Weekly Digest

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Testing Times

This week's title refers not to the notoriously fickle booking system for an NHS Covid test, but to the fact that September has been a bit trying for investors. Not only have global equity markets retreated from their post-pandemic peaks, but safe haven assets have generally failed to provide much of a counterbalance. I'll fill out some of the numbers shortly, but it's fair to point out that this has hardly been the rout that some of the more emotive commentary has suggested.

Even so, there have been a few high-profile casualties. One of them has been Tesla, the electric vehicle and battery technology company. Regulations and Compliance do not permit me to make an investment recommendation, but I can make some observations about the nature of the market for its shares (and others of a similar nature). Rumours about unconventional activity in its call options started to surface in July, rumours that I put to the company's largest shareholder, Baillie Gifford, at the time. They declared no knowledge of any such behaviour. However, it has become clear with the passage of time that there was an unusually high volume of buying of out-of-the-money call options (bestowing the right, but not the obligation, to buy the shares above the current price), and this, in turn, forced the underlying share price higher as those who had sold the options had to hedge their positions. I think it's impossible to say whether or not there was any deliberate manipulation of the market taking place, but one cannot argue against the fact that Tesla's shares rose from $215 to $498 in two months.

The trade quickly reversed in September, with the shares hitting a low of $330 - before recovering to a current $407. Movements of more than $100bn in the market capitalisation (about a third of its value) cannot be justified by "fundamentals" alone. The average share price target from the thirty broking analysts who cover it is just $315, suggesting something of a disconnect between the expectations of analysts and those of investors (speculators?). Furthermore, an era of increased polarisation and identity politics seems to be reflected in the burgeoning "pro" and "anti"-Tesla camps. On the one hand there are all sorts of online communities displaying an almost religious fervour for founder Elon Musk and his products. On the other I have discovered a podcast that has so far published forty-four episodes with the apparent main intent of proving that Tesla is a fraud!

The reason I mention all of this is to remark that, to some extent, at least, some areas of investment markets today have moved away from investing and into the realms of speculation and belief systems, which is not entirely healthy. Having worked through the Tech Boom of 1999/2000,

I can identify many of the same traits today. Indeed, I can own up the fact that I had my own "religious experience" with one such company involved in video compression technology. Suffice to say that the remnants of this business, which once had a market capitalisation of over £4 billion, are now wrapped up in another company worth just £39 million. (It's OK, I did actually make a profit!)

One of the possibly most misleading concepts when it comes to "blue sky" investing in new technologies is the "Total Addressable Market" (TAM). Once an opportunity has been identified (such as the potential market for electric vehicles or batteries, for example), the race is on to work out just how many of the products could be sold and at what sort of price (creating the TAM). It is usually a seductively large number. However, it often fails to account for how many competitors might be scrapping over this market, and how much capital might be invested. It is very rare for any single company to have a monopoly, or anything close to one.

It is companies that benefit from the scaling up of network effects that have often done best. Google and Facebook come to mind. Netflix and Amazon also have benefitted from the ability to reinvest any profits they might have made from their existing customer base into expanding their offer. Apple has shifted its emphasis from being a supplier of technology hardware to one where the information and service platform which it creates will become more valuable. Anybody who uses Microsoft Office products will know that they now have to subscribe to the software package and make an annual payment rather than bootlegging a disc from someone who had actually paid for it (not me guv, honest!). When you think of these businesses in this way, rather than just looking at today's Profit & Loss account and the twelve-month forward price/earnings ratio, it becomes much easier to understand why they are as big and influential as they have become.

But one thing is clear. The beauty of these businesses is that the marginal cost of adding a new customer is relatively small (or even zero). That is not the case for businesses that make tangible objects, where every item requires at least a modicum of raw material and human capital. Yes, there is operational and financial leverage to boost returns as production ramps up, but after a while, should one be successful enough, a new factory will have to be built.

As I mentioned earlier, I am not permitted to make specific stock recommendations, but I hope the points made above will help to shed some light on how to approach investing in companies based on long-term growth potential and what the pitfalls might be.

Returning to the market, then… My trusty Bloomberg data feed tells me that the MSCI All-Countries World Index (measured in dollars) has fallen 6.5% since its peak in early September. For once it is US equities that have led markets lower, with the S&P 500 falling 7.9%, and the more heavily Tech-weighted NASDAQ 100 dropping 10.2%.

There are two main reasons for this. First is the Tech shake-out referenced above in the tale of Tesla. The options factor was also prevalent in other companies' shares. Second, the rising "second wave" fears, lockdown threats, lack of agreement on a further stimulus package in the US, and a slight pushing out of the expected delivery time for a vaccine (at least as considered by the Good Judgment group of super-forecasters) have all conspired to lower expectations for the pace of recovery and, by extension, inflation expectations. While the break-even rate of inflation (inferred from the relative yields of nominal and index-linked bonds) has fallen, bond yields have remained stable, creating an effective tightening of financial conditions.

This might sound like pretty arcane stuff, but it is crucial to valuations. As we have pointed out in the past, the present value of long-duration assets such as equities (especially those with good growth prospects and high free cash flow margins) is highly sensitive to the real interest rate – exponentially so as the real rate approaches and then passes through zero percent. A falling real interest rate (with inflation expectations rising while bond yields were anchored by central bank policy) was a huge tailwind to valuations. For now it has turned into a headwind. However, we do not expect governments or central banks to tolerate any risk of deflation rearing its head again.

Personally, and admittedly with little hard evidence, I am not sure how much current stock market trading is being undertaken by real human beings, and how much by computers. Computers using historical correlation models will sell long-duration growth stocks without question as long as real interest rates rise. They will also sell assets such as gold and silver. That doesn't mean they are right or wrong on a longer term view. They just follow orders today. We try to be a bit more discerning.

I note that tomorrow (or tonight depending on when you receive this) sees the first presidential candidate debate in the US. This election promises to be like none we have ever witnessed, and there is potential for further market disruption. Next week, I will run through some of the key factors to watch over the next few weeks – weeks that could extend well beyond election day!

Last week's Economic Highlights

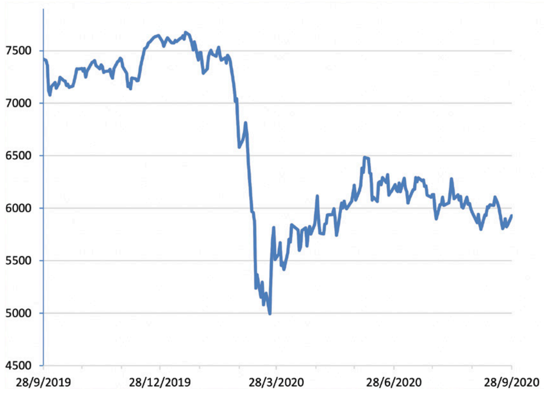
FTSE 100 Weekly Winners

Pearson PLC	15.2%
GVC Holdings PLC	15.0%
NatWest Group PLC	15.0%
Lloyds Banking Group PLC	10.9%
Kingfisher PLC	10.7%
ITV PLC	10.5%
JD Sports Fashion PLC	8.6%

FTSE 100 Weekly Losers

Fresnillo PLC	-8.7%
Rolls-Royce Holdings PLC	-7.1%
Glencore PLC	-4.9%
Admiral Group PLC	-4.4%
Tesco PLC	-3.3%
Polymetal International PLC	-3.0%
BT Group PLC	-3.0%

FTSE 100 Index, Past 12 Months



Source:FactSet

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