Newsletter – Third Quarter 2023

The computer says…

Barely a day passes without some reference to the power of Artificial Intelligence (AI) and the pending demise of humans. With this in mind, I've searched the internet (without the assistance of ChatGPT mind you) to generate an apt song that conveys the evolution of computing. One such song stood out given it's on my playlist, part of my upbringing and a nod to what we are facing in today's digital world… *Video Killed the Radio Star* was a track by Buggles written in 1980 and the lyrics highlighted the changing tides of technology

When giving thought to this quarter's newsletter, I was tempted by the idea of "outsourcing" the idea generation element to a machine learning tool such as ChatGPT. I simply type in what I'm looking for (in this case The Quarterly Investment Newsletter) and voilà, it spits out the text in a matter of seconds. Imagine my disappointment on leaving things to the eleventh hour only to discover that the computer seemed incapable of delivering anything credible. Disappointment then turned to jubilation as perhaps I will not be replaced by a computer or an algorithm able to produce something of better quality in a nanosecond at zero cost… In the interests of fairness (but not transparency), one of the paragraphs in the newsletter is an AI creation, answers on a postcard as to which it may be!

All Hail Artificial Intelligence (AI) the all-conquering technology

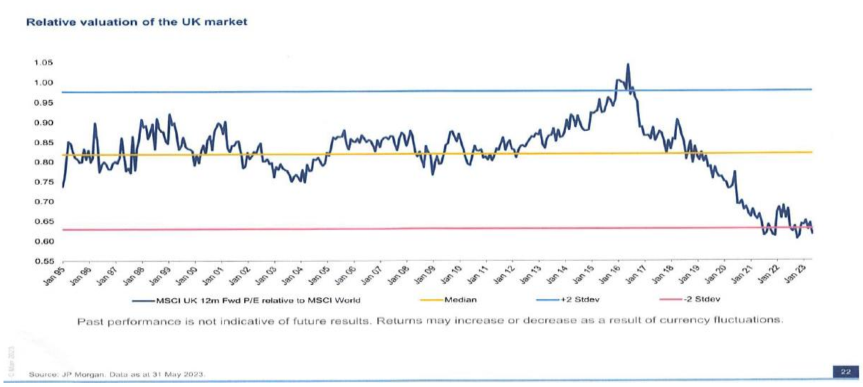
In layman's terms, AI is the structure of super computers to facilitate and perform many human-like tasks. This orchestration of various complex procedures into simpler tasks reduces human error and is already applied to collection of data, easy processing and superior analytics, especially those with large volume of data sets. The key benefits as generally agreed are:

Reducing human error, automating repetitive tasks and processes, handling big data, quick decision making, performing risky and dangerous tasks, improving workflows, assisting medical applications, 24/7 availability at near zero cost.

However, a recent article in the Guardian alerted its readers to the health damage that AI could inflict on millions of humans, the journalist called for a halt in the development of artificial intelligence until it is regulated. This is somewhat counter intuitive to what I recognise as being one of the key benefits of AI; the potential to revolutionise the way we diagnose and treat diseases (AI is already mapping human proteins in a 3D format). However, the other side of the coin relates to patient harm, data privacy and security and the way in which AI may impact social and health inequalities (such as the manipulation in people and the use of autonomous weapons). Perhaps the largest risk is how many jobs could be lost to computers – the range estimates from tens of millions to hundreds of millions over the next decade as AI learns and performs all manner of human tasks. Also, how will China develop its own version of AI, given their different value and societal systems?

Hard to throw caution into the wind..

It's been a tough gig as a cautiously minded investor as equity markets seem determined to recover losses from 2022 despite the persistence of inflation and the continued ascent in interest rates. The growing prospect of recession in the western world hasn't dampened investors' reliance on generating abnormal returns from a handful (7 in total) of US technology behemoths which has driven the bulk of US equity market returns on a year-to-date basis. Part of this is salivating over anything that is associated with AI. Nvidia, the US technology company, that is the poster child of AI, saw its share price appreciate over 30% on the day of a positive quarterly update, its market capitalization exceeding $1trn as a result.



We do, however, take solace in the mantra that: price is what one pays, and value is what one gets. For investors this means the price at which you pay for an asset is effectively the best defence against losing money, or in simple terms, buy cheap to win big. With that in mind, below is a chart showing the valuation of the largest US index (S&P 500) on a historical basis.

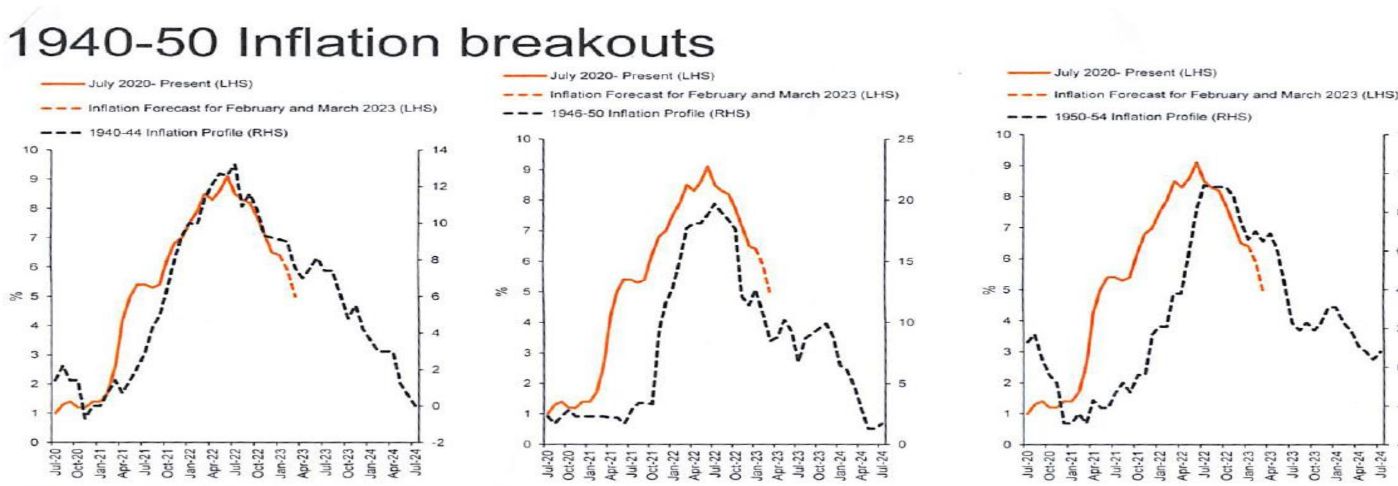
What you can easily identify is that the current valuation of this index puts it at historically high levels. On previous occasions this has led to a period of underperformance. Compare that with the chart underneath it, which shows the MSCI UK index valuation over a similar lengthy period. In our opinion this looks like a better starting point.

CEOs – matching pay with performance

I note with some interest (and observations being previously shared) that a CEO of one US bank, that was saved from bankruptcy in the first quarter, received compensation of $131m over the last 3 years, the bulk of which was share-based compensation. This is meant to better align CEOs with shareholders, however in reality it can promote risk taking for short term gains. Annual statements are full of performance targets and stock renumeration and can be complex. Did you know that the CEO of the largest Japanese bank took home $2m in 2022 despite running a bank with $3trn in assets. Does that mean you should avoid US CEOs with large stock based compensations? Not necessarily, as long as the assessment is that the CEO is on "your side". I like the traits that Warren Buffett, the famed US investor, looks for when making new management hires. He looks for Intelligence, Energy and Integrity. With little integrity and lots of energy and intelligence you have someone who is fast and smart and may cheat you. For someone with low energy and high intelligence and integrity, you have someone who is unlikely to take initiative and someone with low intelligence and high energy and initiative will likely work hard but is unlikely to be a problem solver or visionary.

Reasons to be optimistic

We recently attended an investment conference specifically looking at the fixed income world. Whilst 2022 was this sector's *annus horribilis*, the starting point now does look better, especially in light of recent government fixed income auctions which have attracted strong interest given the current coupons (interest rate) above 5%. A presentation by a UK investment manager highlighted UK inflation rate and its current trajectory versus the 1940s and 1950s, which looks uncannily similar. As some of you may know the 1950's onwards provided a boon for anyone owning risk assets (equities and fixed income etc). So potentially this looks an interesting development…



Pensions vs Property – an investor's dilemma

Regurgitating some data from previous missives, the average house price in the UK currently costs around nine-times average earnings. The last time house prices were this expensive, relative to average earnings, was in the year 1876! In the early part of the twentieth century over three quarters of people rented their home and it was not until the second half of that century that home ownership rapidly expanded, peaking at over 70% in the early 2000s when interest rates fell sharply. Over the last five years, ownership rates have fallen back to below 65% due to house price escalation and the unaffordability element.

The last time there was a sustained decline in the house price-earnings multiple was in the second half of the nineteenth century when house prices fell more than 50%. Given this backdrop is it worth considering whether property is better than investments for your pension?

Given that house prices have tended to rise over time, £100,000 worth of UK property 25 years ago would be worth an average of £454,000 today (£580,000 in London and £407,000 in Scotland) is there any need to diversify? That same £100,000 invested into the global stock market would however have grown to £631,000 and, even if you use differing time periods (10,15,20,25 or 30 years), you get the same outcome.

This highlights the importance of having more than one source of retirement income; it's better to have your eggs spread across many baskets, be it property, equities, fixed income, gold, currency or even more esoteric assets (wine, art and other collectibles).

Market Conclusion:

The second quarter of 2023 has presented investors with promising opportunities across various sectors. Technological advancements, renewable energy initiatives, and emerging markets continue to shape the investment landscape. It is essential for investors to stay informed, assess their risk tolerance, and make prudent investment decisions (I couldn't have put it better myself, albeit with some inherent biases and punctuation errors..)

For those of you perplexed about the likely winners in 2023, take a look at this chart which highlights the performance of all the sectors on an annualised basis. The patchwork mosaic is effectively showing the different sector leadership most years. In our eyes this suggests a balanced diversified portfolio is the way forward…

Asset class performance (%)

2018	2019	2020	2021	2022
Global High Yield Bonds 1.9	US Equities 25.7	Asia Ex Japan Equities 21.2	Commodities 41.6	Commodities 41.9
Global Property 1.2	Europe ex UK Equities 20.0	US Equities 16.2	Global Property 28.4	UK Cash 1.4
Global Treasury Bonds 1.1	UK Equities 19.2	Emerging Markets Equities 14.7	US Equities 27.6	UK Equities 0.3
UK Gilts 0.6	Global Property 18.3	UK Index-linked Gilts 11.0	UK Equities 18.3	Global High Yield Bonds -1.7
UK Cash 0.6	Japanese Equities 14.6	Japanese Equities 9.5	Europe ex UK Equities 16.7	Japanese Equities -4.1
US Equities 0.1	Emerging Markets Equities 13.9	UK Corporate Bonds 9.1	UK Index-linked Gilts 4.2	Europe ex UK Equities -7.6
UK Index-linked Gilts -0.3	Asia Ex Japan Equities 13.6	UK Gilts 8.3	Japanese Equities 2.0	US Equities -9.4
UK Corporate Bonds -2.2	Commodities 13.1	Europe ex UK Equities 7.5	Global High Yield Bonds 1.9	Asia Ex Japan Equities -9.6
Global Corporate Bonds -2.7	UK Corporate Bonds 11.0	Global Corporate Bonds 7.2	UK Cash 0.1	Emerging Markets Equities -10.0
Japanese Equities -8.4	Global Corporate Bonds 10.6	Global Treasury Bonds 4.6	Global Corporate Bonds -1.0	Global Treasury Bonds -11.7
Commodities -8.5	Global High Yield Bonds 8.2	Global High Yield Bonds 3.7	Emerging Markets Equities -1.6	Global Property -14.9
Asia Ex Japan Equities -9.0	UK Gilts 6.9	UK Cash 0.2	Global Treasury Bonds -2.0	Global Corporate Bonds -15.3
Emerging Markets Equities -9.3	UK Index-linked Gilts 6.4	UK Equities -9.8	UK Corporate Bonds -3.3	UK Corporate Bonds -19.3
UK Equities -9.5	Global Treasury Bonds 5.5	Global Property -11.0	Asia Ex Japan Equities -3.8	UK Gilts -23.8
Europe ex UK Equities -9.9	UK Cash 0.7	Commodities -26.1	UK Gilts -5.2	UK Index-linked Gilts -33.6

Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amount originally invested. For illustrative purposes only and should not be viewed as a recommendation to buy or sell.

Source: Morningstar as at 30 December 2022. Notes: All Indices in base currency. Indices used: BBgBarc Gbl Agg Corp TR Hdg GBP, BBgBarc Global Treasury TR Hdg GBP, FTSE Act UK Cnvt Gilts All Stocks TR GBP, FTSE Act UK Index link Gilts AS TR GBP, BBGBarc Global High Yield Yld USD, FTSE AllShTR GBP, FTSE EPRA Nareit Developed TR USD, MSCI EM NR USD, MSCI Europe Ex UK NR EUR, S&P 500 TR USD, TOPIX TR JPY, BBgBarc SterlingAgg Corp TR GBP, S&P GSCI TR USD.