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WEEKLY DIGEST | 23 July 2024

Forty Years On

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Forty years ago today, wearing the only suit I owned, I arrived in Gresham Street, just a few doors away from our current office, to begin my career in the City at the stockbrokers Fielding Newson-Smith. Given that I had only graduated the previous Friday, this was something of a shock to the system. But the fact that 9 am on Mondays had, for the past year, been dedicated to a German grammar lecture, meant there was also a sense of relief.

There is a lot going on at the moment, with the latest news of Joe Biden's withdrawal from the US Presidential election demanding some reassessment of the potential outcome and its effect on the economy and markets. There was also on Friday, what has been reported, as the largest IT outage in history, which provided a salutary reminder of the somewhat precarious equilibrium in which the global economy exists. And this week we wade deeper into the second quarter company results season, where all eyes will be on the technology giants after a fraught week of trading, which has seen a violent rotation out of the winners (mainly large cap Technology) into the laggards (mainly Small Caps).

But I'm going to ignore all that for now, and instead pull back from all the short term "noise" and offer some longer-term perspectives based on some of my experiences over the last four decades, which, I might add, seems to have gone by in a flash. During them I witnessed from the front row, in market terms, the 1987 crash, Black Wednesday (when the UK left the European Exchange rate Mechanism in 1992), the collapse of hedge fund LTCM, the TMT boom and bust, 9/11, the Global Financial Crisis (GFC - when I was working for Lehman Brothers), the eurozone crisis, Brexit, Covid, and Russia's invasion of Ukraine. These are just a few of the events that at the time were painful and even threatened to upend the whole economy, financial system or world order.

And yet, if you look at a chart of equity markets or a typical private client balanced portfolio over that period, it travels inexorably from the bottom left to the top right of the page. I can only get data for the MSCI All-Countries World Index total return (TR) since the end of 1987, but it has produced a 9% annualised return for sterling-based investors despite some hefty drawdowns, the worst being -63% between 2000 and 2003, followed by -48% during the GFC. Locally, the FTSE 100 Index has delivered a TR of 7.6% since the end of July 1984, which, crucially, has outrun inflation over the period, with the Retail Price Index annualising at 3.7%. Even so, "home bias" has worked against UK investors from a relative perspective with the US S&P 500 index's annualised return running at 11.9% over the same period (remarkably, it's almost exactly the same in dollar and sterling terms). The FTSE Private Balanced Portfolio Index (a reasonable proxy for a private client portfolio) has data going back to the end of 1986, since when it has delivered an annualised TR of 4.6%.

The first observation I should make is that past performance is no guarantee of future returns, although the returns mentioned above are consistent with very long-term trends. I would also point out that the two decades to the end of 1999 were exceptional in terms of returns and unlikely to be repeated imminently. It was a period which started with high inflation, very low equity valuations, double-digit interest rates and government bond yields and it was characterised by persistent disinflation. Bonds and equities were positively correlated in a good way (unlike in 2022), with balanced portfolios' two main asset classes both delivering strong gains. It wasn't quite like shooting fish in a barrel, but it was close, and I don't really think anyone who was living through it appreciated quite how good those times were.

The '80s and '90s positive correlation between bonds and equities gave way to two decades of negative correlation from 2000, as inflation continued to fall and remained low, with even deflation being a threat at times. Although overall returns were more muted, the trade-off between bonds and equities reduced portfolio volatility and increased risk-adjusted returns, another magnificent marketing point for fund managers. The return of inflation in the 2020's upset that equilibrium, and the relationship between inflation and the bond/equity correlation promises to be one of the biggest challenges to balanced portfolio construction in the years ahead.

One huge difference between now and 1984 is the availability of information. "Live" prices were delivered to our desks by the Stock Exchange's monochrome Market Price Display System and were updated manually by someone running around the stock exchange floor looking at the prices being written by jobbers with

felt pens on the big white boards on their “pitches”. There was a single TOPIC screen in the research area where there was a bit more depth and it was in colour! The best information edge came from lunches with company management where it was standard practice for a trading update to be delivered. That practice was banned a long time ago, but not before having been a consistent source of “alpha” for many stockbrokers and their favoured fund managers over the years!

Now we are deluged with information, or, more accurately, data. There is a continuum which starts with unstructured data and moves through information (which is when it is structured) and then onto knowledge (which is the practical application of that information). But the final step is to wisdom, because even with knowledge one can draw the wrong conclusions.

One of my biggest bugbears in recent years has been the result of the explosion in data mining, which has been associated with stock market history. It tends to go along the following lines: on the last x number of occasions that such and such an event has happened during the last however many years, the average performance of an index has been this, meaning that, all other things being equal, you have this percentage chance of the same thing happening this time. Given that a lot of investment is based on the balance of probabilities, there is a decent amount of money being traded on these observations.

But it turns out that all other things are not always equal, and we are reminded of the six-foot man who drowned crossing the river that was, on average, two feet deep. One recent example was the slavish adherence to the belief that an inversion of the US bond yield curve would inevitably lead to a US recession (especially when combined with a downturn in the Lead Economic Indicator). We’re still waiting. We also saw very relaxed responses to Russia’s invasion of Ukraine based upon the average performance of equity markets following past geopolitical events, but they failed miserably to consider the wider picture of inflation, interest rates and bond yields. OK, markets have recovered well since then, but not without a lot of pain first, some of which could have been avoided.

The current favourite doing the rounds is that if the US stock market has performed as well as it has done in the first half of the year, then there is more than a 70% probability (based on historical examples) that it will generate further positive returns in the second half. Well the data may be true, and it does speak to the power of underlying trends and momentum, but I’m not comfortable basing my asset allocation on that premise alone.

Talking of momentum, another observation is that it seems to be a stronger factor than ever, especially in the short to medium term - witness the relentless performance of companies exposed to Artificial Intelligence or to appetite reducing GLP-1 drugs, for example. It does appear that herd behaviour is extremely influential, reinforced by the development of the hedge fund industry, the easy availability of more speculative products and instruments to retail clients and the marketing heft of increasingly powerful fund management groups. It has always amazed me how much time it takes for the last buyer (or seller) to emerge, often long after I thought that everything was more than fully discounted in the price. But that also means that markets (or sectors or individual shares) can be subject to violent short-term reversals when the sentiment shifts. I think we just have to accept that this is all as part of the game today.

One constant mistake I have seen from both policymakers and investors is what one might describe as “fighting the last war”. Central bankers and fund managers spent most of the early 1990s waiting for inflation to reignite when they should have been more focused on global disinflationary trends. It took a long time for investors to cotton on to the improving environment for technology shares in the 2010s because they were still scarred by the TMT bust. The same goes for banks more recently as many continue to fear a rerun of

the GFC despite banks being much better capitalised as well as the central banks being much more attuned to the need to guarantee liquidity to the financial system.

What's the current "last war" risk? Possibly too much fear of another bout of double-digit inflation now that the worst effects of Covid and Ukraine-related disruptions are behind us. Having said that, I am still of the opinion that we are unlikely to return to the benign sub-2% inflation world of much of this century and that inflation could be more volatile henceforth.

In one of my recent Monthly Commentaries, I cited the aphorism "When is the best time to plant a tree?", with the answer being "Twenty years ago". The same can be said for investing. I certainly wish I'd known more about the concept of compounding returns forty years ago. Indeed, I think the whole industry would have been much better served by taking longer term views. It would certainly have benefitted from a much greater focus on returns on capital because I can think of many instances when investors were seduced by apparently strong growth in sales and earnings per share which were being delivered at the expense of the balance sheet.

Unless I am planning to work until past my hundredth birthday (which I am not!), I think I can safely say that I am closer to the end of my career than to the beginning, but the great thing about this job is that there is no "end" to it, and I still love it. Markets, economies and technologies evolve constantly and there is something new to learn every day. Over the years I've had the opportunity to meet many "captains of industry" on equal terms and have been able to question them about their businesses and to listen to all sort of experts who provided amazing insights into their specialist subjects. Once, when in the offices of Fidelity in Boston, I even caught a glimpse of the legendary fund manager Peter Lynch at work at his desk! I met Mrs. W-E when we were both working at Lehman Brothers, which (I am obliged to say!) eclipses all the other achievements and benefits of my time in the City. And so, it's "Happy Ever After" on all fronts, which is worth remembering when we are constantly assailed by negative headlines and portents of doom.

Economic Commentary

FTSE 100 weekly winners

DS Smith Plc	6.3%
International Distribution Services plc	4.0%
NatWest Group Plc	3.7%
Ferguson Plc	3.0%
J Sainsbury plc	2.9%
Barclays PLC	2.8%
Tesco PLC	2.4%

FTSE 100 weekly losers

Burberry Group plc	-21.3%
Antofagasta plc	-13.6%
Intermediate Capital Group plc	-8.6%
Glencore plc	-7.6%
Rio Tinto plc	-6.5%
Melrose Industries PLC	-6.5%
Anglo American plc	-6.3%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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