Investment Newsletter

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Heads-or-tails investing

In many respects the world has become more fuzzy. What used to be binary has now become multifarious.

TV or radio? How about Netflix, YouTube or podcasts? Diesel or petrol? Why not try electric, self-charging hybrid, plug-in hybrid or hydrogen? Or what about the ultimate binary machines, computers? These are now moving to a quantum computing world that uses one, zero and the new 'superposition' of both one and zero.

However, in the investment world, some key factors have gone in the opposite direction and become extremely polarised.

To name just a few, trade war or US/China tariff agreement? Brexit or Remain? If Brexit, hard or soft? Johnson or Corbyn? Value shares or growth shares? Positive or negative interest rates? Recession or growth?

Headless chickens

Whilst some of these are market-related, the prevalence of geopolitical risks raises new challenges. Politics has become sharply polarised and brinkmanship is the order of the day. Politicians are far more likely to adopt extreme or crazy behaviour to wrong-foot their opposition.

Economist Nouriel Roubini recently likened this to the game of 'chicken' where two drivers race directly toward each other, and the first to swerve is the loser. If neither swerve, both will probably die. As he puts it, in the current political game, "if I can make it look like I have removed my steering wheel, the other side will have no choice but to swerve. But if both sides throw out their steering wheels, a collision becomes unavoidable."

Rarely in recent history have there been so many black-or-white issues affecting investment decisions. These games of chicken mean there are some small-probability events that could have a very significant economic impact if they come to pass. Navigating these decisions will be key to investment returns, and it is only right that our clients understand our approach.

Fat tails

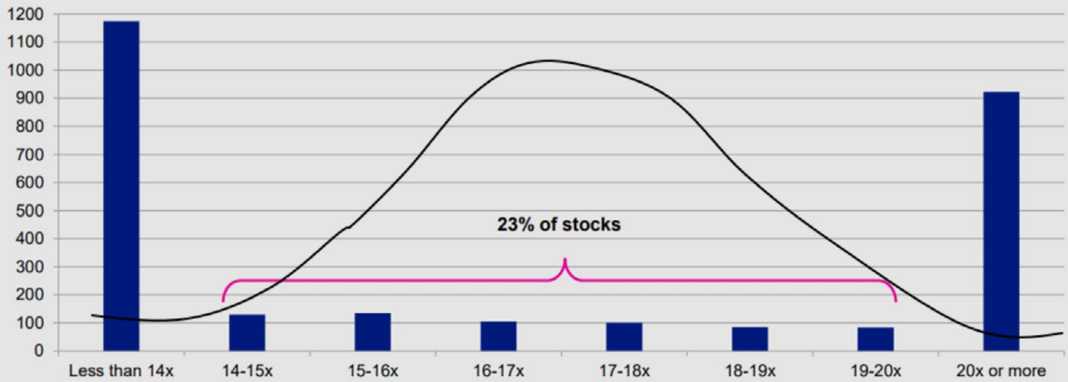
Just to give you a flavour of the kind of binary decisions there are in markets, look at chart one below. It shows the number of the companies in the All-World Index on the vertical axis and their valuation on the horizontal axis.

Throughout most of history this graph looks bell-shaped with the highest numbers grouped around the average in the middle, as shown by the black line I've crudely drawn. But look at the distribution now.

Investors essentially have the choice of many very lowly valued companies to the left or very fully valued stocks to the right. In stock terms this is the choice between a cheap, boring bank or an expensive technology stock – with very little to choose from in the middle.

By the way, if we had invested all your equities in the left-hand 'cheap' stocks over the last two years, the returns would be around 8% and would have seriously underperformed a portfolio of the right-hand stocks. This would have returned nearly 23%, or almost three-times as much as the 'cheap' portfolio.

Chart one: Number of MSCI ACWI stocks by forward PE



Source: Bloomberg as at 31 July 2019. 114 of MSCI ACWI's 2849 stocks not included given adsence of fwd PE figure.

It's a wrap

We are very wary of investing in the light of these uncertainties. Our approach incorporates many of the aspects of the WRAP framework for avoiding psychological traps developed by Chip and Dan Heath, in their book *Decisive*:

- Widen your options – expand your set of choices as far as possible
- Reality-test your assumptions – collect reliable information and explore dissenting views
- Attain distance before deciding – avoid making decisions based on short-term or emotional factors
- Prepare to be wrong – what will happen if things do not go according to plan?

What does this look like in real-life? In 'reality-testing our assumptions', for example, we do not blindly face these binary situations and cross our fingers that it will all work out fine. We run extensive scenario testing on the holdings that examine how stocks moved in similar situations in the past. That provides us with strong indications of what will gain or lose in either outcome.

For 400 years the Vatican employed a 'Devil's Advocate', the promotor fidei or 'promotor of the faith', to provide arguments as to why individuals should not be made a saint. Similarly, we use opposing viewpoints to challenge our decision-making. This provides balance to decisions, combats natural biases and we can clearly understand the consequences if we are wrong. (Interestingly, John

Paul II eliminated the office in 1983 and since then saints have been canonised about 20 times faster than previously.)

If we were to sum up our core mantra to binaries in three words, it would be 'don't lose money'. Our focus is on not losing clients' capital rather than trying to make mega-profits from these situations. This means that we are not going to pretend to know the answers or bet on black or white when the outcome is truly indeterminate.

From a risk perspective, markets do not like uncertainty, especially the binary form, and so caution is paramount. This was part of the calculation behind the inclusion of the Allianz Strategic Bond Fund in the portfolios earlier this year which served to increase the credit quality of the bond portfolio.

Similarly, however, uncertainty kicks-up mispricing which can also present opportunity for us as investors. The extreme negative sentiment towards the UK has resulted in weakness in sterling, the UK stock market and value stocks.

This presented the opportunity to buy into the Polar Capital UK Value Opportunities Fund at a triple discount earlier this year.

The market schizophrenia between fear and greed also meant that, in September, we were able to sell out our volatility trade in the FTSE 100 Index Fund for a gain of nearly 5% and were then able to buy another one at 7,100 when fear took grip again.

There is no doubt that such binary issues are likely to persist in the future, but we adapt our decision-making to ensure we can make level-headed investments rather than heads-or-tails bets.

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General economic overview

With the Brexit deadline looming at the end of October in the UK, there remain many uncertainties regarding the economic outlook. Growth has been sluggish over the last quarter, but consumer demand has been robust, and the weak value of sterling has lifted overseas earnings for many companies.

In the United States, the pace of consumer spending has also been pretty good which has kept the momentum of growth up. The issue of the trade dispute with China hangs in the balance and this may yet have a bearing on future growth.

As a major exporting region, Europe has suffered more than most from the slowdown in global trade as a result of the trade dispute. The markets are expecting a fresh round of quantitative easing from the European Central Bank to provide support for the anaemic pace of

Equity markets

The number of bids from overseas for UK companies continues to rise, underpinning our view that many UK stocks are undervalued and with the weak sterling, are very cheap from a global viewpoint. US stocks are expensive whilst some Asian markets have fallen to buying levels. We are cautiously optimistic on the outlook but volatility is expected to persist.

Fixed interest

We expect future returns to be low but still expect positive returns over 18 months. We like active bond funds which can move between government and corporate bonds and move up and down the maturity spectrum as market conditions change.

Commercial property

Given the rising risks and concerns over liquidity, we have reduced property exposure to around 5% of most portfolios. Property returns are likely to be in the low single-digit percentages for the foreseeable future.

Cash

With interest rates remaining at record lows, returns on cash will remain below average for the foreseeable future.

Balanced asset allocation

For a typical balanced portfolio, we are underweight fixed interest, property and traditional equity. This is balanced by additional holdings in defined returns and alternative equity, giving an overall risk/return profile roughly in line with our long-term average position.

These represent Equilibrium's collective views and in no way constitutes a solicitation of investment advice. The value of your investments can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested. We usually recommend holding at least some funds in all asset classes at all times and adjusting weightings to reflect the above views. These are not personal recommendations, so please do not take action without speaking to your adviser.