CREDO WEALTH

Living in interesting times

Deon Gouws - Chief Investment Officer - 11 January 2019

At Credo, we often stress the fact that we never really concern ourselves with most of the daily news flow. Neither are we ever typically tempted to try and forecast the unforecastable. In addition, we shy away from timing the market as we tend to invest with an eye on the longer term.

Over the past few days and weeks, all of these points have come into renewed focus:

- we've been witnessing all the to-ing and fro-ing within the UK parliament in dealing with the upcoming Brexit, moving markets in the process (at least according to some);
- this being the month of January, we find ourselves at the height of "forecasting season", with practically every strategist and commentator out there seemingly wanting to share with the world what they guess will be happening in the investment world over the course of 2019; and
- we've just been through a tumultuous few weeks for investors of all descriptions, with December 2018 eventually ending up as the worst month for US and global equities since February 2009.

Let me deal with these three points in reverse order.

Those who follow markets will be aware that 2018 ended up being the weakest year across asset classes since the global financial crisis. This one-line summary does however mask the fact that the year appeared to be on track for some solid gains right up until the end of the third quarter: the S&P 500, for example, reached an all-time high of 2,930 on the 21st of September 2018, at which point the market was up nearly 10% for the calendar year. Most of the action was once again to be found in the technology sector; as a result, the NASDAQ did even better over that period, trading up more than 17% from where it started the year at a point in time.

And then everything changed rather suddenly. After declining by 6.9% in October, the S&P 500 was marginally up for the month of November, only to lose another 15% of its value between the beginning of December and Christmas Eve. As a result, the market entered bear market territory (defined as a drawdown of more than 20% from previous highs). **In spite of a few strong days to end the year, it also meant that this was the first calendar year in a decade where the market registered an overall decline.**

Whilst all of this was playing out, investment managers such as ourselves had the relatively new MiFID II rules to deal with. This legislative framework was instituted by the European Union and rolled out across the financial services sector in the UK and elsewhere at the beginning of 2018, covering a variety of topics, including market transparency, product governance, transaction reporting, inducements, and best execution.

One of the specific requirements of MiFID II, is that investors have to receive a notification whenever the value of their portfolios drop by 10% in any given calendar quarter – something which did of course happen to a number of our clients towards the end of 2018, given the wild swings in equities as outlined earlier.

With a lot of the market action taking place in the second half of December (and a temporary bottom being reached on the 24th of December, of all days), this meant that we were compelled to send out some of these emails around Christmas. Whilst this may seem like rather odd timing to some for such a communication to go out, the very strict MiFID II rules unfortunately left us with no choice in the matter.

Adding insult to injury, equities then promptly started to go up in what seems like pretty much a straight line. Unlike markets such as the UK and South Africa, stock exchanges in the US were open on Boxing Day, and the 26th of December 2018 ended up being one of the strongest days in history: the S&P 500 gained nearly 5% in that one session. At the time of writing this a couple of weeks later, further gains amounting to some 5% have been added; on the 8th of January 2018, Bloomberg TV showed a statistic in terms of which the index was on track for its best ten-day gain in ten years!

In his first piece of 2019, celebrated Bloomberg columnist Matt Levine included the following two paragraphs:

> ***Some stats for you. The last Money Stuff of 2018 was sent out in the morning of December 20; the previous day, the S&P 500 Index had closed at 2506.96. The first Money Stuff of 2019 - this one - is going out in the morning of Wednesday, January 2; the previous trading day, Monday, December 31, the S&P closed at 2506.85. That's a seven-trading-day move of 0.11 points, or about 0.004 percent. In the last ten years, there have been only six seven-trading-day periods with smaller stock-market moves. Basically my vacation was as quiet as the stock market ever gets, if you look only at the endpoints, which I did, because, remember, I was on vacation.***
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> ***In the middle, it was otherwise. The market went down a lot for a couple of days, and then it had an up 5 percent day last Wednesday, December 26, a day that was so good that it "was the first time ever, according to data compiled by Bloomberg that stretches back to 1990, in which more than 500 stocks in the S&P 500 finished positive."***

Which brings me back to MiFID II, a framework that sets out to regulate markets more efficiently and improve protections for investors. Whilst no-one can fault such lofty objectives, the question can be asked whether or not the best interests of investors are in fact served by having to send out notifications that portfolio values have dropped by 10% at the very point that a temporary market bottom may be formed (during the festive season, no less)?

This, especially when there is no concomitant requirement to notify the same clients of a fairly strong rebound in their portfolio values soon after. One could in fact argue that, given the well-established behavioural finance principle of loss aversion, said notifications may lead to significant opportunity costs (i.e. if investors are "spooked" into selling out their holdings at what proves to be exactly the wrong time, locking in losses in the process)?

Having addressed the recent market gyrations, what about the future? Will the recent strength continue? Can we honestly say that the bear market is over after such a short period?

The true answer to these questions, is that nobody knows. Neither does it have any impact on the way in which we manage investments at Credo: as stated before, we've always shunned forecasts, preferring to focus on a relatively simple investment philosophy in terms of which we build diversified portfolios of quality assets at reasonable prices.

The one thing that can of course be said is that, given the recent sell-off (and even following the subsequent gains), markets are trading at more reasonable levels than they have for some time. Although it is early days, it would further appear as if Value as an investment style is starting to outperform Growth (the recent weakness of FAANG stocks being a case in point); as Value investors, it should thus augur well for us as far as our relative investment performance is concerned going forward (assuming the trend is sustained).

In this regard, we are pleased to report that the Credo Best Ideas Portfolio outperformed the MSCI World benchmark by 1.0% in December and 3.8% over the last quarter of 2018, whilst the outperformance in the case of the Credo Dividend Growth Portfolio over the same two periods amounted to 1.0% and 2.9% respectively (all numbers measured in dollars).

Finally, what to make of Brexit? This is a vexed question indeed, and whilst everyone has an opinion, I don't believe there is any clear visibility in terms of exactly how this will play out in the coming weeks and months.

Whether we end up seeing a so-called Hard Brexit, some form of Soft Brexit (or perhaps even no Brexit at all?), there is a plausible argument that most of the bad news may already be discounted by the investment markets. As a consequence, there could in fact be some upside in both UK equity prices as well as sterling from current levels once more certainty dawns.

Having said that, we do not build portfolios based on any specific view, and whatever the outcome of the process, we believe that the impact on our returns is likely to be relatively limited. We have done some analysis in this regard, the results of which show that the Credo Dividend Growth Portfolio, for example, has an effective economic exposure to the UK of approximately 10%, in spite of the fact that as many as 7 of the current 18 holdings are listed in London (and therefore denominated in pounds).

In conclusion, and as the Chinese proverb goes, we are certainly living in some interesting times. But whatever the circumstances, our clients can rest assured that we will never stop working hard in order to protect and grow their wealth over time.

It has always paid to stay invested for the longer term, and those who have been able to do so even in the face of tremendous uncertainty – such as that presented by the global financial crisis a decade ago, for example – have been richly rewarded. We accept that volatility is part and parcel of financial markets; in fact, it often presents us with some of the best buying opportunities. It is with this in mind that we will continue striving to add value to client portfolios on a daily basis. ■