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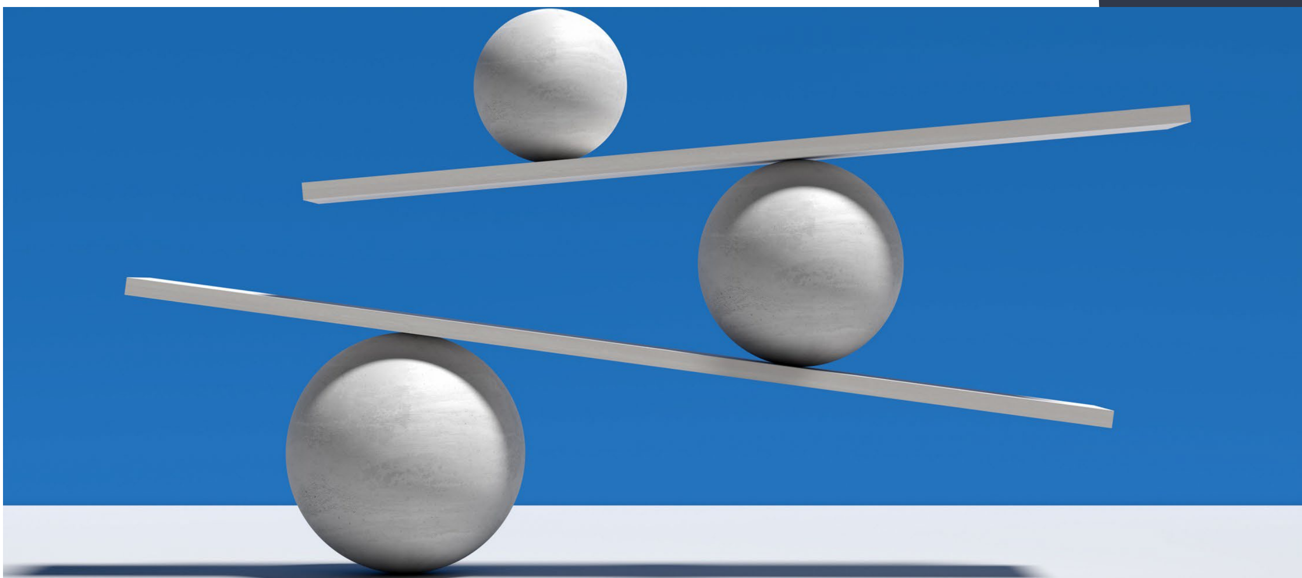
Voting and Weighing



John Wyn-Evans
Head of Investment Strategy

Versions of the saying that “In the short term the market is a voting machine, but in the long-term it is a weighing machine” are generally credited to Benjamin Graham, the financial analyst and investor, although they were popularised by his most famous pupil, Warren Buffett. In the 1930s, Graham published Security Analysis (with David Dodd) and The Intelligent Investor, regarded as foundational works on the subject of (value) investing.

An authoritative-looking analysis on the website Quote Investigator suggests that Graham and Dodd's original observation was that the market is, indeed, a "voting machine rather than a weighing machine", in that it "responds to factual data not directly, but only as they affect the decisions of buyers and sellers [whose choices] are the product partly of reason and partly of emotion". It was Buffett who changed the emphasis from the short-term reaction to the long-term outcome, which befits a man whose preferred investment holding period is "forever".

Last week, I observed both activities. The "voting" mentality was widely evident in markets, while (metaphorical) weighing machines were on display at the annual London Value Investor Conference, which probably has the highest ratio of Warren Buffett and Charlie Munger aphorisms per speech of any event I attend.

The "voting" mentality covered extremes of behaviour. It was initially evident in the return of "meme stocks" in the US market, and then in investors' reaction to a minimal positive surprise in the US inflation report for April. Here in the UK, it could be seen in the outsized share price movements of BT and Sage in response to their results (or, more accurately, their comments about the future).

Starting with the really bonkers stuff first... Last week saw the return of Roaring Kitty, the online persona responsible for triggering the meme stock craze back in 2021. If you want to remind yourself about that, here's the link to my Weekly Digest from 1/2/21: Weekly Digest: The Tiger Kings of 2021 (investec.com). Such speculative activity is often seen as a sign of a market top. Market volumes in the United States, which had been extremely low the previous week, suddenly jumped much higher in terms of share count, with Thursday being the second busiest day of the year so far. However, 45% of market volume that day was attributable to stocks trading below $1, which compares to a year-to-date average of 12%, and notional value traded was 10% below the average. The trend carried over into Friday morning, when all of the Top 20 most traded stocks during the session had a share price lower than $5. All of this is indicative of speculative retail activity.

In an echo of 2021, GameStop shares spiked from $17 to more than $50 before ending the week at $22. Another speculative favourite, cinema chain AMC, jumped from $3 to $12 before ending at $4.40. Both companies took advantage of the situation to do some repair work to their balance sheets. GameStop filed to sell 45 million shares and AMC completed an offering that was already in progress as well as executing a debt-for-equity swap. And so, it looks as though both loss-making companies will be around for a while longer. Even so, although a still large base of short sellers will have been squeezed and experienced losses (at least on paper), there are no signs of the disruption that led to the demise of the hedge fund Melvin Capital and this all looks as though it will blow over pretty quickly. In the meantime, I can recommend the film Dumb Money as an entertaining potted history of the meme stock craze of 2021 (and I even predicted there would be a film!).

Next, we move on to the US inflation data. The monthly reading was one basis point below the consensus expectation, coming in at 0.29% vs an expected 0.30%, but such a tiny marginal positive surprise was enough to boost both bond and equity markets. No doubt, the fact that we had just had three consecutive higher-than-expected inflation prints was weighing on investors' minds ahead of this release and so there was palpable relief. It's always dangerous to anthropomorphise financial markets, but sometimes they do just seem to want to go up, and that appears to be the case at the moment, although not in a headlong charge. It seems to be more a case of investors identifying certain obstacles and negotiating a way past them. Last week's possible tripwire was that US inflation print. As per the earlier quote from Security Analysis, this was a case of "reason and emotion" reacting to the news rather than a meaningful shift in the "factual data".

Here in the UK, some of the biggest share price moves last week involved BT and Sage. BT's 17% one-day gain was the stock's biggest in its history (by some margin). It turned out to be painful for those on the wrong side of the FTSE 100's most crowded short trade, much to the delight of the new Chief Executive, Allison Kirkby, who said: "I love to squeeze the shorts... and prove them wrong". For some context though, over 20 years BT has returned 91% on a total return basis versus 313% for the MSCI UK Index, and so it remains to be seen whether that trend can be changed. Much will depend upon Ms Kirkby's ability to deliver the cash flow that was promised in the guidance.

Meanwhile, Sage moved sharply in the opposite direction, not a good outcome for what is the UK's leading Technology company in terms of representation in the stock market indices. Its report on the six months to March was bang in line with expectations, but its "sin" was to make slightly cautious noises about the next six months. Even so, a reduction in revenue growth guidance from 10% to 9.5% would hardly constitute a disaster, especially as there was a hint of higher margins to come. But that didn't stop the votes being cast and the shares plunging (and I use that emotive word quite intentionally) by 20% at the open before recovering to close down around 10% on the day. Such are the perils of even the slightest mishap when one is held in high regard. By contrast to BT, Sage has added a lot of weight to the scales over the last two decades, returning just shy of 1,000%. That is a better perspective upon which to judge the company.

And so, to the cavernous Queen Elizabeth II Conference Centre in Westminster for the annual London Value Investor Conference. It wasn't "standing room only" as it has been on occasion in the past, but there were still several hundred investors in attendance to listen to a whole days' worth of twenty- or thirty-minute presentations from fund managers. I promise I don't get royalties from past issues of the Weekly Digest, but here's a link to what I wrote after last year's edition: Weekly Digest: Value Vultures (investec.com)

Now, as then, I still find "Value" to be too broad a term to be of great use, because it covers too wide a range of approaches. I am also of the opinion that much value investing can rely too heavily on mean-reversion. Not only does this require immense patience on the part of investors, a virtue that tends to run out just as it is about to reap benefits, which waves a big behavioural red flag, but it also necessitates the constant replenishment of the portfolio when reversion to the mean is complete.

That's not to say that we don't want to buy cheap stocks, and we do pay a lot of attention to valuations relative to some sort of "intrinsic value". But our real preference is for "compounders", the sort of companies that can recycle the capital that they generate into further growth.

Even so, it's always interesting to listen to other people's approaches and to see if any themes emerge. If there was one thread running through this year's presentations that stood out to me it was the potential for managers to find value outside the US, and this went for several of the US-based managers too. Whereas the US stock market is well picked over, there are still plenty of inefficiencies elsewhere, with bottom-up stock-picking having the potential to produce returns above the local indices in Japan and Emerging Markets in particular. Of course, the US market also contains some of the most important "must-own" Technology companies in the world and so, from a portfolio perspective, one is not going to ignore them. But any pure value approach is going to end up having a lot of tracking error relative to the headline indices.

Another theme was the increasing prevalence of share buybacks and how companies can use them to boost shareholder returns. Historically, these have been most used in the United States, with companies even borrowing money at low interest rates to buy back shares and therefore enhance earnings per share (with the same amount of profits being divided amongst fewer shares, even allowing for the cost of borrowing). However, there are a lot of companies around the world which have either hoarded cash (Japan) or which are generating more cash than they can reinvest sensibly (increasingly in the UK and Europe) which are now embarking on share buybacks.

As always, the scoreboard of past stock recommendations was unveiled. The 2023 vintage was a very mixed bag, ranging from Stella International Holdings (a Hong Kong-based footwear producer which was +102%) to EC Healthcare (-67%, a medical service provider also Hong Kong-based), both of which were chosen by the same fund manager. Hmmm… He pitched two other HK companies which were up 7% and down 33% respectively. I think that adds up to a total return of 2.25%, which was worse than the average of +8% across all 18 on the list. But even that pales by comparison with the MSCI All-Countries World Index (ACWI), which rose 20% over the period.

Maybe Value stocks need more time to mature. I reported last year (see link above) that the 2022 vintage was also disappointing, returning a capital gain of 3% vs 5.9% for the ACWI. Given an extra year, the value stocks' return rose to 24% vs 20% for the ACWI. Top of the charts was German industrial company Rheinmetall (+188%), which has benefitted enormously from its defence-related business, notably munitions. Looking back at my notes from two years ago, I see that the same manager also picked Univar (+23%, a US chemical distributor) and Westrock (+22%, US paper and packaging), and so he had a highly creditable "portfolio" return of 44%. It's very difficult to "rifle shot" value stocks, it appears, but a portfolio approach has some merit.

Finally, the quote of the day: "Keep an open mind, but not so open that your brain falls out!"

Economic Commentary

FTSE 100 weekly winners

BT Group plc	27.4%
International Distributions Services plc	14.2%
Vodafone Group Plc	11.2%
Just Eat Takeaway.com N.V.	9.5%
Experian PLC	6.9%
Fresnillo PLC	6.5%
Barratt Developments PLC	6.2%

FTSE 100 weekly losers

Sage Group plc	-7.7%
Entain PLC	-7.3%
Burberry Group plc	-6.4%
Ferguson Plc	-6.1%
Shell Plc	-4.8%
Shell Plc	-4.8%
CRH public limited company	-4.6%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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