Weekly Digest

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One Hump Or Two?

Earlier this year I responded to various market commentators who were asserting that financial markets, notably equities, were in a bubble and that a crash was imminent. Our conclusion was that this was not the case, although we acknowledged that certain sub-asset classes were displaying varying degrees of potential speculative excess. These included cryptocurrencies, Special Purpose Acquisition Companies (SPACs) and Non-Fungible Tokens (NFTs), which we were wary of. All three have subsequently had some air removed from their tyres, but equities go marching on. Indeed, despite a wobbly start to last week's trading, several indices ended up posting new highs by the close of play on Friday.

And so it seemed timely that last week I was sent a magazine article in which no fewer that twenty-one investment cognoscenti were asked to score the current risk of markets being in bubble on a scale of one to ten. Four of them didn't answer the question, but of the seventeen who did the average was 5.9. That might look like a collective shoulder shrug but is a highly misleading average. The answers were not distributed along a normal curve with a single hump in the middle, but clustered into two distinct camps of (for want of a more accurate descriptor) bulls and bears resulting (in statistical parlance) in a bimodal distribution. Think Bactrian camel as opposed to Dromedary. Indeed, there was only one score of four, one five and no sixes.

This is not entirely surprising to me. As with so many other things in the world today, views are becoming more polarised. Psychologists have been weighing in on this phenomenon, suggesting it has a lot to do with tribalism and identity. If you are not "for" something, then you have to be "against" it. In political terms it can be seen in the split between the Leave and Remain camps over Brexit, or in the increasing distance between Republicans and Democrats in the United States. It has even spilled over into the COVID situation, either in terms of levels of tolerance for restrictive measures or in attitudes to vaccination and mask-wearing. If you don't believe that, look at some of the graphics that are being produced showing the differences between majority Republican and Democrat states in the US vis-à-vis vaccination rates (and what

that also means for current infection rates). And as I have commented before (citing broadcaster Alistair Cooke from as far back as the 1970s as well as, more recently, physician and author Hans Rosling) the media – broadcast and social – has a role to play in this too, with ever more shrill opinions required to make oneself heard. There seems to be less appreciation for balanced views.

Returning to the bubble debate, the next thing that struck me about the article was that not a single one of the participants actually runs any investment funds. Most were academics, with the odd former central banker and a handful of economists thrown in for good measure. One might observe that they are wonderfully positioned to provide an objective opinion of the current state of financial markets, but by the same token they are also far removed from the nitty gritty of having to manage portfolios and generate a return for investing clients. As with much opinion-giving in the world today, there was a lot doom-mongering but very little by way of practical solutions.

The bear case, especially for equities, tends to rest on two planks. The first is that valuations have lost touch with reality; the second is that only central bank liquidity is propping up the whole edifice, and once it is removed everything will come crashing down. Witnesses for the prosecution are often the Tech Bust at the turn of the millennium and the Great Financial crisis. We continue to believe that both of these historical precedents are misleading owing to the far greater profitability of today's technology leaders, and to the much better capitalisation and regulatory oversight of the banking sector. And, for better or worse, neither do we believe that central banks will abruptly pull the liquidity plug. That's not to say that we live in a risk-free world – far from it – but some perspective is required.

Looking more closely at equity valuations, we rely on two separate methodologies in our investment process, one being more "top down", the other more "bottom up". At the Global Investment Strategy Group level, where we decide how much equity risk to take in portfolios relative to Strategic Asset Allocation benchmarks, we use a dividend discount model (DDM) applied to the S&P 500 Index as a proxy for developed markets (which we think is reasonable, given its more than two-thirds weighting in developed markets and the fact that the US market sets the tone for the rest of the world). The DDM approach currently suggests that US equities are somewhat ahead of the game. To find better value, we would either have to see an increase in dividend expectations, which is not improbable, or a lower bond yield. Indeed, a lower bond yield recently has been beneficial for equities, but, as we have noted on various occasions, the gains have once again been concentrated in the "longer duration" parts of the market, such as large capitalisation technology shares. Here we witness yet another example of those polarised attitudes, this time between "Value" and "Growth" investors.

At the stock selection level we have embedded the Cash Flow Return On Investment (CFROI®) approach into our research process. This is provided to us by Credit Suisse under the HOLT® banner. This methodology also utilises a discounting mechanism, this time focusing on current and future cash flow as opposed to dividends. Crucially, it also takes into account the cost of capital (combination of debt and equity), with companies that make positive returns over their cost of capital tending to prove better investments over time. Of course, there is a price for everything, and so we also have to decide whether or not the market is overpaying for all that cashflow.

The HOLT® models themselves are mean-reverting, meaning that they expect all companies' returns to fade towards the cost of capital over time (either upwards or downwards). This is where the subjective skill of our analysts comes into play. They need to assess whether current returns are sustainable or not. As our HOLT® team leader is wont to say: "HOLT® gets you asking all the right questions but does not give you all the answers". Sounds as though our equity analysts' jobs aren't in danger of being outsourced to robots just yet.

It is by using this sort of valuation tool that we have been able to continue holding on to the shares of companies that, when viewed through a simple "twelve month forward price/earnings ratio" lens might have looked overvalued years ago. And yet they have continued to serve us very well by compounding high excess returns over their cost of capital, while also, in many cases, continuing to reinvest their cash returns into new capital assets and also through the profit and loss account. Sustained high returns on a growing base of invested capital hits the sweet spot for investors.

There is little in the current HOLT® valuation framework to suggest that equities are wildly overvalued, which is very important in that it keeps us from succumbing to the siren voices of the bubble-mongers. Of course, things could change, and we are well aware of the risks. The most obvious macro risk is a sharp rise in the cost of capital, and we cannot deny that a reversal of the multi-decade trend of falling bond yields would present a considerable headwind. But we will deal with that as and when it comes. Another risk would be a permanent margin squeeze. This could be the result of higher tax, wage or raw material costs (with no offsetting price rises), or, perhaps in the case of the technology giants, tighter regulation. Again, all things that we will have to factor in as and when they arise.

But one thing is clear to us, and that is that, on a relative basis at least, markets will, in the longer term, continue to reward the companies that innovate and drive their returns higher. One of HOLT's® key observations is that investment in Research and Development is a major factor in generating strong and persistent returns, and that US companies have, on average, been bigger spenders in this area and thus justify their premium valuations.

I am painfully aware that this could easily sound like an echo of the famous last words of economist Irving Fisher, who, in 1929, just weeks before the Wall Street Crash, opined that "stocks have reached what looks like a permanently higher plateau". The rest is history. Suffice to say we make no such grand claims and continue to invest on the evidence we see in front of us.

Last week's Economic Highlights

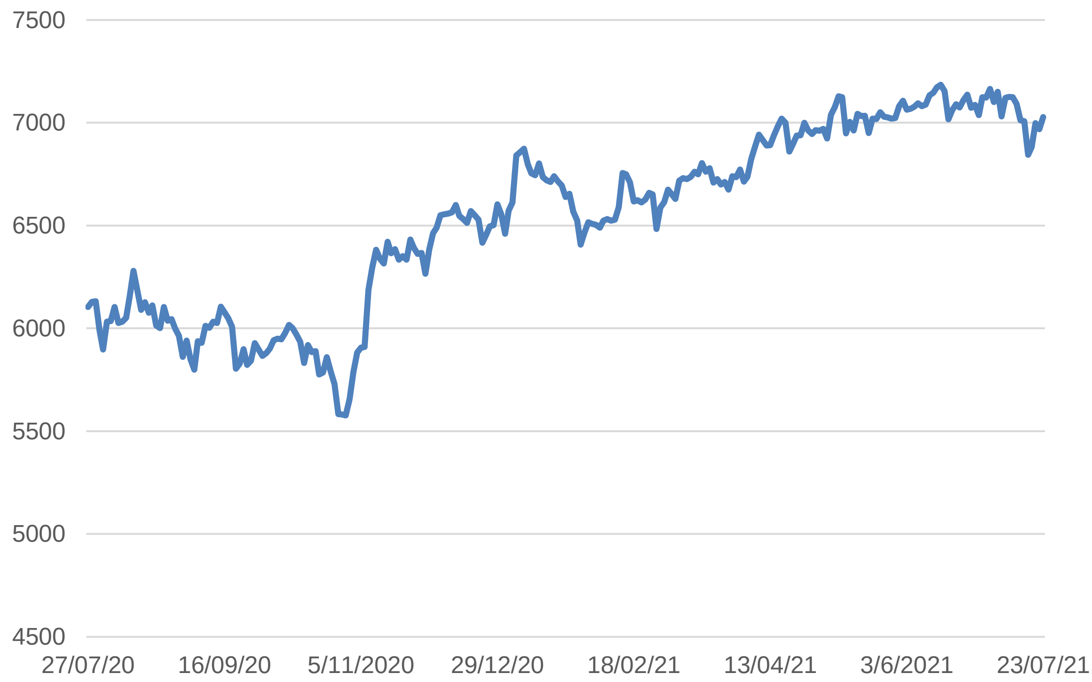
FTSE 100 Weekly Winners

3i Group plc	11.7%
Next plc	7.7%
Intermediate Capital Group plc	7.5%
Burberry Group plc	7.1%
Taylor Wimpey plc	6.9%
Melrose Industries PLC	6.2%
Berkeley Group Holdings plc	6.2%

FTSE 100 Weekly Losers

Fresnillo PLC	-6.2%
Avast Plc	-5.1%
Unilever PLC	-4.9%
Polymetal International Plc	-4.4%
Reckitt Benckiser Group plc	-3.4%
BP p.l.c.	-2.8%
British American Tobacco p.l.c.	-2.7%

FTSE 100 Index, Past 12 months



Source: Factset

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