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OUT OF THE ORDINARY

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Being Brave

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Welcome to 2022, and I hope the start to your new year has been a positive one. John Wyn-Evans has loaned me the first Weekly Digest column of the year, and so I thought I'd partake in a custom that most Chief Investment Officers love, the 'yearly prediction' article. Well, sort of.

I've spent many January days reading these type of articles. They tend to fall into two camps – those out there, wildly opinionated pieces that make you splutter into your cup of tea and your eyes widen, and those that stay within the confines of well-defined subjects and have all the excitement of a plain cheeseburger. The prospect of having to write one of them made me wonder – what's more important in an investment prediction, coming out punching, or playing it safe?

This question is one explored in one of my all-time favourite books, Superforecasting by Philip Tetlock and Dan Gardner, which I re-read over the holiday period. One of the points they make is that we're naturally drawn to people who make big forecasts, stick to them religiously, and build drama by arguing against opposing viewpoints. The strength of these views means that the outcome of their forecasts are big, and binary – very right, or very wrong. We reward those who get it right by making them wildly successful, and those who get it wrong by being a bit rude about their skills and then...well...just forgetting about them.

This effect has played out in equity market investing over the past few years. Fund managers who have taken a positive view on a number of stocks in the technology sector and backed these views with large bets have reached almost god-like status, outperforming the market and their peers significantly as the sector has delivered. Those who have taken the polar opposite view have faded, to put it charitably, with their returns left languishing. A lot of airtime is currently being spent mulling the ramifications of any reversals of this trend, and in particular the effect of bond yield expectations on different sectors of the market. It's an important conversation to have, but I fear that a rehash of the discussion here would put this article firmly in the cheeseburger camp. But it is worth having a closer look at what happened to those who have played their forecasts more safely.

Investors who haven't taken a big view, and just aimed to consistently outperform by taking smaller bets haven't just been labelled as the boring crew. It's worse, they've been called 'closet trackers' – which is what you get when actively managed fund returns mimic the index, and any gains are eroded by the fees charged for doing it. Faced with this outcome, surely it's better to buy the market as cheaply as possible? It's exactly this argument that has been a particularly strong driver of purchases of index exchange traded funds (ETFs) over the past few years.

But the reason it's been so hard for active managers to outperform the index isn't because they've made poor predictions, or even played it too safe. It's because over the past decade there has been one overriding theme in the market: Distribution. The companies involved in this theme have grown, and grown, and grown a bit more as the digital revolution and improvements in technology have enabled the development of mega distribution channels.

Last week saw Apple become the first company to hit a $3trillion stock market value by distributing a combination of design, applications that make life easier and communications power. Amazon distributes stuff, and allows other people to distribute more stuff in myriad ways. With Tesla it is future transport methods, and Microsoft, a standardised way for people to get things done. But it goes deeper than this. These companies and networks have become the ways in which we distribute our culture, our way of being in the world. They are the conduits through which we feed our internal selves and decide who we want to be. Whatever you think of Facebook, it connects people and gives them communities to which they can belong. Google lets us become proficient in any subject going and assuages our anxieties by giving us answers to questions we wouldn't dare ask out loud, whether it's a health question or how to act on a date, or even how not to get lost on your way to that date. Instagram distributes ego – it allows us to create a vision of the person we wish we were, and provides a never ending set of templates for whoever we want to be, hooking us in with those pangs of jealousy when we see the perfect lives of others.

The sheer power and scale of this change in distribution, coupled with a low interest rate environment and a pandemic which has pushed pretty much everyone online, has seen these companies become increasingly large, and as a result more important in the global equity indices. At its monster size, Apple now represents around 4% of the MSCI All Countries World Index, upon which a large number of Exchange Traded Funds (ETFs) and performance benchmarks are based. Microsoft and Amazon are the next on the list, forming another 5% of the index between them, followed by Alphabet and Tesla. In fact, the top ten stocks in that index now form nearly a fifth of it, and only one of the stocks (Taiwan Semiconductor) is listed outside of the US.

When large companies dominate an index, it sucks the air out of performance of everything else in there. The smaller members have to put some seriously big returns on the table to make the overall index move, but there will be big effects from what could be only marginal moves in those larger constituents. And this is why the sensible forecasts haven't been as successful as some of those heroic ones have. The predictions might have been amazing, but they have been offset by the effect of magnitude. Which leads us back to the original question. If those big bets open you up to the prospect of getting it very wrong as much as you might get it very right, and playing it safe doesn't cut it when we're experiencing societal paradigm shifts, what should we do with our forecasting?

Ultimately, we shouldn't be boring, or binary. We should be brave.

Brave forecasts happen when we take a significant view, but hold that view lightly. This means opening our thinking up to strange interpretations, different opinions, and the possibility of change. It means calibrating our views, getting to grips with the issue of magnitude, and then being ready to pounce on opportunities when we see them. And it means using absolutely all of the resources and the thinking that we have to make sure we're as confident as we can be that where we are heading is right.

As well as coming to terms with all the complexities of the market that John Wyn-Evans noted in his last Digest of 2021, as we move through the year, we will have to consistently calibrate our views of the distribution theme and where it can continue to go. So not just thinking of it in traditional terms of the technology sector, or the US market, or how many subscribers Netflix has this month, but also in terms of broader social and cultural factors. It will also be important to make sure we don't get overwhelmed by the sheer scale of those companies and put too much focus on the influence they have on index performance right now compared to thinking about the opportunities on the horizon. We have to think about what comes next.

There are some extraordinarily compelling things on our radar that have the potential to drive the same type of societal shifts – for example we're thinking about how the distribution theme applies to healthcare, what the impact of the energy transition will be, and how decentralised finance might change how businesses operate. I'm hugely excited about some of the weird and wonderful conversations I'm having with people in our business, and am looking forward to sharing more of their insights and interpretations with you in the coming months.

So there you go, a prediction piece with no predictions, but a promise. This year, we will be brave.

Economic Commentary

FTSE 100 weekly winners

Lloyds Banking Group plc	9.3%
Barclays PLC	9.1%
NatWest Group Plc	9.0%
Standard Chartered PLC	8.9%
BP p.l.c.	8.9%
Melrose Industries PLC	8.1%
Anglo American plc	7.9%

FTSE 100 weekly losers

Scottish Mortgage Investment Trust Plc	-10.6%
AVEVA Group plc	-9.9%
Just Eat Takeaway.com N.V.	-8.5%
Polymetal International Plc	-8.2%
Halma plc	-7.3%
RELX PLC	-7.1%
Ocado Group PLC	-6.8%

FTSE 100 index, past 12 months

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