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1981-2011*

OFFSHORE PILOT QUARTERLY

Commentary on Matters Offshore

March, 2011.

Volume 14
Number 1

Tigers, Turtles and Idiots

"It was usually on about the fourth day that I put in that note of spontaneity for which I am known". So wrote the late economist John Kenneth Galbraith whom I also quoted in the last issue of this newsletter on the subject of modesty which, despite this latest revelation, he was not known for. He worked hard at his prose and would often write a passage at least five times, which puts me in good company except that I have neither Mr. Galbraith's intellect nor skill. But surely, for the conscientious, effort is at the root of every endeavour, including good writing – unless you are one of those few people blessed with a natural talent; and whilst I recognise the march of progress which, through ballpoint pens and electronic wizardry, has consigned the fountain pen practically to the museum, I question whether the same degree of effort is exercised by many of those who are producing commentary today. Computers have enabled their users to play the role of journalist to an international audience when often their main skill is in their fingers and although I confess to being jealous of those whose keyboard dexterity rivals a concert pianist, do they make good music? The same goes for sound bites and mountains of data, both seeming to be more readily received (and, dangerously, accepted) today.

A number of economists are concerned that the abundance of statistical analysis produced as a result of the Great Recession has created a forest of figures from which it can be difficult to separate the wood from the trees. Yale University professor and economist, Robert Shiller, argues that the fundamentals of finance are being side-stepped and replaced by science which pays little heed to the conventional approach. My own profession is suffering a similar fate where the foundations of equity, upon which the English trust was constructed, have suffered

several cracks due to a shift from the fundamentals, in the name of innovation, which practitioners such as myself have to grapple with. The trust law of India enacted in 1882 has hardly been changed, maintaining its Victorian persona, and still today is a valuable reference in some areas of trust law as my associate, Paolo Panico, points out in his authoritative tome *International Trust Laws*. Similarly, the Turks and Caicos Islands trust law, for which I am responsible, was built upon a simple, straightforward framework. In this case, surely, what's good for the tiger is good for the turtle so whenever I draft either a trust deed or a foundation's charter and regulations, simplicity is the goal.

Those economists who believe in the purely scientific approach to finance are at home with such phrases as "equity risk premium" and "efficient-market hypothesis" whereas professor Shiller described this data-driven approach as leading to academic departments at universities "creating idiot savants" who derive a sense of authority from work drowned in data. He argues that it would have been far better to have studied readings of history, institutions and laws. In other words, as he put it, "We should have talked to grandpa". Regular readers already know which side of the argument I support.

John Galbraith, who gave us the phrase "conventional wisdom", was also sceptical about economic theory that posited an idealised world of perfect competition and yet was blind to what drove man; he regarded this as tantamount to a "wilful denial of the presence of power and political interests".

The right choice is to analyse, listen and read, but selectively, because as Mark Twain reminds us, "The man who does not read good books has no advantage over the man who can't read them". The dilemma which investors face has been described as a choice



between evidence-based decision-making and decision-based evidence-making. In other words, either foresight is used to decide or facts are manipulated to support the decision already made (perhaps encouraged by one or more kings of the keyboard). The crunch, of course, is if you get it wrong. At school I remember being taught about Lord Nelson at the Battle of Copenhagen; when he was told that his commander had sent a signal to retreat, Nelson raised a telescope to his blind eye, saying, "I really do not see the signal". A few hours passed and the Danish fleet had been defeated. Clearly, the admiral had made his decision to fight and then shaped the evidence to fit.

Last month in my Latin Letter I wrote about, *inter alia*, the uncertainties surrounding our lives and which cannot be, by definition, planned for. It was the Roman poet and satirist, Juvenal, who wrote of "A rare bird on earth and very like a black swan" and whether he drew inspiration from that, Nassim Taleb, professor of risk engineering at New York University, created the now famous phrase "black swans" to address the unexpected. In centuries past, and right up to the present (amongst a group of people of a certain age), the Latin term, *Deo Volente* (God willing), has been employed as an acknowledgment to mankind's frailty. Miguel de Cervantes used it in his dedication of Part II of *Don Quixote* to the Conde de Lemos, as did an ill, bed-ridden, George Orwell, when he expressed the hope in a letter that he would complete his magnum opus 1984. God was on his side.

But, as I also wrote, attempts can be made to oppose fortune, as suggested by Niccoló Machiavelli, the Italian author of *The Prince*, a dissertation on politics, which one critic has called the Bible of *realpolitik*, despite Thomas Macaulay, England's famous 19th-century historian, describing the 15th-century Florentine thus: "We doubt whether any name in literary history be so generally odious as that of the man whose character and writings we now propose to consider". But as is so often the case in life, reality and reputation do not always correspond, as a celebratory dinner at a leading London hotel proved to me when warm champagne and under-cooked salmon were served.

Grandpa, Soldiers and Cowboys

Regular readers know the one numeral which professor Shiller's grandpa and I put faith in (see the June, 2010,

issue of this newsletter) is 8, with its shape constantly reminding us of the cycles of change which are often in league with uncertainty. Fortunately, none of my clients in New Zealand lost their lives in last month's earthquake which struck Christchurch, but homes were devastated and lives changed, as attested to by the sombre e-mails I received. Last week it was Japan's turn, except that the scale of the disaster has reached biblical proportions.

Being aware of life's cycles does not always help us to oppose fortune, but it is a constant companion when advising clients on the future succession of their estates; and although I would never give them personal investment advice, I often remind them of the perpetual flow of the figure 8 when long-term planning is involved.

Governments going broke, for example, is nothing new – except that today's figures could make your eyes water. The debt owed by the world's governments is thought to be standing at US\$43 trillion (Japan and the US are painfully aware of this).

Latin American countries know all about the subject too (Argentina, for example, suffered in 1890, 1931, and 2001) and the conquerors of most of South America, the Spanish, notwithstanding the country's present difficulties, have experienced cycles of catastrophe before, thanks to several debt defaults under Philip II in 1557, 1560, 1575 and 1596.

China, which is enjoying a particularly propitious period in its history, is also a fan of my favourite number (perhaps for a similar reason?) and Château Lafite Rothschild is ensuring that its bottles of 2008 vintage will feature the Chinese character for the numeral (a nod to the growing influence of China as a wine market). Do not, however, expect the Middle Kingdom mandarins to act rashly, no matter how many bottles they consume, for China too has had its "Spanish moments" – although I suspect the Chinese have learned more from them than we in the West have.

It is true to say that numbers in general can often have power over all of us (I need not explain 9/11, for instance). To my mind, however, they are at their most mischievous, when they are blended with theory, as opposed to facts, which the author of *Irrational Exuberance*, professor Shiller, also recognises. Back at the height of McCarthyism in the US, Senator Joseph



McCarthy, using witch hunting tactics in his exposure of communists, captured the public imagination with a list that comprised (his assertion) the number of communists working in the State department: it became known as “the list of 205”. The figure, for an unexplained reason, was then reduced to 57. So, while the senator’s campaign was real, his figures were not; conversely the films “The Dirty Dozen” and “The Magnificent Seven” were works of fiction, but the numbers were right: there were indeed 12 soldiers and 7 cowboys.

Man’s Labour and Toil

As the dust settles from the impact of the previous decade’s most unexpected debt débâcle, a search is on in the US in particular to find the guilty, those identified as being responsible for the country’s economic woes (John Galbraith could have helped). The bankers, politicians, regulators and the rating agencies have all taken a bashing, but what about the academic economists who professor Shiller criticises?

John Maynard Keynes’ now famous and oft-repeated warning about animal spirits was sidelined in the years before the last crisis due to academic theories, emerging in the 1980s, which created computer models and supported the perception of efficient markets and the rationality of both investors and consumers. What followed were regulators who allowed banks to deal in Mickey Mouse mortgages; in one case, to borrow 50 times its capital. Bankers relied on outdated academic theories which, in turn, produced bad policies and mountains of bad debt. Great faith was placed in the “rational expectations hypothesis” and its methodology claimed to prove, with what seemed to be mathematical certainty, that solvent banks would never experience sudden liquidity crises; for banks to hold excess capital was inefficient. Remember, these masters of finance included Nobel laureates who estimated that distress of the kind caused by Lehman Brothers would not even occur once in a billion years. Was this a Nelsonian moment? If so, I suggest the admiral had more experience backing his decision ahead of shaping the evidence.

Virgil, ancient Rome’s greatest poet, observed that “to retrace one’s steps, that is the labour, that is the toil”. Human psychology will ensure, however, that

whenever there is an imbalance between greed and fear, when over-confidence rears its ugly head, we will start to see, what for centuries we have seen, the recurrence of bubbles; they just seem to be getting more frequent and in the last couple of decades they have been appearing regularly. In 1980 gold produced a big one, with Mexican stocks suffering a similar fate in 1982 and once again in 1994. It was the turn of Japanese stocks to peak and plummet in 1990 followed by the stocks of the other Asian economies plunging in 1997 as an overture to the crash in Western stock markets. The turn of the century saw the infamous dotcom (which I have always described as dotcon) disaster. In this last decade bubbles have been on parade: house prices, mortgage-backed bonds, oil, industrial metals and Latin American, Chinese, Russian and Indian stocks. Currencies, too, (including Brazil’s real, Australia’s dollar and the pound sterling) have unsettled markets. One wonders what role financial innovation has played, so often driven by doctorate-driven dogma.

This blind faith in whatever the prevailing main economic theory is continues to place its followers, and by extension all of us, in peril. There is a wasteland strewn with bankrupt theories and ideas; George Orwell described the “major mental disease” which some intellectuals suffer from and criticised harshly those who “bow down before the conqueror of the moment, to accept the existing trend as irreversible”. This seemingly infinite supply of data, supporting theories and, indeed, affecting economies in general, is too much for one man to absorb. What this leads on to is decision-making based on imperfect information. I would recommend “Hard Facts, Dangerous Half-Truths and Total Nonsense”, written by Jeffrey Pfeffer and Robert I. Sutton (both Stanford University professors), who are strong proponents of, what they call, “evidence-based management”.

As a practitioner, rather than professor, of financial services, I have always run my firm along those lines, whilst at the same time maintaining cash reserves and being debt-free, both being buttresses against fortune (in this month’s Latin Letter, Devils and Princes, you will see why Niccoló Machiavelli would have approved). As Nassim Taleb has said, debt-laden companies are in trouble these days and he predicts that those who will



survive will be the ones more black-swan resistant, especially those that are smaller, family-owned, unlisted on exchanges and free of debt.

In all our endeavours we need to step carefully. We may accept that the Chinese believe that a journey of a thousand miles begins with a single step but we in the West prefer to use the fastest mode of transport available. We should question our assumptions, such as the idea that American-style, free-market capitalism

and democracy were, as Pankaj Mishra, the Indian author of literary and political essays puts it, “the terminus of history”. Not so; it is only an offshoot along the road which democracy has travelled for 2,519 years since the year 508, before the common era, when Cleisthenes established a democracy in Athens. I think the Chinese (let’s not forget Latin America) are on the same road, but it will be a journey made on foot; it may be slow, but you see more along the way.



Offshore Pilot Quarterly has been published since 1997 by Trust Services, S. A. which is the British face of trust business in Panama where it is licensed under the fiduciary laws. It is written by Derek Sambrook, our Managing Director, who is a former member of the Latin America and Caribbean Banking Commission as well as a former offshore banking, trust company and insurance regulator. He has over 45 years private and public sector experience in the financial services industry about which he has written extensively and our website provides a broad range of related essays including his Latin Letter column which appears in every issue of Offshore Investment.com, a British professional journal published since 1986.

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