Sound Thinking

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Finding comfort in an uncomfortable world

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As I write this we are only a couple of weeks into 2021, and already people are muttering about how much they miss the good old days of 2020. In the time since I last wrote one of these start-of-year documents the world has changed entirely, and it is difficult for investors to look forward to 2021 with much certainty. Nevertheless, we need to think about plans for the year, and try to cast an eye over the prospects for investment—both assessing what we got right over the last 12 months and trying to put some structure in place to help us form expectations for the upcoming year.

We need to begin by putting what we're trying to do here in context. Unlike brokers, we don't set ourselves the task of predicting specific market levels. Our job is different. Our focus is more on the actual work of investment boards, and that work is driven by the agendas of board meetings, where time is always scarce. These ideas then should be thought of as topics an investor might want to add to their agenda for the year, either as a specific item or as a theme to raise during their ongoing discussion. By the end of the year it's generally easy to look back at the topics covered in meetings and assess whether each item deserved board time: that's the metric we use here for success. The items below, then, are part forecast, part good practice, part discussion idea: but they stand or fall based on whether allocating board time to them during the year[1] would have added value.

As I've done before, I will begin by looking at how our ideas for consideration for 2020 held up against reality, and I'm pleased to say that despite the bizarre nature of the past twelve months I believe the result of that assessment is in fact rather positive. Next, I will try to put some markers down for 2021, identifying issues which are likely

1. *Or, depending on the specific advice, avoiding the temptation to spend Board time on them*

to be important for investors to spend time on and trying to set a tone for how to approach the year. Most important, I believe the following is a central theme: 2021 is a year when we have to try to find comfort in the discomfort offered by the markets, the economy, and the general environment.

2020 – Our report card

This time last year we produced a list of ten ideas we thought were worth considering. How did these hold up in the context of the spectacularly unusual conditions we saw in 2020? Upon review of the topics we covered, I think we were fairly successful. Investors following these ideas would have been focused on topics which were useful despite the highly unusual conditions seen in 2020.

1. **Relativity: OK looks bad next to awesome**
   The first idea was focused on trying to make sure investors did not take down their U.S. equity allocations following the exceptional performance of 2019. As we said at the time, an adequate return may look unattractive when compared to an exceptional one, but the prospects for U.S. equity still seemed relatively good. One year of exceptional returns does not necessarily imply major changes to investment approach are warranted. Despite volatility throughout the year (in particular the spectacular events around the first lockdown) staying allocated to U.S. equity paid very well indeed, and investors who remained allocated there were well rewarded. I would score this idea as a success.

2. **Earnings: The basis of equity returns**
   The second idea focused on the importance of earnings growth as the driver of equity returns, and suggested that investors concentrate on the likely behavior of earnings when trying to assess the prospects of equity investment during 2020. This would have paid off in part during 2020. It explained much of the panic selling we saw as COVID-19 was assessed by the markets, and as investors realized earnings would be difficult or impossible to forecast for many companies. It also explained a good part of the investment upside that we saw, as the focus shifted towards the types of businesses where earnings could be expected to remain strong. Earnings were certainly not the whole story – the underlying provision of massive amounts of support from central banks and governments provided much of the music to which the market danced during the year – but as a hook to begin the conversation they were a good start. This idea then probably merits a half-passing grade – useful, but not the whole story.

3. **Certainty: P(Income) > P(Capital Gain)**
   The third idea focused on the importance of the income element of investing, and suggested investors needed to be careful to understand the robustness of the income streams they were purchasing. This emphasized the importance of relying on actual income, not simply expected capital appreciation, when constructing a portfolio. Our proposed approach would have been extremely useful during 2020: investors who had already spent time thinking through the underlying drivers of their portfolio would have been better positioned for the market turbulence we experienced, and portfolios constructed with an eye to the resilience of income streams are likely to have been better positioned for the uncertainty COVID-19 brought to asset markets. This suggests the idea should be scored as a success.

4. **Economies: Dory had the right attitude**
The fourth idea focused on the relatively good conditions of the economy, indicating an approach of "just keep swimming" would be a reasonable approach to 2020. It is possible to imagine a prediction that was less successful than this, but only barely. However, if the effect of COVID-19 on the world economy doesn't qualify as an unforeseen exogenous shock then I'm not sure what does. With fairness it's difficult to mark this idea as a success.

5. **Rates: Low rates may be normal**
The fifth idea focused on the low interest rate environment, and warned investors not to bank on rates rising in the near future simply based on an expectation for some "normalization" toward the "natural long-term rate of interest". 2020 certainly provided further evidence for the idea that rates could go lower: investors who had avoided the temptation to bet on a rising rate environment were compensated for sticking to the lower-for-longer position. This idea then counts as a success.

6. **Brexit-it: The thump of falling shoes**
The sixth idea related to Brexit, and we suggested 2020 would be the year of a final deal. One of the most important roles of Brexit was to allow us to calibrate the effectiveness of commentators: those who predicted either that Brexit wouldn't happen or that it would be an immediate disaster would either be proved right or wrong. In both cases the latter proved true, although the last-minute nature of negotiations meant the full impact will take time to assess. Relatively good sense seems to have prevailed at least for now, while the UK has made decent progress on the creation of new trade relationships with trade partners around the world. This idea counts as at least half a success, too: delayed, but still broadly accurate.

7. **Politics: Not a betting matter**
The next idea focused on is politics. In particular, we advised investors to invest based on economic rather than political factors. We discussed the possible outcomes of the election, recognizing that incumbent advantage was real and that challengers were likely to do better in an environment of economic disruption. Most important, we suggested investors try as hard as possible to separate political considerations from investment considerations, and that these should only be combined once the likely economic outcomes of political events were clearer. The events of the political cycle of 2020 provided good evidence that this approach is generally advisable. We would also count this as a success.

8. **China: Beta or alpha?**
The eighth idea related to China. We communicated that investors need to think carefully about the nature of the bets they are making in this country, especially in the context of increasing index exposure to the market. We suggested investors think carefully about the specific allocations they are making, and what the characteristics of them were, highlighting that there were likely further pressures coming in this space. Events of 2020 proved this to be important, with continued increasing complexity of tensions with the U.S. and an ongoing focus on the nature of the trans-pacific relationship. This topic will likely continue to be important for a number of years, but for these purposes it counts as a success.

9. **Commodities: Spikes, bleed and diversification**
   Commodities were the next focus, with a suggestion that investors spend the year thinking hard about the nature of their exposure to the space and the reasoning behind that exposure. One needs only look at the extreme volatility experienced in the oil market to understand why this reconsideration is important. Investors choosing to maintain positioning in this space need to be very clear in understanding the reasons for doing so. We can count this idea as a success.

10. **ESG: The value of clear thinking**
   Our final topic was a call to action relating to ESG – suggesting investors need to understand what approach to ESG fits with their organization, rather than simply accepting a one-size-fits-all approach. ESG products had periods of good performance in 2020, but the fact that this was driven in many cases by strong tech sector performance and anomalously weak energy performance drew some attention to the fact that the ESG investment process, done correctly, is not inherently simple. It requires thought, care, and attention. Again, this is a multi-year topic, but one that would have been worthwhile for investors to focus on in 2020. We therefore can count it as a success.

So how can we think about 2021, and what tools can we use to help set portfolios up for success?

Thoughts for 2021

We can boil our thoughts about 2021 down into the following simple ideas.

1. Investing is hard
2. The Charles Montgomery Burns Market
3. Really? Estate
4. Chaotic to Kinetic
5. Churchill Was Right
6. Inflation Eventually?
7. Functionally Focused Thinking
8. Crypto-confusion
9. China Isn't Going Away
10. Thinking Harder & Better

INVESTING IS HARD

This first basic idea was captured in the opening sections of our recent Topic of Interest paper "Is Painless Diversification Dead?", where we identified the challenges of the low interest rate environment. A key insight from this piece was the fact that there are strong temptations for investors to assume that all of the investment problems we are faced with have solutions. It is important at times to recognize that this is not always true. Sometimes there are no easy answers to the problems we are trying to solve – and sometimes this is the case even though there have been easy answers to the same problem in the past. In this situation it is important to be able to recognize it and pivot towards a better way of thinking about the problem. Instead, find solutions to the individual components, potentially recognizing the outcomes that are achievable are less good than we would like. The example in this recent paper comes from the fact that the painless diversification which used to be available from long-term fixed income is no longer there in the same way – at such low interest rates the balance of risks and opportunities is quite different than it used to be. Spending time trying to exactly replicate the beneficial payoffs that were available in that other time and place is likely not a great use of resource – better, instead, to focus on what is achievable now in the current market and pricing structure. The end result of this will be better conversations around the investment team and board table, more effective portfolio construction, and greater focus on the achievable range of outcomes. We can count this as a success if the risk and return diversifying benefits of an allocation to long-term government bonds in an equity portfolio are lower than the average experienced over the last 20 years.

THE CHARLES MONTGOMERY BURNS MARKET

One of the long running characters in the TV cartoon The Simpsons is the owner of the local nuclear power plant, Montgomery Burns. He is old and sinister – and suffers from every known disease in the world[2]. Indeed the only reason he remains alive is the fact that the effects of these illnesses cancel each other out – a condition described by his doctors as "Three Stooges Syndrome". The current market might be seen as being in a similar situation. The economic effects of the lockdowns designed to bring COVID-19 to an end have been significant, and many companies have been kept alive due to the extremely low interest rate environment and the generous support packages put in place by governments. Any strength in the economy runs the risk of rate rises, cancelling out the advantages gained from the strength. Any weakness in the economy raises the probability of lower rates and more stimulus, which of course come with the longer-term danger that tighter money (to stem inflation) or higher taxes (to pay for stimulus) become more likely. All of these different tensions are pulling in different directions on the market at present, creating the beneficent environment which is causing stock prices to appreciate. Just like Three Stooges Syndrome, the current environment is unlikely to be a stable one. We believe it is likely that investors begin (once again) to become more fixated on government intervention than economic fundamentals. This would suggest a probability of quick market selloffs due to a concerns over any possible slowdown in government stimulus, and even potentially due to positive economic news as investors might expect a stronger economy to result in less stimulus.

REALLY? ESTATE

The effect of COVID-19 on the economy has been extensive, and the scale of the impact has been extremely difficult to assess. At the same time, the combination of extremely low interest rates, high levels of government subsidy, and leniency from lenders and landlords, has obscured much of the effect that would be expected on the real estate market from such an economic impact. This leaves real estate investors with a dilemma: it will take some significant time to get a clear picture of the true

2. *Including three previously unknown diseases discovered during his examination*

effect of the economic downturn on the asset class, and in the meantime there are allocation decisions to make. Add to this the fact that rapid movement of capital into and out of the asset class is very difficult and the challenge for investors becomes more evident. Investors would do well to spend significant time in discussion with their real estate managers – and those who wish to manage money on their behalf – trying to put together an honest and accurate picture of the way the real estate market is developing. It will be important to look ahead of the curve by taking account of likely tenant behavior over the coming years, and trying to understand likely long term structural changes to the market. By doing this, the investor may not only be able to ensure that their real estate portfolio is constructed appropriately, but by staying focused on both short and intermediate as well as longer term data they may also gain a broader insight into the developments in the economy as a whole.

CHAOTIC TO KINETIC

The last four years of U.S. foreign policy represented a significant departure in a number of ways from the previous, relatively bipartisan, consensus around "how diplomacy is done". There were concerns from within the foreign policy establishment that the approach of the administration to the rest of the world would be unpredictable and aggressive, and that this could lead to a higher probability of significant conflict. As it turned out only part of those predictions came true. The language used by the administration changed significantly, became much more unpredictable and at times went well beyond the normal diplomatic parlance. Foreign policy positions were not necessarily held consistently, and there was an underlying perception of instability. Many observers might describe the result as a more chaotic approach to international relations. At the same time the use of language became significantly more volatile, however, it seemed the desire for the actual use of force was lower than has been seen in other post-Cold War administrations. The last four years, then, can be well described as more *chaotic* but less *kinetic* than we have seen in recent years. The next few years may represent a reversion to more typical U.S. foreign policy behavior: an approach to diplomacy and international institutions that is much more consensus driven, and meets with broader approval from international institutions, but which may possibly involve greater actual use of force as a tool for international relations. This move from chaotic back to kinetic would represent a return to the status quo ante, and would in some ways provide a more "comfortable" environment for markets, which generally abhor uncertainty and unpredictability. At the same time, however, it is important to remember that an increase in kinetic foreign policy carries its own risks for markets: while the trope says "buy on the bullets", that's usually because risk assets have sold off in the run up to the bullets being fired. We may see more of these news-driven events over the next four years, then, and should be watchful for the effects they may have on markets in the shorter term.

CHURCHILL WAS RIGHT

The move to Democrat majorities in both House and Senate means policy is likely to change across a wide range of social and economic issues – our focus here is, of course, on the economic ones. When considering this we should remember the maxim Winston Churchill told a new Member of Parliament who described the other political party as "the enemy": he responded they were simply the opposition – but the enemy were actually sitting around them (members of the same party who would fight tooth and claw for advancement and for their own view of the right policies). It is important to bear this in mind when considering the prospects for radical change over the next two years: there will no doubt be major issues where solid blue consensus exists, and some significant policy changes can be expected. But at the same time the challenge of holding the very disparate members of the Democrat caucus together should not be underestimated, and this challenge will likely constrain the scope of changes that can be expected. Similar to our advice last year, this simply suggests investors should avoid putting too much emphasis on their ability to predict specific political outcomes, and should avoid drawing excessively drastic conclusions as to the probability of radical political or economic change. Instead, they should work on the presumption that we are likely to see a range of somewhat left-leaning policies, with a general tendency to somewhat higher taxes and increased regulatory influence, but the more radical proposals being floated are unlikely to be delivered. As is usually the case, focusing on broader economic outcomes and the fallout from COVID-19 is more likely to be a worthwhile use of time and attention in market terms than attempting to become a political pundit. A good measurement of this is the degree to which the program enacted varies from that being discussed during the height of the campaign of 2020.

INFLATION EVENTUALLY?

Investors worrying about inflation can seem like the boy who cried wolf – and the audience is sick and tired of hearing him yell. Skeptics would reasonably ask if inflation had not appeared over the last ten years, when would it come? Have wolves become extinct, or are they simply hiding, biding their time (very, very patiently, mind you) and waiting to come rushing out the moment the last inflation-driven investor turns her back? This is likely to be important during 2021. Monetary policy has certainly not become any tighter, and governments have been generous in a wide range of novel ways. At the same time, the economic disruption from COVID-19 remains significant, unpredictable, and growing: the effects on supply chains are likely to be important, and the effects on the ability of both consumer and business to generate demand are also likely to be impacted. Does this all add up to the possibility of resurgent inflation – or worse, its ugly cousin stagflation? That is certainly possible, and the chances are high enough that investors should remain focused on the possible impact of inflation on their portfolios. But at the same time, it is difficult to get clarity as to the exact inflationary mechanism that is supposed to drive this effect, and the underlying damage to the economy combined with the existing technological and other deflationary mechanisms that have been in place for some time mean that continuing low inflation remains a high probability. Investors should likely work on the base case that inflation will remain low, while at the same time working on understanding the possible impact they might suffer if this is, in fact, the year where the wolf returns for reasons other than short term technical base-effects caused by the 2020 downturn. We expect that PCE, the Fed's preferred measure of inflation, will remain on a sustained basis below their long term target of 2% during 2021.

FUNCTIONALLY FOCUSED THINKING

Portfolios are often designed as a single unit: looking at the asset allocation of the portfolio as a whole is simple, clear, and accurately describes the top-line level of outcome the investor achieves. However, taking a more functionally focused approach to the portfolio can provide insights for the investor, and can also help the investor think more clearly about the decision-making process they use. The underlying idea is for the investor to set money aside in highly liquid investments (often cash and short-term bonds, although there is an opportunity to take some credit risk in this space if desired) to defease the expected cash flows out of the fund over the next few years (three or four, maybe). The balance of the portfolio can then be invested for long-term growth, often in illiquid investments, and in a more liquid diversifying sleeve that allows for rebalancing and diversification of the risk in the growth sleeve. This structure can allow the investor to take meaningful risk in the growth portfolio, while feeling comfortable that this risk will not endanger the next few years of payments. The behavioral consequences of this thinking can be beneficial – the comfort supplied by the short-term liquidity pool can allow enough risk to be taken in the growth sleeve to raise the total expected return of the whole portfolio above what might be seen as achievable for a more traditionally constructed portfolio. This approach is worthy of consideration, although it does represent a significant change in the type of portfolio being constructed, and therefore needs careful consideration and modelling. Direct measurement of success of this idea is difficult, but including this idea in the broader discussion is likely to be worthwhile as long as a simple 60/40 portfolio produces an expected return lower than that needed by the particular investor, something that is likely to be the case for the significant majority of institutional investors in the US.

CRYPTO-CONFUSION

Crypto-currencies have been on the investment landscape for a number of years, with few institutional investors quite sure how to approach the space. The underlying concept of crypto-currencies is unfamiliar, the legal framework around them is unclear, the practicalities of purchasing and holding them are only beginning to be addressed, and discussions around how to value them often sound more like religious arguments than professional investment conversations. Most important over the last few years has been the regulatory uncertainty around the space: there was the possibility for some time that regulators would treat them in a way that could cause significant regulatory problems for those holding or transacting in crypto-currencies. Over the course of the last couple of years some of these broader problems have begun to be worked through, and it is increasingly likely there will be some long-term future for the space. Finally, in the more recent past a number of serious institutional investors have begun to allocate to crypto-currencies. All-in-all it is beginning to appear more likely that some exposure to crypto-currencies may end up in fiduciaried portfolios over the coming years. But this does not mean we would recommend investors allocate to this space during 2021. Even if there is a chance that doing so could result in a significant gain, there is also the chance of the inverse, and many elements of professional investment in this space remain unclear. Instead, we would suggest investors slowly become more familiar about the space over the coming few years. There may come a time when the infrastructure, regulations and general understanding are robust and clear enough for large scale institutional investment in crypto – but that time is unlikely to be 2021. We do not expect to see clear guidance by regulators that crypto-exposure is an appropriate investment for fiduciaried institutional assets during 2021, and this provides us with a good measurement of the success of this idea.

CHINA ISN'T GOING AWAY

During the 2016 election there was a hugely popular video on YouTube that consisted of a series of clips of Donald Trump saying "China" edited together: it lasted for 3 minutes, and as I write had nearly 20 million views. At the time this was such an anomalous view (that China was more competitor than partner, more opponent than friend) that it was a matter of comedy. Four years later it can be easy to forget the degree to which the center of gravity of this discussion has shifted towards the view expressed by President Trump — and to miss the fact that this view is no longer unique, but also no longer particularly partisan, even if countered by an equally strong view that the relationship with China should be a strong one. There are China-skeptics as well as Sinophiles in both major parties, and while the Biden administration may well take a more positive view of the relationship than the Trump administration did, the old days of happy unconcern over the nature of the relationship are likely gone. China is likely to continue to grow at a rapid pace, to continue to try to expand power and influence around the world, and to be focused on improving the standard of living of the Chinese people. It will remain an extremely important market and counterparty for the U.S. and other major world powers. Questions about human rights, intellectual property rights, and the nature of participation in the international political and business community are likely to remain on the agenda, however. China isn't going away — but neither are questions about the appropriate relationship with China. Investors need to be aware of the opportunities available there, but need to be sure they are capturing them with their eyes open, and aware of not only the nature of the investment they are making (is it alpha or beta, what are the characteristics of the investment, how does it fit within the investor's ESG framework and so on) but also how it can go wrong. The underlying idea here focuses on continuing tension between the U.S. and China — while we may see a moderation of rhetoric, we are unlikely to see a reversal to the policy stance of the last 20 years relative to China.

THINKING HARDER & BETTER

Our final topic focuses on how to make decisions: 2021 is likely to be no easier a year than 2020 was, and investors will have to try to form a clear-eyed picture of the future in a changing environment. This requires clear thinking, and practicing the skills required to think clearly is something that will help any investor make better decisions. As an example, I think back to the period around the turn of 2019/2020, and the way we approached the question of the likely impact of COVID-19 on markets. At Verus we have a daily morning meeting — we had discussed the rise of a new disease in China in that meeting towards the very end of December, and were concerned even then that it might have some impact on the economy, at least in China. The discussion that was happening in the marketplace, however, assumed any effect of COVID-19 would be similar to that experienced with SARS. When using that as a model, even the analysts who were covering the issue seemed very comfortable there was likely to be minimal impact: SARS, after all was localized in spread. A number of us were still worried that this was failing to capture the whole picture. Rather than try to turn ourselves into 6-hour-experts in virology and produce a more complicated model, we took a different approach: assume SARS was a good model for COVID-19, but set a simple trigger test (in this case a rate of growth test) where we could reasonably assume the proposed model was no longer valid. Invalidating the SARS model didn't give us a different, more accurate model (that would be very hard), but it did allow us to identify that COVID-19 and SARS were very different (and that the coronavirus was likely to be much more infectious than SARS). We came to that conclusion by some time mid-January, and were able to adjust portfolios accordingly, leaning out of risk well before the downturn happened. The drivers of this decision were simple: reading broadly about global news (and not just market news), thinking about what the news might mean, building candidate models of the world and setting tests for them which could help identify which models are working and which are not, and then acting on the basis of what we learned. Being careful not to over-stretch is important too — in this case setting a simple test to invalidate the current popular model was an achievable task that allowed us to be comfortable adjusting portfolios, while creating a more accurate complex model would have been much more challenging, even though the resulting portfolio behavior would have been identical. What should investors do, then? Simply try hard when talking about outcomes to think of multiple possible scenarios, and a range of things that might happen, while being careful to challenge the assumptions they bring to the table. Being careful to avoid assumptions and instead to focus on data is important – and hard – but investors who successfully do that should have a better time during 2021 than those who don't. This idea is, I recognize, difficult to measure independently – but focusing on this approach to decision making will likely help any investment team or Board that adopts it.

Conclusion

The output of this exercise is a set of things I believe are worth concentrating on during 2021, and mostly involving things that can be measured at the end of the year. So much of the news-flow during the year is likely to be unpredictable, and so much of the economic impact of COVID-19 is, at this stage, unknowable. The keys to this year, then, are likely to be flexibility, careful decision making, rigorous focus, and an understanding that while there is a time to capitalize on opportunity, there is also a time to be careful, and to ensure decisions are made with deliberation rather than haste. 2021 is likely to be one of those years.

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