Predict - ability

I know it's my turn to write the Weekly Digest as soon as the Tour de France rolls around. The race has changed completely over the past ten years with the creation of Team Sky – now Team Ineos – which has taken the yellow jersey in seven of those. The team's dominance is often put down to the use of the 'Sky Train' tactic, where Ineos' cyclists try to exhaust their competition by riding hard at a consistent pace. But as successful as that strategy is, even the team's fans have to admit that it's a teeny bit boring. And that's because it's predictable.

I spend most of my time at work meeting investors, and realised recently that what I'm really looking for is the fund manager equivalent of Team Ineos. A team which is dependable, applying a consistent process, but one where reviewing their performances and making continual improvements to that process enables them to maintain an edge over their competition. Predictability might be a bit boring, but it works. Equally, those fund managers are also looking for predictability in the companies and markets in which they invest, because the easiest way to make money as a fund manager is not to lose any in the first place, and the second easiest is to buy things which can compound their advantages over time. But, right now, it's getting much harder for all of us to find predictability, because not only is our world seeing an exponential increase in complexity and information availability, but because deliberate unpredictability is the political strategy du jour.

Without a doubt, Donald Trump is the master of this tactic. Most people like to think that he gets up in the middle of the night to have a Twix and just happens to get on Twitter, but in many cases his aim is more likely to create opportunities for negotiation by rendering the well-established playbooks completely defunct. Equally, you could argue that this is exactly the negotiating tactic being taken towards the EU in the Brexit negotiations and that what looks like dysfunction is actually a pretty interesting tactic to knock an institution that has a love affair with rules and regulations totally off kilter. So that's why we continue to emphasise the 'political risk premium' in our thinking, and are anticipating continued volatility as companies and investors try to interpret what might be uninterpretable. This also links in well to one of my favourite concepts in decision making psychology – that of 'kind' and 'wicked' environments, which is based on work by Gary Klein and Daniel Kahneman. A 'kind' environment is one where similar patterns repeat over and over again, so those best placed to exploit it are those with lots of experience who can spot which patterns are emerging and know what the solutions are – they are puzzles with an answer, like 1+1=2. A 'wicked' environment on the other hand, is one where patterns aren't immediately clear, and feedback about solutions are neither quick nor easily available. Wicked environments are hard to navigate, rules can't be applied, and previous experience often rapidly becomes obsolete – they are mysteries which may not have one solution, or even be capable of solution.

I've been running a bit of a thought experiment with this concept, applying it to Value and Growth investing, where everyone seems to be obsessed with the market's polarisation between the two. In theory, Value investors are the puzzle kings of the kind environment. The manager values a company's assets, and if the market isn't pricing it to the same level then he buys it, hoping that over time, the market realises that the business is worth more and the discount closes, generating his 'value' – 1+1=2. On the other hand, Growth investors are the ones who thrive on operating in a wicked environment. The manager is trying to figure out what she can see that others can't about the prospects for a company and will happily pay a high valuation because she forecasts that the company will do even better than anyone thinks possible – the mystery will unfold in her favour, even if she doesn't know exactly how that will be.

But right now it's actually the Growth investors that feel like they are living in a kind environment, and the Value investors who are struggling to figure out the mystery due to the effects of lower interest rates combined with technological disruption. These have meant that those who invest in companies which have good levels of growth (and particularly the kind which is seen as dependable or highly expandable) have seen their stocks continually rewarded by the market – it's what everyone wants, so prices have kept rising to higher and higher valuations. It feels like Growth investing has become almost like a solvable puzzle – find a company that is growing, buy it, it goes up – 1+1=2. Value investors are sat waiting for their value to be realised in stocks where the prices just don't want to budge, or – even worse – keep going down for reasons that they can't seem to fathom.

One of the most frequent questions I see within the industry asks when this relationship is going to turn around – when exactly will the highly valued Growth strategies lose out and Value make a resurgence? I think that's the wrong question, one which is designed to make those who are positioned at those extremes feel better about it. I think the correct questions to ask are whether a kind environment is ever really possible in markets, and just how wicked the environment could become.

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FTSE 100 Weekly Winners

Fresnillo	11.1%
Just Eat	7.3%
WPP	4.7%
EasyJet	2.7%
Experian	2.6%
Rentokil	2.6%
BAE Systems	2.5%

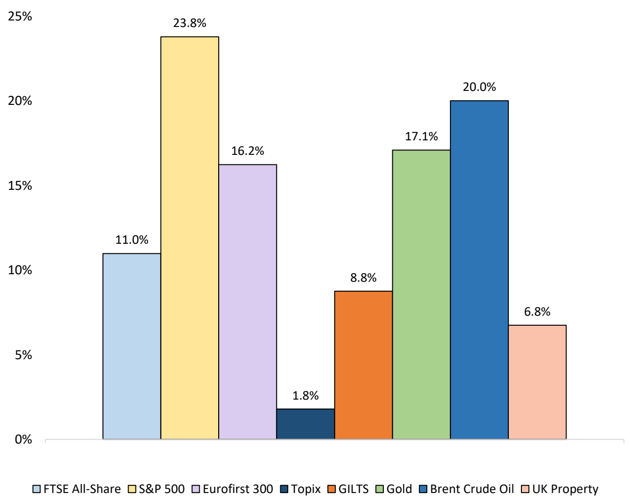
Source:FactSet

FTSE 100 Weekly Losers

NMC Health	-15.8%
Standard Life Aberdeen	-14.2%
Centrica	-9.4%
Evraz	-8.2%
Rio Tinto	-7.5%
BT Group	-7.0%
Direct Line	-6.9%

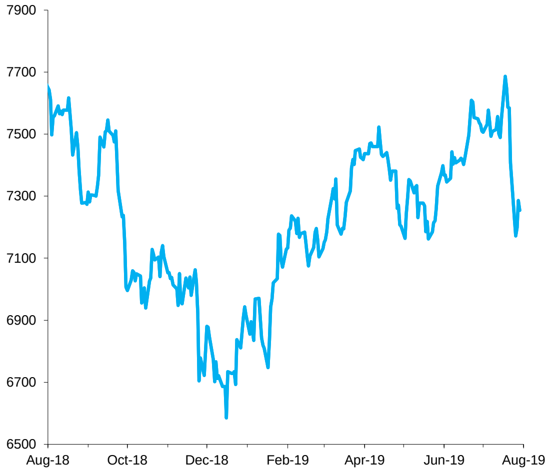
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet