Investment Newsletter May 2020

EQUILIBRIUM

Predictably unpredictable

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"***It is difficult to make predictions, especially if it's about the future.***"
– Niels Bohr.

Some things are more than predictable than others, but in general any attempt to predict the market over short periods is a mug's game.

We always say that if you try to call a market top or bottom, you will either be too early, too late or just lucky. People are rarely lucky.

We will always tell you our honest views about where the market will go in the short term, but we won't make big calls based on what we admit is little more than an informed hunch. Our investment decisions are made with the long term in mind.

How can we make an accurate prediction of what will happen in the next few months, when we don't know how long lockdowns are going to last, or when effective testing or treatments for COVID-19 will be available? We don't know how bad the economic hit will be or how long it will be until the economy recovers.

By extrapolation, we know that company earnings are going to go down in general, but we don't know by how much and how quickly or steeply they could rebound.

However, the longer the time horizon, generally the more confidence we have in our 'guesses'.

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Read the book

We often talk about the price/earnings (PE) ratio of the market as being a good indicator of potential returns over the long term. At present, the UK market is valued at around 13.5 times the overall earnings (profits) of the companies that make up the market. This is below the long-term average and, in the past, we have tended to see above average returns over periods starting with similar levels of PE.

However, given what I just said – that earnings will almost certainly go down substantially - how reliable an indicator is it? If, for example, profits on aggregate are down 20% over the next six months (just a guess!), is the 'real' PE ratio maybe more like 17x, which is not quite so cheap?

Happily, there are other indicators that historically have been equally good, if not better, predictors of returns.

One of our favoured indicators is called the price/book ratio. The book value of the companies is essentially the total value of its assets minus liabilities, as stated in its accounts.

We then compare this to the total market capitalisation of the stock (the number of shares in issue x the share price). A price/book ratio of 1.5x means that the market value is 1.5 times bigger than the book value, for example. A number below one means that a company's market value is less than its book value.

In theory, a company's book value shouldn't be quite so volatile as its profits. Yes, asset values may fall and liabilities may increase, but book values ought to be much more stable than earnings given that many companies may become loss making in the short term.

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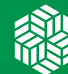


History lessons

At present, the UK stock market is valued at about 1.1x book. This is very low by historic standard.

The charts on this page show the relationship between price/book and historic returns over various time periods. There are four charts looking at one-, two-, five-, and ten-year periods.

Each dot on the chart represents a different period of the UK market. The higher the dot is on the chart, the higher the returns were. The horizontal axis has what the price/book ratio was at the start of that period.

For the statistically minded reader, I've included the r-squared number on the chart. This is a measure of how strong the relationship has been, with zero meaning no relationship and one meaning a perfect relationship. Alternatively, you can just look at the patterns on the charts!

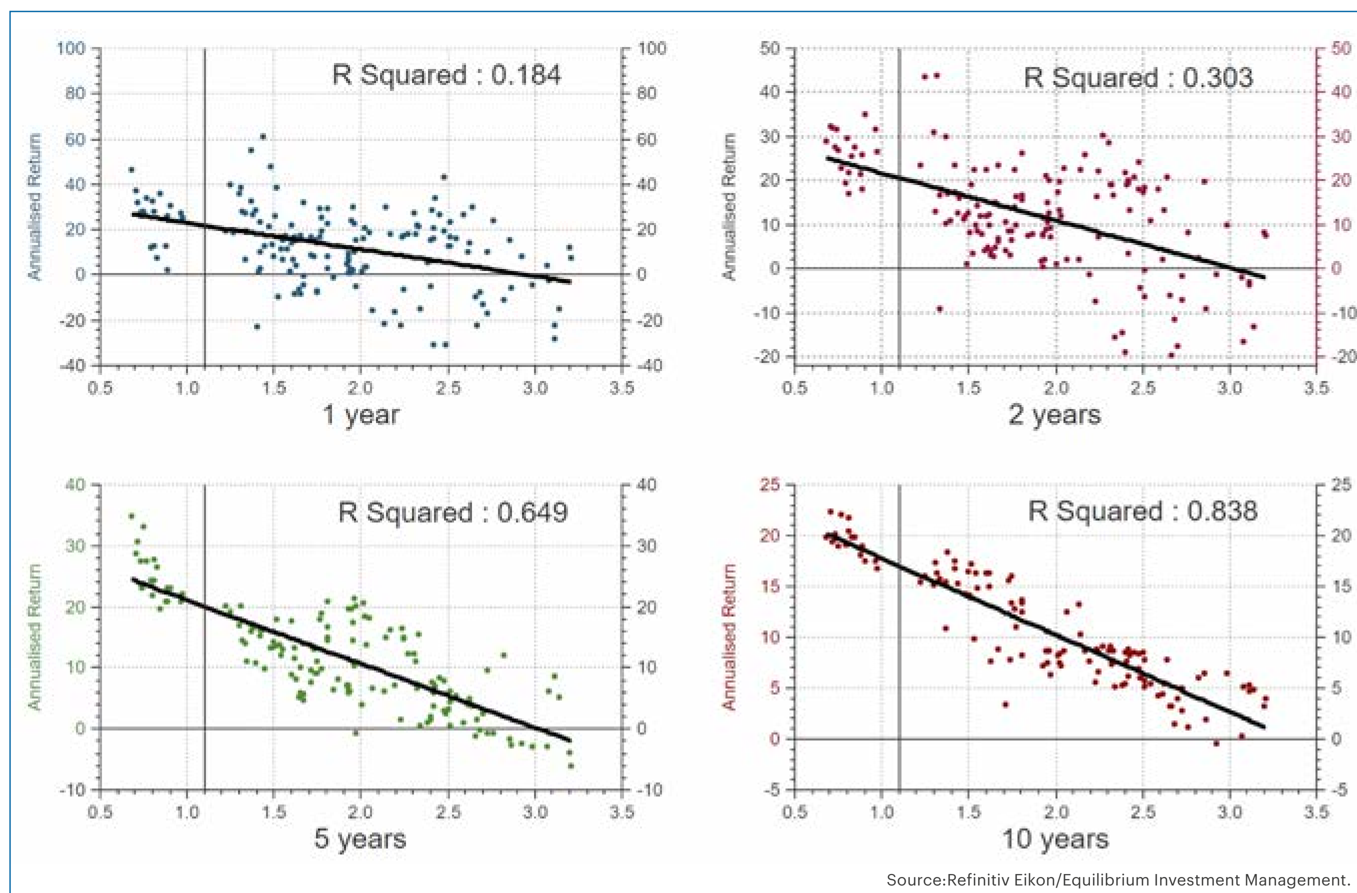
The vertical line shows where the price/book is at present, whilst the sloping line is a line of best fit.

On the one-year chart, there is almost no pattern (an r-squared of just 0.18 which is statistically insignificant). In other words, what the valuation of the market is now probably has almost no bearing on what level the market might be in 12 months' time.

Over two years, there is something of a pattern forming but still not a very tight formation! Visually, we can say we've not seen a negative return over past two-year periods when we've been at current levels, but we can draw few other conclusions.

When we get out to five-year periods though, things become more interesting. We now see a much clearer pattern and have a decent r-squared of 0.65 (roughly a 65% correlation). Our line of best fit intersects with the vertical line which shows the current valuation, at roughly the 20% pa mark.

Ten years is even better, with an r-squared of 0.84 (an 84% correlation) and the two lines intersect at above 15% pa.



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The future...

We can't predict the future, but we do believe we can learn from the past. In the past, we have seen some very good returns when markets have been this cheap, but only if we've been prepared to be patient. It has taken at least five years for this to be a useful indicator.

Of course, I should point out that this is all history and things may be very different in the future. In particular, accounting standards change over time and how assets and liabilities are recorded will of course affect book value.

There is an argument to say that this indicator had more value historically when companies made 'real' things. It is easy to value a building, a machine, cash in the bank etc, but it's much harder to value intellectual property.

With our increasingly service-based economy, these intangible assets become more important. What is the book value of Microsoft based on? Its software is its most valuable asset, not any particular machinery.

However, if anything, this means that book values are perhaps understating such companies' true worth. Book values are therefore less useful for tech-heavy markets like the US, but perhaps still worth bearing in mind in the UK where we have fewer such firms.

I have no idea which direction the market will go tomorrow, over the next week or even the next few months. However, there are reasons to believe that the long-term returns can be very positive.

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General economic view

We are in the middle of a global recession, but there is still little clear evidence as to how steep this will be and how long it will last. The world's second largest economy, China, appears to be getting back to something like a normal level of economic output, which will help cushion the global impact of recessions in the West. In addition, many countries in Europe are taking tentative steps to re-open their economies.

Whilst we are wary of making predictions about the level of economic contraction, we are stronger in our belief that low interest rates will remain for the foreseeable future. In the short term, central banks remain more worried about deflation than inflation.

Equity markets

Equity markets have had a good recovery given the current economic conditions. We are somewhat nervous of a short-term pullback but believe we could see some good returns over the longer term. We have recently cut exposure to UK equity income stocks given the likely dividend cuts, instead increasing exposure to global quality growth stocks.

Fixed interest

Government bond yields are generally at very low levels given the low interest rates around the world. However, many corporate bonds are now priced at attractive yields. There is an increased risk of default given the economic outlook, but generally we think the higher yields compensate us for this risk and are looking to increase exposure.

Commercial property

We expect commercial property to be hard hit by the economic downturn. The lockdown has exacerbated existing issues in the high street and more people are shopping online. We think the office market is also challenged by the increase in remote working. However, some part of the industrial market may benefit from these shifts.

Cash

With interest rates remaining at record lows, returns on cash will remain almost zero. We retain higher cash balances than usual as protection against further market falls and have diversified this into different currencies.

Balanced asset allocation

For a typical balanced portfolio, we are increasing exposure to fixed interest by reducing cash and alternative equity. We are underweight traditional equity but are instead holding more defined returns. The overall risk/return profile of our portfolios is slightly above long-term averages given our positive long-term equity outlook.

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.

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