Rothschild & Co
Wealth Management

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Changing your mind

Foreword

Stay the course. Stick to your guns. Hold your ground. The English language is brimming with expressions which reinforce the idea that refusing to change your mind is a trait to be admired.

You may instead be accused of 'flip-flopping', 'chopping and changing' or 'doing a U-turn' if you alter your views. These phrases paint a picture of someone who is indecisive, erratic and weak-willed.

But context clearly matters. For a ship's captain, 'staying the course' is foolhardy if they know they're heading towards an iceberg. Performing a U-turn, on the other hand, is a prudent move if the road ahead has collapsed.

We shouldn't be afraid to change our minds when new information challenges what we thought we knew.

The same thinking applies to investing. At Rothschild & Co, we believe a willingness to change our mind is a strength, not a weakness. Knowing how and when to make necessary course corrections is key to our goal of preserving and growing your wealth over the long term.

There will still always be bumps in the road; these are an inevitable part of any investment journey. Our diversifying assets help us to cushion the impact, and we'd like to reassure you that they are currently performing just as we would expect them to during the current volatility in markets.

Nevertheless, we analyse all our decisions – good and bad – so that we can continue to improve our investment approach. A learning culture is very important to us.

That is why, in this *Quarterly Letter*, we want to examine some of the ways we've changed our minds as investors, whether it's due to new data, a different perspective or any mistakes we've made.

Lastly, we would also like to thank you for not changing your minds, by continuing to place your trust in us.

Helen Watson
CEO, Rothschild & Co Wealth Management UK

Cover: Framed portrait
This frame contains the portrait of Hannah de Rothschild, wife of our founder, Nathan Mayer de Rothschild. Her portrait greets you as the lifts open to our 9th floor at New Court in London.

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Changing your mind

Irving Fisher and John Maynard Keynes were two of the most influential economists of the 20th Century. Both were gifted mathematicians whose captivating personalities and contributions to the field of economics made them celebrities during their lifetimes. They were also shrewd stock market investors.

Keynes died in 1946 with his fame and fortune intact. He had also expertly managed other people's wealth on their behalf. However, when Fisher died – nearly a year to the day after Keynes – he was living in poverty and his professional reputation was in tatters. How did they end up on such wildly different paths?

The quick answer is the Wall Street Crash of 1929. But this doesn't tell the whole story, because their contrasting fates had nothing to do with one man's exceptional foresight, or astute stock selection, or even dumb luck. Neither Fisher nor Keynes saw the crash coming, and they were both hit hard when it did.

The difference between them was that one was willing to change his mind. Keynes saw the writing was on the wall when stock prices began to fall, so cut his losses and altered his investment approach. Fisher, meanwhile, refused to believe it was anything more than a temporary blip and was financially ruined when markets continued to slide downwards for nearly three years.

As for the changes that Keynes made? Prior to 1929, he was a top-down investor who tried to predict macroeconomic trends and then select stocks that he believed would perform well based on the prevailing market environment. The Englishman quickly abandoned this approach; if he, one of the world's best economists, hadn't foreseen an event like the Wall Street Crash, then no one reliably could.

Instead, Keynes changed tack, saying:

"As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes."[1]

This line of thought should be familiar to our readers, as it's very much aligned with our investment approach at Rothschild & Co. Keynes became an early advocate of bottom-up investing, selecting strong, well-managed businesses and holding them over the long term.

It worked. A 2013 study of Keynes' management of King's College's portfolio found he outperformed the stock market by six percentage points a year on average over a 25-year period, with only modest risk.[2]

Fisher, unfortunately, wasn't so lucky. He will possibly be best remembered for a comment he made just nine days before the Wall Street Crash:

"Stock prices have reached what looks like a permanently high plateau."[3]

THE PERILS OF BELIEF PERSEVERANCE

Why was Fisher so reluctant to change his mind? According to economist Tim Harford, whose 2020 book 'How to Make the World Add Up' was the inspiration for this anecdote, Fisher was a victim of his previous successes.

The Yale graduate had written many popular books, including a best-selling guide to better health. He was also the inventor of an index card system – an early version of the rolodex – which he sold for a small fortune to a stationary firm. Predicting there would be a productivity boom in the 1920s, Fisher used borrowed money to invest heavily in stocks and was handsomely rewarded when proved right.

He had never tasted failure and couldn't imagine he might be wrong.

Fisher was also possibly suffering from 'belief perseverance', a tendency to cling to your beliefs despite evidence that contradicts or disproves them. The more central a particular belief is to a person's worldview, the more likely they are to ignore the evidence against it.

Imagine a game of Jenga. In Jenga, building blocks are stacked on top of each other to form a tower, and the aim is for players to take turns removing a block from the tower without it collapsing.

1 Stephen Dunn. The 'Uncertain' Foundations of Post Keynesian Economics: Essays in Exploration, p90.

2 Tim Harford. How to Make the World Add Up, p276

3 New York Times. 16 October, 1929, p8.

Our beliefs are like the building blocks. Some are relatively trivial and removing them is easy. Others are fundamental to who we are and how we see the world. They are the bedrock of our tower of beliefs, supporting all of the others.[4]

Removing a building block at the top of the tower barely causes a wobble in our belief structure, because it's not central to how we view the world.

Firmly entrenched beliefs are a different story. A person's stance on religion, politics or economics, for instance, can be a cornerstone of their personality, one that underpins everything else about them. Challenging this is like taking a building block from the base of the tower – the whole structure can easily come tumbling down.

When faced with mounting evidence that our core beliefs are flawed, many people often fall victim to defence mechanisms such as rationalisation or cognitive biases (more on these later) to resolve the mental discomfort of holding two seemingly contradictory viewpoints. In fact, research shows that presenting people with evidence contradicting their strongest-held opinions is more likely to *strengthen* their belief than weaken it.

This could be what happened to Fisher during the Wall Street Crash. Changing his mind would have meant admitting his investment approach – and by proxy the economics expertise that his wealth and fame were built on – could be wrong.

He instead doubled down, said that markets were "shaking out the lunatic fringe" and accused investors of succumbing to the "psychology of panic".[5] Fisher continued to overleverage himself and eventually lost everything.

CHANGING OUR MINDS

We firmly believe making better investment decisions means being willing to change our minds.

This is not something we expect to do too frequently. The extensive research and analysis we conduct prior to investment gives us a high level of conviction in the long-term prospects of every company that we choose to own.

However, we live in a fast-paced, uncertain world, and every holding must continue to earn its place in our portfolios. As active managers working with a concentrated set of companies, we monitor each investment's performance closely and, if necessary, change course when new information comes to light.

Take Nestlé, Diageo and Unilever, for example. At the beginning of 2018, each of these three companies had been in our portfolios for at least six years. During that time, they produced very healthy returns.

Nevertheless, they all underwent renewed scrutiny as part of our regular review process. They had performed well, but we wanted to know if our reasoning for investing in them was still sound and, just as importantly, whether it would remain sound for the foreseeable future.

Our reviews showed they all continued to be high-quality companies, with well-respected management teams and robust business models and practices. But their future revenues and margins were under threat from multiple headwinds, including changing consumer tastes, increased competition (particularly from new market entrants) and broader challenges to the consumer staples sector.

[4] Philip Tetlock and Dan Gardner. Superforecasting: The Art & Science of Prediction, p162

[5] Donald Rapp. Bubbles, Booms and Busts: The Rise and Fall of Financial Assets

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And, in combination with these factors, our expected forward returns for all three companies dropped into the mid-single digits. Diageo and Unilever had previously provided returns in the mid-teens and Nestlé was not far behind.

The upshot? We had changed our minds about how confident we were in the future of these companies and decided there were better opportunities elsewhere, fully selling our holdings in 2018.

When choosing whether or not to divest (or invest), we strive to recognise and avoid psychological biases that may affect our decisions. Letting go of a losing position can be particularly difficult due to the impact of loss aversion and the endowment effect.

Nobel Prize-winning behavioural psychologist Daniel Kahneman explored these psychological biases (and many others) in his international bestseller 'Thinking, Fast and Slow'.

It's also important not to overcorrect. When markets are volatile, we must be wary of recency bias (placing too much emphasis on recent events), anchoring (becoming fixated on irrelevant information) and other psychological tendencies.

These can cause knee-jerk reactions, and changing one's mind should be a product of fact-finding, not fickleness.

We don't pretend that we are immune to psychological biases; they have been baked into human decision-making processes since our ancestors were hunter-gatherers. But our investment analysts, portfolio managers and client teams are encouraged to challenge each other, ensuring any investment decision is well researched, transparent and open to debate. [6]

This approach, in combination with a keen awareness of how biases can affect our thinking, provides us with confidence that when we change our mind – as we did with Nestlé, Diageo and Unilever – it's the right choice, for the right reasons.

MAKING CHANGES TO OUR APPROACH

When we invest in a company or external manager, our aim is for the relationship to be a long-term partnership. Exiting a position is therefore never an easy decision, but adjusting our thinking on individual investments because of new information is an essential part of prudent portfolio management.

To return to our Jenga metaphor, our belief in any single company's performance is a building block near the apex of the tower – removing it does not shake our conviction in our overall investment approach.

But what about building blocks further down the tower? As we have mentioned, challenging those beliefs is more difficult because they often support a particular worldview, such as an investment philosophy. It is nevertheless important to do so.

Over the last few years, we have made a subtle, yet distinctive change to the thinking behind our investment approach. We have always conducted deep research, looking at companies from every possible angle and investing only when we have high conviction in our analysis. This has not changed.

Our 'ten-year test' for return assets meant we would not invest in a company unless we were prepared to take a sizeable position and leave it in place for ten or more years.

LESSONS IN LOSS

Loss aversion refers to a phenomenon whereby losing has a greater psychological impact on us than winning – it's between 1.5 and 2.5 times more powerful on average. This means you would need to be able to win between £150 to £250 on a 50-50 bet to feel comfortable with losing £100.[7] Because losing is so painful, people try to avoid it, which can lead to more dramatic losses.

Meanwhile, the endowment effect causes us to place greater value on things we own. A famous series of experiments by Kahneman and fellow behavioural economists demonstrated this bias in action. Participants were split into buyers and sellers before being asked to negotiate the price of a branded coffee mug. The average seller's price was nearly twice as much as what buyers were willing to pay.[8]

Investors can also fall into this trap, valuing certain companies as being worth more than they are, simply because they have them in their portfolios.

[6] Daniel Kahneman. Thinking, Fast and Slow, p284

[7] Ibid, p295.

[8] For more information on psychological biases and how we address them, please read our Quarterly Letters 'Fighting against our instincts' and 'Straying from the herd.

While this demonstrated our conviction, it also opened the door to certain psychological biases. For example, high barriers for entry may cultivate confirmation bias, whereby investors seek evidence that reaffirms a previous decision to invest in a company, while ignoring any contradictory data. The impact of the endowment effect and loss aversion can also be magnified.

There are other issues. The extensive work we do researching companies may give us considerable confidence in their business and management, but there is only so much we can learn from the outside looking in. We risk missing out on excellent opportunities if it is not possible to meet our threshold requirements.

Instead, we adapted our thinking. The breadth and depth of our research remains the same, and we must still be convinced of a business's fundamentals and price before we invest. Furthermore, our commitment to the core principle of the ten-year test has not changed; we want to find and own high-quality companies for at least ten years, preferably longer.

However, we also acknowledge that our understanding of a company will evolve as our relationship with a business and its management develops. As such, we now believe in taking smaller opening positions in companies. From there, the insights we learn as we get to know their business and people more intimately will either grow or weaken our confidence, and we can adjust our holdings accordingly.

Our investment in Eurofins is a good example. The company operates a global network of laboratories that provide sophisticated testing for healthcare, food, agriscience and other sectors. After identifying Eurofins as a potential investment opportunity in 2020, we began to learn more about the business, its management and the testing ecosystem, which was unfamiliar to us.

We analysed Eurofins and more than a dozen other companies in the sector, researching their annual reports, investor call transcripts and investor day presentations. Our team also spoke to Eurofins' CEO, CFO and investor relations department on multiple occasions, as well as more than 25 testing industry experts, including suppliers, ex-employees and customers of the company and its competitors.

Suffice to say, this and other research gave us a far better understanding of Eurofins and the wider testing industry, which increased our confidence in its future growth and earnings potential. We had learned a lot but also recognised our familiarity with the sector was still lower than for other investments that have been in our portfolios longer.

So, rather than make a large initial investment, our opening position was relatively small. Over time, our level of conviction in the company has continued to grow, and we have added to our holdings.

MAKING MISTAKES

Earlier, we talked about Daniel Kahneman and his fascinating work on behavioural psychology. Long-time readers will know we are fans of Kahneman and often refer to his research in our *Quarterly Letters*.

We have always conducted deep research, looking at companies from every possible angle, investing only when we have high conviction in our analysis.

But everyone makes mistakes, even the experts.

Not long after 'Thinking, Fast and Slow' was released it was swept up in a replication crisis that struck the social sciences. The results from studies Kahneman had used couldn't be replicated when the experiments were repeated, which was awkward, considering he had written:

"Disbelief is not an option. The results are not made up, nor are they statistical flukes. You have no choice but to accept that the major conclusions of these studies are true."

What was his response when the evidence began to mount up that some experiments were deeply flawed?

"I placed too much faith in underpowered studies," he said. "This was simply an error: I knew all I needed to know to moderate my enthusiasm for the surprising and elegant findings that I cited, but I did not think it through."

There was a particular irony in Kahneman's mistake because one of the psychological biases he has personally researched is the 'law of small numbers', a cognitive error where people read too much into small sample sizes.[9]

While Kahneman is a good example of how pernicious these biases are, we are more interested in his response. Rather than double down and compound his mistakes, he was quick to admit fault and use it as a learning experience.

We strive to do the same. Despite the rigour of our investment approach, our decision-making occasionally falls short of the high standards that we set for ourselves. When this happens, we aim to be clear about why those decisions were made, where we went wrong and what changes were made as a result.

An example of this is our investment in gold, which we owned prior to 2014 as part of our diversifying assets. Like many, we believed gold was a good hedge against inflation. But what was the basis of that belief? We weren't exactly sure.

True, the price of gold has stayed remarkably stable over the very long term, but after re-examining the data, we saw that its track record during past inflationary periods is patchy.

After performing excellently throughout the 1970s, gold prices peaked in 1980 and remain considerably short of that today in real terms. We instead discovered that the correlation between higher inflation and gold price rises has been relatively weak over the last 40 years.

By following the perceived wisdom of the crowd without performing our own deep dive into the data, we had made a mistake.

Our view now is that owning gold may well hedge against inflation, but we have little conviction that it does so reliably enough to merit inclusion in our portfolios. As a result, we replaced gold with other diversifiers that we believe are more reliable inflation hedges. These include bonds, funds and options that are directly linked to inflation.

CONCLUSION

Changing your mind is difficult. Our entrenched beliefs and psychological biases can lead us to dig our heels in rather than reconsider a previous position. This can be dangerous when investing, especially if a tightly held position isn't rooted in research, data and honest debate.

A quote often (but mistakenly) attributed to Keynes is: "When the facts change, I change my mind."

At Rothschild & Co, we give ourselves room to do exactly this, updating our opinions and even our investment approach if it's in the best interests of our clients.

We believe this creates greater value and helps us achieve our goal of preserving and growing their wealth – and this is a belief we don't expect to be changing our mind about anytime soon.

[9] It is worth noting that many of Kahneman's observations remain correct and the results from his own experiments, including those on anchoring and loss aversion, have been replicated.

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.

Important information