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Diversity of Time Horizons

Global Matters Weekly

1 November 2021

– **Mark Wright, CFA**

A commonly accepted definition for market efficiency is "the degree to which market prices reflect all available, relevant information". Given the speed with which news is now disseminated around the world, along with the rapid growth in algorithmic trading, one might expect markets to be reasonably efficient.

That is certainly one way to explain the wild oscillations in equity markets last year. These violent swings made the volatility associated with the Global Financial Crisis (GFC) look tame in comparison. In February and March last year, global equity markets took less than 5 weeks to erase all of the gains they'd grinded out over the previous 3 years. They then went on to reach all-time highs just a few months later in August, before bouncing higher again post 'Pfizer Monday' in November[1].

Are these extreme moves simply an efficient equity market rapidly incorporating into prices the changing economic landscape - the lockdowns that hurt corporate profits, the subsequent financial support from the governments and central banks, and then the economic boom thanks to the discovery of a new vaccine?

Probably, to some extent. However, arguably of greater significance is the myopic, irrational behaviour of market participants driven by fear (and then greed).

My colleague, Gary Moglione, touched on this in his article a few weeks back in which he cited one of Warren Buffett's most famous quotes that far too many investors forget, "Be fearful when others are greedy and greedy when others are fearful". I am going to introduce a new concept that we take advantage of called, "diversity of time horizons", a phrase coined by Lyrical Asset Management with whom we invest in North America.
I've outlined below some examples from our investment portfolio that demonstrate how irrational investors can be at times and the extent to which time horizons can diverge.

The direct UK equity portfolio we manage traded at about 5x forward earnings in the middle of March last year[2]. Granted, those earnings forecasts lagged reality at the time, but in

> **"Be fearful when others are greedy and greedy when others are fearful"**

the grand scheme of things, it meant the UK equity portfolio was effectively trading at around 5x times earnings that are achievable in more normal times. Sounds like a bargain and, indeed, it was.

Those valuations were so low that they could not have been the result of anything other than short-sighted, irrational investors, who considered only the imminent lockdowns and failed to look further ahead to the strong likelihood of central bank or government action. Not to mention neglecting to consider a return to more normal times from the discovery of a new vaccine.

Admittedly, the timing of any central bank or government financial support was uncertain, as was success on the vaccine front, but this is a great example of diverging time horizons and the sort of opportunity it can present for investors such as ourselves and our friends at Lyrical Asset Management.

Was it really unrealistic for the patient investor to assume that central banks and governments would take preventative action against the financial system imploding and the economy collapsing? Or that a new vaccine would be discovered within a few years which would aid a recovery in corporate earnings back to those achieved in more normal times? I don't think so.

Let us not forget, it wasn't much more than 10 years or so before the pandemic that central banks and governments were last put to the test during the GFC. There was also a vast amount of research being undertaken across the globe to find an effective vaccine against Covid-19; by 8th April 2020, there were already 115 vaccine candidates.[3] This was all information the market was aware of.

One could argue that share prices reflected the prospect of equity dilution, because companies would need to issue equity in order to shore up balance sheets. Therefore, even

[1] *Bloomberg Finance L.P.*
[2] *Bloomberg Finance L.P./MGIM*
[3] *The COVID-19 vaccine development landscape (nature.com)*

if historic earnings were achievable once more, those profits would be spread more thinly across a larger number of shares.

The reality is that, out of a portfolio of 20 names, only one of our direct UK equity holdings ultimately raised equity last year as a consequence of the pandemic. This was because balance sheets were strong enough in the first instance and central banks and governments had acted quickly to limit collateral damage. Again, this was information the market had in its possession when the direct UK equity portfolio was still trading at a paltry 7x earnings towards the end of April[4].

Turning to specific stock examples, the equity of companies such as Halfords, the cycling and motor accessory retailer, traded as low as £100m on 13th March[5] - just 2x historic earnings[6]. This was despite the company having a healthy balance sheet. Even by late March, the equity was valued as lowly as £150m[7], despite the Government having already announced its Coronavirus Job Retention Scheme on 20th March and despite Halfords having been deemed an 'essential retailer' and thus able to open its stores.

As the share price recovered, the market capitalisation of Halfords peaked at £870m[8], a nine-fold return from its lows in March 2020 when we were adding to our position. In their 2021 financial year (12 months to 31st March 2021), the company generated cash available for distribution to shareholders that was one and a half times that at which the market had valued the entire equity just over 12 months prior – a 150% free cash flow yield![9]

As contrarian investors, we relish the opportunity to take advantage of market inefficiencies such as those witnessed last year, and we look forward to more opportunities in the future, as a result of diverging time horizons and irrational investor behaviour. In our day-to-day portfolio management, we see little evidence that equity markets are becoming any less inefficient. Long may that continue.

[4] *Bloomberg Finance L.P. / MGIM*
[5] *Bloomberg Finance L.P./ MGIM*
[6] *Bloomberg Finance L.P.*
[7] *Bloomberg Finance L.P./ MGIM*
[8] *Bloomberg Finance L.P. / MGIM*
[9] *Halfords FY21 results*

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The **Marketplace**

- Global equities rose 0.8% last week
- Iran and the EU will stage negotiations to restore the 2015 nuclear deal, signalling prospects for Iranian oil supply to return to the market
- Brent crude fell -1.3% over the week to $84.4 a barrel
- Gold fell -0.5% to $1783.4 per ounce.

Market **Focus**

US

- US equities rose 1.3% last week
- GDP grew +2.0% in the third quarter, missing estimates of +2.6%, its slowest rate since the pandemic recovery began
- Initial jobless claims saw a fresh post-pandemic low of 281k vs expectations of 288k
- US consumer confidence for October jumped to 113.8 from 109.8 in September, ahead of expectations of 108.0
- Chicago Fed's National Activity Index declined to -0.13 vs 0.20 expected
- The Dallas Fed Manufacturing Activity Index rose more than expected in October to 14.6 (vs 6.0 expected)
- New home sales for September came in at 800k, surpassing estimates of 756k
- President Biden revealed a new social and climate spending framework containing $1.75trn in spending measures as well as revenue-raising offsets.

UK

- UK equities rose 0.5% last week
- The Debt Management Office revised its gilt sales until fiscal year end from £252.6bn back in April to £194.8bn, below market estimates of £219.6bn
- During the budget and spending review, Chancellor Sunak reported the UK is to see the fastest growth since 1973, forecasting growth rates of +6.5% in 2021 and +6.0% in 2022.

Europe

- European equities returned 0.8% last week
- Germany cut its growth forecast for 2021 from 3.5% in April to 2.6% on the back of supply chain issues
- German GfK Consumer Confidence came in at +0.9 vs an expected decline of -0.5
- Spain reported a +2.0% jump in October inflation vs forecasts of +1.2%
- German CPI came in at +0.5%, beating forecasts of +0.4%.

Asia/Rest of The World

- The benchmark Global Emerging Markets index returned -2.2% last week
- Japanese equities were flat over the week
- Chinese equities fell -4.3% last week
- Sentiment in China is being clouded by the news of another developer, Modern Land China Co., defaulting on a bond payment
- China's official manufacturing PMI fell to 49.2 in October, from September's reading of 49.6 (vs 49.7 expected). The non-manufacturing PMI also fell to 52.4 from 53.2 in September
- The Caixin manufacturing PMI came in at 50.6 for October, back into expansionary territory
- Japan's services prices declined to 0.9% in September from August's 1.0% gain
- China's September industrial profits saw a +16.3% year-on-year growth, despite rising commodity prices
- The Bank of Canada ended its quantitative easing programme earlier than expected and shifted forward the expected timing of interest rate hikes. The 2y yield on sovereign bonds saw the largest one-day increase since 2009 with these moves reverberating around the world
- The Bank of Japan cut its forecast for this fiscal year's growth due to supply chain issues and the Covid surge in the summer.

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Asset Class/Region	Currency	Currency returns			
		Week ending 29 Oct. 2021	Month to date	YTD 2021	12 months
Developed Market Equities					
United States	USD	1.3%	7.0%	23.6%	40.6%
United Kingdom	GBP	0.5%	2.3%	16.4%	35.5%
Continental Europe	EUR	0.8%	4.8%	21.1%	41.2%
Japan	JPY	0.0%	-1.4%	13.1%	26.8%
Asia Pacific (ex Japan)	USD	-2.0%	1.7%	-0.4%	14.1%
Australia	AUD	-1.2%	-0.1%	14.7%	27.3%
Global	USD	0.8%	5.7%	19.4%	38.9%
Emerging markets equities					
Emerging Europe	USD	-1.5%	3.7%	27.8%	71.4%
Emerging Asia	USD	-2.3%	1.3%	-2.9%	9.8%
Emerging Latin America	USD	-1.2%	-5.3%	-10.6%	20.2%
BRICs	USD	-3.3%	1.4%	-5.3%	3.8%
China	USD	-4.3%	3.2%	-14.0%	-11.0%
MENA countries	USD	-0.8%	2.8%	31.2%	42.7%
South Africa	USD	-4.2%	-0.1%	4.0%	28.1%
India	USD	-2.4%	-0.6%	24.5%	52.0%
Global emerging markets	USD	-2.2%	1.0%	-0.3%	15.2%
Bonds					
US Treasuries	USD	0.6%	0.0%	-2.8%	-2.7%
US Treasuries (inflation protected)	USD	0.0%	1.2%	4.6%	6.9%
US Corporate (investment grade)	USD	0.8%	0.2%	-1.0%	2.0%
US High Yield	USD	0.1%	-0.2%	4.4%	10.5%
UK Gilts	GBP	2.5%	2.2%	-5.6%	-5.2%
UK Corporate (investment grade)	GBP	1.4%	0.6%	-3.2%	0.0%
Euro Government Bonds	EUR	-0.3%	-0.7%	-3.6%	-3.5%
Euro Corporate (investment grade)	EUR	-0.1%	-0.7%	-1.1%	0.0%
Euro High Yield	EUR	0.1%	-0.6%	3.1%	8.0%
Japanese Government	JPY	0.1%	-0.1%	-0.2%	-0.2%
Australian Government	AUD	-1.5%	-3.5%	-5.3%	-6.0%
Global Government Bonds	USD	0.1%	-0.3%	-5.9%	-3.6%
Global Bonds	USD	0.1%	-0.3%	-4.8%	-2.0%
Global Convertible Bonds	USD	-0.2%	1.5%	0.2%	11.1%
Emerging Market Bonds	USD	0.5%	-0.1%	-4.3%	1.4%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 29 Oct. 2021	Month to date	YTD 2021	12 months
Property					
US Property Securities	USD	0.3%	7.7%	31.6%	49.4%
Australian Property Securities	AUD	-2.7%	0.4%	12.1%	25.3%
Asia Property Securities	USD	-1.7%	0.2%	2.0%	13.1%
Global Property Securities	USD	-0.6%	4.7%	18.3%	36.5%
Currencies					
Euro	USD	-0.8%	-0.3%	-5.6%	-1.0%
UK Pound Sterling	USD	-0.6%	1.6%	0.2%	5.9%
Japanese Yen	USD	-0.5%	-2.3%	-9.5%	-8.2%
Australian Dollar	USD	0.6%	4.1%	-2.4%	7.1%
South African Rand	USD	-3.3%	-1.2%	-4.1%	7.4%
Swiss Franc	USD	0.0%	1.9%	-3.5%	0.0%
Chinese Yuan	USD	-0.3%	0.6%	1.9%	4.8%
Commodities & Alternatives					
Commodities	USD	-0.3%	5.4%	43.6%	67.3%
Agricultural Commodities	USD	1.8%	3.8%	29.2%	46.0%
Oil	USD	-1.3%	7.5%	62.9%	124.1%
Gold	USD	-0.5%	1.4%	-5.9%	-4.5%
Hedge funds	USD	0.2%	0.9%	4.8%	10.0%

Source: Bloomberg. Past performance is not indicative of future returns

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The Rex Building, 62 Queen Street, EC4R 1EB

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