COVID-19 INVESTMENT UPDATE: SUSTAINABLE FUNDS UPDATE – 20 NOVEMBER 2020

What is happening?

As Lenin famously said: 'There are decades when nothing happens; and there are weeks when decades happen.' The last three weeks has certainly felt like that. As investors we like narratives, it makes the complicated nature of the investment world easier to digest. Writing narratives in the last 15 days has been more akin to live blogging. The day before the US election, a 'blue wave' was coming with the Democrats winning both Congress and the Senate. 'Buy value' was the recommended course of action. Then the 'blue wave' did not appear as expected. 'Gridlock in US politics, buy growth' was the new narrative. Then a potential vaccine for Covid-19 was found. 'We are going back to 'normal' buy value' returned. As investors have run from one side of the metaphorical ship to the other, it has created huge volatility and sector rotation in markets, the scale of which has been unprecedented. We have had so many unprecedented events this year it is easy to begin to doubt what normal actually is.

Before we get too much into the investment consequences of recent events, it is worth stepping back and appreciating the breathtaking speed of innovation in the development of a vaccine for Covid-19. The genetic sequence for Covid-19 was shared with the world in early January and less than 11 months later we have two highly effective vaccines, with more likely to follow, which have used new scientific techniques to create them. History is rife with examples where major dislocations such as disease and war have supercharged innovation in ways that have transformed society for years to come. This is turning out to be another example. So whether you are long or short of the market, value or growth, equity or credit, it is good news we may finally have some light at the end of the tunnel.

The events of the last three weeks really do emphasise the idea that investing is about adapting rather than forecasting and we must be thoughtful in how we assess 'the weeks in which decades happen'. Is this a structural change in the investment environment? Does it challenge any of the assumptions which underpin how we have positioned our funds? These are not easy questions to answer in the moment. We can however give you some insight as to how we are thinking about them.

If we think about investing in equities, we start with the view that the long-term performance of share prices across a range of sectors will reflect changes, trends and outcomes in the business world and broader society. This is opposed to the business world and society reflecting changes, trends and outcomes in share prices. This is important to remember given the huge movements we are currently seeing in the share prices of certain companies and the disparity currently being seen between the performance of 'value' and 'growth'. In the long-run the share prices of those companies and industries classed as 'value' will perform better than they have in the past if the businesses they reflect see improved long-term prospects and become more relevant and useful to society themselves. Equally the long-term performance of growth stocks will weaken if the business trends they are seeing weaken and they become less relevant and useful to society. It is in this thought process we expect to find some of the answer as to if the investment environment has changed.

Alongside this we must also acknowledge the valuation disparity between value and growth stocks which until recently was at an all-time high. With respect to this issue it is important to note this disparity hasn't happened for no reason. It has happened because the future prospects (for example) of oil, coal tobacco, business travel and offices have deteriorated whilst the future prospects for the digital economy, renewable energy and medicine development have improved. There should be a large disparity in valuation between value and growth stocks – the point for debate is how large this should be.

Of these two factors we are much more confident in business fundamentals, which to us more than ever point to the case for owning 'growth' over 'value'. Innovation is accelerating, not slowing, and the value creation/destruction as a consequence will continue at a rapid pace. Reversion to the mean, which underpins value investing to a large extent, is structurally challenged. With respect to the valuation disparity it is much more reasonable to assume this became overextended in the midst of the panic, with some closing of this possible, and indeed has already occurred. If the current market rotation is a pullback in a trend that has been in place for the last decade, or a fundamental change in investment environment, will become clearer in time. We will keep an open mind and keep you updated on our thinking.

What will happen next?

One positive aspect of recent market developments is that it has broadened out the winners in the market from just technology shares to almost everything. More than 90% of stocks in the S&P 500 are now above their 200 day moving average share price, a commonly used indicator of momentum. Market technicians, chartists, take this as a positive signal for the health of indices. While we can't claim to be experts in this area, one criticism of markets this year, their narrowness, has been removed, at least for now. It seems more likely to us that equity markets will rise than fall in the months ahead, as continued stimulus meets a gradual move into a post pandemic world. Of course there are risks, not least of all the reality that today Covid is prevalent and growing in major parts of the world. And of course 2020 has taught us the perils of forecasting and unforeseen events….

What are we doing?

Not a huge amount in summary! Generally we find fewer opportunities for activity in a rising price environment than a falling one. The market sell-off earlier this year was a busy time for us as it created opportunities, but the recent rapidly rising price environment has made the terms on us making any changes to the portfolios less favourable. Within the mixed asset portfolios we have been selling some equities to ensure we remain at our target levels (we fix asset allocation in our mixed asset funds) as prices have risen. Within the single asset funds activity has been minimal.

How are we performing?

The last few weeks have certainly not suited our investment approach. For example, looking at the US stock market in the two days after an effective vaccine was announced, the energy sector was up 14%, financials 9% and healthcare only up 1% with technology down 1%. Over the same two days value was up 7.3% and growth down 0.5%. This trend has continued since then. Year to date performance remains strong and well ahead of target. If, as we expect, equity markets to continue to rise our mixed asset funds will benefit. Should current trends continue we would expect some relative underperformance in our single asset equity funds in the context of a strong 2020.

Anything else?

One topic that fascinates us is how much information we need to make effective investment decisions. We have to respect that we work with imperfect information and the world is a dynamic place: There is a limit to how much we can know. If we try to use too much information in our decision making we risk what could be called 'analysis paralysis'. Equally, if we use too little we may be relying too much on instinct and short-hand thinking. These pitfalls in decision making can be seen more generally in life too!

Our approach is to have a framework to our decision making. We think we need to see a number of defined and important factors before we make an investment decision. For us these start with Sustainable factors, such as corporate governance standards and socially useful products and services. Then we progress to financial characteristics such durable growth, genuine value creation as a result of innovation or other sources of competitive advantage, and a reasonable valuation. Once we see these characteristics our experience shows us that we are more likely than not to be making a good decision. Further analysis has more limited benefit and can actually be harmful if it stops us actually making a decision. We do think this approach will work well in the current environment when at times it feels like there is almost too much information from which to make any decisions. Separating out the signal from the noise in decision making is a crucial skill in investing and one we continually try to improve.

Please note that this is a fast moving environment and markets and impacts on portfolios are changing. Opinions contained in this document represent views of our fund managers at time of writing, and performance numbers are estimates and not audited.

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