

THE VICE IS RIGHT

DESPERATE TIMES CALL FOR DESPERATE MEASURES. ROWENA EVERSON EXPLORES THE NOT-SO-SEEDY WORLD OF VICE FUNDS

PLEASE heed the following warning before reading this article. Persons of a sensitive nature, strong moral disposition, humanitarian, baby-kissing, teetotal, anti-smoking puritans please move on. All persons of a more flexible outlook, please read on.

Now that the legalities are over, it's time for some hard truths: mutual funds are screwed, at least for the time being. Plummeting stock markets around the world meant that the value of mutual funds shrank by almost 10 per cent in the first half of 2008 alone; a combination of fleeing investors and falling share indexes. Add in the effect of the great hedge fund exodus in the last quarter of the year and you have the situation we now find ourselves in. Which means all those hard working responsible adults, who regularly invested in



mutual funds for their retirement, are facing a tough choice. Option one – forget the plans for a villa in Koh Samui and pina colodas, and settle for a hut in the kampong and a pig.

Option two – take what little is left and gamble on a higher risk-higher return investment to try and recoup the losses.

Neither is particularly appealing. No one wants to work their entire life just to end up where they started, even if they like pigs. Nor do people with a typically low risk profile (the sort of people who think black coffee is dangerous) enjoy taking a punt. It's the sort of thing that sets the heart racing and stomach churning. No coincidence then that Bayer, manufacturer of Alka-Seltzer and aspirin, is enjoying a boom time.

There is, however, a third option. An option for the individual who likes the formality of structured financial instruments, but doesn't care if the company is ISO 9001 compliant. The sort of individual who says "live and let live" at human indiscretion, or maybe live and let die. That option is the Vice Fund, and now might just be the time to take a quick peak.

The Vice Fund invests in companies in the aerospace, defence, gambling, tobacco and alcohol industries. The sort of industries shunned by the moral majority or, at the very least, which devote only a portion of their portfolio to "sinful" pursuits. That moral backbone comes at a cost – 7.5 per cent to be precise. In the five years to December 2007, the Vice Fund beat the Russell 1000 Index (the top 1,000 large capitalisation stocks typically selected by money managers in the US) on average by a healthy margin. But why have the bad boys been doing so much better than their goodie-goodie peers? Can a terrific run over the last five years continue in depleted equity markets? What are the risks of investing in a non-diversified fund like The Vice? And, ultimately, how would you feel about admitting to your friends that you profit from gun-running, gin-swilling, fag-taking gamblers?

THE PLAYERS

A good way to measure your friend's likely reaction to the last question is easy to gauge: simply toss the word "spanking" into your next conversation, and see what happens. If their response is one of righteous indignation at an affront to human dignity, they're probably unlikely to become an investor. Loud snorts followed by uncontrollable fits of giggles, similarly reveals the non-sympatico. A question of "How much?" means you've found a kindred spirit.

Drilling down into the fund components, you'll also find the likely suspects easy to spot. Among the top ten stock components of The Vice in 2008 were: Philip Morris and British American Tobacco representing the smokers; Diageo and Pernod Ricard for the drinkers; Altria straddling both fags and booze; Lockheed Martin, Boeing and Raytheon holding the corner for defence; and International Game Technology for gamblers. Rather timid by comparison, the final member of the top ten Carolina Group is a real estate company – although, judging by the recent actions of some of the US mortgage foreclosure companies, I'm not sure real estate is such a timid market these days. Timid or otherwise, all of these companies managed to do well during a period when global equities

have been shakier than a dipsomaniac at a health farm. But why? For that answer we will have to view industry by industry.

The last time tobaccoists enjoyed good times, the late US President Ronald Reagan was still making movies. But the happy tunes began to return to the Blue Ridge Mountains of Virginia with the finalising of The Master Settlement Agreement – the largest ever civil law settlement in the US, which capped the bill to tobacco companies for providing healthcare to angry smokers in exchange for one big fat cheque. The settlement effectively means that in future US smokers with tobacco related diseases will have to turn to their state for healthcare rather than attempting to sue the likes of Philip Morris. It also means the tobacco companies are free to pursue exotic markets like China, India and Azerbaijan without worrying about a never-ending stream of litigation back home.

It's not all good news in the smoking corner though. Rising fuel costs and unemployment in the mature markets has meant that some smokers are switching brands, abandoning their traditional packs of Marlboro in favour of cheaper alternatives.

However rapidly increasing tobacco use in places like China and Indonesia coupled with growing sales of premium brands in places like Russia and Malaysia (BAT reported a 7.6 per cent rise in sales of premium brands in 2008) means that profit is still growing for the fag-makers, which is good news for The Vice Fund.

BOOZE, BETS, BOMBS AND BUTTS

Nothing gives waning GDP a shot in the arm like a good war. It worked for Germany in the 30s, America in the 40s, and the UK for most of the 19th century. And the War on Terror certainly gave a boost to Lockheed Martin, Boeing and Raytheon, the world's largest and second largest defence contractor and manufacturer of guided missiles respectively. But with Iraq scaling down and Osama still AWOL, will the good times keep rolling for the bomb-makers? Well,



WHETHER YOU'RE A COUNTER-CYCLICAL INVESTOR, AN AMBULANCE-CHASER OR AN ASSET FLIPPER, BULLS OR BEARS ALIKE ALL TURN TO THE BOTTLE TO CELEBRATE VICTORY OR DROWN THEIR SORROWS.

there's certainly no sign that spending is being cut back. Lockheed's F35 Joint Strike Fighter is currently the US government's most expensive defence programme and its US\$298bn budget has just been boosted by a further US\$5bn because the government wants its new shiny jets sooner than the original due date of 2011. Similarly, Raytheon and Boeing have been popping the champagne corks recently as the US Defense Security Cooperation Agency (DSCA) approved a US\$1.5bn deal between Raytheon, Boeing and the Australian government. If it goes ahead, the two will supply F/A-18 fighter jet support services and equipment to the Australian forces. According to the DSCA, Raytheon's Sidewinder missiles and Boeing's electronic warfare countermeasure systems will have a "significant impact" on regional stability. They'll also make a significant impact on the Vice Fund where Boeing and Raytheon account for over 10 per cent of total assets. And for all his "change" rhetoric, I doubt anyone seriously imagines that Barack Obama is about to open the back door to America's defence, particularly given the jobs that could be created in building more bombs.

Global GDP may be waning these days, as we all cut back on non-essential spending, but the likes of Diageo are still forecasting profits – though smaller ones. Proof that in good times or bad, there's one thing you can always rely on – booze. Yes, whether you're a counter-cyclical investor, an ambulance-chaser or an asset flipper, bulls or bears alike all turn to the bottle to celebrate victory or drown their sorrows. So if you're bullish about a return to the good times, buy Diageo. If you're not, take solace in the fact that champagne sales actually go up in a recession and take a piece of the action by buying Diageo, global distributors of the world's number one champagne Moët et Chandon. And with their share price trading at a 30 per cent discount on 2008, the only thing worrying the liquor kings is whether we're all about to switch to home brew.

Dan Ahrens, former portfolio manager of the Vice Fund, wrote in his 2004 book *Booze, Bets, Bombs & Butts*, that gaming was immune to recessions, since people were more likely to try to win big in order to stave off the effects of a declining economy. This might be the one element of the Vice Fund to suffer since Las Vegas casinos have been feeling the pinch – although how much of this has to do with over supply in a recession hit market and how much to do with a switch to online gambling is unclear.

In fact, non-correlation is the one common factor in the Vice asset portfolio. From smoky pubs, to smoking Indonesians, to smoking guns, the Vice Fund has reeled in the profits over the past five years. And whether the world economy recovers or retreats, the global wealth factor makes less difference to these kind of industries. It sounds like a no-brainer, but there are dissenters. A small but

growing number of investors argue that the future lies not in the traditional vices but rather in a conscientious stock picking or socially responsible investments (SRIs). Are they right?

SAINT OR SINNER?

The classic response from an investment advisor when discussing SRIs is that it's better to invest in winning stocks and write a cheque to charity than to select your investments based on the morality of an industry. Restricting your portfolio by refusing to invest in tobacco, liquor, gambling and weapons suppliers or companies with poor human rights records can never be as successful as a diversified "normal" portfolio... or so they say. The problem with this argument is that it makes two very big assumptions: one, that non-SRI funds are fully diversified; two, SRIs must avoid "immoral" industries completely.

Blowing the lid on the first assumption is easy. The Vice Fund makes no pretensions at diversification, taking pride in its focus, but you don't need to look at anything nearly as glamorous as vice to see that global stock markets are increasingly faddish. Cast your mind back to the tech bubbles of the late nineties and the effect of the dot-com crash on index-tracker funds, or where overuse of CDOs has taken banking stock. SRIs tend to avoid energy assets like oil, which means they haven't been able to participate in the oil boom but it also means that they aren't vulnerable to what was possibly the most volatile commodity of 2008.

Lower volatility isn't the only reason why SRIs can succeed in a morally diversified world. Like a preacher reaching out to flock of sinners, some SRI managers actively seek out the "vice" industries, looking for examples of "best in breed", such as companies that actively clean up pollution rather than ignoring it. Supporters of SRIs will also point to statistics that show an average return equivalent to non-SRI mutuals, proving that you can get rich and go to heaven without having to perform juggling tricks with a camel and the eye of a needle. They will also argue that the Vice Fund has only managed to outperform during a strongly bullish market – the fund was founded in August 2002, near the start of the latest run.

All of which is correct, but with the VICEX less than half the price it was in October of last year, I'm reminded of a statement Warren Buffett made recently: "Be greedy when those around you are fearful and fearful when they are greedy," because ultimately, it comes back to the bottom line. And when the chips are down, time is called at the bar, and you're playing Russian Roulette with your last bullet, the Vice Fund has still made better returns than the top 1,000 companies in the US. And you can put that in your pipe and smoke it. ■