INVESTMENT NOTES - April 16th, 2019
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Reporting is starting to come into full swing this week so investors are talking about whether the P/E of the market is too high considering earnings are expected to be down slightly for this year. If one can depend on a QE4, the P/E is reasonable. If not, it is probably high. Therefore as last week's investment notes mentioned, the market is not reflecting investor valuations, but instead being driven by government actions.

Stuart Dunbar, a partner at Ballie Gifford, wrote an interesting paper that expands upon what we wrote last week- the evolution of investment management and the effects upon the market. He states that investment companies no longer concerns themselves with actual companies and projects but instead are concerned about abstract concepts such as regional allocations, sector positions and factor weights. He makes the case that this cannot be broken down into passive/active investing in that many active investors are not carrying out their fundamental purpose- that of using available capital from those who have surplus to fund the ideas and projects of entrepreneurs and company managers who see an opportunity to generate profits. Professional investors should weigh up the risks associated with those ideas and projects, the range of possible outcomes and their probabilities and thereby put a price on the equity or debt that is being used as funding. Passive investing has fared well against active investing because active investing has become a second-order trading of existing assets, with the main focus being to try to anticipate the behavior of other investors creating over-trading and volatility. It also has no purpose other than obtain a very handsome living from transactional activity. Secondary markets only exist to create liquidity but the financial industry now describes its value in terms of market-referencing data points. By buying and selling existing assets, a zero-sum gain environment is created which has little to do with wealth creation for clients or society.

In Europe, over the last 8 years to 2017, passive investment increased by $1trillion. Active investment decreased by $600 billion. Costs now dominate the narrative instead of value for money as active concentrates on analysis of the behavior of the market participants instead of the underlying uses of capital. Mr. Dunbar states, "The market is in fact made up of a huge number of essentially idiosyncratic underlying investment projects, so why do we now talk in term of industry and country attributions, over weights and underweights, factor tilts, momentum, style, mean reversion and any number of other artificial measures that tell you everything except what your actual investment risks are? You can measure your tilt towards developed market growth momentum stocks if you like, but it won't tell you much about how plummeting gene sequencing costs are combining with big data to upend the healthcare industry as we know it."

Mr. Dunbar blames this evolution on the CAPM model (we had the pleasure of working with Dr. Bill Sharpe in the early 90s) which led active managers to focus less on fundamentals and more on the beta component of the model- with success now being defined on a relative basis along with costs and transparency. Active managers started to employ ever more sophisticated and costly trading strategies with no reference at all to making fundamental investments. Therefore now most investing is no longer about taking long-term risks in definable investment projects but it's about free-riding on the mythical 'market return' at minimum cost, shuffling risks around through financial engineering and confusing costs.

What is the answer to combat this? Investment managers need to engage more with their clients to help them understand what investment really means. Instead we create structures where we measure ourselves on quarterly performance against benchmarks, incentivize ourselves on short time periods or assets under management and hug benchmarks so as not to stand out from the crowd. This makes being predictably average more attractive than being unpredictably outstanding.

Only 4.3% of the firms listed on the US stock exchange between 1926 to 2016 collectively account for all the wealth creating in the US stock market since 1926 according to a paper by Hendrik Bessembinder at Arizona State University. This means really big winners compound their gains over long-long periods. Sustainable competitive advantage has incredible power and stock prices of the winners do not revert to the mean. It also means short-term volatility means nothing. This also means that active managers will probably be wrong more than half the time, but if they are successful, their winners will more than offset their losers by an order of magnitude.

This short termism is also reflected in the companies and their lack of investment for the future. Over the past 25 years the ratio of investment (capex plus R&D) to pay-outs (dividends and buybacks) fall by almost 75%. A company should be reinvesting capital in new opportunities- since so few are doing this, the potential gains for those who do invest in their future are magnified. This outperformance is reflected in those managers having active risk (they differ from the benchmarks) and low turnover (so hold their investments instead of trading them) outperform the benchmark by 2.3% per annum.

Therefore, we are continuing with investing in companies who are investing in their future and we have low turnover. Companies we are currently researching: Japanese robotics and the effect of 5G, Repligen US, Goldman Sachs, Nokia.