UK bond market at the moment?

PT For the UK bond investor, in the last few years the best place to be was to stay at home in the UK gilt market. Firstly because the pound has appreciated after its ERM debacle back in the early 1990s, so being in overseas bonds

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you lost money because of currency. Secondly because of the fact that the UK gilt market has gone through a huge rerating after the crisis years of the late 1970s and early 1980s – the poor man of the world, problems with inflation, problems with huge deficits, continual sterling devaluations, and so on. Over the last decade we've seen the spreads between UK gilts and US treasuries and European bonds come right in.

We think that could be about to turn round again. It will be time for UK investors to start diversifying into overseas bond markets. That is partly because, from a currency standpoint, sterling looks overvalued. Two things in particular look ominous. One is the budget deficit. The OECD have been on record saying the Treasury must either raise taxes or cut spending to meet Gordon Brown's golden rule. The tax and spend policy we think is going to be damaging to the economy ultimately.

The second worrying thing is that the shape of the yield curve in the UK is very flat. As elsewhere in the world yield curves are still quite steep, you can buy overseas bonds and if you don't want to take the local currency risk, hedge that back into sterling. You get quite a handsome pickup in yield over the UK gilt market, purely because of the relative shapes of the yield curve. In a global context, the UK looks pretty grim.

PAUL THURSBY: "Competitive currency relationships create volatility and opportunities for us."

PETER GEIKIE-COBB: "Because we feel so strongly that we're moving into a very different market environment, our volatility is much, much lower than our competitor."

Where are the opportunities in currencies at the moment?

PGC Sterling is going to stay reasonably tight against the euro, we think. But Asian currencies have halved in value over the last two years against sterling and the euro. That seems an unlikely outcome given what's going on in that part of the world relative to what's going on in our part of the world. We don't think the dollar's very attractive. We don't particularly like the Euro, and we think the yen is extraordinarily cheap. We have been involved in both the dollar-related Asian currencies and the yen, and right now it's just the yen. As we speak, our position is 70% sterling and 30% yen, and we are looking to build our yen position into further periods of weakness. That should be enough to generate the returns we need to do a good job relative to what our clients expect, and if history is any guide it will also be enough to outperform the competition.

How do your monitor the risk in your funds?

PGC Because we only target specific value opportunities, the effective risk in our portfolio is much less than most of our competitors. Most people with global portfolios look at their bond duration [interest rate sensitivity] as their main measure of risk. They tend to look on currency risk as something you just have to accept when you do global bonds. In contrast we use absolute volatility as our measure of risk. That means looking at both the duration of the bonds and the currency. We have an overall limit to our portfolio of between 5% and 7% total volatility. Because we feel so strongly that we're moving into a very different market environment, our volatility is much, much lower than our competitors.

Why aren't more investors taking the same position as you on Asian currencies?

PGC For some reason Asia is seen as the exclusive reserve of equity buyers. The way we see it, Asia is an equity play for sure, but also a currency play, because currencies will be used at some point to adjust the economic management structure. The currencies are very undervalued. The authorities depressed the values to try and get their economies going, and eventually those values will realign. In a growth and inflation environment, there will be opportunities to add some value in other currency blocs as well – one day there will even be some value in the US again!

PT Because we're in this environment where the market is alternately worrying about deflation, as per last year, and swinging round to worry about inflation, as it has this year,

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the pendulum is bound to swing back and forth. That is why you'll see much greater volatility in bond markets and currencies looking forward. In that environment you want liquidity above all else, which you have in investment grade government bonds. In credit markets you have less discretion to move around, particularly given the current tightness of the spreads on offer.

How do you think your portfolio might develop from here?

PGC We're getting to the point where we've got a nice, healthy position in yen, and we'll add on extreme weakness in terms of market moves, looking for corrections, looking for opportunities. The anomaly is that the dollar has been going up, and it shouldn't be going up. It is probably going up because everyone's short of it, but we think that will play out in two to three months, and create a new opportunity. The yen is still the major value play relative to the US.

As for bonds, we will be long of duration at some stage. Indeed, while we're bearish on bonds right now, our feeling is that the bond market could correct very quickly. We'd expect to be buying long duration bonds again sometime this year, perhaps towards the 6% yield mark in the US. We think the correction in prices and yields will come fairly sharply.

PT What tends to happen (see graph on page 3) is that you get a big repricing in yields, but once that is over you then get a return to the longer term trend. We think it's going to do the same again this time round. Is this the end of the 20-year bull market in bonds? We wouldn't necessarily agree with that because, providing 10-year Treasury yields hold at around 6%, we would still be in a long term downward trending market. The market has to price in some risk premium because the Fed is behind the curve and wanting to reflate. Once we are back at 6%, unless we see something radically change in the meantime, there could then be a good buying opportunity.

PGC If Treasury yields get back to about 6% to 6.5%, we could well see a rerun of the 1980s, when markets would overreact. At that point you have to have the confidence to get back in, read the sentiment right and get over the huge negative inflation psychology that is bound to develop at some point, knowing that at some point you will get some tasty yields.

But the bond market is vulnerable to repricing?

PGC Corporate bonds haven't gone really wrong yet for people. Yes, they're beginning to produce negative returns, but nothing's really blown up yet, unless you happen to have owned Parmalat in any size. The mayhem in the credit market is still to come, in my view. Once the dust settles, people will think more carefully about the risks. Bonds will in any event be an inherently more risky asset class going forward because of the uncertainties about inflation, the uncertainties about government policy, the risk of policy mistakes. The markets have been applauding central bankers for the last decade, but their focus on core CPI may well have driven us into a deep cul-de-sac, and out of that will come a great disillusionment.

PT You can understand how policy mistakes might happen if the markets continue to oscillate either side of zero inflation, and nobody is quite sure whether the enemy is deflation or inflation. For example, we have had a classic policy error in the UK with the shift from RPI to an inflation target that excludes housing costs, which are such an important part of the economy. Now we have the Monetary Policy Committee tightening monetary policy, pushing rates up from 3.5% to 4.25%, when they're right at the bottom of the inflation target. It is difficult for them, because they are having to work with an unrealistic and inappropriate target. We would regard that as an underhand reflationary strategy by Gordon Brown.

Is there a danger of a repeat of the bond market bust of 1994?

PGC There's a danger that interest rates have to go much higher than people expect, so the shock to the market could be quite severe. Markets could react very badly if they begin to feel the Fed really is behind the curve in tightening policy. If the markets start to go on the front foot for themselves, it could be quite painful – and then of course we have the degrees of leverage in derivatives and so on, which are unheard of before. Nobody knows what effect that might have. The fallout in mortgage backed securities especially could be severe.

PT We're also a long way from a neutral policy stance. With a 1% Fed funds rate, it's not as if we are starting at 2.5% and looking to get to 4.0%. We are still at 1% and 4% is the minimum perceived level of interest rates we need to get to. So, yes, there could be another event like 1994, with the market being repriced quite quickly rather than it being a dragged out affair. The leverage and damage to the mortgage business in that case would be quite severe.

PGC The beauty of government bonds is that the markets can reprice them to being cheap, and produce a risk premium, very quickly. Once politicians start to make mistakes, the bond market vigilantes will drive up yields to a level at which the governments will have to stop what they are doing, because it will affect the property market, mortgage rates or whatever. Governments have to keep refinancing themselves, and the brokers will always price their markets so they don't get caught with too much expensive paper. That is different from the corporate debt market where as soon as there's a problem, or a buyer's strike, there is no price, the market just goes dead.

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Peter Geikie-Cobb (left) and Paul Thursby

What sort of returns can investors in your fund realistically expect in these conditions?

PGC We're expecting to do 8%, or double the market coupon. If you're aiming to make three to five big decisions a year as trends develop and then reverse, there should be enough opportunities to do that. We are only going to put risk in the portfolio when we see there are opportunities. The latest example is South African short-dated bonds. Yields are up above 10%, yet inflation is reasonably well behaved. You've also seen the rand sell off as another commodity currency. The dollar is rising against everything.

So you have a good fundamental story in short dated South African bonds and an interesting play on the dollar at the same time. If the commodity currencies start to rise again, which we expect them to do in the next 2 or 3 months, and the rand starts to appreciate, then you will get a big rally in South African bonds. We're also looking at Hungarian bonds, which are yielding about 10%. The shorter end in the markets generally are getting pretty cheap, for economies where inflation is 3% to 5%, and unlikely to go much higher.

How do you decide between these bond and currency market opportunities?

PGC Our job as managers is to work out where the best opportunities lie. Right now, we'd say the currency play is more interesting. Once we get back to decent yield levels, we may well eliminate the currency play completely, and then you might see us own 100% in 10 year bonds. That is the maximum you will ever see. In that case we would have no currency at all. Our view is that our job is to make one or two or three key decisions every year that will make the sort of returns that will pulverise any benchmark and produce the absolute returns that investors want.

What rate of turnover do you have in the fund?

PGC We don't really target turnover. Two or three times I guess might be expected. Because of the transparency of our markets, transaction costs are not a drag on performance. Turnover is primarily a function of volatility. It really is the case that in our markets you can rebuy your whole position every day, if you wish. We are always testing our positions. While we passionately believe in the Asian currency story, for example, we can also see signs of problems. If Asian stock markets keep on falling, it will have an effect on currency. The currency is just beginning to react to that. If we decide next week to get the position back on board, there will be an opportunity cost, but no physical cost involved in the trade.

Does your hedge fund pursue the same strategy as the long only fund?

PT The fundamental approach is the same in the hedge fund: it is value in bonds and currency, though with the ability to go short. We have the same approach to risk as with the main fund. We try to manage the downside. So we may hate the bond market but we'll only be short a few bonds. We may love the yen, but we're only at a 15% weighting. We can use a bit of leverage, but not much – twice assets, 200%, would be the maximum. We don't think leverage is that important. There's enough going on in our universe of markets to use up our risk budget without having to gear up!

How has the hedge fund performed?

PT It's only been going since November, and basically it is at breakeven, not a result either way. It has the same views that are expressed in the long only portfolio. So we've been short bonds and long the yen. The bonds have done reasonably okay. The yen has been more complicated. What we have managed to do is to minimise the drawdown. There have been a couple instances like the February US payroll figures [which were unexpectedly weak] which have caused big market dislocations. Currency managed funds and some macro funds are having a tough time as a result. We're pleased that we've not come to grief in such tricky markets.

What might happen to the long end of the yield curve as interest rates rise?

PT We think the yield curve will flatten but ratchet up. Our anticipation is that short rates will go up, the yield curve will flatten, but in absolute return rates there will be no hiding place. The thing to remember is that they are not issuing 30-year bonds any more, certainly in the US, yet we are in a period when analysis would suggest that people

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increasing need longer term debt. At the end of the day, there will be a shortage of long term, high quality cash flows. As we get out of this period of adjustment, these other issues will come to bear in due course. Our sense is that the peak's more likely to be 6% than 8% in terms of longer dated bonds and at those levels, when the market turns, they'll be very good buys.

When do you think we will see the top of the interest rates increases?

PGC We think that will happen very quickly. We could be there by the start of the fourth quarter of 2004. Usually in the bond market you have one bad year in every four or five, a bad year being when you get a zero return. It is very rare to get a negative return in a local currency market. I think the US has done it once in 40 years. Maybe this will be the exception because the coupon level is much lower than we've had in previous years. But the downturn is going to be 2% - 5%, not minus 25%.

PT A lot of forecasters are saying it will 5% - 5.25% by the end of the year. We think it could go higher than that. Then we'll just have to see how the property market reacts - has there been a crash in the UK, what's happening in the US, what's the stock market doing? - and so on. We're at the start of something new. We have had inflation coming down for 20 years, now it's going to pick up, all the central banks are having to adjust or change their strategies, and they're all doing different things. We've not really had this before. It's going to be very interesting.

How do you read the Federal Reserve's intentions?

PT The Fed hasn't wanted to tighten too quickly. Their experience in the 1930s was that they tightened too early and then they had a double dip. The articles on the Fed website suggest they are very conscious of being too early to tighten, but we think there's enough evidence across the board of a broad brush recovery now leading on to expansion that the bond markets are beginning to start worrying about inflation again. The dilemma of deciding whether it is deflation//inflation is going to mean that monetary policy will be more volatile.

Is there a risk of government intervention blindsiding the currency markets?

PT The Japanese have been trying and they have succeeded. In general, though, I think we are moving toward a world where market forces, not intervention, are what drive markets. Of course the US doesn't really care. They would like to see a weaker dollar, but unless things get dramatically more volatile, it is not going to drive the FX market. The noises coming out of the US and Europe on the back of huge Bank of Japan intervention and the noises coming out of the G7 meeting in Dubai last year are that there are differences amongst policymakers about what the right medicine is. So intervention is unlikely. Trade protectionism is a risk though. One can envisage intervention if things get nasty on that front.

What else should the markets be worrying about?

PGC The big worries at the moment are obviously the outcome of the election in the US and the Middle East, the uncertainties about Iraq, the oil markets. Who's John Kerry, for example, and what's he going to do if he wins the election? When you get German Cabinet ministers saying they don't know which way their economy is going, there's a lot of uncertainty around. There are also a lot of untried politicians around – look at Spain, where the Prime Minster has gone from nowhere to office in about three seconds.

The case for taking an active management approach today is that in the last 15 years you could buy a 15 year bond and not really worry, because nothing much changed. There were trending markets and the politics were pretty predictable. Now however buying anything other than a bond that matures in the electoral cycle is risky, because al-Qaeda could blow up the White House and you could find a neo-conservative, even a Donald Rumsfeld, in power. It's a very different world to the one we knew in the 1990s.

Are markets being too complacent?

PGC What the Wall Streeters in their ivory towers seem to think is that economic growth is going to peak out fairly soon. That is why we suspect the bond markets have been so incredibly restrained in their reaction to what we perceive to be the inflation problem coming through. People like to think that US job creation is not going to get out of hand. Who knows? All you can do is collect as much information as possible, gather the evidence on both sides, and build a case. Our view is that the market hasn't yet priced in the rising inflation that we think is already on the table. But you have to be flexible. The good news is that we're in asset classes where we can change our minds overnight. We have a pretty open mind.

PT We are particularly worried about the oil price. It seems to us that people have been very complacent about the ability of the world both to produce oil and the need for oil within our economies. It's getting harder to pump the oil out of the ground in known places and we're using a hell of a lot more. The Chinese are buying 14,000 new cars every day. They are not going to buy green cars, are they? They're going to want SUVs, just like the Americans. You also need to look at the lack of investment in electricity production in developed companies, and at refining capacity - they haven't build a new refinery in the US since 1977. An energy crisis is perfectly possible. ■

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