Dear fellow shareholder,

Kings' Ransom

I was on the front page of *The Guardian* in 2005[1]. I lived in Covent Garden and had watched it cast off the last of its history as London's fruit and vegetable market. The old warehouses were empty and in the process of conversion to theatres, museums, shops and chic flats. The beautiful Opera House stood watching, to one side, unchanged since Henry Higgins met Eliza Doolittle on its steps. Yuppies like me had discovered it and made it a lifestyle destination. Over the years I was there the tourists arrived and nightlife spread from other parts of the West End. It became terribly noisy and when I went down to complain about someone selling newspapers at 2am I found I'd walked into a stunt related to the TV show, *The Apprentice*, cooked up by *The Guardian.* It was time for me to go.

My own life had also gone through a restructuring while there. When I moved in, I was a banker and by 2005 I was in the investment business. Banking is a lot more established than investment, although it is only eight hundred years' old and flowered in the same Northern Italian Renaissance that gave us the modern humanities, exploration and technology.

Lending was initially an adjunct to trade. The wool merchant in England who wanted to supply weavers in Germany had his payment guaranteed by a banking house. Europe became a continent of competitive nation states and lenders found a new source of revenue. Kings had always had high personal expenditures (otherwise, why be a king?) but there were a couple of other drains on the royal purse. One was the buying off of barons to maintain a king's position at the top of the power pyramid. Traditionally this had been achieved by land grants (including the grant of the land around Covent Garden by the King to the Earl of Bedford in 1552) but the economy was increasingly money based – and sometimes only cash will do. Secondly, armies, which had historically been feudal, with the obligation to fight built into the agricultural system, also began to march on money, as standing armies formed and mercenaries were recruited.

To the extent to which the Exchequer could not finance these rapidly growing expenditures by taxation, in other words as public deficits emerged, bankers filled the gap. Deficit finance was provided by and managed by banks. This led to the a classic question: how do you demand repayment from a monarch? Kings were all powerful. They had many means to escape the debtors' prison: they could imprison the banker; pass a law making the loan invalid; mint more coin (what we now call "money printing") to inflate away the debt; debase the currency by using less precious metal per coin; or simply refuse to pay. Monarchs could offer collateral (the Knights Templar lent money secured on Crown Jewels) but they could just as easily take it away. Ultimately, the lender had little recourse. Indeed, the history of sovereign finance is littered with recalcitrant kings, a foreshadowing of the perpetual sovereign defaults in Latin America in the nineteenth and twentieth centuries. The sixteenth century King Philip II of Spain defaulted four times but the lenders continued to lend to him. Why?

[1] I had also been on the front page of *The Telegraph* three years' before when I was mistakenly announced as the new Chairman of Chelsea Football Club. This was hilarious for anybody who knew me, so little did I know of football; and clearly equally hilarious for the readers of *The Telegraph*, who had never heard of me

If you take this Amex card offer they will give you £100 cashback on expenditure of £2,000 and charge you £458 if you are late paying it back! Likewise, the kings' lenders. The rates of interest charged in the late Middle Ages were steep, Amex steep. English kings normally paid between 15 and 25% per annum and this would increase to between 40 and 60% when they were under financial pressure. A lender charging 60% a year can afford the occasional default.

Modern states have learned from kings. Deficit spending was boosted by the mammoth cost of the second world war (which nearly bankrupted the UK) and the slow spread of the democratic franchise, which ushered in the welfare state. But the relative size of deficits has been tamed by the same thing which controlled the mediaeval monarchs – any government that borrows too much and gets close to default suffers not only lack of credit but cost of credit.

"I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody." – James Carville

In about 1993, when Michael Portillo was the Exchequer Secretary, I heard him speak at a private meeting in the House of Commons. He said there were far more savers than borrowers in the UK and he always got complaints when interest rates were cut – which was far from the newspapers' belief that interest rate cuts were popular. Since then, the saver-borrower balance has shifted and the numbers are now nearly even. Whether cause of effect, this move coincided with another trick Finance Ministers discovered: repression. By encouraging their central banks to buy government bonds, the Ministers were able to force the (invisible) hand of the bond market. Governments were still issuing the bonds but they were also buying them and pushing down interest rates in the process. This was effective and apparently without cost. As you won't need reminding the trick was

prosecuted so far that many government bonds yielded a negative amount. Governments had at last squared the circle that kings could not – they had vast debts at little or no cost.

But hidden costs are still costs and two parties will pay the bill. First, the central banks themselves (and thereafter the governments which sponsor them) will shortly find that they are sitting on massive unrealised losses. As interest rates return to their market level, bonds which were bought at, for example, a -1% yield will be revalued to a 4% yield producing a 40% loss on a ten-year instrument. Secondly, there has been a massive transfer from savers to borrowers as "market" interest rates could not keep up with inflation.

Now savers are emerging blinking from their bunkers to find yield again. Elderly relatives of mine who had spent many of their waking hours moving funds from bank to bank in search of the best returns forgot this skill in the past few years, as bank rates dropped to zero. As rates revert to form, I am having to remind them that they are sitting on cash that once more able to pay to support them. Derby Street is in the same boat. In the past few months we have for the first time bought gilts – risk-free, short in maturity and easy to sell; and at last paying a reasonable income.

As I have pointed out in a number of recent letters, rising risk-free yields punish existing bonds most but their effect on equities is complex. Here is a recent example. We own shares in Capital & Counties, which as it happens is the current owner of much of Covent Garden. The area was effectively shuttered during the lockdown but has recently recovered and is trading ahead of where it was pre-pandemic. However, its properties have been down valued both because of the pandemic (which temporarily reduced rents) and interest rate rises. The former factor has now disappeared. Capco's value has become a race between the downward pressure that increased interest rates are exerting and rental increases. But consider the actual maths. The independent property valuers are using a rate of just over 4% to value the estate. In other word, all future rents are discounted back by this number to find today's value. Covent Garden is a unique tourist destination in the heart of London. Isn't it likely that rents, through organic increases (helped by inflation and growing demand) and selective estate improvements, can increase far faster than that rate? Moreover, although Capco has relatively modest debts these are largely fixed at an average of 2.7%. Capco ought doubly to benefit from increases in rents and the effective deflating away of its debts.

Thank you for supporting Derby Street. We look forward to speaking to you all soon,

Richard Simmons
Portfolio Manager
Derby Street Investments

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