The Least Surprising Surprise Sell-Off:

It's almost comical how the sell-off in global stocks that began around the 1st February and is continuing as this piece is being written seems to have caught so many people by surprise. Akin to a poor joke in a US sitcom, the lead up has been painstaking and the delivery is just as bad. But you can't say that you didn't see it coming.

Let's look at some of the clues about what was coming: repeated comments throughout 2017 having been the first calendar year in ten not to have witnessed a 10% correction; comments in this publication about markets climbing the stairs but falling out of the window (with an accompanying picture); the S&P 500 having chalked up a record 402 days without a 5% drawdown; bond yields spiking; retail investors in the US had their largest allocation to stocks since 2000; although not directly comparable, but a gauge on sentiment nonetheless, crypto-currencies are being advertised everywhere on London Underground as the latest easy way of beating the system and making easy money; our own reference to the biggest bubble to be wary of being the bubble in complacency.

None of this is supposed to come across as smug – far from it. Why would we want markets to stop going up virtually in a straight line? Everyone is happier when they are doing that than when they are falling or flat. Reality, unfortunately, determines that the value of one's investment can fall as well as rise, although it's amazing how many people forget that this is the case.

It's how you ***deal*** with market uncertainty that is the key to a good investment manager. There are several strategies that managers can employ, ranging from shrugging their shoulders and blaming the market for the fall (whilst taking all the credit personally when markets have risen, mind) to claiming to have seen it coming for so long they have been ensconced in cash for months beforehand (and subsequently missing any bounce by remaining ensconced in cash for months afterwards). We practice something more practical, and real.

Watch Out, There's A Robot About:

We've been keen advocates of the "if you can't beat them, join them" approach to robotics. Fund management and financial advice are two key areas where robots are forecast to take humans' jobs from them, but like the corner shop owner who, on the day his shop went bust because of online competition, retired in luxury because he'd invested heavily in Amazon shares, we have invested in robotics and automation as a long term global theme. However, the use of algorithms was surely behind the extraordinary acceleration in the February 5th plunge on the Dow Jones as it shed 1,000 points in seconds, only to recover 500 points within the next 15 minutes. This is a sign of automated trades kicking in at certain predetermined trigger points, raising intra-day volatility to eye-watering levels. Interestingly, a Bloomberg article highlighted how a number of the new "robo-advisers" in the US, untested in periods of market volatility, failed to step up when needed, leaving their users unable to trade. Together with the collapse in price of many cryptocurrencies that we've seen since Christmas, the first week of February has been a bad time to be a "savvy" Millennial.

At times like this, there is a lot to be said for good old fashioned human pragmatism, and that's exactly what we see as a main staple of our style of fund management.

What's Changed?:

With so many moving parts and alternatively focussed components to markets in general, it is worth hanging on to certain fundamentals when trying to make sense of it all. Peter Berezin of BCA Research reminds us that "as a rule of thumb, **technical factors drive stocks over short-term horizons of one to three months, business**

cycle developments and financial conditions drive stocks over horizons of one to two years, and valuations drive stocks over ultra-long term horizons of five years and beyond."

It's absolutely crucial to work out what your own aims and objectives are about and how they fit in with this. We, as fund managers, are not traders, but we try to deliver meaningful ongoing annual returns to our investors, and so we are more drawn to the importance of the middle ground, business cycle developments and financial conditions. If we get the annual returns right, the long term looks after itself. However, we can not deal with the very short term whiplash moves that we have witnessed in February, and neither will we try. The very long term investor should perhaps consider passive funds where they make an active decision to buy everything, then hope it goes up over time. Short term traders need a specialist vehicle, plus a lot of luck.

So what has changed in terms of cycles and financial conditions since the end of January? Get this right, and we have satisfied investors.

One of our key strategies lies in identifying themes that are with us for many months into years. As we've alluded to, robotics are with us and are likely to stay. Has the threat of cyber attack diminished? Not that we can see, and so cyber security remains a prominent theme. Is the demand for healthcare in decline? Not with an ageing population it's not, although we need to keep a close eye on political interference around pricing. Are the wealthy refraining from buying luxury goods? Not from the early results we've seen this year, they're not.

So What Of The Economy?:

This is where some clouds are building, but not until later this year. Companies are generally announcing ever-improving profits. Of the 500 companies that make up the S&P index, 45% have reported their fourth quarter results. 80% have beaten consensus EPS projections, while 82% have beaten revenue projections.

These are not figures that herald a recession, but with this many beating estimates, what happens when they disappoint? We've seen in the UK (Capita, Provident Financial to name but two) that disappointing results lead to an absolute hammering for the share price. So things may look rosy now, but what we've seen with market moves in this recent ***technical*** correction could be amplified significantly if the ***fundamentals*** deteriorate, and it is these that we lose sleep about. At the moment, we're sleeping OK.

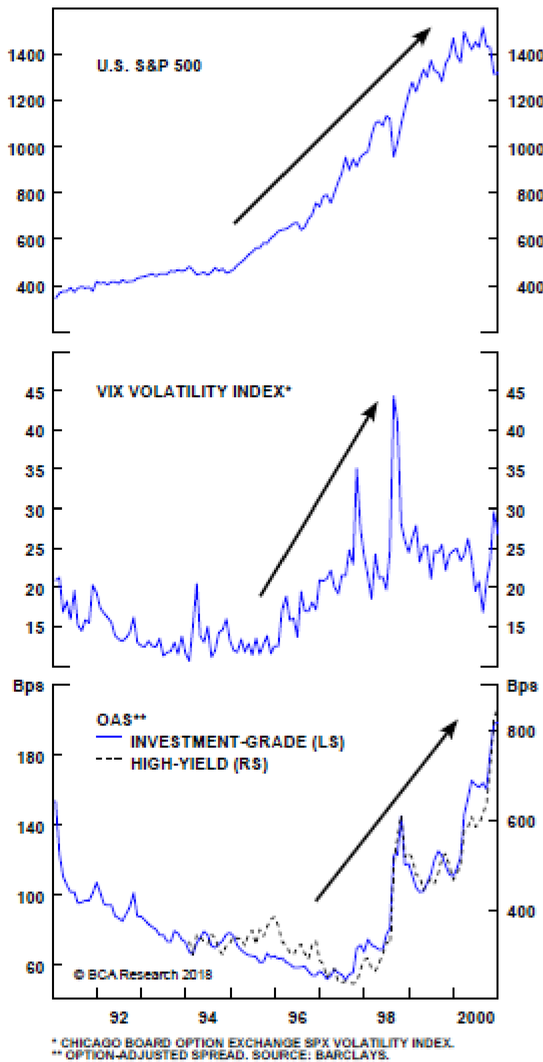
At the start of the year we put a flag on 10 Year Treasury yields as our canary in the coal mine. When bond yields are super low, as they have been since QE began in 2008/9, the risk of holding bonds turns equity-like. At 1% yields, there is very little upside in the value of the bond you own, but the risk to capital should yields rise is skewed so that owning bonds presents the same type of risk to capital as owning equities. As yields rise, however, this risk to capital reduces. Yields typically rise as interest rate and inflation expectations rise too, and this is what we've seen recently in the US.

If yields on 10 year Treasury bonds hit 3% we could see a rotation of longer term investors moving out of a consequently higher risk equity basket into bonds. This could alter our own longer term view on what remains a profitable theme over an expensive one.

In a nutshell, this shows how short term, medium term and longer term factors blend to create puzzles to be solved on a regular basis, and there are times when the short term can change the medium and longer term outlook significantly. In this particular instance we will bide our time to put our shorter term cash accruals to work as we don't think that the medium term fundamentals have changed too much in just a few days.

However, with higher volatility and wider credit spreads accompanying a generally rising equity market, the current bull market is beginning to look increasingly like the one we saw in the late 1990s (see chart below) which, for those old enough to remember, was typified by potentially world-changing advances in technology and a blue sky backdrop fuelled by a bull run that had lasted for most of the preceding decade. We're not there yet, but when we are we'd like human pragmatists looking after our cash rather than robots or woolly-headed "buy everything" advocates.

Volatility Can Increase And Spreads Can Widen As Stock Prices Rise



* CHICAGO BOARD OPTION EXCHANGE SPX VOLATILITY INDEX.
** OPTION-ADJUSTED SPREAD. SOURCE: BARCLAYS.

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