Quarterly Letter

Managing uncertainty

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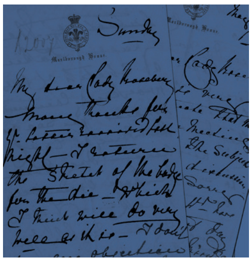

Cover image:
Foreground: Our office at New Court, London
Background: Letters written by Alexandra, Princess of Wales to Hannah, Countess of Rosebery (née de Rothschild) concerning their shared interests in fundraising activities for a number of charities. Courtesy of The Rothschild Archive.

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Foreword

Uncertainty is a permanent feature of the financial markets. It's not something that's new for 2017.

We may have entered a new political era, but investing has not become any more complex than it was 12 months ago.

The investment outlook will always involve ambiguity. There will always be things to worry about. For those who seek them, there will always be reasons to stay on the sidelines.

With financial assets, a preference for certainty often comes at a high price. Consider £10 million in cash in a savings account. Assume it earns 1% a year in interest, and that annual inflation averages 4%. After 10 years, you can be reasonably sure about the outcome. Yet while the outcome is likely, it's not very appealing – adjusted for inflation, and before any taxes, the real value of your £10 million is now just £7.46 million. Your purchasing power has dropped by more than 25%.

Rather than be constrained by what we can't know, our investment approach is designed to recognise and cope with uncertainty. Our focus is on preserving and growing the real value of our clients' wealth, through always-uncertain times, for the long haul.

Helen Watson
CEO, UK Wealth Management

Managing uncertainty

"Investors who confine themselves to what they know... have a considerable advantage over everyone else."
– Seth Klarman, CEO, Baupost Group

After the vote for Brexit, the election of Donald Trump, and the spectacular rise, fall and rebound of Leicester City Football Club, professional forecasters may seem like an easy target. Yet they show no sign of becoming an endangered species.

The human craving for certainty means forecasters will always be with us. Confident, articulate experts can make the future seem more manageable, less risky. The financial media need these experts: bold predictions make for engaging headlines and great TV; uncertainty and doubt lead readers to skip articles, and viewers to switch channels.

In this Quarterly Letter, we set out how we think about uncertainty, and how we approach it when managing wealth for our clients.

Predictability is a matter of degree
Every investment involves making some assumptions about the future.

Take the decision to buy a ten-year government bond. The investor is assuming that the issuing government will honour its promise to pay – to pay the stated coupon (interest) at set dates in the future, and to repay the full face value when the bond matures in a decade's time. Similarly, a decision to allocate capital to a fund manager assumes that the manager can continue to apply skill, delivering returns that more than justify his or her fees.

"Predictability is a matter of degree," to quote Nick Bostrum, Director of the Future of Humanity Institute at the University of Oxford, "and different aspects of the future are predictable with varying degrees of reliability and precision... There is a vast gulf between knowing exactly what will happen and having absolutely no clue about what will happen".

In the financial markets, different types of decision will place the investor at different points within this "vast gulf" between exact knowledge and being clueless. In theory, this is not controversial. In practice, however, we fear many professional investors don't differentiate enough. Admitting uncertainty tends to be seen as a weakness, an obstacle to product sales and marketing. Yet we believe *not* admitting uncertainty is the bigger danger – it's a threat to strong and sustainable long-term performance.

Our investment process is structured to maximise our probability of success in an uncertain world. It is designed so that the most important decisions we must make are in areas where we can have good degrees of confidence about what is likely to happen in the future. Equally important, we are happy to recognise the limits to our knowledge, minimising or eliminating decisions where our degree of confidence can only ever be low.

"One forecast that is almost certain to be correct is that market forecasts are almost certain to be wrong." Bob Seawright, Chief Investment Officer, Madison Avenue Securities.

Making prudent assumptions
To illustrate, consider our approach to protecting clients' portfolios.

We do not know what will cause the next large fall in the stock market. It could be a missile launch in North Korea, a new president in France, a rise in US interest rates, extreme drought, or a large-scale cyber attack. The list of possible causes was endless yesterday, is endless today, and it will be endless tomorrow.

What's more, we also don't know when the next market downturn will take place. We don't know how severe it will be, how long it will last, or the time it will take afterwards for markets to regain the lost ground.

So what can we know? At some point in the future, equity markets are likely to fall by a substantial amount. History shows that stock markets are cyclical, prone to boom and bust. It may be that a shock triggers panic, leading to a sharp drop in prices. Or the fall may be long and drawn out. Markets enter downward spirals: worried sellers push market prices lower, triggering selling, pushing prices lower still, which triggers more selling.

Let's invert the issue: what is the probability that markets will not experience a fall of 20% or more over the next ten years? Having analysed market conditions over recent decades, the probability appears low. Of course, a market fall on this scale may not take place, but we think it is prudent to plan for what could go wrong.

Being prepared involves careful planning for downturns and for large falls in the stock market.

The role of diversification

Following from that, we know that when there is a large downturn, we want to protect our clients from the full impact. Our investment objective is to preserve and grow the real value of our clients' wealth, while avoiding large losses along the way.

This is why we always hold diversifying assets. Currently, we devote around one-third of a representative balanced portfolio to diversifiers. Our holdings here include high-quality bonds, cash, options that rise in value when equity markets fall, and funds that follow alternative strategies[1].

We own these diversifying assets to protect against many possible upsets. Rather than spend time trying to pinpoint causes – whether French elections or North Korea – we seek to cover multiple bases. As a result, our approach is not dependent on us timing the market correctly. Nor does it rely on us accurately identifying specific future risks.

This approach to diversification should make our clients' portfolios more robust.

Seeking resilience

While much in investing is uncertain, there are many areas that are within our control, and we strive for success where it matters most. Once again, predictability is a matter of degree.

In our approach, we concentrate our resources and energy on building in-depth understanding of our portfolios, their component parts, and how both the whole and the parts are likely to perform in different market conditions. In our ongoing research, we focus on deepening our knowledge of the companies, funds and securities we own.

When investing in external funds, we seek out managers who complement our skills and who are disciplined in how they make their investment decisions. Our assessment includes testing the manager's approach to uncertainty. When we invest with a manager, we see it as a partnership, but not as a marriage. The relationship is built on trust and shared values, with an ongoing need for confidence in the manager's sound knowledge and judgement. If we feel, over time, that a manager no longer merits a place in our clients' portfolios, we will redeem our investments and allocate capital elsewhere.

Our equity selection process begins by being clear and specific about the type of companies we are looking for – businesses that can sustain high rates of return over the long term. To do that, a firm must have a sustainable competitive advantage, so that it is able to defend profits against existing and potential new competition over the next 10 to 15 years. We look for firms with good pricing power, robust balance sheets, and business models that are able to withstand shocks and economic downturns[2].

Because these businesses are resilient, we can confidently make reasonable and robust assumptions about their future.

Colgate-Palmolive, a company we added to portfolios at the end of last year, is a resilient business. The company began making toothpaste in the 1870s. Today its oral care business has a dominant position in almost all of the world's major markets, with particularly high market share in much of the developing world[3]. Colgate has a history of delivering high returns on capital. The company is run on a clearly defined and long-standing strategy, a strategy based on using its strengths in innovation and distribution to deliver organic growth. The current management team thinks long term, and has an impressive track record of running the company's operations.

Over the next decade, Colgate should continue to benefit from a number of major structural trends, including global population growth, higher disposable incomes in emerging markets, and growing awareness of the importance of good oral hygiene. (If everyone in the world brushed their teeth twice a day, toothpaste consumption would rise threefold.)

Because Colgate has a sustainable competitive advantage, we feel comfortable with the assumptions that underpin our investment decisions. Put another way, we can have much more certainty about what Colgate's business might look like in 2025 than we can about where the global equity market might be, and how it might perform, in the same year. The same point

1. These alternative strategy funds can perform well at times of market turbulence, providing us with further diversification.

2. In our experience, very few firms worldwide meet these criteria.

3. For example, Colgate accounts for 80% of the toothpaste market in Mexico, 53% in India and 73% in Brazil.

applies when making comparisons between sectors – we believe Colgate will still be leading its sector in 2025, but we could not be confident that a top-five technology firm will still be in the top five in eight years' time.

Price and positioning

The search for resilient businesses is an important part of our investment process, but to build a portfolio of resilient investments, we need to go a stage further.

Both risk and return will also depend on the price we pay for an investment. We need to determine what each business is worth, and therefore what sorts of returns we can expect. Here, our assessment will include a range of values and expected returns, under good and bad scenarios.

It is important to understand not only the gains we might make if we are right but also how we much we might lose if we are wrong. In a world of uncertainty, we want the profile of risk and reward to be stacked in our favour.

Overpaying for investments will damage returns. We seek to be disciplined about the price we pay.

Focus on the long term

It may seem counter-intuitive, but we can often be more confident about the long term than we can about the short term.

When we invest in a business, we do so expecting to hold its shares for at least five years. This should give us the time to benefit from that business compounding its underlying earnings. High and sustained earnings growth means shareholders can enjoy good returns, with a lower risk of permanently losing capital.

Our investment in Ryanair is a good example. Ryanair is a strong business in an industry known for poor shareholder returns. The airline has a dominant position in its niche, but operates in a cyclical industry that is vulnerable to shocks. Quarter by quarter, Ryanair's corporate results will be hard to predict. Passenger numbers are influenced by everything from air traffic control strikes to the weather. In addition, small fluctuations in exchange rates or the oil price can have a big impact on profits.

Over the long term, however, there is an established trend in the European airline market: low-cost providers taking share from the legacy flag carriers. Ryanair's costs are substantially below even its low-cost competitors. Its average cost per seat, excluding fuel, is just €29. That compares with €51 at easyJet (76% higher), €62 at Norwegian (114% higher) and €107 at Air Berlin (269% higher).

In the years ahead, it is reasonable to assume that many customers will continue to be drawn to the lowest prices. Ryanair's structurally lower costs will allow it to undercut its competitors. We believe Ryanair can do that while still delivering profitable growth.

Often, the outlook will be clearer over the long term than the short term.

Since our initial purchase of Ryanair shares back in 2011, we have deepened and expanded our knowledge of the company, focusing on its long-term prospects.

A long time horizon, combined with deep company knowledge, also makes us well placed to take advantage of short-term fluctuations. For example, we bought more shares in Ryanair in October, as its shares had fallen after the UK's vote for Brexit. (The shares have since risen by 19.6%[4].)

Conclusion

In managing portfolios, we need to cope with uncertainty. Our approach is designed to be resilient, minimising or eliminating decisions where our degree of confidence can only ever be low.

We believe our approach is stronger because we recognise the limits to our knowledge. This supports robust decisions, helping us invest with confidence.

Post-script – book recommendations on the subject of making predictions

Walter Friedman's *Fortune Tellers* gives the historical perspective. Friedman tells the story of the rise of the economic forecasters in the early 20th century, profiling Roger Babson, Irving Fisher and John Moody, among others.

Philip Tetlock's *Expert Political Judgment* is more academic, and perhaps a slower read (although most of the equations are confined to an appendix). The book documents a body of work Tetlock began in the mid-1980s, to keep track of expert predictions, and to measure the accuracy of these predictions over time. It explores what constitutes good judgement when forecasting future events.

The Signal and the Noise, by Nate Silver, is a guide from a practitioner. Silver, a statistician, is founder and editor of the website FiveThirtyEight. *The Signal and the Noise* explores why some predictions succeed while others fail, in areas from baseball and chess to US congressional elections.

4. As at 23rd March 2017.

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.