Weekly Digest

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What I Did During The Global Pandemic

"What does a fund research team do during a global pandemic?" I don't hear many people ask. As Head of Collectives and Fund Research at Investec Wealth & Investment, I am unsurprisingly well placed to answer my own question!

We are content that the majority of our fund investments have outperformed their benchmarks in the first half of the year, a pleasing continuation from 2019. But aside from the actual relative performance delivered from our investments, the past four months have been a once-in-a-lifetime opportunity to press home our fund research competitive advantage.

Our fund research process is based on leveraging our competitive advantage: our size. Our assets under management and our six-strong fund research team gives us the access and the resources to 'out-analyse' the competition. We know that past performance is a very poor way to pick future winners, as are many other popular means such as manager name recognition, fund size, fund flows or marketing campaigns. Rather, by knowing more about funds than other investors, organised in an intuitive, coherent way, we have the best chance of picking the future winners.

In 'normal' market conditions this works extremely well. The face time we get with our fund managers, the willingness of fund managers who we don't invest in to speak with us and our ability to meet analysts and investment professionals well beyond the named fund manager all serve our fund research process. Simply put: collectively we have spent many thousands of hours evaluating investment processes, a foundation that we believe helps us know the difference between a good and a bad investment proposition, regardless of the slickness of its marketing. The investment decisions an investment team make (and don't make) and the thought processes we learn about behind these decisions all feed into our qualitative assessment of both the intuitive appeal of what a fund is trying to do and their ability to actually do it.

Since the market peak back in February, the fund research team has spent over 150 hours speaking with our fund managers and a further 50 hours talking with Chairs of boards of investment companies in which we invest. Quizzing them on how they have dealt with the extraordinary events of the past four months has given us a unique opportunity to further our information advantage and 'out-analyse' even more the fund investments we invest in on behalf of our clients.

In so doing we are less interested than one might think in assessing how well they dealt with the on-set of a global pandemic. After all, this would be backwards looking and at an event we all hope won't happen for another one hundred years!

Rather, it provides an extremely rich stream of

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events and data points to test our knowledge and understanding of the investment proposition.

Fund manager responses to Covid-19 have naturally varied by investment strategy, but all have followed a broadly logical progression:

First, an urgent review of investments that may not even survive the lack of revenue from a lockdown or a serious economic hit or may only be able to do so through a serious dilutive equity raise. Valuation models are strained as traditional inputs such as earnings become fingers in the air, at least in the short-term. This initial appraisal shouldn't lead to too many exits, even from more value-oriented strategies. After all, we typically see little long-term value in companies that are so precarious or dependent on a robust economic cycle in the short-term. However, it has been interesting to observe levels of risk aversion, the robustness of these reviews and who – when the chips are down – is really providing the decisive decision-making input. This phase is a challenge to fund assessors as long-established investment processes may to some extent go out of the window and fund managers need to be nimble, imaginative, fleet-of-foot and uber-reliant on their experience and judgement.

Second, once any immediate problems have been dealt with, teams typically undertake a more medium term review of the prospects of their fund's holdings. By now, several weeks if not months into the crisis, visibility is much improved due to more management contact, a clearer direction of policy making and a more obvious economic growth trajectory. Identifying survivors now becomes identifying winners. Which investments are best positioned to benefit from the expected future environment and with a sharper outlook for earnings which investments offer the best value for money? At this stage fund managers start to look as much at what they didn't own that perhaps they should. Depending on the strategy fund managers are looking at those companies with the best competitive positions to deal with the future economic outlook or changing trends in demand for goods and services. Equally, they are looking at the relative valuation gaps that have opened up; often the most obvious winners are equally overpriced and the most obvious losers equally underpriced. Thus in this environment relative valuation is more important than ever for future relative returns.

Third – and this is the phase we see the majority of our fund managers now in – execution of the hard work undertaken over the past few months begins. This may not manifest itself in a flurry of trades now. Indeed, it may take many more months of work for the right entry levels to be found or the requisite conviction to be acquired in what is still a volatile and uncertain market.

Throughout these three phases we have been blessed with what we devour the most: information. So what broad lessons have we learned from the past four months?

1. Don't be fooled by perceived inaction over the past several months. In nearly all cases the fund managers we talk to expect turnover to increase from here as they move from phase two to phase three.

2. Depending on the strategy a fund needs to get only a handful of big trades or a lot of small trades right to deliver strong outperformance. Regardless, what will ensure success is the quality of the thought process that happens well before any trades are made. It is the continued rigorous application of an investment philosophy right for these times that will deliver future relative performance and this should always be our focus, along with ensuring that any action taken is consistent with this investment philosophy.

3. Past performance has never been a guide to the future because it has always been mainly driven by luck. This is especially true of the first half of 2020 where a fund's initial relative performance was mainly driven by how it was positioned going into Covid, an event few of us foresaw. That being said, that excuse was short-lived and fund managers were all

afforded the same opportunity to sink or swim. Insofar as past performance is relevant to our qualitative assessment, we need to separate bad luck from bad judgement.

4. Fund managers may be exceptionally well paid and occasionally molly-coddled, but these investment teams have suffered from the same stresses (professional and personal) and discombobulation as the rest of us. How employers have supported employees and how teams have worked together has been a crucial part of our assessment as it will have a strong impact on the future ability of the team to generate relative outperformance.

5. Be wary of shifts in overall relative risk. A value portfolio that fell 20% might see the opportunity to pick up quality companies that are now 10% cheaper than they were. However, to do so is probably to de-risk the portfolio and limit future upside. Ensure the level of optionality in the portfolio reflects the manager's outlook and our expectations of the strategy's future risk and return.

6. Growth's outperformance of value has continued apace. Whilst this can largely be accounted for by using style benchmarks, it is amazing how few observers take this into account when assessing fund performance. Long-term outperformance comes from identifying manager skill and that nearly always manifests itself in an unwavering investment style that can lag the main benchmark for long periods of time.

7. For investment trusts, which still represent in many instances an exceptional way to generate relative outperformance, ensuring the independent board is undertaking everything we have written here and more on behalf of their investors is crucial. Where they don't, investors such as ourselves should be willing to be much more forceful in effecting positive change.

We are reassured by the relative performance of our fund investments during the Covid crisis. However, the real opportunity to outperform on a sustained basis starts from here and, if done well, will be multi-year. We believe the groundwork we have done over the past four months puts us in a strong position to deliver for our clients. That is what we have been doing as a fund research team during a global pandemic. Not the same as baking sourdough bread or learning to speak French, but crucial for our clients' future prosperity nonetheless.

Last week's Economic Highlights

FTSE 100 Weekly Winners

Melrose Industries	18.8%
Rightmove	5.9%
Polymetal International	5.0%
SEGRO	4.8%
Fresnillo	3.4%
Smurfit Kappa	3.0%
BAE Systems	2.6%

FTSE 100 Weekly Losers

Diageo	-8.4%
HSBC	-4.9%
Imperial Brands	-2.1%
Reckitt Benckiser	-1.7%
British American Tobacco	-1.3%
Unilever	-0.7%
AstraZeneca	-0.7%

FTSE 100 Index, Past 12 Months

Source:FactSet

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