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Compounding Errors

John Wyn-Evans
Head of Investment Strategy

Sometimes life delivers timely reminders about the nature of compounding errors and the need for a margin of safety. One morning last week I set off from home for a meeting in the City at 11.30am. An app had me arriving there at 11.25am if I left at 11.00am. I ended up leaving a couple of minutes late but was not concerned. I arrived at my tube station just in time to see the doors close on the train I should have been on, with the next one three minutes away. That should be OK, I thought. The same thing happened at my interchange, leaving me

with the choice of then taking the next train that would involve a longer walk or waiting for the second train a couple of minutes behind that would leave me a marginally shorter walk from Monument. I opted to take the first train, which then sat outside Aldgate station for what seemed like an eternity waiting for the track crossing to clear. Meanwhile the train behind overtook us on the other line. Needless to say, I ended up being ten minutes late, all for the sake of the odd minute at the beginning of the journey.

Luckily, this was not an error that is going to have a negative impact in the long-term. But in today's world of investing, making a few seemingly minor mistakes in the present could have negative long-term consequences. These could be looked at through the lens of margins of safety, compounding returns and sequence risk.

How a margin of safety works

Let's start with the margin of safety. In investment terms this is often considered to be a function of value. There are all sorts of methods of arriving at what one might consider to be the "fair" or "intrinsic" value for a security or asset, but it is advisable to build in some sort of discount to provide a safety net. This could be needed to offset any errors made in the value calculation or to provide a buffer against unexpected events which might undermine profitability. Of course, one can't be unrealistic. A degree of risk must be taken to generate acceptable returns, and searching for things that look too cheap to be true can be a fool's errand. Warren Buffet, as is often the case, coined the perfect aphorism in this regard: "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price".

Another safety net comes in the form of a strong balance sheet. We want to be around to invest tomorrow. While highly leveraged slivers of equity that sit upon a mountain of debt can provide stupendous returns in a recovery phase, they can also dissolve to nothing in adverse circumstances. There is a time and a place for taking risks with such potential investments and they must be sized accordingly. Right now, they would not be where we prefer to direct clients' cash, but we are always on the lookout for opportunities at the right time in the cycle. We can envisage that happening in an appropriate way within our medium-term investment horizon which stretches about 18 months ahead.

Leverage can also be an issue for investors. We run unleveraged portfolios. That is to say, we don't borrow more money on top of what we have been entrusted with and then invest that too. But plenty of investment and trading in the broader financial industry is made with borrowed funds. It is not unknown for whole enterprises to be brought down when the underlying asset prices fall to become worth less than the outstanding borrowings. If a debt cannot be rolled over or if a margin payment is called, this can set off a cascade of selling which triggers similar demands elsewhere in the system. The failure of hedge fund LTCM in 1998, the bankruptcy of Lehman Brothers almost exactly a decade later, the UK's LDI crisis in September 2022 and the demise of Silicon Valley Bank (SVB) earlier this year are all nasty examples of falling asset prices revealing leveraged balance sheets with a big mismatch between the duration of assets and liabilities adding fuel to the fire.

Central banks can and do step in to provide liquidity when required, but usually only when financial markets have thrown a tantrum. There are plenty of regional banks in the United States that are currently reliant upon the US Federal Reserve's Bank Term Funding Programme, which allows them to hand over a government bond that is currently worth, say, 90 cents, and to receive a dollar in exchange. This can then be used to repay depositors without crystallising a loss on the sale of the bond which would take a chunk out of its capital base (which is what triggered the end for SVB). The Fed knows that the government bond will mature at a dollar eventually. Of course, someone must pay for this, and the bill ends up in levies paid by banks or in taxes, but that form of drip-by-drip water torture is deemed preferable to an immediate cold bath.

The whole fractional reserve banking system is built upon leverage of capital, and one thing that regulators have done since the financial crisis is to demand that banks have more capital, or a greater margin of safety. This should give us some degree of comfort, although the quid pro quo is that they can't be as generous with their lending as in the past. This has opened up a whole new opportunity for the private lending sector, which is less well regulated. For various reasons, private equity and now private lending are seen to be attractive areas for returns, but they are still equity and lending products at the end of the day and need to be subjected to normal, possibly greater than normal, levels of analytical rigour.

How compounding returns work

Next, we look at compounding returns. Albert Einstein famously described compound interest as the eighth wonder of the world. In our equity analysis, we prefer to invest in companies that can earn an excess return above their cost of capital and reinvest at least a chunk of that back into the business, compounding returns for shareholders. The vagaries of economic cycles and short-term influences on valuation mean that the path to solid gains is not linear, but it tends to lead to the right place in the longer term.

At the portfolio level, although markets are always subject to short term volatility, the biggest long-term risk is in not being invested. Equities have comfortably outperformed bonds and cash over the long term and given their claim on the profits generated by real economic growth, we would expect them to continue to do so.

After two years of lacklustre portfolio returns, we can see that the temptation to cash everything in and put the money on deposit is widespread. A guaranteed 6.2% one-year return from the government-backed NS&I bond is tempting. But it comes with risks that are not immediately apparent. While we acknowledge that equity and bond markets are not insulated from further falls, we also believe that we are around the peak of the interest rate cycle and that, on a 12-month view, equity investors will be able to be a bit more optimistic. We have said in the past that a lot of a bull market cycle's returns are compressed into the early phase of recovery. If one is not invested during that period, that is a base of returns that cannot be compounded into the future.

And what about those cash deposits? If we are at the peak of the rate cycle, the interest levels on offer today are not necessarily going be on offer next year, leaving one exposed to diminishing returns. It is this reinvestment risk, alongside the lack of excess return assumed for taking some risk with one's capital, that condemns cash to the bottom of the investment stack. By all means hold a little for a rainy day, and even tactically hold some to take advantage of juicy opportunities if there is a temporary market dislocation (so called "optionality"). There is nothing wrong with holding larger short-term cash balances if they are matching a soon-to-be-met liability that might not be met if markets don't have time to recover from a fall, such as a wedding, a house purchase, school or care home fees, or even the trip of a lifetime. But don't turn it into a comfort blanket.

How sequence risk works

Finally, we look at sequence risk. This is especially important for investors who are taking income to live on from their investments. No two cases will be same, and so I would always advise financial planning advice. But, in a nutshell, the risk is that the sum being drawn down is not moderated when investment returns are poor. It might be a human tendency to live high on the hog when things are going well, but its much harder to rein back in tougher times. However, that should be done to some degree to maintain the possibility of decent longer term returns and not, in the worst-case scenario, to run out of money.

Taken alone, failing to take the right course of action in any of these cases could be detrimental to future returns. It goes without saying that combining them all could be disastrous. And yet, with emotions running high and with so many negative headlines to contend with, it is almost inevitable that some will fall into one or more of these traps. As repetitive as the message sounds, we maintain that it is in investors' longer-term interests to stay the course, however difficult that might feel.

Economic Commentary

FTSE 100 weekly winners	
United Utilities Group PLC	2.5%
Severn Trent Plc	2.1%
Unilever PLC	1.6%
Reckitt Benckiser Group plc	1.5%
Diageo plc	1.5%
Admiral Group plc	0.8%
British American Tobacco p.l.c.	0.3%

FTSE 100 weekly losers	
Rentokil Initial plc	-23.8%
Rightmove plc	-17.0%
Ferguson Plc	-8.7%
Mondi plc	-8.5%
Ocado Group PLC	-8.3%
Anglo American plc	-8.1%
Rolls-Royce Holdings plc	-6.7%

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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