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Finding the Polar Bear in a Snowstorm

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These are extraordinary times, and no-one can predict the immediate future with any great confidence. Anything I, or any other commentator, writes is therefore likely to be proved false and in shorter order too. It's therefore very tempting for me simply to wait on the sidelines and follow my normally quarterly letter writing cycle. Unfortunately, you, as a client, don't have that luxury with your decision-making, so I took the view that it was better to pitch in, just in case my views are helpful. However, I do risk looking completely foolish in a month's time (or sooner!). If so, I hope you will be tolerant of me. I should make clear that – even more than usual – what follows is my own personal view.

What should we make as long-term investors of the extraordinary market behavior in the last few days and weeks, and how should we respond? I think the first step, interestingly, is to acknowledge that none of us has real, in-depth insight, firstly on how the spread of COVID-19 will progress globally, and then, secondly, on what the impact of the actions we are taking as a set of nations to combat this spread will play out economically or in markets. The reality is that we are all guessing. This guesswork is compounded by the fact that the economic outcomes will be determined by the second-order impacts i.e., the consequences of the actions that nations are taking to protect their peoples, and indeed the third-order impacts are highly relevant too, i.e., what steps will governments take to ameliorate that second-order impact, and will they be effective?

So, if we are all guessing, and no-one has insight, it should clearly be no surprise that we are seeing extraordinary volatility, when you add the guesswork to the natural herding behavior the industry exhibits, and the understandable risk aversion of financial institutions in such conditions. For comparison's sake, even in the Global Financial Crisis (GFC), there actually was information to be had, it just wasn't very pretty. Moreover, as yet, we don't have much insight as to how large are the unseen technical factors in play e.g., big forced sellers. (There have certainly been some extraordinary unpredictable combinations of market moves e.g., equity markets, gold and JGBs (Japanese Government Bonds) all falling last Thursday, which you could wait a long, long time to see again, so there are many rumors of substantial forced selling behind the scenes.) Therefore, my first point is that it's important to try and fight our subconscious here, and not let the extreme volatility cloud our thinking, which is hard when you hear the jump in the VIX described as a "surge in the fear factor." Actually, against this backdrop of uncertainty, compounded impacts and human behavior, we should expect huge volatility day by day, and very importantly, not be deterred by it.

Therefore, if we know nothing about what's about to happen in the short term, and volatility is potentially going to continue, how can we try and make sensible decisions? I am going to advance two propositions in this letter, and both are anchored in my belief about staying long-term being the key to investment success. The first is around trying to imagine the future a while ahead, beyond the short-term noise, and the second is to use valuation rather than news as the yardstick.

And here we come to the first point, where I risk looking truly foolish, but I am going to advance the proposition that in 12 months' time, we should have a reasonably high degree of confidence that the great bulk of the COVID-19 direct impact will be behind us. We will have had time to explore vaccines, treatment regimes, adapt health systems and, of course, many if not most populations will have been exposed and perhaps developed immunity. In illness terms, my central proposition is that this is a one-time hit, not a repeating movie. Normal economic activity will have resumed, albeit from what will undoubtedly be a lower base than it was going in. Moreover, there is reason to look to other awful human situations where, nevertheless, once we have mentally attenuated to the risks, activity does recover. Furthermore, as we have already seen, governments and central banks are clearly united in their determination to explore ways of providing relief, and potentially to do so across party lines. Short-term relief is also arguably easier to provide. There is still a big unknown in terms of how low that base is, which in turn depends heavily on the success of the various government and bank actions, but I stand by my belief that economies will be recovering.

This is a fundamentally different proposition than we faced in the teeth of the GFC. Then there was a genuine question almost about whether financial capitalism would survive, and when one approached valuations, there was a real probability to be assessed in the calculation about whether non-state owned banks would exist in the same form. I believe that far fewer of these existential probabilities come into play in today's calculus – in the early days, strains across the European Union financial system have bubbled up, but the ECB, as ever, is taking steps to mitigate those, for example. As I say, none of us knows the short-term path, but if you take the medium or long-term view, then I believe there are lots of places to look for actions to have a smoothing and supportive effect rather than a concatenation downwards.

So, if we don't know the short-term, how can we have any basis for decisions? To me, this is where valuation becomes the crucial yardstick, since movements in current prices are clearly excessively volatile and founded on guesswork, overlaid with risk-averse biases and unknown but likely compounding technical factors. Valuations are how we can try to look beyond the noise, and keep perspective. Moreover, if you accept my previous logic, there is no "end of the world" scenario here, unlike the GFC, to layer in.

Before discussing where that takes us, it's worth highlighting that one facet of this year exaggerated by the last few weeks has been the returns to size have been completely outsized i.e., big stocks have driven relative performance, and generally the bigger (in market cap terms) the more so. Again, this is not surprising: it's a classic panic reaction. Perhaps it has been compounded this time because so many of the biggest stocks started this period with all their earnings in the future: if you weren't expecting to make much money this year, then making even less money doesn't matter so much – but I would argue that there is a less-appealing corollary about the future for such stocks, but that debate is perhaps for a different day.

It's not the place of this letter to beat the drum for a particular strategy let alone a particular stock – but there are currently some extraordinary individual valuations out there. I started writing this letter on Tuesday, March 17th, and at Monday's close, I am going to provide one example: DuPont was at a price to book ratio of a little above 0.6, and a price to sales ratio of just over 1. These are roughly 50% below typical metrics. I would argue that there is no existential crisis for DuPont here: its products will be in demand for many, many years to come, even if it takes a short-term hit.

So how would I pull all of this together from a client perspective? I am going to spare you platitudes about "not taking hasty decisions in the middle of extreme volatility" because (a) I think most clients have enough street craft to have known this for some time and (b) my whole premise is to get off the fence a bit here to try and be more helpful. Instead I would make 3 points:

1. I have written previously about leaning in to cycles as a way of ending up on the right side of cyclical behavior (here). I believe there is a direct analogue here. We know that there is excess volatility around in both

directions, and I have expressed my belief that this crisis has a finite lifespan. These add up to suggest that we will see a form of truncated cyclical price response: there may continue to be sharp potential overreactions down on perceived bad news, and then relief rallies on slightly better news. If we then use valuation as our guide, that suggests leaning into the out-of-favor asset i.e., equities. As I talked about in my letter on investing through cyclicality, you shouldn't go all in until you are absolutely sure the cycle cannot go further against you, but make partial moves when valuation is on your side and stand ready to lean in more if valuations move further (barring some major long-term new development). For the record, using this principle, personally I was a buyer of equities on Tuesday, and I can't be more unambiguous than that!

2. The easy way to do that is, of course to up index exposure. The one downside of that to at least be aware of is that the nature of an index is effectively to capture momentum: you tilt more to the assets whose price increases relatively. When we have seen disproportionate returns to size, as we have this year, that matters more. Now, that may be a necessary price to pay for quick and easy exposure, but it should at least be something to be conscious of.
3. Just in case I need to put something in the bank and history judges this letter unkindly, I will bang the drum again for the importance of building diversification from equities and bonds (here). I am not, of course, saying that this course of events was foreseeable, but the concept of building a more robust portfolio design, and not placing reliance on two asset classes that have endured exceptional bull markets remains valid. If and when you are rethinking your future allocations, I hope that true diversification will get the weighting and focus that I believe it should.

I do very much hope these thoughts are helpful in offering some perspective on where we are. I have tried to avoid fence-sitting with the view that would be more useful to you, our clients, whether you agree with me or not. I would, as ever, be delighted to discuss or debate them with any of you. We are committed to being even more available to our clients through this volatile period and beyond, even if we have to do so virtually rather than in person for a few months.

We wish you, your families and your loved ones all the very best as we navigate this incredibly testing situation together. All of us at QMA and QMA Wadhwani are trusting that we will all come through as safely as we can, and looking forward to being able to resume normal activity together, whenever that may come.

With all best wishes,

Andrew Dyson

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