Saying goodbye

Quarterly Letter

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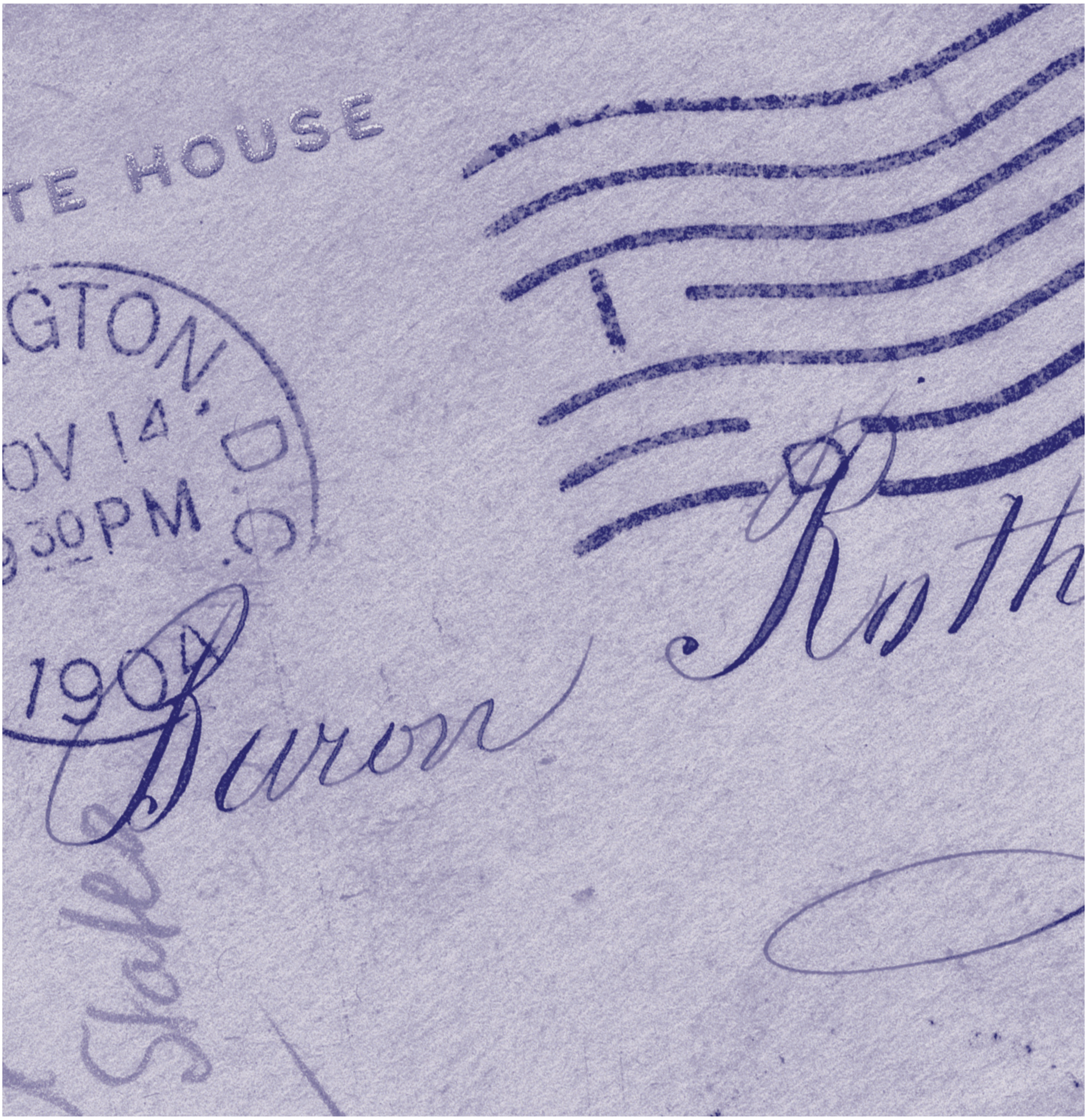

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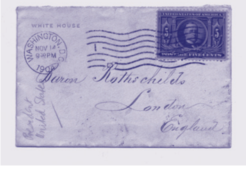

Cover image:
Envelope from a Presidential 'Thank you' sent to Nathaniel 1st Lord Rothschild (1840–1915), Senior Partner N M Rothschild & Sons, from President Theodore Roosevelt (1858–1919) in 1904.
Courtesy of The Rothschild Archive

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Foreword

Every family has its own Christmas rules: presents in the morning or after lunch, always turkey or always goose. This Christmas, my family added another commandment to our list of festive dos and don'ts – no talking about Brexit.

For the sake of family harmony, I am happy to report that Christmas Day and Boxing Day passed without a single mention of the 'B' word. That said, with the deadline to exit the EU getting ever closer, even if Brexit didn't cross my lips it was never far from my mind. Now, with the festivities over and my family's ban lifted, I just wanted to mention two things about this pivotal issue.

The first is that we expect continued uncertainty over Brexit to be one of the factors that could make investment markets volatile over the coming year. Secondly, I want to reassure you that as a business we are fully prepared for wherever the Brexit process may lead.

With our focus on long-term wealth preservation, we believe we are well positioned from an investment point of view. Volatile markets often throw up opportunities. Indeed, we were adding to positions during the market sell-off in the final quarter of 2018. We believe that remaining focused and ready to grasp any opportunities that arise is the best way to prosper in these uncertain conditions.

Saying goodbye to the EU was never going to be easy, nor is saying goodbye to our investments. As well as adding to positions during 2018, we also completed the sale of some holdings that have been in our portfolios for a long time. Taking the decision to sell long-held positions can be difficult, and it is this element of our process that we set out to explore in this *Quarterly Letter*.

I hope you find what follows enlightening. I would also like to wish you and your families a happy, healthy and prosperous 2019.

Helen Watson
CEO, UK Wealth Management

Saying goodbye

Next time you are getting dressed and open your wardrobe, take a good look inside. Glance beyond the clothes that you wear on a regular basis to those jackets, trousers and overcoats that you haven't worn for some time.

At this time of year, with New Year's resolutions ringing in our ears, many of us will be deciding it is time to clear out belongings that have outlived their purpose. For many people, clothes will be high on that list. Wardrobes are often crammed with items that were once treasured but are now just taking up space. However, anyone who has attempted a clothing purge will know that it is often easier said than done.

Even if that jacket is now hopelessly out of fashion, no longer fits or has been attacked by moths, you may be more emotionally attached to it than you realised. A once-prized overcoat has a history – it is part of your past, with associated memories. When you bought that designer handbag you were investing in it, in its power to make you feel good and look great. Rationalising inaction is often the easier option – the leather jacket you bought in your twenties could look great again in your seventies, couldn't it?

Making a decision to sell a once-valued investment can be equally fraught and guided by a similar mixture of reason and emotion. Part of the problem is that the rationale underlying the sale of a company or fund tends to be much less talked about than the premise for buying. Selling doesn't have the positive associations that buying does, whether you are getting rid of an old overcoat or a stock that has started to show signs of stress. Nevertheless, it is a crucial part of the investment process.

Anticipating regret

Selling investments at the right time is a really difficult thing to do well. Firstly, it requires making assumptions about the future. When making decisions against a background of uncertainty, investors often suffer the fear of regret.[1] This is when we anticipate feeling regret if we make the wrong choice, and we take this anticipation into account when making decisions.

Such feelings of regret are particularly strong when we experience a loss. Indeed, loss aversion is a related behavioural bias that stems from the fact that people feel more pain from a loss than the joy they feel from an equivalent gain.[2] In fact, research indicates that the emotional pain associated with a loss is about twice as powerful as a gain of equal size.

In a fascinating experiment into academic performance, loss aversion acted as a powerful motivator.[3] Some children received a financial incentive prior to the test, up to $20, which would be taken back if they didn't meet the test's standards. The money was theirs, they held it, and it was in their pockets. The researchers found that this group saw the biggest improvement in results. They put in the extra effort to avoid the pain of the loss.

Investors adopt a range of tactics to try to avoid unpleasant feelings of loss and regret. One of these ploys is to hang on to poorly performing shares that have lost value – even when the fundamentals signal it is the wrong thing to do. In these situations, we hope that losing stocks will eventually turn into winners and are neither forced to realise a loss nor accept a bad decision. Sometimes things come good, but, if not, more often the pain is delayed and better opportunities are missed.

Research shows that humans also seek out actions that give them pride – we relish the positive sensation when a decision turns out well.[4] This tendency can encourage investors to sell investments prematurely to capitalise on a short-term gain. We get the temporary pride buzz but lose out on future profits.

Together these impulses leave investors in the worst of both worlds, hanging on to losing investments and missing out on strong future returns. Decisions about whether to stick or sell are made even more difficult by the market noise (which we've discussed in previous *Quarterly Letters*) that constantly surrounds us. In such situations, it can be difficult to maintain a clear-sighted approach and to avoid the trap of making instinctive snap judgements. Risk management

[1] *The Journal of Finance*: 'The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence', July 1985.

[2] Daniel Kahneman: *Thinking, Fast and Slow*, 2011

[3] National Bureau of Economic Research: 'The Behaviouralist Goes to School: Leveraging Behavioural Economics to Improve Educational Performance', June 2012.

[4] *The Journal of Finance*: 'The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence', December 1984.

processes can also kick in, forcing decisions that, without explanation, might appear counterproductive.

Let's take a look at Apple to demonstrate what we mean. The technology giant had its initial public offering way back in 1980. Had you invested then you would have paid $22 per share. So 500 Apple shares would have cost you $11,000. If you had held on to those shares, your investment, following several stock splits and including dividends, would as of 1st October be worth around $6.1 million and achieved an annualised performance of 17.8%.[5]

The process that leads up to our sell decisions begins long before a sale is made. In fact, it is baked into our overall investment process right from the start.

Very impressive, but we seriously doubt that anyone who bought Apple shares in the early 1980s still holds them today. In the intervening period, investors would have experienced times when the company's share price surged higher and the urge to sell and cash in on their profit would have been strong. Indeed, the risk management rules would have encouraged profit-taking to prevent this one company from dominating portfolios.

Apple investors would also have had to endure bad news, including management fallouts, failed products and huge share price slumps. Some of the downturns were very severe. For example, Apple's share price was in a downtrend from April 1991 until December 1997. Investors who clung on during that period would have seen their Apple shares lose 82% of their value. A bitter pill to swallow.

At times of difficulty, the temptation to quit and take remaining profits is high. Notably, Steve Jobs himself sold almost every share he owned when he walked out of Apple in 1985. He bought them back again in 1997, but soon sold, explaining he had lost faith in the company.[6]

There are other factors that can muddy thinking even further. Many investors, quite sensibly, take a long-term approach. But the longer investors hold a stock, the more invested they can become in it – not just financially, but emotionally. If an investment has made you good money, the temptation can be to assume that the same will be true in the future, even if the underlying fundamentals have changed and your rational self says that isn't likely. You can end up holding a company longer than is optimal because you have bought unquestioningly into its story.

Overcoming hurdles

At Rothschild & Co, we try to overcome these hurdles by having a clear and robust investment process which guides us as to when we should sell. One that means we don't end up metaphorically hoarding clothes in our wardrobe which should have been thrown out because we were unable to make the necessary decisions.

The process that leads up to our sell decisions begins long before a sale is made. In fact, it is baked into our overall investment process right from the start. It begins with an estimate of forward returns over the next 10 years. We do this for every company we invest in based on a range of expectations about dividend yields, earnings growth and expansion or contraction of price earnings multiples over the period.

To be clear, this isn't one number. Instead, we think in terms of a range of forward returns that differ on the basis of key variables such as growth and margins. We call this range of forward returns the 'heatmap', and it gives us a good sense of the potential upside or downside for each holding.

Every position also has a 'roadmap', detailing our rationale for investment and how we expect a business to perform in the future. Regular readers of our *Quarterly Letters* will have come across several references to roadmaps recently. We don't want to labour the point, but they are a central part of our investment process.

Roadmaps set out our expectations for a business. We conduct regular in-depth reviews to ensure a business or fund is performing as we would expect. We assess every position in the context of forward returns, clearing our assumptions and formally discussing any concerns.

Beyond this, we keep a close eye on business performance by following results, talking to management and gathering first-hand information from all possible sources. If something unexpected happens and a business departs from our investment rationale, this prompts an ad-hoc in-depth review and, if necessary, action.

[5] Bloomberg, 2018.

[6] Cnet: 'It's official: Jobs sold Apple stock', 10th August 1997.

We also track market prices, as they can impact forward returns and might present an opportunity to add to a position, trim a holding or even sell. That doesn't mean we react thoughtlessly to market noise. Instead, when market prices do shift sharply, we rationally and – we hope – coolly analyse whether there is an opportunity to be seized.

Reasons for a sale

We see all the positions in our portfolios as competing for your – our clients' – capital (as an aside, this is also our own capital, as we invest alongside our clients). This encourages us to methodically check our assumptions and constantly consider whether we are positioned to achieve the best results.

Broadly, there are three factors that can prompt us to sell an investment. In no particular order of importance, we may be motivated to take action if the quality of a business no longer meets our standards, we spot better opportunities or an investment has become expensive.

Quality of business

In this regard, when a business diverges from our roadmap it is a very helpful indicator that something may be amiss. Either we have made a mistake, or the quality of a business has deteriorated.

An example of how we think is demonstrated by our decision to sell out of US-listed National Oilwell Varco (NOV). NOV is a provider of equipment and components to the oil and gas industry, which we exited in February last year.

We first invested in NOV three years earlier during an oil price downturn. At the time, our research suggested it was exactly the type of business we like to own – it had an almost monopolistic grip over its industry and was led by a management team we admired. We believed that the oil price slump and recession in the oil and gas industry allowed us to acquire shares of the business at a significant discount to intrinsic value.

However, during one of our subsequent annual reviews we conducted further due diligence, looking again at the sensitivity of the business to offshore oil and gas market activity. This led us to revise our estimates of forward returns and it became evident that the range of potential outcomes was wider and more uncertain than we originally thought.

In particular, we concluded that the demand and supply dynamics in the industry could overwhelm the good work the business and management were undertaking. As a result of our reassessment of the facts, we changed our assumptions and had to admit we had made a mistake. It's not like NOV became a bad business overnight – it remains a well-run company in a challenging environment. Think of a wagon-wheel manufacturer as Henry Ford's first Model T rolled off the assembly line. NOV, like the wagon-wheel manufacturer, is still a fine business, but not one we would rely on for sustained long-term growth.

We see all the positions in our portfolios as competing for your – our clients' – capital.

Better opportunities

Another reason for selling is that there are better opportunities elsewhere. It is often the same with clothes. That dress or suit you bought last season may still fit reasonably well, may still be in pretty good condition, but the new dress or suit you have your eye on fits just that little bit better, looks that little bit finer.

Back to what we know best – investing. This is where the forward returns heatmap can be really useful. Overlaying heatmaps of different businesses or even industry sectors can highlight disparities that we can use to our advantage.

Recently we sold our consumer staples holdings (a metaphorical clear out), which included the sale of Unilever, Diageo and Nestle. Over the many years that we had invested in these household names they had produced very healthy returns and we still think they are high-quality businesses. However, we were prompted to act following full reviews of each business's competitive position and valuation. These confirmed key factors that persuaded us to invest in the first place were still in place, but also highlighted a number of headwinds to future revenues and margins. In clothing terms, they just weren't fitting as well as they had.

For example, in Diageo's case, our review highlighted the potential threat of changing consumer tastes. Global spirits consumption has been weakening over recent years and is now only modestly positive. Increased competition from the likes of craft distilleries and new Scotch whisky producers are eating into Diageo's market share.

Such issues, allied to an elevated valuation, convinced us that we needed to reduce our expectation of forward returns. The same was true for Unilever and Nestle. In each case, we concluded that a lot will have to go right in terms of growth and margin improvement to get 7-8% returns from these businesses at current valuations.

By contrast, based on reasonably conservative assumptions, we expect mid-teens forward returns from the likes of Admiral, Ryanair and Charter. The clear conclusion was that clients' capital could be better deployed elsewhere.

Valuation

A third reason for selling is when an investment becomes outright expensive. This is probably the trickiest one to evaluate. The danger is that you sell a company believing its shares are overvalued only to see its price go higher and miss out on future compound returns.

Many investors rely on the price–earnings ratio as a measure of value, but it can be deceptive. Again taking the example of Apple, in 2005 it had operating earnings of $1.6 billion and was valued on a price–earnings multiple of 34. On conventional valuation metrics, it seems expensive.

Understanding why investors find selling difficult and often make poor choices can help us to improve our own decision making, but it's not enough on its own. We believe that one needs tools and processes in place to overcome these difficulties.

However, Apple's earnings have risen very sharply since 2005, as has its share price. Today, the operating earnings are $70.6 billion, but the price–earnings multiple has fallen to 15 times. Since 2005, shareholders have earned an annualised return of 28%.

The important lesson to take from this is that something that might appear expensive at first glance may actually turn out to be good value over the longer term. This is particularly the case when companies earn high returns on capital and have a long runway ahead.

That is one of the reasons why we always try and focus on the 'real value' of a business and don't rely on simple valuation metrics. The higher the quality of the business and the higher the growth rate, the more likely we are to hang on to a stock that others might deem expensive. We wait to benefit from long-term compound growth.

Conclusion

For clarity, we have separated out these three different reasons for selling, though often a sell decision is driven by a combination of these factors. Risk management and diversification are important parts of our focus on wealth preservation. Consequently, we have limits to our position sizes. That means occasionally it is prudent to trim back our positions in holdings that have performed particularly well.

By maintaining a clear discipline we are able to respond to changed circumstances promptly and with conviction. Understanding why investors find selling difficult and often make poor choices can help us to improve our own decision making, but it's not enough on its own. We believe that one needs tools and processes in place to overcome these difficulties.

We hope this gives you a better understanding of the thinking and processes that underlie our selling decisions. Not, of course, that it helps to solve the dilemma we raised at the start – clearing out your wardrobe.

Or maybe it does? Perhaps applying similar principles to those above is the way forward. Sifting on the basis of quality isn't a bad place to start. That raincoat may have been the best available when you bought it, but if it is looking a little worn at the seams it is probably time to sell it or bundle it off to the charity shop.

Thinking of valuation, don't assess everything by what it costs in monetary terms. Throw things out because you no longer value them in the broader sense of the term, not simply based on the price you once paid. Finally, if you have replaced a once-treasured item with something better, don't be afraid to say goodbye. If you've got a new jacket for Christmas, are you honestly going to continue wearing your old one?

As with investment, having a robust process in place when clearing out your wardrobe can save much dithering and disappointment. If you're up to the task, best of luck.

Notes

At Rothschild & Co Wealth Management 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.