Why I'm not selling shares

'Investors cut stock positions to lowest level since Lehman' Financial Times July 20th, 2022

There is certainly no shortage of things for investors to be anxious about at the moment. Russia's criminal invasion of Ukraine appears to have turned into a war of attrition, with no end in sight. Commentators question whether the NATO alliance has the determination to brave the sacrifices that war entails, including Russia's threatened weaponization of gas supplies to the West during the coming winter. Inflation, dismissed by most commentators last year as a blip, has thrust itself into the centre of our lives, and is now expected to persist. Interest rates could go much higher, tipping economies into recession (defined as two quarters of economic contraction) and scuppering borrowers whose plans had been built on the expectation of endless supplies of free money. The concept of globalisation is also now in doubt. Governments in China, the UK and elsewhere, appear no longer to be on the side of business. The unprecedented heat waves around the world remind us of the urgency of the climate crisis, made worse by the war and its resulting dislocation. Coal, the dirtiest power source of all, is making a comeback.

While painfully aware of these and other challenges, I am not selling (and in fact in recent days have been buying) shares. In this article I'll explain briefly why I'm not selling shares, looking at four episodes from recent history, of which three occurred during my time as an investment adviser, and the other before I was born, and then asking whether there is something about today's market that sets it apart from these other occasions.

One day in 1988, then a novice investor, I came across Sir John Templeton's Principles for Investors. Templeton was one of the world's truly great investors, eventually founding Templeton College in Oxford. I first read the 'Principles' shortly after the 1987 stock market crash, when most investors, including me, were feeling bruised and rather sorry for themselves. The astonishing insight of Sir John Templeton's words, written forty years earlier, jumped out from the page, and I have remembered them ever since. Here's one:

'Bear markets have always been temporary. Share prices turn upwards from one to twelve months *before* (my italics) the bottom of the business cycle.'

My experience of investing over the last thirty-five years has shown this statement to be correct.

First example from history – 1941

I am indebted for much of the data in this section to a book called 'Wealth, War and Wisdom' (2008) by another legendary investor, Barton Biggs. The book refers mainly to the US stock market. Biggs' main point regarding World War II and the performance of the stock market is that the markets didn't wait for the tide of the war to turn, showing strength as early as the autumn of 1941, before the US was drawn into the war, and hit bottom in May 1942, around the time that Nazi territorial expansion reached its zenith. In Biggs' words:

'It is interesting how well the stock market performed after mid-October (1941) in spite of another avalanche of bad war news...it must have sensed the rising odds of the US being drawn into the war.

Then in May 1942, just *before* (my italics) the US' military fortunes in the Pacific improved and at the point of maximum bearishness, the US stock market made a bottom for the ages.'

The Dow Jones Industrial Average, then the main US stock market index, and still in daily use, hit a low of 92 in May 1942. It reached 120 in January 1943, around the time of the German surrender at Stalingrad, and 147 by the middle of that year. Investors who had told themselves that it would be prudent to stay in cash until the outcome of the war became clearer, would have missed an index rally of more than 60% in just eighteen months.

Second example from history - September 1992

In 1992 I was managing investment funds for a company called Tait Conisbee in Oxford.

The economic backdrop was bleak. The UK had joined the European Exchange Rate Mechanism (ERM) in October 1990 with the pound at what was generally agreed to be too high a rate relative to the much stronger Deutsch mark. In order to maintain the pound's exchange rate above the lower limit required for ERM participation, the Chancellor, Norman Lamont (the Bank of England wasn't yet independent, and the Chancellor set interest rates) had to maintain the base lending rate at a level of 10%, which would attract overseas savers and so create demand for sterling. However, this was far too high for an economy that was struggling to cope with the aftermath of the 80's property boom, making the 1990-2 recession deeper and more painful than was necessary. The stock market remained weak throughout this period.

In early September 1992 there was talk that the pound could no longer be sustained within the ERM and might have to withdraw, which was considered unthinkable by others. There seemed no alternative to very high, and possibly even higher, interest rates and an endless recession. I had a very high level of cash (around 40% with no overseas holdings at all) in my funds and was pleased with their performance relative to others which were more fully invested.

On September 16th (Black Wednesday) hedge fund manager George Soros began his assault on sterling. He sold the pound in vast quantities. The Treasury had been buying the pound in recent days, and now responded by increasing interest rates to 12% in mid-morning and then to 15% in the late afternoon. In vain – by the end of the day Mr Lamont was forced to admit defeat. Sterling crashed out of the ERM.

Immediately the pound lost around 20% of its value against the Deutschmark, interest rates were no longer needed to support sterling and were cut to below 7%. The FTSE-100 index rose by 12% in two days. My funds lagged dismally. My smugness turned to dismay overnight. The overseas assets which I had avoided jumped 20% in minutes with the decline in the pound, and my funds were under-exposed to the UK market rally as well. With much lower interest rates, the UK economy quickly recovered – but the stock market didn't wait and rebounded immediately.

Third example from history - March 2003

In March 2003 I was managing investment funds for Wise Investment.

Everyone knew that an invasion of Iraq was imminent. Tony Blair and George Bush had incontrovertible evidence (they told us) that Saddam Hussain had Weapons of Mass Destruction (WMD). I remember watching the debate Tony Blair held at the Baltic Centre, Gateshead, with an audience of local community leaders, in which he was grilled on this point. Mr Blair was in no doubt as to the existence of WMD. Iraq, he said, had warlike intentions and could land a bomb on the centre of Jerusalem in 45 minutes. Saddam must be stopped at all costs. The consensus among leading figures in the investment industry was that it would be folly to invest in the market before it became clear how the war would develop, and whether Saddam would use his WMD, causing widespread devastation in the region leading to a global economic slump.

As in 1992, I was holding around 40% of the funds I managed in cash. Markets were bound to collapse when the shooting war started, and I would be able to able to pick off cheap assets in the days and weeks that followed. Meanwhile the funds' performance had held up remarkably well against others who were more fully invested.

It was common knowledge at the time that the invasion would begin on March 19th. and indeed the aerial attacks began on that day, followed by the ground offensive on the 20th.

But the stock market didn't wait for the war to begin. It started rising *beforehand* (my italics). From a low of 3287 on March 12th, the FTSE-100 index rose almost 15% in a week to close at 3765 on March 19th, the day of the invasion, and of course our funds missed the bulk of these gains. After the first day, in which the market rose 4.0%, I reasoned that it would quickly come back down again, presenting another opportunity to deploy our cash, but instead it rose another 4.0% the following day, and carried on upwards from there.

The lesson I took from these two occasions, 1992 and 2003, is that when stock markets are cheap, long-term investors do well to stay invested, because the turn will come when you aren't expecting it and will happen too quickly and too violently for investors on the side-lines to respond.

Fourth example from history - October 2020

In 2020, I was co-managing investment funds for Wise Funds Ltd.

March 2020 is a recent, painful memory. We hadn't heard of coronavirus. It was in China, then it was in Italy, then the UK, then suddenly the world economy was in lockdown, a completely unprecedented state of affairs. The stock markets, apart from those fortunate (mainly tech.) companies that stood to benefit from the stay-at-home economy, fell 30-40%, as much as in the Great Financial Crash of 2007-9, but on this occasion in just three weeks. No one could predict anything. It was generally agreed that it would take at least 18 to 24 months to produce a vaccine – no one had ever produced a vaccine in a shorter time than this. Until vaccines were available, no one was safe to go out. The ensuing recession was unlike any other in its speed and depth.

From March to October 2020 the financial markets offered bargains such as investors might see only once in a lifetime. Few people were interested, and indeed, most investors were withdrawing money from the markets, a natural human response at such times.

Earlier I quoted one of Sir John Templeton's principles. Here's another –

'To buy when others are despondently selling, and to sell when others are greedily buying, requires the greatest fortitude while offering the greatest reward'.

In 2020, my colleagues and I at Wise Funds decided that despite the unprecedented risks facing economies and markets at the height of the pandemic, asset prices were quite simply too low for us to risk being out of the market, so we stayed as close to fully invested as was practicable. It was just as well that we did. In late October, the media was full of President Trump's refusal to accept the result of the US Presidential election, but the really important news from a market perspective was the approval of the Pfizer vaccine on October 28th. Anyone in cash then would have missed the 23% recovery which took place over the following nine weeks. I know from experience how difficult it is to time re-entry into the market from a cash position. After missing the initial violent rally our instinct is to wait for a better opportunity, but that opportunity rarely presents itself.

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Today markets are worrying about all the macro-economic challenges mentioned at the start of this article. Unlike the historic examples, we don't of course know how things will turn out this time, as we can't predict the future. I can, however, offer a couple of thoughts which reflect why I believe that shares as an asset class can still offer good long-term returns for patient investors.

The end of financial repression

For over a decade after the adoption of the QE programme in 2009, markets were stuck in a pattern which led over time to ever-increasing distortion. Interest rates were held at or close to zero for the whole of that period. Investors, deeply traumatised by the near collapse of the world's banking system in 2008, were prepared to pay ever more exalted prices for assets regarded as safe. Government bond prices rose to the point where, like cash, their income yield shrank almost to nothing. The safest assets became unsafe because their exorbitant prices offered no protection against a change in market sentiment, which has finally taken place this year. Some price-insensitive investors were prepared to invest in government stock regardless of the derisory returns on offer. Others looked for alternatives, initially the highest quality 'investment-grade' company loans, and subsequently 'bond proxies' such as 'quality' shares (the shares of companies whose earnings are seen as being the most easily defended from competition through offering a unique or patent-protected product or service). Other alternatives included infrastructure funds and more recently clean energy funds.

At a time of slow economic growth, investors had a burning appetite for the shares of 'growth' companies, those capable of growing their earnings faster than the growth of the economies in which they operate. It makes good sense to pay extra for faster growth, but there must be a point where the premium paid becomes excessive, and this point was reached some years ago. Regardless of valuation, the prices of these growth stocks, including much of the burgeoning private equity sector, and of the US technology sector (the largest sector in the world's largest market) continued to rise ever higher.

Thirteen years is an unusually long time for a trend to last in financial markets, but the vogue for bonds and bond-proxies, quality and growth stocks, persisted from early 2009 to the end of 2021. This party appears to have ended, with the onset of higher inflation and interest rates. The sectors mentioned above have seen brutal corrections this year, and whether these down-trends have run their course is moot.

However, the rest of the financial markets, the parts that were never fashionable during the period of 'financial repression' from 2009-21, are outstandingly cheap at present, perhaps not quite the stunning bargains that they were in 2020 but a compelling opportunity all the same. If history is a guide, these assets will recover long before a permanent ceasefire in Ukraine is signed, or inflation returns below 2.0%.

Putting in a word for the UK stock market

Today, July 20th, the FTSE-100 index stands just 5.0% above its closing level at the end of the last millennium, December 30th 1999, over 22 years ago (note that the headline FTSE 100 index doesn't include the receipt of dividends) . This has been its 'lost generation'. At the end of the 90's, the UK market was without question overvalued. Today, it is without question undervalued.

How did this come about?

One explanation is that the UK lacks the kind of global growth companies that are household names in the US – Microsoft, Tesla, Amazon, Apple and the others.

Another is the unprecedented series of disasters that have befallen the UK since 2000 – the Great Financial Crisis, mishandled Brexit, trade wars, lack of clear political direction, covid, and more recently the cost-of-living crisis. Somehow, whatever the global crisis, the UK seems to suffer worse than others –all countries are experiencing inflation but no one is surprised that ours is the highest in the G7. It's easy to overlook the fact that the UK has its fair share of world-class businesses (small, medium and large) and it's easy for overseas investors, who hear nothing but worrying news coming from the UK, to reflect that the UK is just 4.0% of world stock market capitalisation, and that in the circumstances, avoiding its market seems the sensible option.

This isn't a bear market in UK shares

Some commentators have stated that this year has seen a bear market in all asset classes. That isn't quite true. We have seen bear markets in all the fashionable sectors of the 'financial repression' years – in particular bonds, bond proxies and growth stocks. Many of these assets have fallen by more than half. The UK has been an exception. There has been no shortage of bad news (chaotic government, Northern Ireland Protocol, potential breach of international rules on steel tariffs, persistent covid, cost-of-living crisis), but the stock market has been surprisingly resilient. The FTSE-100 index hit a low of 6987 on March 8th, just ten working days after the invasion of Ukraine, and has stayed above that level in the ensuing four months. In bear markets, prices exhibit a succession of falling lows. That pattern is absent from the UK market. In markets, nothing is ever so low that it can't go down lower, but maybe in the UK we are near the point of capitulation where there are few sellers left.

People used to say that when the bellhop (slang for the people who used to operate lifts) or taxi driver offers you hot share tips, that's the time when the market is over-heated and you should sell. Nothing like that has happened to me for at least fifteen years. This long period has been unusually difficult for UK-based value investors, requiring patience and discipline. These are qualities that tend to be rewarded in the end, and I can see no reason why now should be different. It's also worth remembering that the companies which are trading today (and many are thriving, despite the adverse conditions) have been through the same period of history that investors have, and are now emerging leaner and stronger as a result.

In conclusion, there are times when it's dangerous to be out of the market and this is one such time, in my view.

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