

The financial crisis: an interview with Hugh Hendry

Interview by Alistair Craven



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ugh Hendry is the principal portfolio manager and leads both the investment thinking and the research team at London-based Eclectica Asset Management.

Hugh has 18 years' industry experience with Baillie Gifford, CSAM and Odey Asset Management. At Odey he managed a range of funds from \$1bn of long only European mandates, including the award winning Odey Continental European Fund, to the Eclectica Fund. Hugh graduated from Strathclyde University in 1990.

His billion-dollar hedge fund operates in the eye of the financial storm, the blame for which he says lies squarely at the door of the financial elites: the banks, pensions funds, regulators and governments who were all "asleep at the wheel."

In his recent Channel 4 *Dispatches* programme "Don't Bank on the Bailout", Hugh travelled from the Square Mile in London to Wall Street in America, talking to some of the world's leading economists and investors along the way. Hugh thinks the rescue of the banks could doom us all. "We'll have to ratchet up our level of national debt to make this country feel as if it's fighting another world war". And our financial system may recover, but will the wider economy? Are we now simply heading for a recession, or a full-blown depression on the scale of the 1930s?

Hugh argues that in the UK we have to prepare for the worst – and let's not bank on the bailout.

AC: Thanks for joining us today. Can you start by telling us about your day-to-day role?

Hugh Hendry:

My day-to-day role is "the boss", and it is very different to many other occupations. I spend my time seeking distraction from my day-to-day role. I have a very unusual business whereby I've got a mirror reflecting on every action I take. I'm sitting in my office speaking to you and there's a computer terminal which is changing by the second and telling me how much money I'm making or losing today. Most people have an appraisal by their senior people once a year, and if you are good then once a year you get good feedback. If you read the Nassim Nicholas Taleb book *Fooled by Randomness* it tells you the problem about financial markets is that we have too much information, we get too much feedback. Let's say I'm a good investor. Because I'm getting a million data points, almost half of the time it might tell me that I'm bad, when I'm actually good!

I spend a lot of time out of the office. I make TV programmes, I go on radio programmes and I sit in the park reading *The Economist*. I certainly don't read much conventional research. I don't take the product of any investment bank, so instead I read some alternative material which is typically available on the Internet. I don't really read the

Financial Times. I hug trees, I hang out in New York, I go thousands of metres under the ground and examine geological freaks of nature. Two weeks ago I was a thousand metres underneath the Athabasca Basin witnessing one of the true remarkable geological feats which is pure grade uranium. Uranium is found around the world, but in terribly small quantities. If you think of a beach full of sand, maybe one or two grains would be uranium. I was in Canada at a spot where 20 per cent of the soil taken out of the ground was pure grade uranium. That's how I spend my time.

AC: To quote you from Citywire, "I antagonize people, it's part of my skill set."

Hugh Hendry:

An investor is only as good or as strong as his client base. I need secure, long-term funding in order to pursue my whims of intellectual fantasy, if you will. Therefore, I enter into a kind of cabaret. My language is colourful, not fruity, and I want people to overcome the obstacles of me being different in my alternative lifestyle and alternative thinking. I want them to overcome those obstacles, because in doing so they prove to themselves and to me that they've seen through that and they've seen the integrity of the thought process that we have. They've seen that we are individuals and not subject to crowd thinking, and therefore they're committed as long-term investors.

AC: Part of your company philosophy statement is as follows: "Pragmatism – not idealism. Conviction is overruled if the market does not show confirmation." What do you mean by this?

Hugh Hendry:

When one is investing, one is dealing with the future. None of us – regardless of intellect – have actually been in the future, so we don't know what we are talking about. Again, to refer back to the Taleb book, we fool ourselves; we believe that we've seen the future and we do so by constructing conventional analysis. The city spends literally billions of pounds investing in specialists to be experts, and so we do fundamental analysis. But it's just a flight of fancy. Unless we devise time machines and travel into the future, it's a folly. So, we respect the need for conventional thinking – we certainly do our own conventional, pragmatic analytical thinking – but we make money by being emotionally intelligent and seeking opportunities through paradox and irony, which is the undoing of conventional thinking.

AC: Many articles blame cheap money and greedy bankers for the financial "crash", others blame deregulation. What are your thoughts?

Hugh Hendry:

There are certainly elements of that and there are other things that one could add, but I would rather take a more general view of it. I'd say that it's almost pre-destination, it's meant to be. You will never stop it happening, and it will happen again. It will happen 70 or 80 years in the future when we're gone, when our memories have been erased. There's a reason why human beings typically die off no later than their 80s. They die off so that the memory of their mistakes is erased and so future generations can repeat the folly of greed and fear.

AC: Why do you describe short selling as the "pursuit of truth?"

Hugh Hendry:

I see the role of a hedge fund manager as the unofficial opposition party in this country.

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There are companies that employ hundreds of thousands of people. Can you imagine being the Chief Executive or Chairman and you are untouchable, and yet your decisions influence so many? If you get those decisions wrong, people suffer in terms of losing their jobs. Pensioners suffer because their shares don't go up when they should have.

I'm on the prowl, and I devote resources and considerable amounts of money into trying to spot mistakes being made. I'm a guard dog of the capitalist system. My message to people who are out there working for large companies is that I'm on their side. If the guys at the top of their groups are listed in the stock market and if they dare to step out of line, I'm onto them and I promise you I make their lives a misery.

AC: Astonishingly you note that the balance sheet of the Royal Bank of Scotland is bigger than the entire British economy. What do you think should have been done to prevent scenarios like this?

Hugh Hendry:

What we witnessed in the last five years was the Martingale technique, a gambling technique. Imagine a game of coin-tossing, heads you win, tails you lose. If the house allows you to double up every time you lose – so every time you get tails you double your bet – you cannot lose. It's a mathematical certainty that you cannot lose. If you go to a casino in Las Vegas and you try to pursue that strategy, you can't because it is banned. It is banned because the house gives you a limit. For example, "Mr Hendry you have a credit limit of £100,000. You can blow that, but no more." What we saw in the financial markets – unlike the casinos of Las Vegas – was that there was no house limit. So, you got 50 tails and you doubled up and it's exponential. The result is that you find that one entity has got a series of bets called a balance sheet which is greater than the entire British economy.



AC: An incredible situation. Generally speaking, what do you think is likely to happen to banking regulation in the wake of the economic crisis?

Hugh Hendry:

Again, that's quite easy because it's happened before. As a general statement, the governments are coming in and with taxpayers' money they are rescuing bankers. This happened once before. In early 1930s America, 5,000 banks – three quarters of all American banks – went bankrupt. The government insisted that they employ people of modest talent, that they engage modest risk, and that they achieve modest returns. For 40 years banks became utilities until the 1970s, when they began to employ people of less modest talent and began to take less modest risk and they achieved less modest returns.

AC: Following on from this, why do you think that the government bailout of the banks could "doom us all?"

Hugh Hendry:

The government has to bail out the banks. The problem we have is really more focused at the central bank. We had an opportunity a year ago to take some strain away from the economy by immediately reducing interest rates to offset the huge risk aversion that came through from the reality that the banks were insolvent. We missed that opportunity, and we brought rates modestly down from 5.25 per cent to 5 per cent and then we held them there from February of this year until September. That was catastrophic, because with the

amount of debt that prevails in the British economy today, 5 per cent really felt like 15 per cent. It was a straight jacket which has choked the spirit of enterprise out of the economy. There's now a certainty that we will endure a profoundly serious and damaging economic recession.

AC: Looking to America for a second, what did you make of the decision not to rescue Lehman Brothers in the US?

Hugh Hendry:

Initially I had respect for it. It's right that we should demand a pound of flesh. Lehman Brothers was a monstrosity of excessive risk taking. We wanted to run those guys out of town, but with the benefit of hindsight we've cut our nose off to spite our face. What we did was undermine any last vestiges of financial confidence in the present system. The cost now runs to trillions of dollars in terms of the amount of money wiped off stock markets by that one decision. They were trying to avoid moral hazard, but they doomed the system in the process.



AC: On the *Dispatches* programme you stated that investment and retail banking must be separated, and banks must never be allowed to lend more than they have. Can you expand on these two statements?

Hugh Hendry:

After the bankruptcy of the American banking system in 1932, the legislators introduced an act called Glass-Steagall. Glass-Steagall mandated that investment banking had to be carried out separately from retail banking. That's a brilliant piece of legislation, and it survived for 67 years until it was repealed in

1999, nine years ago. Nine years ago, Citigroup bought Travelers, and there were political donations made to congress amounting to over \$200m. They persuaded the politicians to give them the powers that had so destroyed them 70 years previously. As I said, there's a pre-destination that we will repeat the mistakes of today in the future.

AC: Charles Goodhart, a founding member of the Bank of England's Monetary Policy Committee, said on the programme that interest rates will "go down from now, by how far and how fast nobody knows. They could go to zero." Do you agree with him?

Hugh Hendry:

Yes. The role of a central banker can be compared to that of flying an aircraft. The most vital requirement is that the pilot avoids stall speed. If a plane stalls, the controls are of no use, they are unresponsive. We broke stall speed in the British economy earlier this year and Charles's point is that for this reason we could put rates to zero and it wouldn't change the fact that we are going to have a precarious economic situation. Monetary policy has now lost its role in being a relevant tool with which to avoid recession.

AC: In April you said that the recovery could take as much as a quarter of a century to complete. Do you still stand by this statement?

Hugh Hendry:

That is the recovery in equity prices. Again, I keep going back to the 1930s. The American stock market peaked in 1929 and it was 25 years before we saw a new high emerge. It peaked again in 1966, and it was 16 years before a new nominal price high. But remember, we had inflation in the 1970s and if you account for that, it was 25 years before we saw a new, real price high. The Japanese stock market peaked famously at the end of 1989 at 40,000. 18 years later it's at 8,000. It's got another 7 years to get back to its high.

"Monetary policy has now lost its role in being a relevant tool with which to avoid recession."

I see the highs that we achieved 10 years ago and I say that it will be around 2025 before we see the emergence of new price highs. I keep telling my six-year-old that when he grows up he is going to be a bull and not a bear!

AC: The FSA banned new short selling of bank stocks on September 18th this year. How did you react to that?

Hugh Hendry:

I threw my hands up in despair! This action will undermine the solid foundations of the stock market, because in doing so, you are withdrawing liquidity from the market.

What do I mean by that? When you have a day when the stock market is plunging, someone is making money. Short sellers are making money, and they cash that money in. So, they close their position which means they buy shares. Ever since the emergence of size in hedge funds in the 1990s, we haven't witnessed the catastrophe of a stock market crash. The last time we saw that was in October 1987, when in one day 20 per cent was wiped off all shares. That's what happens when there's no liquidity in a market. The presence of short selling has been a net plus. We took it away, and what did we see? We saw the biggest one day declines in stock market history. We saw crashes. I would link the two together.

AC: There seems to be a clear link indeed. Finally Hugh, how far do you think finance should be re-regulated?

Hugh Hendry:

Finance is the most over-regulated part of the economy. The tough part – and nobody's got the answer to this – is how does the political and financial form of regulation remove the punchbowl from the party? When we all have prosperity – and I don't care who you are, whether you work in a car factory or you manage a hedge fund – you don't want the good times taking away. You don't like going to a party where the host pulls out the plug, turns the music off, closes the bar and tells you all to go home. That is the role of a regulator. The problem is that they all court the publicity and goodwill that good times bring. I think the answer is put me in charge. I don't care if people hate me! □

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To find out more about Hugh Hendry and Eclectica Asset Management, please visit <http://www.eclectica-am.com>