Noise-reducing wealth management

Quarterly Letter

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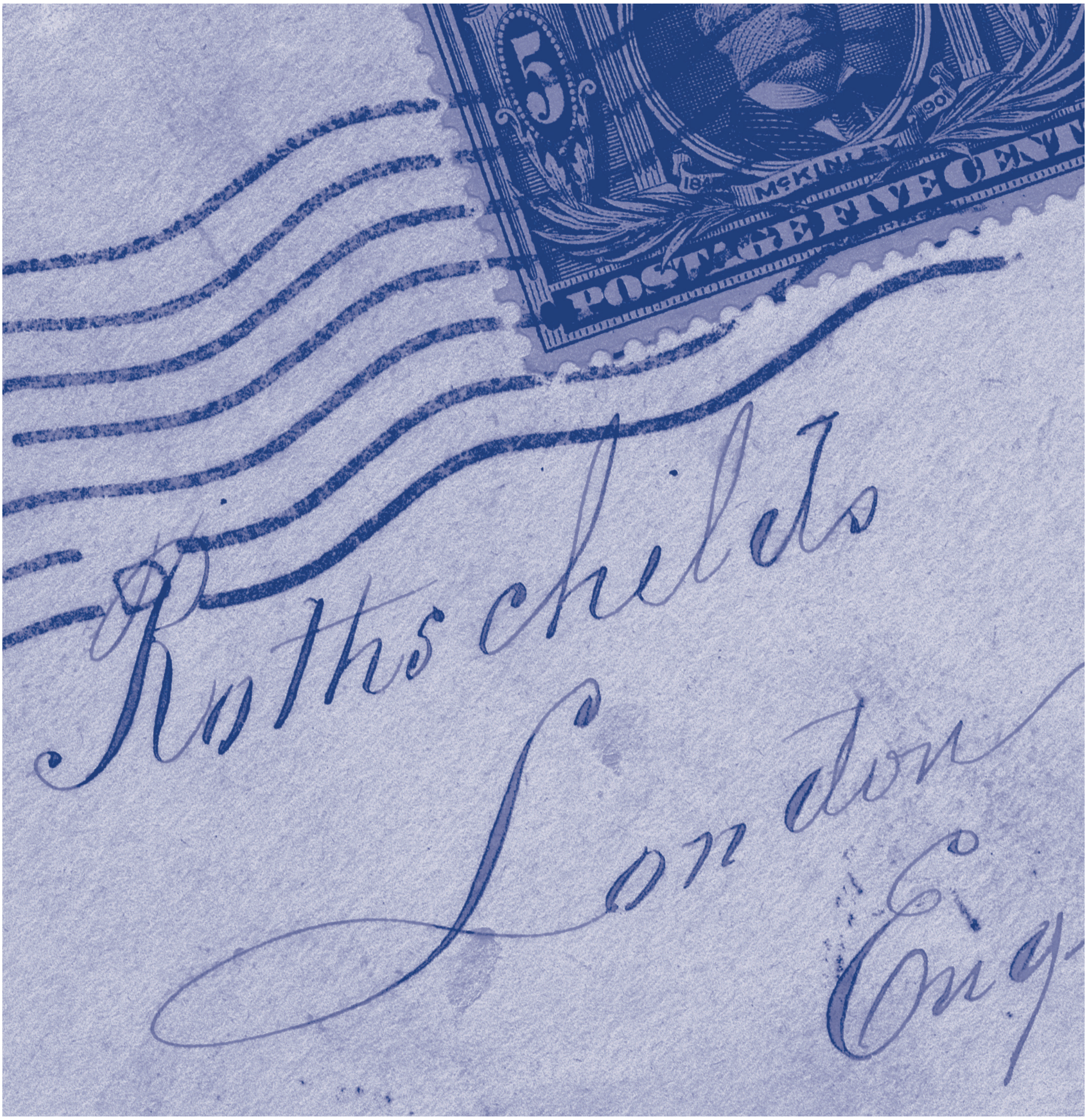

Rothschild
Private Wealth

Cover image:
Envelope from a Presidential 'Thank you' sent to Nathaniel 1st Lord Rothschild (1840–1915), Senior Partner N M Rothschild & Sons, from President Theodore Roosevelt (1858–1919) in 1904.
Courtesy of The Rothschild Archive

Rothschild Wealth Management
New Court
St. Swithin's Lane
London
EC4N 8AL
+44 20 7280 5000
rothschild.com

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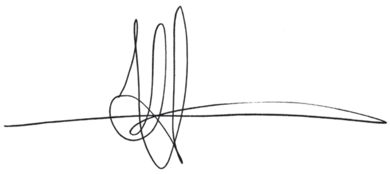
Foreword

In today's world of real time information, 'fake news' and social media, the sheer volume of inputs we experience in our daily lives can seem overwhelming. It is crucial we are able to identify the issues that really matter.

Being well-informed is one thing, and having a view is another – but knowing who to be informed by and about what, in order to make the best decisions on behalf of you, our clients, is key. In this Quarterly Letter, we look at the approach we take to dealing with all these inputs, so-called 'noise', and how we evaluate which indicators are really telling us something and which are just distractions.

If I may, I also wanted to take the opportunity of this letter to congratulate the team here – Rothschild have just been awarded the Private Asset Management (PAM) Award for Client Service for an unprecedented fifth year in a row. I felt my colleagues, both front of house, and behind the scenes deserved some public credit for all their hard work. Despite this success, we know we are not perfect and want to continue to set the highest standards. We are grateful for all feedback, good and bad!

Thank you all for your continued support and confidence and I hope you enjoy this Quarterly Letter.



Helen Watson
CEO, UK Wealth Management

Noise-reducing wealth management

Turn it down!

Background noise is everywhere.

Elevator music, the unwatched TV, other people's phones, a panel debate on Quantitative Easing – noisy distractions all. And investment noise can be costly.

Our asset-managing ancestors had little to distract them from shepherding their flocks but the occasional irrationally exuberant youngster shouting wolf.

The world is busier now, and communication is instantaneous and almost free. Advertising revenue follows eyes and ears. Information and opinions – not to be confused with knowledge – are in excess supply.

Everyone has an opinion on the economy, for example. Most people have several. But there is one area in which ultimately "*nobody knows nuttin'*": the future.

The future is unknowable.

Not in a probabilistic, coin-flipping sense, but profoundly so. Things can happen that have not happened before – an asteroid can strike, interest rates can go negative. And things that have been happening can suddenly stop – the climate can change, bonds and stocks might no longer move in opposite directions.

Which is both a curse and a blessing.

A curse, because investing is all about the future. We invest hoping that the passage of time will see today's value translated into tomorrow's.

A blessing, because it means we can ignore much of that noise.

We see our job here at Rothschild Private Wealth as being to cut through the noise and focus on the things that matter most, allowing us to position clients' portfolios for the longer-term – quietly.

Read (and watch and hear) all about it

As the stream of news is constant – so demand for more content grows and the financial pages are a reliable source of copy.

It's human nature to worry about that unknown future. Life's possibilities are distinctly one-sided: nobody lives forever. It's natural too to want to hear about the latest fashion or fad. We like to flatter ourselves that we live in special times.

Psychologists and economists talk of "loss aversion" and "diminishing marginal utility of wealth" (in plain words: how our pain after losses is bigger than our pleasure after similar-sized gains).

They talk also of "feedback loops" and "extrapolative expectations" – how investors' collective moods are prone to bandwagons, from euphoria to despondency, calling at all stops in between, and all the way back.

And most of us are directly involved in the economy – as employees and employers, spenders and savers.

The numbers lend themselves to sensation. Global GDP is $75 trillion. Financial assets are even bigger – global stock and bond portfolios together amount to roughly $200 trillion. The economy and markets are constantly on the move.

So there is big demand for, and supply of, financial "news". Unsurprisingly, then, there is a lot of it: wall-to-wall 24/7 talking heads, and acres upon acres of newsprint and pixels. Unfortunately, much of this news is noise – and paying too much attention to it can be bad for your financial health.

Show business and your stars

On the supply side, there is plenty for the talking heads to talk about.

Real-time movements in stock and bond markets, currencies, commodities. Economic data releases. Reports, prognoses and policy statements from central banks, governments, think tanks, supranational bodies such as the IMF, the BIS. Elections and referendums, idiosyncratic politicians, geopolitical events.

And the operations of the thousands of quoted companies – often reported in outline several times a year, and in great line-item detail at least annually.

To cap it all, numerous consultancies and investment banks – and yes, private wealth managers – offer regular and ad hoc research and analysis on the above.

All this information is broadcast not just for its own sake – though entertainment (deliberate and otherwise) is indeed part of the game – but because of what it might tell us about the future. Is this a good time to invest, or should we sell? Are interest rates about to rise, and how far? Is a recession coming? Will the yuan replace the dollar? Can Company X maintain its margins for much longer?

Investing is assumed to be ceaseless, perfectible and urgent, with managers constantly reappraising a fluid outlook, fine-tuning unique, "optimal" portfolios in pursuit of table-topping, money-doubling returns. The reality is that very little of that information helps us to see into the future, and there are no unique, optimal portfolios.

The first goal of investment is not to get rich quickly, but to avoid losing what you have to begin with. There are many different ways in which to try to do that. Our approach involves patience.

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Sound and fury, signifying nothing?
It can sometimes pay simply to tune out.

Some years back, Paul Samuelson, the Nobel Prize-winning economist, quipped that the stock market had predicted nine of the last five recessions.

More recently, from Shanghai's opening bell in 2016, global stocks went into a steep decline. By mid-February that year they had fallen by double-digit amounts, and in the case of continental Europe were close to "bear market" territory (defined as falls of more than 20%).

The oil price was falling steadily. The US and Chinese economies were supposedly slowing sharply. A large European bank reported a record loss. The dollar had risen strongly, and financial conditions were said to be at recessionary levels. China had recently engineered a "competitive devaluation". There were geopolitical issues. "Sell everything" was the considered verdict from one analyst.

Then global stocks rallied as unexpectedly as they'd dropped.

Eventually they closed the year up. And we saw that China hadn't really slowed much at all, monetary conditions had not been draconian, and the US had not been on the brink of recession.

More recently, bitcoin's price has flown and cryptocurrency "Initial Coin Offerings" are everywhere as blockchain technology has been seized on as the next big thing in finance. But as in 2016's market sell-off, we suspect that much of what we're hearing in this respect is noise, and ex-post rationalisations of it.

In reality, changes in the investment climate – and the practical implications of technological revolutions – usually evolve gradually, and there can be time to wait and see before acting.

There are exceptions. The surge in oil prices in 1973/4 heralded a decade of stagflation. The 2008 Global Financial Crisis (GFC) froze liquidity and precipitated a dramatic – but brief – economic collapse.

Mostly, though, developments are incremental, and the front pages are telling us little new. The data itself can be incomplete, erratic (it reflects human behaviour after all), and misinterpreted. Some countries matter more to portfolios than others.

There are plenty of game-changing corporate events. Blockbuster products, key personnel moves, lawsuits, M&A activity. But most corporate news is too routine.

Quarterly results for example rarely alter the longer-term trajectory of stock prices. They distract executives from more important matters – like running their businesses. Even when those special once-in-a-decade events occur – OPEC, the GFC, the tobacco lawsuits – and we correctly identify them as game-changers, their investment impact can still be difficult to fathom.

The economy and markets do not work mechanistically, and even if they did, the reactions of central banks and governments would need to be taken into account too.

There is also what we might think of as the "denominator" problem.

Most investments are assessed relative to something else. We can think of the assessment as a ratio: our investment is the top half (the numerator) and the thing it is compared with is the bottom half (the denominator).

For conventional wealth managers the comparison is with an explicit benchmark. At Rothschild Private Wealth we pay more attention to the Consumer Price Index (inflation).

And that "something else" often has the capacity to surprise too. Focusing only on the noisy numerator when the denominator is quietly off to the races is little use.

Investment noise is costly

Most obviously, the noise eats into our time (as in "surfing the internet"). Trying to stay on top of all that information is not easy.

Some people can absorb prodigious quantities of facts and opinions. But in investing, it is not possible to know it all. Much of what matters is unknowable.

Meanwhile, all those forecasts, decimal points and optimisation algorithms can make us overconfident, feeling we know more than we really do. Then when the next crisis comes along we are traumatised.

Less obviously, but perhaps most importantly, reacting to the news can actively damage your wealth.

As long as financial markets exist, emotion will be part and parcel of investing, and our collective emotions tend to follow the business cycle.

When times are good, we are optimistic. When we are optimistic, we spend more, and those good times get better still, at least for a while.

But eventually we've spent enough for the time being. Business turns down, leaving our emotional legs spinning, like the cartoon roadrunner, above a void which has opened beneath our feet.

Similarly, when times are bad we're gloomy, and spend less, making those bad times worse – until eventually our dilapidated cars and production lines need replacing and business gets better, even as we've been miserable.

It can be difficult for even the most seasoned professional investors to keep their emotions at bay.

Buying when you feel sick with worry is not easy (unless we're talking about bonds of course: they tend to do well when people aren't). It's much easier to sell. But the chances are you'll be that worried only after the market has already fallen a long way – and has been loudly reported to have done so. And then, of course, it might be better to buy.

Similarly, selling when business is booming and our stocks have done well – and the talking heads are telling us so, almost as loudly – can be difficult.

The picture changes subtly as our investment horizons lengthen. This may seem an odd thing to say. Didn't we say above that the future is profoundly unknowable?

It is, and the fallacy of induction – reasoning from the specific to the general, believing that because things have always happened they will carry on happening – is always a danger.

But just as we set aside the risk of an asteroid strike, and expect the sun to carry on rising, so there are some long-term economic trends we're willing to use as working assumptions. And the further ahead we extrapolate, the more confident we might feel about expecting those trends to emerge from the background noise.

Rising global prosperity is a well-documented empirical fact we're happy using as a working assumption for long-term investing. Talk of "secular stagnation", or an end to innovation and technological progress, is unconvincing – we see it as part of the current business cycle's background noise.

If we're right, the long-term risks of following our emotions are not evenly balanced: it is probably better to be in the market, invested in the businesses that deliver that rising prosperity, than to be out of it.

Several studies have shown that both excessive trading (errors of comission?), and being out of the market (errors of omission?), can be expensive. Trading costs add up, and holding too much cash is an opportunity cost when stocks are trending higher. In the jargon, realised "investor returns" have lagged "market returns".

As a colleague suggested: at times of crisis, the best investment advice can often be "don't just do something, stand there".

So the costs of listening to that background noise are not confined to excessive trading, though those costs are real enough. Over the longer-term, it may encourage us to spend too much time out of the market. The noise is not just interference – it can give us the wrong message altogether.

Noise-reducing wealth management

So what can we do to help?

We do not downplay market volatility. Investing the proceeds from selling a business or property, at a price fixed for posterity, in constantly-moving securities markets can be unsettling, even for the entrepreneurially-minded. It helps to be prepared. And of course some investments are not equally suitable for all investors.

But we try not to trouble our clients with detailed commentaries on that market noise.

How do we decide what is noise and what isn't? A starting point is to recognise that much market reporting is fanciful.

Assertively anthropomorphic accounts – as in "investors were undecided as the market paused for breath" – need to be kept at arm's length.

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Nor is it an animal. Bull and bear markets are no easier to predict than the common or garden variety.

Some assets and data are intrinsically noisier than others. Stock markets for example are much more volatile than bond markets. A 1% movement in stock prices is less significant than a similar move in bond prices. Similarly, trade statistics are much more volatile than retail sales data. Quarterly corporate profit and loss statements – with their "extraordinary" and non-recurring items – can be noisier still.

In our investment approach, we try firstly to limit our vulnerability to the noise.

William Bernstein, the influential investment writer, has talked of looking for the financial equivalents of "Pascal's Wager", the importance of trying to avoid the sorts of either/or decisions in which one of the payoffs is spectacularly bad – such as betting strongly against inflation when interest rates are already very low.

We also, to borrow an engineering metaphor, try to raise the "signal to noise" ratio in all that financial information – to find ways of ensuring we detect the right message amidst all that background static.

There are perhaps two ways of doing this. We can either try to cancel the noise, or reduce it.

Cancelling it involves tackling each item, ensuring it contains no essential information – just as noise-cancelling headphones cleverly react to each unwanted vibration by setting up offsetting vibrations of their own. But you'll be familiar with the vaguely pressurised feeling that noise cancelling headphones can deliver. Imagine how stuffed our heads would feel if we responded to all that data.

Better instead simply to decide on what matters most, and how, and to concentrate on reducing the noise rather than cancelling it.

So there are certain things we won't usually listen to. At the macro level, these include any talk of Austrian schools of economics, the velocity of money and Tobin's Q. We will not obsess about monthly data points, and may ignore some things (such as the Baltic Dry index, copycat purchasing managers' indices and "alternative" Chinese GDP data) completely.

At the corporate level, we are wary of those quarterly results and public relations guff. Our portfolio managers focus on longer-term trends in market shares, operating margins, cashflow and sustainable return on equity.

Our team also trade relatively infrequently, and have been known to quote Warren Buffett's comment that the ideal holding period for an investment is forever. They also invest in assets which can perform in different circumstances, helping to diversify returns and providing a form of portfolio insurance that can reduce the impact of unpredictable setbacks.

But whether we seek to cancel the noise or reduce it, we think delivering inflation-beating long-term returns requires concentration.

And we can promise to communicate them quietly.

Financial terms

"Austrian schools" of economic thought focus on interest rate formation.

The "velocity of money" is the ratio of nominal GDP to a specified money supply.

"Tobin's Q" is a valuation measure which compares the stock market value of businesses with the estimated cost of acquiring their assets directly.

Pascal's Wager

For some, "Pascal's Wager" is a practical argument for believing in God. If God exists and you choose not to believe in him, the cost to you would be infinite. Pascal's reasoning is often applied to choices in which uncertain outcomes have very one-sided payoffs.

Notes

At Rothschild Private Wealth we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.