



WEALTH MANAGEMENT INTERNATIONAL, LTD.

Proactive Investment Management & Financial Planning

Global Perspectives, May 2018: Strategic Intelligence and the Search for Good Investments

As an analyst at the Central Intelligence Agency years ago, I was always impressed by the view from the Operations Center, high atop the headquarters building in Langley, Virginia. Most of my time was spent in an enormous, hermetically sealed vault deep in the bowels of the building, where I could securely pore over intelligence reports from around the world. I had a couple of narrow windows that looked out over the central courtyard, so I could see the magnificent magnolia trees as they blossomed in springtime, but that was about it. In contrast, the enormous windows in the Ops Center offered spectacular, unobstructed views of the rolling woodlands of Northern Virginia. I could see to the horizon, as if I were standing on top of a mountain looking out over a vast forest. It was a welcome change from feeling “lost in the trees” down in my office.

As I look back on those times now, I realize that the view from the Ops Center was a perfect metaphor for the kind of analysis that’s practiced by the CIA. What the CIA offers our national leaders is “Strategic Intelligence,” or a global, big picture view of what’s happening around the world, based on a specific, disciplined mode of analysis. What the CIA offers is a view of the forest, rather than the individual trees (even if a CIA analyst might occasionally feel a bit too focused and isolated). In contrast, “tactical intelligence” deals with more specific, localized developments and is generally practiced by lower-level military units and law enforcement agencies. In today’s environment of global investment opportunities and free-flowing capital, the thing that makes my approach to portfolio management unique is that I constantly harness CIA-style Strategic Intelligence to identify and assess investible trends around the world. I’ve learned that Strategic Intelligence is just as valuable to the investor as it is to our national security leaders. If Strategic Intelligence can help the military decide where to deploy an aircraft carrier or bomber wing, why can’t it help guide where to invest a portfolio?

Elements of Strategic Intelligence

To better understand why Strategic Intelligence can be so useful for investment strategy, it may help to dive deeper into what it is. I think it’s handy to identify the key elements of Strategic Intelligence as follows:

Taking a Global Perspective. During my time at the CIA, one of my greatest delights was eating my bag lunch downstairs in the Media Center. The facility allowed you to dial up virtually any radio or television station around the world, so I would watch the Moscow evening news “live” as I ate my sandwich. Besides keeping my Russian language skills sharp, watching the video feed and listening to the leaders’ speeches gave me a much more nuanced understanding of things than I otherwise would have had. How I miss that today! After all, the discipline of Strategic Intelligence recognizes that important opportunities and threats can arise virtually anywhere on Earth. That’s precisely why the CIA made sure it could access any potentially important broadcast, whether it was from Russia, China, or anywhere else. For investors, it’s exactly the same situation: Investment opportunities and threats can arise anywhere, so it’s worth the time and effort to track developments across the globe. In one recent example that shows how profitable this approach can be, my analysis of the capital flows between China and Hong Kong convinced me in mid-2016 to put added emphasis on Hong Kong stocks (in the WMI strategies that include equities). As a result, those strategies were able to take full advantage of the huge 36% gain in the Hong Kong stock market during 2017. Of course, the big, global developments that are truly important aren’t always as sudden or short-term as the changes in capital flows. Important global developments often play out over long periods. For instance, as discussed in greater detail below, population aging in the developed countries is widely expected to boost the demand for healthcare in the coming decades, and it is already boosting returns for certain healthcare stocks. My detailed analysis suggests certain other global sectors are also likely to benefit. Similarly, I expect climate change to create economic winners and losers over time, so I am already researching how to take advantage of that trend in WMI’s portfolios.

Thinking Multi-Dimensionally. By the end of the Cold War, the CIA had grown to the point where it felt like a small city, and it seemed just as diverse. I was always amazed that the headquarters building alone included everything from its own medical office and credit union to a library and cafeteria. (Now, it reportedly has its own Starbucks!) The analytical corps was similarly

1

diverse. In my division, we had analysts following virtually every aspect of Soviet society, from banking to regional politics. In fact, Strategic Intelligence is multi-dimensional by necessity, since it recognizes that important opportunities and threats can arise not just in any country, but in any sphere of society. For the investor as well as the policymaker, I believe the most important sphere to watch is **national security**, since a military conflict or threat of conflict can drive asset prices dramatically higher or lower. In an example of the unique way that I link military analysis to investment strategy, my tracking of North Korean nuclear threats recently convinced me to increase my holdings of gold across the various WMI strategies, since precious metals often appreciate in times of international tension. Obviously, the **economy** also has a huge impact on asset prices, so it has to be a prime focus. Economic analysis has to be comprehensive enough to capture every development that could affect corporate and government finances. In an example of how I utilize economic analysis, I have developed a proprietary method of analyzing U.S. nonfarm payrolls to gauge when the next economic recession or bear market in stocks might hit. In addition, **political trends** are important, as they can affect not only the military and economic dimensions, but also market optimism. While all these various dimensions can affect asset prices, I also track the **independent financial market dynamics** that develop as investors respond to the market trends they see. I work to understand and exploit those dynamics through the daily, disciplined use of "technical" market analysis. There are also other social aspects that tend to affect asset prices over a longer period, but are no less important. **Demographics** and **climate trends** have already been mentioned above. In addition, I am always tracking developments in areas like **technology**, **cultural norms**, and **social cohesiveness**.

Using Multiple Sources. Many people don't realize that the CIA is just one of many intelligence-related organizations in the U.S. government. What makes the CIA unique is its role as the central hub of the intelligence community. The other agencies generally focus on more specific aspects of information gathering (such as the National Geospatial-Intelligence Agency's satellite imagery, or the National Security Agency's communications intercepts). At the CIA, my fellow analysts and I spent hours each day collecting and reviewing all that information, whether it was from our own agency, a sister agency, or an allied agency. We integrated it, analyzed it, and used it to produce finished "all-source intelligence." Strategic Intelligence recognizes that if opportunities and threats can arise anywhere in the world, and in any dimension of society, then making sure that you have all the relevant information for decision making requires you to utilize a wide variety of information sources. For the investor, that ethic means developing the habit of using multiple news sources. It means investing the time and money to access both the *Wall Street Journal* and the *Financial Times*, and preferably a few other news sources (because of Russia's aggressiveness under President Putin, I like to read *Krasnaya Zvezda*, the newspaper of the Russian armed forces). The most conscientious practitioner of Strategic Intelligence would probably even watch the BBC or TEI on satellite television (for a British or Spanish perspective). Strategic Intelligence also implies scouring for information in scholarly journals such as *Foreign Affairs*, or even reviewing global webcams that might be capturing newsworthy protests or calamities. Obviously, all these information sources would complement the financial market data from sources like Bloomberg, FactSet, and Standard & Poor's. The idea is to leave no stone unturned if it might give you more or better information than the next investor has.

Figure 1.



CIA headquarters building in Langley, Virginia.

Being Disciplined and Systematic. When I was at the CIA, the specific topic that an analyst was assigned to cover was called an "account," and the analyst was expected to become the Western world's top expert on his or her account over time. The idea was to build up a nuanced understanding and insight that would help you evaluate the incoming intelligence and understand what it implied for the future. My account was Soviet/Russian defense budgets and military accounting, and during the economic crisis after the collapse of the Soviet Union, my understanding of how finances flowed within the Soviet military allowed me to counsel top policymakers on whether the armed forces could handle their deep budget cuts without revolting. The thing that allowed us analysts to develop such expertise was systematic, regular monitoring of the incoming intelligence. Likewise, for the investor, the discipline of Strategic Intelligence requires that all incoming information be analyzed

rationally and systematically, keeping in mind historical relationships that connect current trends to the likely future outcomes. The discipline of Strategic Intelligence requires constant, regular monitoring of news and data flows so that the analyst can spot unusual developments that might be important. For my own work at WMI, that's why I track dozens of weekly, monthly, and quarterly data releases relating to the global economy and financial markets.

Figure 2.



Ship in Russia's Caspian Fleet firing anti-aircraft missile during recent exercise. A threat to your stock portfolio? (Krasnaya Zvezda).

Being Initiative-Oriented. At first glance, some might think Strategic Intelligence is limited to collecting and analyzing information. However, just as the CIA has an "operations" side that acts proactively in response to the intelligence collected and to the directives of policymakers, the discipline of Strategic Intelligence implies action. In my example in the previous paragraph, when top policymakers asked whether the Soviet military might revolt in response to its budget cuts, the question wasn't merely academic. It was deadly serious. It was asked in order to determine what the U.S. government should do to prepare for such a risk. For the investor, all the habits described above need to be carried out with the end goal in mind: What do I need to know in order to earn a good return on my investment without taking undue risk? What are these developments telling me about the available investment options? What should I do to take advantage of what I'm seeing? A good recent example of this is my analysis of inflation. Since inflation and higher interest rates can be a key risk during the latter stages of an economic expansion, I've been paying particular attention to the incoming data on prices, wage rates, unemployment, inventories, and industrial capacity utilization – all with a view to adjusting my investment strategies to minimize the negative impact from higher

interest rates. Since my analysis suggests most idle resources in the U.S. economy have already been used up, I suspect continued demand growth will drive inflation higher and create ever more risk that the Federal Reserve will hike rates too far. As discussed in detail below, I have therefore adjusted my bond holdings (in our various strategies that include fixed income).

Implications for Current Strategy

So what does this global, multi-dimensional, multi-source analysis suggest for investment strategy today? I believe that one of the broadest, most over-arching trends today is the on-going decline in birth rates and an associated rise in the average age within most major industrialized and developing countries. Going forward, I believe this population aging will tend to retard economic growth and inflation, while shifting production towards healthcare and certain other sectors. Another important trend that I'm watching is the continued integration of China, Russia, Mexico, and other developing countries into the world economy, as well as the political push-back that the process has spawned in the United States and some other countries. Whatever the outcome of that push-back, I expect China and Russia to continue strengthening their military capabilities and striving to regain the international security and influence they once had. If they succeed, they will have created a tri-polar world that will spawn more geopolitical risk than we've seen in decades. On a more positive note, I am excited that information technology may finally be ready to produce a new wave of productivity growth through advances in robotics and artificial intelligence, while the latest discoveries in genetic engineering seem to hold promise for great advances in healthcare. On the other hand, I am warily watching the growth in government debt in many major countries. I am also watching closely to see how these various trends affect each other.

Strategic Intelligence is also helping me make sense of shorter-term conditions. Perhaps most important for WMI's investors, I think the continued strong growth in the U.S. economy will boost corporate profits and push stocks higher in the near term, but that same growth is pushing up inflation and creating a risk that the Fed might start hiking interest rates too aggressively. I am also seeing signs of improved growth abroad, but inflation pressures and tighter monetary policies seem to be developing much more slowly there. I am being especially vigilant regarding the threat of miscalculation in international security and trade policy. A crisis in either of those spheres could suddenly disrupt the economy and financial markets. I even sense that there is an increased risk of burdensome regulation over some business sectors (such as technology), though I think that risk could play out over a somewhat longer time

frame. Within the financial markets, I am focused heavily on the high valuation of stocks, which has made them more vulnerable to a short-term pullback, and I am closely watching some nascent signs of rising defaults in lower-rated debt instruments.

In response to these developments, my current investment strategy across WMI's various portfolios is to maintain my allocations to bonds, stocks, and alternative assets right at WMI's long-term targets, which I consider "neutral." Within my bond allocations, I have adopted an over-weight position in fixed-income instruments that might hold up better in the face of accelerating inflation and higher interest rates, such as inflation-protected Treasury securities, floating-rate notes, and corporate bonds. Within my stock allocations, I have moderately over-weighted my exposure to the technology, energy, and consumer discretionary sectors. I am keeping my allocations to alternative investments mostly balanced among real estate, infrastructure, private equity, arbitrage, and commodities, but I am keeping a fairly high level of exposure to gold as insurance against an international crisis or higher-than-anticipated inflation.

Conclusion

In sum, the discipline of Strategic Intelligence as practiced by the CIA, Britain's MI6, or any other major intelligence agency is incredibly useful. Not only does it help political leaders make good national security decisions, but it can also help investors identify, understand, and respond to the big, investable trends that are taking place at any given time around the world. The use of Strategic Intelligence to inform investment strategy is the thing that makes my approach to portfolio management unique. It's a skill set and perspective that you can only get from actually practicing Strategic Intelligence over a long period. Strategic Intelligence allows the investor to not only make sense of the world, but to also figure out how to take advantage of the changing landscape. It can help investors and

Patrick Fearon, CFA
Chief Investment Officer

investment managers make smart decisions about stocks, bonds and all kinds of alternative assets. After all, maybe that's why Britain's most famous intelligence operative was known as James "Bond!"

Figure 3.



Take note, investors: He's not called James "Bond" for nothing!