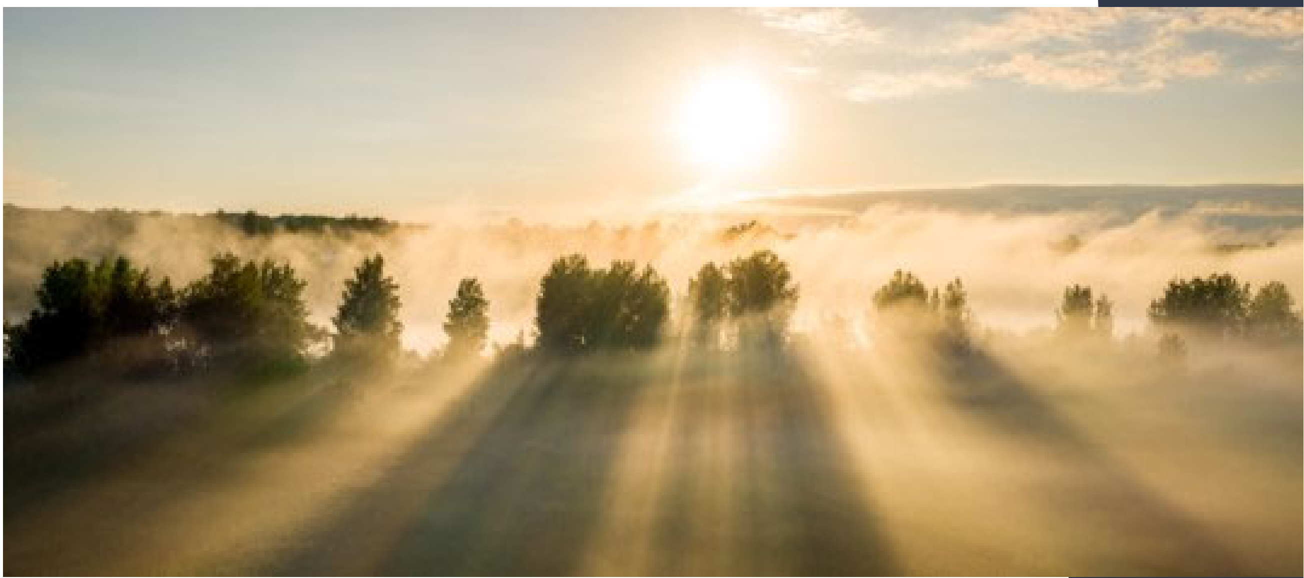
Investec

OUT OF THE ORDINARY

WEEKLY DIGEST | 19 September 2023

Ten Years On



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My first Weekly Digest was published on 23 September 2013, and, according to a very quick and dirty count, this is edition number 409.

Inflation is everywhere – not least in my word count. Owing to the restrictions of the existing format, I started out at around eight hundred words, although now regularly run to twice that amount. Maybe there is something to be said for physical constraint rather than the unbounded scope of electronic publishing,

although there does seem to be an awful lot more stuff to comment on these days. I see that I mentioned having bought my first flat in London in 1984 for the princely sum of £32,000 and that it was deemed to be worth around £500,000 by 2013. Roll on another decade and a quick internet search suggests more like £800,000.

I limited my first investment-related comments to some very broad views on future returns. My initial observation was that conventional bonds offered very little potential return. The judgement on that outlook could go either way. As yields continued to surprise to the downside initially, falling from 3% for the 10-year Gilt to as low as 0.07% in 2020, there were some decent capital gains to be made, especially by holding longer duration bonds. For example, had one bought the 4.5% issue maturing in 2042 at £120, one would have seen it rise to a peak of £183 (and clipped a decent coupon). Now however, it trades at £97. The total return over a decade is 15.2%, or an annual equivalent of 1.43%. That's hardly going to have kept the wolf from the door, especially when adjusted for inflation. The UK Retail Price Index is up 48.5% over the period, or 4.1% annualised. Leaving market timing aside, I'll give myself a tick for that call.

Countering that in a balanced portfolio setting was my belief that equities were the favoured asset class for long-term returns. I tentatively entered a few equity indices into the securities field on my Bloomberg this morning, hoping for a decent outcome. Actually, I knew things would be OK at the global level because of the performance of US equities, but I was less confident about the rest of the world. And so, what did I find?

Let's start at the bottom of the pile. The FTSE 100 Index has managed a capital return of just 19%. However, thanks to being a strong dividend payer, the total return is 72%, or an annualised 5.7%, handily keeping its head above the inflationary water, at least over a decade, which has to be the sort of time frame one considers to take short term volatility into account.

Second worst is the MSCI Emerging Markets (EM) Index, with a total return of 75% (5.8% annualised) when converted into sterling. This will have come as a great disappointment to many who expected the strong economic growth of EM to provide equally strong returns. Then again, it depends where you look within EM. There were strong performances from the likes of India (+14% ann) and Taiwan (+13% ann), but China (+4.5% ann), Hong Kong (+3.5%ann), South Korea (+5% ann), South Africa (+2.7% ann) and Brazil (+2.5% ann) were lacklustre (all returns translated into sterling). This certainly confirms my opinion that a broad EM definition is highly misleading and does not serve investors well, although it might afford EM fund managers ample opportunity to outperform their benchmark if they are willing to take some active risk.

Another observation about Emerging Markets concerns that disconnect between GDP growth and stock market performance. While there are no doubt shorter term shifts in performance based on rerating and derating, which can be caused by several diverse factors, in the long term we believe that returns are best delivered by companies that generate sustainable excess returns over their cost of capital. It would appear that capital allocation is not always optimal in some EMs, and neither are the incentives of managers and shareholders aligned. Add in, for example, government interference in countries such as China and several in South America, and the case for active management is strong.

The MSCI Europe Index has returned 105% (7.5% ann), but even within that France (+9.3% ann) has shown Germany (+6.5% ann) a clean pair of heels. Luxury Goods seem to have more allure than metal bashers. And if you don't think that a near 3% performance difference adds up to much, the magic of compounding means that France is +144% in total return terms versus Germany, which is up just 88%. Still, considering that the eurozone crisis was still fresh in everyone's mind and that there were grave doubts about the sustainability of the whole European project, those returns are very much in line with long-term expectations, which is not a bad achievement.

Unsurprisingly, among the major developed markets it's the United States that has triumphed. The S&P 500 Index has more than trebled in capital terms over the last decade, with total returns of 309% (15.1% annualised). That is way ahead of any long-term average and ahead of what was generally expected. No doubt a lot of those gains were driven by mega cap platform technology companies, although even the equal-weighted version of the index delivered annualised returns of 13.4% (there is some exchange rate flattery here, with the US dollar returns being 12.2% and 10.5% respectively – but still exceptional).

This is where I decided to dig out some old Long Term Capital Market Assumptions (CMAs). I have used the CMAs from a leading global asset manager that are available on the internet. These documents are a key tool in setting out long-term return expectations. They drive Strategic Asset Allocation benchmarks and provide information to clients as to how much risk they might need to take in the pursuit of adequate returns. Our experience is that everyone's CMAs look pretty much the same because they tend to use a similar methodology, not least some sort of mean-reversion of valuations, trend growth or inflation.

If we look at the set of CMAs I went for, its projections for ten-year total returns had Emerging Markets coming out on top (+9.75% ann), falling into that growth expectations trap that I referred to earlier. Everything else started with a seven. It's clear that they underestimated the power of a group of US companies to achieve an extraordinary combination of profitable growth and sustainable free cash flow. There is obviously some scepticism that this can be maintained, but we find it hard to bet strongly against the US in the long term.

The nature of such studies tends to throw out returns expectations that are built on academic theory. Thus, they arrived at projections of 5.75% for Commodities, which (using the Bloomberg Spot Commodity Index) only ended up achieving 2.4%. There again, nobody forecast the Chinese currency devaluation in 2015, an OPEC-led attempt to put US shale oil producers out of business by crashing the price, or Covid.

Perhaps the most interesting projections miss is on currencies. I have long argued that nobody has an "edge" in foreign exchange, and it has proved impossible to find a fund to invest in that displays persistent alpha generating capabilities in the asset class and therefore be something we could use as a risk diversifier. None of the CMA projections suggested more than a few percent moves either way across various major currencies over the next decade, and I would suggest that there is a lot of anchoring to present exchange rates when it comes to currency forecasting. The most spectacular miss has been on the dollar/yen which they pitched at ¥75. The Yen has effectively lost half of its value against the dollar to a current ¥147. Of course, monetary policy and the introduction of Yield Curve Control by the Bank of Japan in 2016 played its part. That was another unforeseen factor.

I make these observations with no intention of criticising the original projections. It proves to me that, even on a ten-year view, investment returns can deviate from long term trends, and that events will occur, and policies will be implemented that were not remotely considered. Thus, we have to remain flexible in our thinking and in our investment approach (while sticking to core investment principles in our process); and remain patient when returns do not accumulate as fast as we would like them to. I think I can say with some certainty that plenty of things will take us by surprise over the next decade too. Whether I'll be heading towards the thousandth Weekly Digest by then remains to be seen.

Economic Commentary

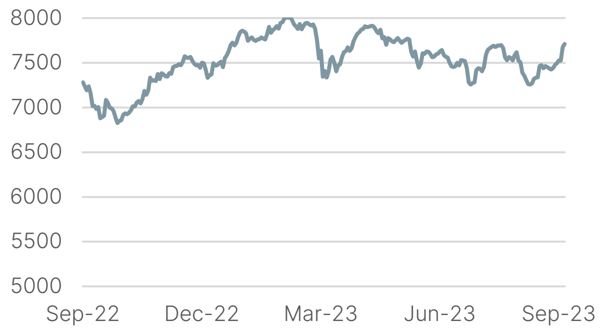
FTSE 100 weekly winners

AVEVA Group plc	700.0%
Anglo American plc	13.8%
Just Eat Takeaway.com N.V.	10.8%
Rio Tinto plc	9.4%
Vodafone Group Plc	9.0%
Barclays PLC	8.9%
Aviva plc	8.5%

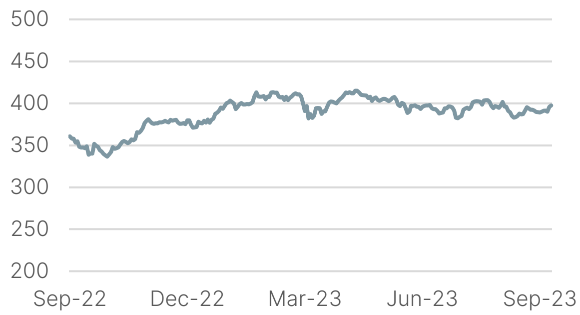
FTSE 100 weekly losers

Ocado Group PLC	-7.6%
Croda International Plc	-4.5%
Smurfit Kappa Group PLC	-3.7%
Entain PLC	-1.7%
Halma plc	-1.4%
Diageo plc	-1.2%
Hikma Pharmaceuticals Plc	-1.1%

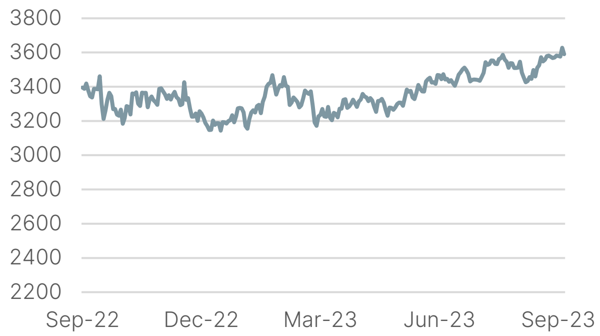
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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