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Ray Dalio

Man and machine

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The economic ideas of the world's most successful hedge-fund boss

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"THE most beautiful deleveraging yet seen" is how Ray Dalio describes what is now going on in America's economy. As America has gone through the necessary process of reducing its debt-to-income ratio since the financial crash of 2008, he reckons its policymakers have done well in mixing painful stuff like debt restructuring with injections of cash to keep demand growing. Europe's deleveraging, by contrast, is "ugly".

And my returns look like this

Mr Dalio's views are taken seriously. He made a fortune betting before the crash that the world had taken on too much debt and would need to slash it. Last year alone, his Bridgewater Pure Alpha fund earned its investors $13.8 billion, taking its total gains since it opened in 1975 to $35.8 billion, more than any other hedge fund ever, including the previous record-holder, George Soros's Quantum Endowment Fund.

Mr Dalio, an intense 62-year-old, is following in the footsteps of Mr Soros in other ways, too. Mr Soros has published several books on his theories, and is funding an institute to get mainstream economists to take alternative ideas seriously. Mr Dalio, too, is now trying to improve the public understanding of how the economy works. His economic model "is not very orthodox but gives him a pretty good sense of where the economy is," says Paul Volcker, a former chairman of America's Federal Reserve and one of Mr Dalio's growing number of influential fans.

Whereas Mr Soros credits the influence of Karl Popper, a philosopher who taught him as a student, Mr Dalio says his ideas are entirely the product of his own reflections on his life as a trader and his study of economic history. He has read little academic economics (though his work has echoes of Hyman Minsky, an American economist, and of best-selling recent work on downturns by Carmen Reinhart and Kenneth Rogoff) but has conducted in-depth analysis of past periods of

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economic upheaval, such as the Depression in America, post-war Britain and the hyperinflation of the Weimar Republic. He has even simulated being an investor in markets in those periods by reading daily papers from these eras, receiving data and "trading" as if in real time.

In the early 1980s Mr Dalio started writing down rules that would guide his investing. He would later amend these rules depending on how well they predicted what actually happened. The process is now computerised, so that combinations of scores of decision-rules are applied to the 100 or so liquid-asset classes in which Bridgewater invests. These rules led him to hold both government bonds and gold last year, for example, because the deleveraging process was at a point where, unusually, those two assets would rise at the same time. He was right.

What Mr Dalio calls the "timeless and universal" core of his economic ideas is set out in a 20-page "Template for Understanding" that he wrote shortly after the collapse of Lehman Brothers in 2008 and recently updated. The document begins: "The economy is like a machine." This machine may look complex but is, he insists, relatively simple even if it is "not well understood". Mr Dalio models the macroeconomy from the bottom up, by focusing on the individual transactions that are the machine's moving parts. Conventional economics does not pay enough attention to the individual components of supply and, above all, demand, he says. To understand demand properly, you must know whether it is funded by the buyers' own money or by credit from others.

A huge amount of Bridgewater's efforts goes into gathering data on credit and equity, and understanding how that affects demand from individual market participants, such as a bank, or from a group of participants (such as subprime-mortgage borrowers). Bridgewater predicted the euro-zone debt crisis by totting up how much debt would need to be refinanced and when; and by examining all the potential buyers of that debt and their ability to buy it. Mr Volcker describes the degree of detail in Mr Dalio's work as "mind-blowing" and admits to feeling sometimes that "he has a bigger staff, and produces more relevant statistics and analyses, than the Federal Reserve."

Two sorts of credit cycle are at the heart of Mr Dalio's economic model: the business cycle, which typically lasts five to eight years, and a long-term ("long wave") debt cycle, which can last 50-70 years. A business cycle usually ends in a recession, because the central bank raises the interest rate, reducing borrowing and demand. The debt cycle ends in deleveraging because there is a "shortage of capable providers of capital and/or a shortage of capable recipients of capital (borrowers and sellers of equity) that cannot be rectified by the central bank changing the cost of money." Business cycles happen often, they are well understood and policymakers are fairly adept at managing them. A debt cycle tends to come along in a country once in a lifetime, tends to be poorly understood and is often mishandled by policymakers.

An ordinary recession can be ended by the central bank lowering the interest rate again. A deleveraging is much harder to end. According to Mr Dalio, it usually requires some combination of debt restructurings and write-offs, austerity, wealth transfers from rich to poor and money-printing. A "beautiful deleveraging" is one in which all these elements combine to keep the economy growing at a nominal rate that is higher than the nominal interest rate. (Beauty is in the eye of the beholder: Mr Dalio expects America's GDP growth to average only 2% over a 15-year period.)

Print too little money and the result is an ugly, deflationary deleveraging (see Greece); print too much and the deleveraging may become inflationary, as in Weimar Germany. Although Mr Dalio says he fears being misunderstood as saying "print a lot of money and everything will be OK, which I don't believe, all deleveragings have ended with the printing of significant amounts of money. But it has to be in balance with other policies."

Mr Dalio admits to being wrong roughly a third of the time; indeed, he attributes a big part of his success to managing the risk of bad calls. And the years ahead are likely to provide a serious test of whether the economic machine is as simple as he says. For now, he is in a more optimistic mood thanks to the European Central Bank's recent moves, in effect, to print money. Although he still expects debt restructuring in Spain, Portugal, Italy and Ireland, on top of that in Greece, he says that the "risk of chaos has been reduced and we are now calming ourselves down." Here's hoping he is right again.

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