Food for Thought

By: Peter Bill

Winning and losing the Dot Plot

On February 2nd the US Federal Reserve raised their Base Rate by 25 basis points to 4.75%. No surprise to those who follow the Dot Plot. The what? Take a look at the table. The dots represent the best guess on December 14th 2022 on where interest rates may stand in 2023, 2024, 2025, then in the 'longer term.' The very best of guesses. The dots represent the guess of each of the 18 members of the Federal Open Market Committee. These prophets from the Federal and Regional Reserve banks guessed high in December, then proved themselves right in February. They next opine publicly on March 22nd.

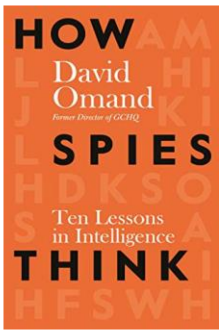
The Dot Plot

Roiling the market

Making a guess, then having the opportunity to prove yourself right, is not a luxury open to property investors. Very hard right now to guess a market enveloped in uncertainty. 'Should we be buying now, or holding off' is the question being asked. 'No idea' is my answer. 'Depends on the individual deal' is about the best I can do. Doing a profitable deal has got harder since temporary PM Liz Truss roiled the markets last September. Until then the game relied on low borrowing costs to provide 'magic of gearing' returns. Buy for £20m, borrow £15m and sell for £25m. Bingo, 100% return on £5m equity with the interest and transaction charges covered by rent. Not now. Anyone who bought into UK warehouses on these terms 12 months ago has seen 25% price falls. Bingo, equity gone.

Let's hope the dot plotters are right and interest rates will fall. If it is of any comfort, the Monetary Policy Committee of the Bank of England broadly agree with the Fed. The MPC pushed up the UK base rate by 0.50% to 4.00% on 1st February and is forecasting a rise to 4.50% by summer, then falling back to 3.25% in three years' time. But, for now, it seems hardly worth borrowing, even if you can find a lender. Debt costs of 6.00% - 7.00% can easily exceed rental income and can chew away at the equity after transaction costs have taken a bite. Uncertainty on capital growth or shrinkage means the magic of gearing has disappeared, for now. But buying with 100% equity takes nerve. You need to be a very good guesser indeed. Happily, there are ways to improve your skills.

How spies think



Sir David Omand, 75, is a former director of GCHQ and Britain's first Security and Intelligence Advisor to the Prime Minister. The former spymaster published a book in 2021 called How Spies Think. Last year as I watched him explain how spies are trained to think, I came to think his book a handy blueprint for how business folk ought to think. In the case of real estate, what thought processes need to take place before any deal is signed. The central message is: 'Know theyself' and 'Know thine enemy,' well, counterparty. Ask yourself, what are your real motivations - and make sure you take a damn good guess at enemy intentions. Do you have true 'situational awareness' as Omand puts it, or are you going along because the deal sheet numbers look fine, it fits the strategy, and the seller is a mate?

The SEES model

"My experience is that it really helps to have a systematic way of unpicking the process of arriving at judgements and establishing the appropriate level of confidence in them," writes Sir David, now visiting professor of intelligence studies in the War Studies Department at King's College London. The spy-turned-academic has published what he calls the SEES model. A framework that forces dispassionate thinking and analysis before acting. A model you imagine has been stress tested by British Intelligence. SEES leads you through four types of information that can help you reach an intelligent conclusion:

- **Situational Awareness** - Of what is happening and what we face now.
- **Explanation** - Of why we are seeing what we do and *the motivations of those involved*. (my italics) Those involved, including you (my advice).
- **Estimates** - and forecasts of how events may unfold under different assumptions.
- **Strategic Notice** - Of future issues that may come to challenge us in the longer term.

The next stage of SEES is rarely seen outside the world of spying: 'constructing the best possible explanation consistent with the evidence – *including the motives of those involved*. (Again, my italics.) Any intelligent investor does of course think along these lines. It's the stuff of many an investment committee's deliberations.

Crimping analysis

But are these deliberations carried out in such a rigorous, introspective and honest matter? Group-think, deferral to higher authority and inelastic investment policies can crimp honest analysis.

Difficult questions can be left unsaid. Are we doing this deal as part of some job preservation scheme? My job? Are we doing this because my bonus is structured in such a way as tip me towards saying yes rather than no? Are we doing this because our principal has hazily instructed us to 'to grow the portfolio.' In other words, are we doing this because, well, the money has to be spent, and it is to my advantage to spend it on something? Conversely: 'what is the counterparty hiding?? What do we think they may know that we need to find out? How much do they need the money? Can I trust them to complete? Do I trust those giving me the answers to these questions to be honest? Have things got a bit too cosy all round?

A big grain of Salt

The trick then is simple to articulate, but hard to execute: think honestly in order to guess well. Even then… well, let's leave the last word to Big Chief Dot Plot. "Dots are to be taken with a big, big grain of salt," Federal Reserve Chair Jerome Powell said at a June 2021 press conference. "They're not a committee forecast, they're not a plan. The dots are not a great forecaster of future rate moves. And that's because it's so highly uncertain."