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2020 – How we hope it will look…

Setting the Scene

The focus of our annual report this year will be on looking at some key developments that we are aiming to implement shortly with the intention of improving client's the overall investment experience. Market conditions have remained mostly unchanged over the past few years and are characterised by: -

- Developed equity markets led by the US remain at or near all-time highs.
- Low interest rates have forced other asset classes to highs.
- It is incredibly difficult to diversify a portfolio in these conditions.
- Fundamentals such as revenue and profit growth remain stretched and suggest equity market overvaluation.
- Investors continue to assume recent gains will continue indefinitely.
- Economic growth is modest despite Central Banks best efforts.
- Geo-political tensions and risks continue to rise.

Based on the above most of us would usually be heading towards Cash Deposits or Government Debt that offered a reasonable rate of return and relative safety; however, interest rates are too low to attract investors, so risk assets such as equities continue to maintain their allure. The new paradigm that has developed since the Financial Crisis means that it is important to be pragmatic when it comes to investment strategies; whilst we are big fans of value investing - that remains out of fashion – we have been researching other strategies (and variations on existing one) that could potentially make a positive contribution to returns.

Within the remainder of this report we will be looking at two very different approaches; one focused on momentum and market sentiment, the other a variation on the traditional value approach that aims to avoid prolonged periods where funds are not invested.

There will also be a closer look at Gold and how it could provide protection from the rising tensions and uncertainty across the Globe. The final section discusses how client's risk tolerance is assessed; traditional questionnaires can be daunting and misleading for both you and us – can we find a better way?

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Introducing Momentum

We are certainly not "throwing in the towel" when it comes to long term value investing; we must however be pragmatic and look for alternatives that can hopefully make a positive contribution whilst keeping a tight grip on risk management. Our full report on our Momentum Strategy is available on request; the following summarises the key points.

What is a Momentum Strategy

A momentum strategy aims to capitalise on the continuance of existing trends in markets, typically using a strict set of rules to take advantage or over and under reaction by market participants. Investors can apply this strategy to the wider market using indices, or individual stocks, selecting those that are exhibiting strong upward trends. A momentum or trend following strategy can best be described as follows:

i. The objective of a Momentum Strategy is to increase returns whilst managing risk.

ii. Momentum is not timing; it is a quantitative approach to risk management that aims to benefit from trend following.

iii. Decisions mechanical, price based and can often be applied to different asset classes.

iv. Behavioural finance tells us that individuals exhibit biases when investing; a mechanical process helps avoid this removing emotion from the decision process

v. Moving average systems have historically proved to be not only the simplest but also some of the most effective.

The approach is the opposite of the "buy low and sell high" concept and works on the basis that investors will continue to be attracted to the winners and this will continue to generate strong returns. When investor perception changes the momentum or trend will be reversed and declines will occur – in other words "the trend is your friend".

Our View

Current market conditions have made it clear that waiting for "true value" to appear before investing can be extremely frustrating and the risk exists that we will miss out on potential gains that still appear if sentiment takes control. Over the last few years for example it has been clear that market conditions are significantly overvalued in the United States; however, this has not stopped the market moving upward as investors continue to prefer US equities.

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In recent years what we would consider “true value” has only appeared twice since the turn of the Millennium, in 2002/2003 post the Technology Bubble and again in 2008/2009 as the Financial Crisis unfolded and equity markets suffered significant losses. This lack of opportunity should not come as a complete surprise; in the US for example Bull markets have persisted for prolonged periods – including over 15 years in the 1950’s and 1960’s – and investors can be left waiting a long time for real value opportunities to arise.

The Strategy

Based on our research and testing several approaches we established that a Momentum Strategy based on a ten-month simple moving average (buying/selling if the price is above/below the moving average) produced excellent result for Developed Market Equities in comparison to a simple strategy of buying and holding the same market. When the strategy recommended a sale, the funds were invested in Short Dated UK Gilts that have historically provided a return above cash deposits.

The Results

Focusing on the US and UK we found that since 1986 the Momentum Strategy performed best in the US, and whilst it underperformed buy and hold in the long term in the UK there were advantages – in particular the minimum return.

Strategy	Total Return	Total Return % Per Annum	Minimum Annual Return	Maximum Annual Return
UK Buy & Hold	1810%	9.1%	-29%	41%
UK Momentum	1363%	8.2%	-13%	30%
US Buy & Hold	2014%	10.7%	-30%	39%
US Momentum	2456%	11.4%	-17%	39%

It is also important to understand that the date the strategy started also plays a part with Buy & Hold outperforming Momentum from market lows – a well-known fact for those who use this strategy.

In our view, using this strategy as part of a portfolio should provide diversification in terms of how investment returns are generated; with a more than reasonable track record of performance compared to other strategies, its clear rules ensure consistent risk management are maintained.

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Making Value Fashionable Again

A lot of time and effort is required when undertaking investment analysis; particularly when considering individual equities and stocks. The availability of information and the advent of algorithmic and high frequency trading has made it increasingly difficult to exploit opportunities. In fact Benjamin Graham who is considered the founder of Value Investing stated not long before his death in 1976 that he was : -

".... no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, 40 years ago, when our textbook "Graham and Dodd" was first published; but the situation has changed a great deal since then. In the old days any well-trained security analyst could do a good professional job of selecting undervalued issues through detailed studies; but in the light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their cost. To that very limited extent I'm on the side of the "efficient market" school of thought now generally accepted by the professors."

Whilst we accept this may be the case with individual stocks, and certainly agree with the time consuming nature of the endeavour, the broad market (as defined by major indices) continually fails to be efficient as investors sentiment frequently takes charge and drives prices further away from fundamental/reasonable valuations. As big fans of Value investing, we couldn't resist exploring different strategies and ways that we could exploit them to improve returns.

How to Measure Value

The Cyclically Adjusted Price Earning (CAPE) Ratio is one of the most reliable measures of equity market valuation; developed by Professor Robert Shiller it seeks to provide a valuation of the stock market using a 10-year average of earnings that are also adjusted for inflation.

In the US the correlation between the CAPE ratio and the subsequent 10 years returns from the stock market has been over 82% since 1973; a high/low CAPE ratio is associated with low/high future returns.

Understanding what drives these returns is also important as changes in Stock Market Company Earnings and the rate of inflation play a key role; in driving valuations from or back to their long-term average.

The Strategy

As with Momentum we explored several permutations (full details are available on request in a separate document) establishing that simply investing in the countries whose equity market had the lowest CAPE Ratio was not enough.

Instead the most promising results came from investing in the equity markets of those countries where the CAPE is the furthest from their median value. A good example is Russia that has had one of the lowest ratios for a number of years and still produced poor returns; in contrast other regions have a higher ratio than Russia but it was below its long term median and produced stronger results.

The strategy we selected was relatively simple; at the start of each year we would rank countries by not only their CAPE Ratio but also how far the ratio was from its long-term median from high to low. Once this was completed, we would invest equally in the bottom 30% of countries whose CAPE was furthest below their median. At the end of the year the same process would be completed, and any changes made accordingly.

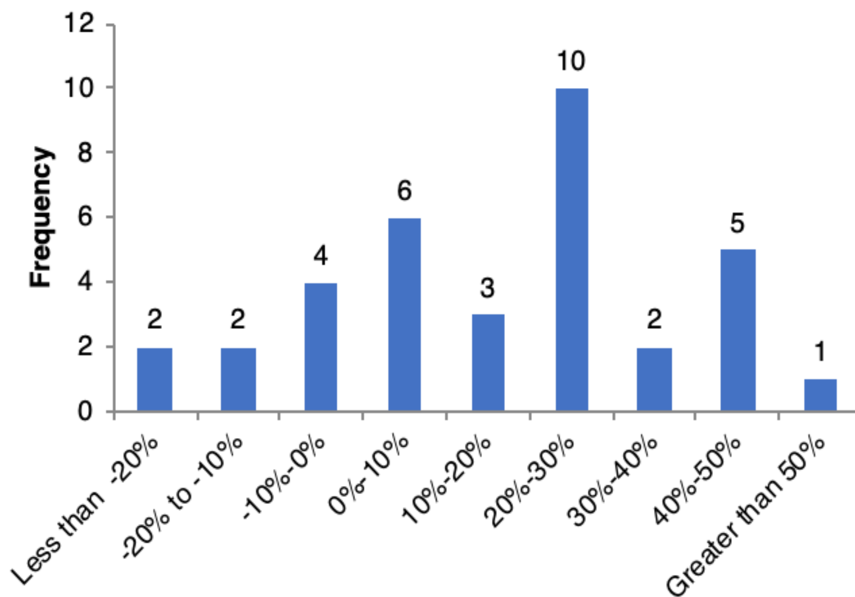
Following this strategy will on occasions make investors feel uncomfortable; in particular when being asked to invest in areas that may not only be volatile in investment terms but also suffer from geo-political uncertainty.

The Results

These would prove to be compelling as following the strategy from 1984 would have increased annualised returns substantially; the worst year would have been unpleasant, but it was an improvement on simply investing in all market equally.

	Investing in all Markets Equally	**Investing in Markets with CAPE furthest from Median**
Return Year One (1984) %	32.5%	36.40%
Total Return £10,000 Invested	£259,835	£991,921
Total Return %	2498%	9819%
Annualised Return %	9.75%	14.04%
Median Return	11.8%	20.10%
Best Year	48.9%	58.7%
Worst Year	-42.8%	-36.4%

The range of returns was also interesting over the thirty-five year period of testing as the graph below shows.



Negative annual returns only occurred on eight occasions whilst positive returns in excess of 10% occurred on twenty-one occasions. We can never predict with certainty what will happen in any given year but staying in this game over the long term the odds certainly seem stacked in our favour.

As with the Momentum Strategy using a proportion of portfolios to generate different types of returns will help diversification and fits well with our own views and investment process.

Gold Plated Protection?

With increasing correlation between overvalued assets reducing the benefits of diversification, interest rates at all-time lows and rising global tensions.

Traditionally Gold has been seen as a hedge against inflationary pressures; however, it is also a hedge against possible equity market volatility that looks increasingly likely to rise over the coming months and years.

After peaking in 2011 in the aftermath of the Financial Crisis Gold fell substantially and has only recently started to recover from its multi-year lows.

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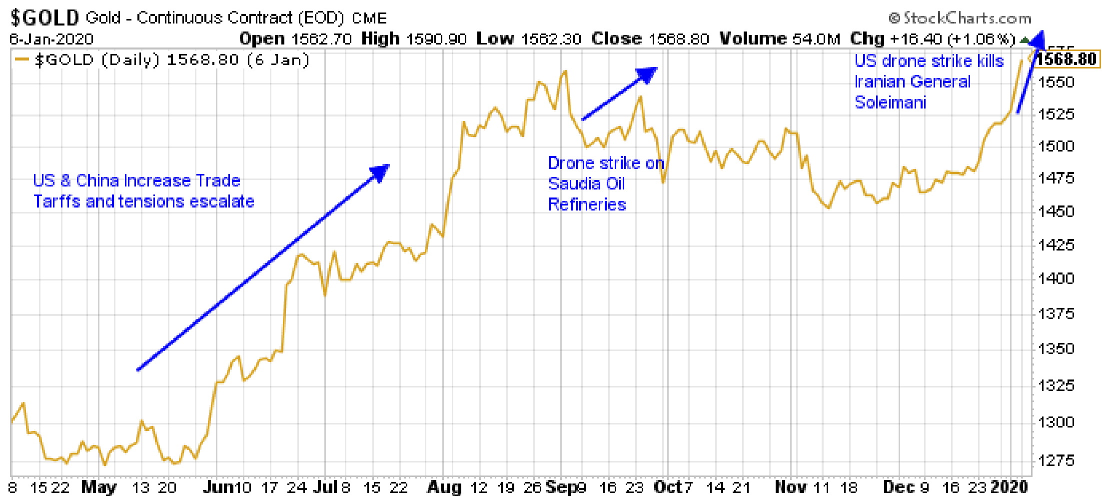
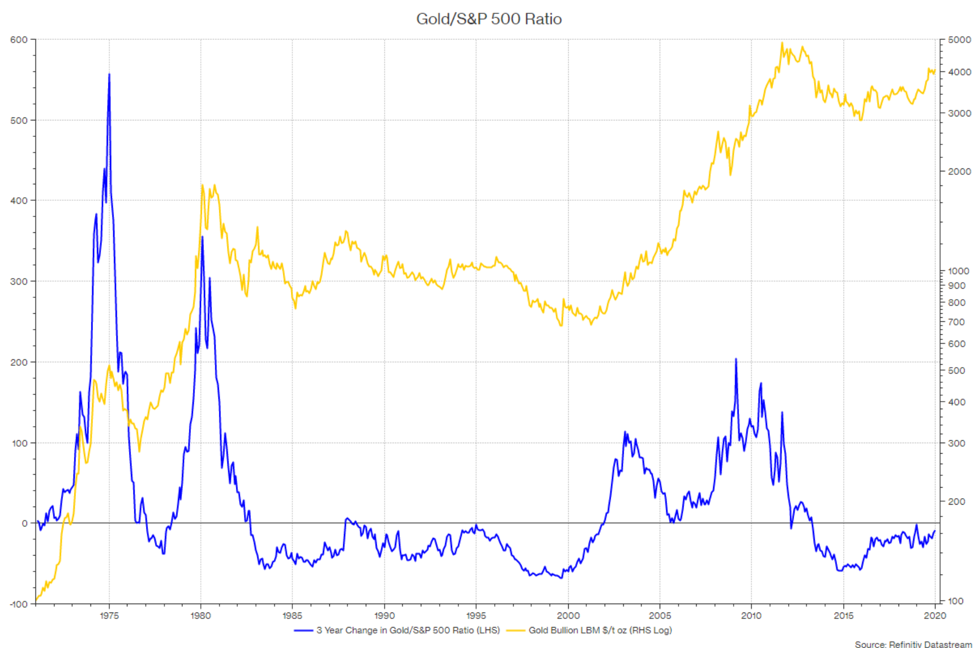
Whilst there are several reasons for holding Gold at present the graph below shows how the price reacted to recent events that created geo-political tension; in the current climate this may not be a bad idea.



There may also be a good technical reason with the Gold/S&P 500 ratio (blue) looking like it may move above the zero line; since the US left the Gold Standard entirely in 1971 this indicator moving to positive has provided a good gauge of when to invest.



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Improving Risk Profiling

The ubiquitous attitude to risk questionnaire that all clients should receive from their Adviser on a regular basis is one area that we think needs to be improved upon; not just by us but by our whole industry. Here are just a few of the problems....

- A limited menu of choices mean that an investors reality is not accurately reflected.
- Numerical calculations cause stress affecting reasoning and answers.

Questionnaires often test investors knowledge of markets not their risk tolerance.

- Asking investors expectations of returns can create unreasonable expectations.
- Investors are typically more bullish/bearish at the wrong time and more willing to take on risk at the wrong time – this is how bubbles are created in assets.
- Timing of when the questionnaire is completed can also have an effect; asked when the weather is good my guess is that the responses would be more positive than if we asked in the depths of winter!
- Do we answer honestly? If asked what you would do if your investment fell by 20% or more many would reply “invest more” as this is the prescribed response; its easy to say what you should be doing but how many (us included) followed this mantra at the height of the Financial Crisis.
- Framing of the question is also key and how the author of the questionnaire presents the dilemma will affect your response; this is what famous psychologists Amos Tversky and Daniel Kahnemann called Prospect Theory and is demonstrated in the following test when two separate groups were asked these different questions: -

  Group 1 Question

  A disease is expected to kill 600 people; antidote A will save 200 people whilst antidote B has a 1 in 3 chance of saving everyone and a 2 in 3 chance no one will be saved – which antidote will you chose?

  Group 2 Question

  A disease is expected to kill 600 people; antidote A will kill 400 people whilst antidote B has a 1 in 3 no one will die and a 2 in 3 chance everyone will die – which antidote will you chose?

In tests the majority of Group 1 will tend to opt for Antidote A and Group 2 will opt for Antidote B; the eagle eyed amongst you will have spotted the trick....

The answers are exactly the same and demonstrate that as individuals we tend to avoid risk when things are framed positively but we seek risk when things are framed negatively.

We don't know what the answer is; but we do know we must work to find a better answer, and this starts with a two-way dialogue with clients.

Our Objectives 2020

Whatever the World throws our way, by the end of this year we hope we will have gradually transitioned to portfolios to include new strategies that are making a positive contribution to returns.

By following an "All Weather" approach to provide diversification across strategies as well as sectors we can achieve our objective of a reasonable long-term rate of return without suffering too many sleepless nights.

We also hope to improve on the way we assess risk, linking it more closely to individual's objectives and how these can change over time depending on a range of factors rather than a simple "mechanical" questionnaire that conveniently pigeonholes everyone into a specific group.

These may be lofty ambitions but there is nothing wrong with having aspirations!