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Reflections and Insights*

*"It serves me right for putting all my eggs in one b******d."*

– DOROTHY PARKER

Were you to look back at these reviews over the years, you would conclude that the views proffered have barely changed in nearly two decades. Which is, to be diversified across geographies and asset classes, and to focus on the signal rather than the noise. That's basically it.

A legitimate question is whether that has been the most profitable advice you could have followed. The answer is unequivocally not. You would have made more money just investing in U.S. equities, probably passively, and ignoring everything else. Sure, you would have had to surf through the financial crisis, the various geopolitical spats and the political shenanigans; you would have had to avoid panicking when something threatened to bring the house down or when democracy seemed under threat; you would have had to be immune to issues of valuation, inflation, recession, stock market boom and bust. In the end, none of this mattered as long as two conditions were met. The first is that you had a very long-term time horizon; the second, that you are highly tolerant of risk.

These reviews contend that most investors are not like that. Investors may think they are, and may have (metaphorical) cojones of steel, but they are human and, so, subject to the views of other people, to information flows and to emotion. They may be able to shut their eyes to these influences, but almost certainly have experienced long periods of stress where anybody rational would be questioning the basis of the assumption of sticking all your assets into one locked box.

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That is why these reviews try to highlight a way to achieve a smoother ride.The outlook at the beginning of this review did not suggest the best return in the short run, but it may allow you to sleep at night and, over time, could stand the test of providing decent results.

Financial markets have always tried to define risk in statistical terms, but if you think about how you as an individual react to risk, you will discover that you don't see it statistically. You don't calculate the odds of being run over when you cross the road, even though it can be done. It is something you feel. The economist Frank Knight drew a distinction between quantifiable risk, which is measurable and can be built into processes and structures and, on the other hand, true uncertainty, where possible outcomes are so numerous or complex that they can't be modelled. This is how individual investors view risk, and it is why the diversified approach is a common one for most investors. Of course, the exact proportions allocated to different geographies and asset classes will vary depending on factors such as life cycle and tolerance for loss, but they cannot all be captured statistically.

There have been attempts to build models to navigate the uncertainty Frank Knight focused on, as mentioned above, but they are invariably subjective, as one would expect. The best-known is from Professor Saras Sarasvathy, whose approach is to be practical – look at what you resources you have on hand; build networks; exploit anomalies; be aware of the downside and concentrate on what you can control. That seems not a bad set of rules to guide how you invest, and in most circumstances will push you to diversify.

RESILIENT ECONOMIES, BUT...

That's enough of that, you say, what about what's going on now?

Well, the reason for the tangential rambling in the previous paragraphs is that not much has changed, despite the Iran war, oil prices, Putin, Trump, Starmer and a new Chair of the U.S. Federal Reserve (Fed). Globally, economies remained resilient enough, despite the efforts of these people/events to stamp their imprimatur all over asset prices.

Although not much may have changed, there are nonetheless, several risks out there.

Inflation is somewhat worse than expected, particularly in the U.S. (and in the U.K., but that's a different story). Prices of tech products and services have risen sharply - Apple has put its prices up by 18-20%, and Microsoft has pushed substantial increases in some areas. This reflects significant shortages further back in the supply chain. Prices of computer 'memory' (dynamic random-access memory or DRAM) have increased fourfold in the past year. It isn't surprising that the earnings of companies that make these things have gone up like rockets, although, like rockets, they are likely to run out of fuel at some point. DRAM prices are notoriously fickle, and new supply has a habit of coming on stream just as demand peaks; peaks which are often determined by price rises in end products. For now, though, tech goods are proving relatively price inelastic. This inflation is underpinned by interest rates which are too low for this level of economic activity, tax cuts in the U.S. and a wealth effect which results from high asset prices.

RATE HIKE WRITTEN IN THE CARDS?

We have heard, over time, how Trump would like interest rates to be closer to 1%, but it seems his new pick for Fed Chair, Kevin Warsh, may be more independent than billed, and the likelihood of a rate hike after the mid-term elections in November is very much in the cards.

Then there's Artificial Intelligence (AI), now so embedded in our consciousness that the acronym (almost) no longer needs to be spelled out. The so-called hyperscalers (who dreams up these words?) are investing as quickly as possible in what has become known as 'compute', or processing capacity. Data centres are being built at speed and

scale and are putting great strain on the electricity grid. To fund these enormous capital projects, the major Information Technology businesses, which have been the most profitable enterprises in the history of the world, are now becoming cash flow negative and are starting to borrow on an industrial scale. They are competing with each other, and each fear that being slow will mean they are locked out of what every AI promoter believes will change the world. They had better be right that the returns from these investments are not competed away, or they will be the dinosaurs of the 2030's. Interestingly, the valuations of these companies have started to fall, although earnings growth in this sector and elsewhere remains very robust.

THE INDUSTRY OF AI PROMOTION

It is not within the purview of this review to express an opinion about how big an impact AI will have, as the writer simply has no idea, but would surmise that nobody else does either. That does not stop an industry of AI promotion, both to consumers and, more significantly, to politicians through lobbying (and donations) to minimize regulation. The problem for the AI businesses, though, is that AI is deeply unpopular amongst the general public because of fears of job losses (and to a lesser extent, annoyance with the tech bro vision of humanity). It remains to be seen how all this pans out, but a combination of competition (also from cheaper models in China and elsewhere), overbuilding of capacity and regulation is not the best backdrop for great long-term investor returns.

In the short run, though, the investment in AI is inflationary and also a very significant contributor to U.S. growth overall. In the longer run, it is probably going to be a deflationary force as it will almost certainly improve productivity. On the question of job losses, though, it is obvious (and lazy) to posit that new jobs will emerge to replace those which are lost. In the fullness of time, that is, no doubt, correct, but the friction that exists between the disappearance of one profession and the emergence of another is not an academic matter. It affects people, who have opinions and votes. The risk of social instability if this phenomenon develops too quickly cannot be overstated.

AND NOW TO THE DEVELOPED WORLD

The fiscal situation around the developed world is not getting any better, and with the combination of broken politics and aging populations, will not do so. This is another area where the theoretical models seem to have been correct everywhere except the U.S. The theory stated that growth would be affected negatively as the percentage of government debt rose above a particular level. Growth has indeed been disappointing in Europe and in Japan. In both areas, things are only likely to worsen, given the need to counter rising populism (simple, wrong answers to complex problems), as well as the rewiring of geopolitical alliances, which are forcing Europeans, in particular, to increase defence spending exponentially.

In the U.S., for reasons already discussed, growth has simply continued, and there is optimism that it will push ahead despite (and partly because of) fiscal profligacy. There is some truth to the U.S. view that its own economy is dynamic and flexible, whereas Europe is a historic theme park, destined to be an old people's home. Needless to say, pessimism on Europe, both at home and in the U.S. (where it smacks of triumphalism), is generally overdone and things are not as bad as they seem, with corporate earnings set to advance and growth likely to pick up as the impact of the Iran war fades. Europe is also well positioned in the green transition and has plenty of homegrown entrepreneurialism, albeit without the depth of capital markets or a arge unified domestic market. Some of the solutions required in Europe are in plain view.

Writing from the U.K. has been a rather depressing experience of late as we prepare to

crown our umpteenth new prime minister in an embarrassingly small number of years - the U.K. was supposed to have boringly stable administration. A combination of BREXIT, estimated to have cost between 6% and 8% of the economy, underinvestment generally, and flip-flop policies have leached the energy out of the economy. Despite the erosion of Britain's soft power, and despite the poverty of its politics, the underlying issues and advantages here in the U.K. are very like those in Europe, with particular dynamism in life sciences and technology, including AI. U.K. investors who want access to these sectors must either stick to private markets or go to the U.S. Disappointing.

When you put all this together, you won't be surprised that the conclusion is to go full circle back to the beginning. Stay diversified. There are plenty of risks out there, and nobody knows what is going to happen.

Steve Bates

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