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MARKET COMMENTARY

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The Superforecast: Buy The Dip

After a fairly uneventful start to the year across most of the global financial markets, the calm was broken in the last 10 days of February as the Covid-19 coronavirus started to attack investor nerves. The S&P-500 recorded its fastest ever 10% fall, achieved in just six trading sessions with every sector and every market cap getting hit. The oil price fell back below $50 a barrel and with OPEC set to meet this week, prospects of a rally seem remote in the current climate. Gold proved to be no safe haven falling almost 8% in the last week of the month, however government bonds strengthened on talk of a 50 basis point cut by the Fed.

Causality isn't always easy to prove in financial markets and the media often finds the issue confusing. The headlines tell us that stock markets are "plunging on looming coronavirus pandemic" whereas they are falling due to the potential disruption and possibility that the crisis could tip the global economy into recession. With some sporting events postponed, companies freezing business travel, and events such as the Geneva Motorshow axed, talk now is that the Tokyo Olympics in late July may be at threat. It is understandable that with many economies, particularly in Europe, seeing GDP growth stall anyway, the impact of lower global demand, containment and supply chain disruption could be the final straw. Predicting this outcome with any confidence requires an ability to demonstrate causality. To what extent will a lower oil price prove to be a stimulus? Will central banks action offset any slowdown? Will Donald Trump push through a series of measures that boosts share prices just before his election later this year? Forecasting in the financial markets is a fraught task at the best of times and it creates a knotty problem for us analysts who regard ourselves as realists. Clients want to see countless detailed predictions undertaken with accuracy yet the industry knows deep down that, for the large part, it is not possible. Nevertheless, using the smokescreen of charts, tables, big numbers, tiny numbers and opinion masked as facts they continue to pretend that it is.

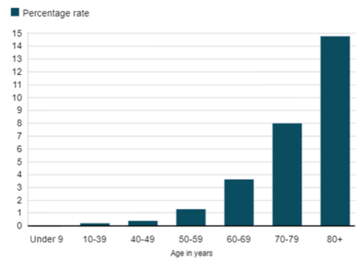
This is all rather topical following the re-emergence of 'superforecasters,' a group of people thrust into the spotlight last month by Boris Johnson's chief advisor Dominic Cummings. When questioned over the resignation of Andrew Sabisky, a Number 10 aide, Cummings, in his own inimitable style, suggested to journalists that they should read "Superforecasting: The Science and Art of Forecasting" by Philip Tetlock and Dan Gardner. The inference was that anyone involved might find the answers here rather than listening to political pundits.

First published in 2005, this excellent book should have appeal to everyone, regardless of their interest in the financial markets; essentially it is all about the human condition and its frailties. Decades in the making, it demonstrated that most forecasters across a range of disciplines could produce results no better than chance, a metaphorical 'dart throwing chimp'. However, there were a few who could and the question therefore emerged, what did these individuals do differently? Where there any unifying characteristics? Tetlock went on to produce a detailed list of traits to look out for in a superforecaster, including natural caution, humility, open-mindedness and an ability to accept new information.

Interestingly, a higher IQ did not seem to matter noticeably, grit was far more important – a tenacity to continue to strive to find an answer, a solution, even in the knowledge that it might be unachievable. In practise a common technique used by these superforecatsers was the ability to break down a prediction into simple questions. We pick up on this methodology further below, but the there is an excellent real life example citing the work of nuclear physicist Enrico Fermi in his needless quest to estimate the numbers of piano tuners in Chicago, in this video.

So using the lessons provided by Tetlock et al, our conclusion, which is in effect a forecast, is to 'buy the coronavirus dip'. There are a number of ways of attacking this statement, but we would strongly defend is the pushback that "Albert E Sharp has said the same thing four or five times in the last six years – sooner or later they are going to be wrong". Although this fact is probably correct if we take a fifty year horizon, to suggest that the number of sell-offs is linked to an increasing likelihood of predictive failure has no basis of evidence. Again the element of causality is very difficult to establish.

So let's try and break this down into smaller questions. How dangerous is this virus – will it wipe out whole countries, cities or communities? The answer is maybe found at the very end of the alarming leading story on BBC1 Weekend News at 10.00pm on Sunday 1st March. The very last words uttered by Hugh Pym (shown here at 8m 20s) were that, "Four out of five patients experience only mild symptoms". So how many people does it kill? According to the NY Times, of the 90,000 reported cases around 3,000 have died. However, to conclude that the rate is therefore 3.3% arguably overstates the threat insofar that many of these were the early cases in China where the authorities were caught off-guard. It seems likely that the rate, particularly in the West, where preparedness is much higher will prove closer to 1%. Is the virus selective in its victims? The chart on the right suggests that it is, with the 70+ age group dominating the fatality list.



Source: BBC, Albert E Sharp

Looking at these metrics, and observing that the numbers are already fading in China, we find it very difficult to believe that large scale events such as the summer Olympics will be cancelled. We cannot deny that there will be disruption, some industries will suffer and no doubt some will fail, particularly those in the travel business. This is hardly superforecasting. What we are prepared to assert is that Covid-19 will not plunge the world into recession. Not that recession won't happen at some point, but we need a crystal ball to say when that will be. After all, as Paul Samuelson (the first US winner of the Nobel Prize for Economics) once famously said, "economists have predicted nine of the last five recessions".

Many outsiders think that at Albert E Sharp we spend our time crunching numbers and trying to predict the things like the level of the FTSE-100 in a year's time or where interest rates will be in 2025. We have no idea and will never pretend to do so. The reality is that our job is to hunt out the fund managers who can consistently beat the market. These rare creatures are few and far between; they behave and think very differently to others, but they often exhibit similar traits and we think that we have a good idea of what they are. Knowing what to look for here is a skill and one that we have acquired over more than 30 years, helped by research conducted by the likes of Philip Tetlock, Amos Tversky, Daniel Kahneman, Steven Pinker and Malcolm Gladwell. Note here that none of these individuals were trained as economists – most are psychologists.

This has provided us with the basis for compiling a list of fund managers who could easily be classed as superforecasters. They all tick the boxes that Tetlock lays out and also have a track record of consistently beating the stock market. In other words there seems to be causality here, the evidence coming from a lengthening track record of outperformance. Warren Buffett is probably the most famous – his first investment was in 1941 and today he is the fourth richest man on the planet as a result. Less familiar will be Nick Train, Keith Ashworth-Lord or Terry Smith, three UK-based fund managers who have an approach that have clear similarities.

In short, they have a clear criteria of what they look for in a company and stick to it with exceptional discipline. These frameworks of criteria is the equivalent of breaking down forecasts into manageable questions, such as how sustainable is a company's key competitive advantage? How strong are the brands? Can it finance itself? These measures can become quite detailed, but the checklist is invariably repeatable and unambiguous. Maybe it is their determination, their stamina to keep going and a desire to win that we can see so clearly, or grit, as Philip Tetlock called it. There is a definite confidence that runs through their process, but there is also an acceptance of what is realistically achievable. Nick Train said in the Lindsell Train Investment Trust Plc interim report that:

" The thing about investing is that everything is so uncertain. This is especially so, in our view, when it comes to valuation. What makes an asset "cheap" or "expensive"? That's a problematic question because the validation for whether something is dear or good value depends on future developments that are by definition more or less unknowable – because if they were known they would already be in the price."

So we are saying buy the dip, any spare cash should be used to buy into the funds run by the managers that we identify. In our model portfolios that contain open-end vehicles, CFD SDL UK Buffettology, LF Lindsell Train UK Equity and Artemis US Smaller Cos jump out as contenders.

We cannot be precise on the timescale or quantum of any recovery, suffice to say that by the end of the year, it seems likely that much of the recent losses will have been clawed back. We cannot predict a V-shaped-recovery either, but the investment trusts Smithson, Finsbury Growth & Income, Allianz Global Technology, and Baillie Gifford US Growth Trust have seen their share price drop to a rare discount to the NAV in recent sessions - these situations don't tend to persist for long. For the more adventurous, we've taken a look at the top holdings in the funds that we like. Crucially, none look set to be sold on the basis that coronavirus has wrecked their business model – they are still fantastic companies. We've listed what might prove timely in the table below. **NB: This should not be taken as an investment recommendation.**

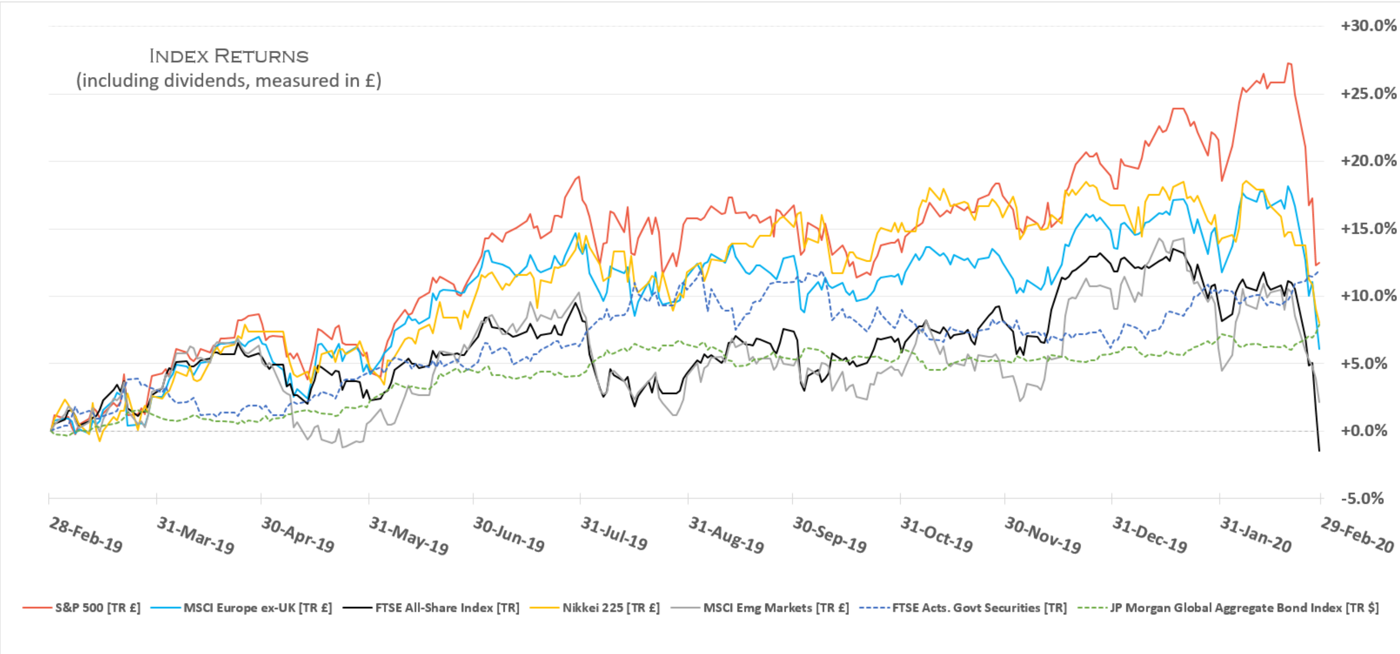
Of course we could be wrong. The outbreak could worsen, persist and wreak havoc. We cannot claim to be the fount of all knowledge on a disease that was barely recognised a couple of weeks ago. But with cases slowing in China and strong measures put in place to contain it in the West – we think we can be so bold as to say buy the dip.

Finally, the most important event in February was the release of Berkshire Hathaway's annual shareholder letter, written by Warren Buffett. This always makes for great reading and in it he makes reference to an obscure book written by Edgar Lawrence Smith in 1924 called "Common Stocks as Long Term Investments," highlighting the significance of retained earnings. The key lesson is the importance of finding companies that can finance their own growth, that do not rely on leverage, or the wider economic climate to direct them. Smith was onto something and his conclusion – one that surprised him and one that forced him to change his prior beliefs – was that these companies perform best over the long term. It should come as no coincidence that the companies that we have picked out below fall into this category, helped by Edgar Lawrence Smith, undoubtedly a superforecaster of his time.

Company	Days Since All Time High	Drop from High (%)	Forward PER (x)	Country	Industry	Fund
Mastercard Inc	9	-11.7	34.3	United States	IT Services	Fundsmith
RELX	10	-9.5	19.5	Britain	Professional Services	Lindsell Train UK Equity
Stryker Corp	10	-12.9	21.6	United States	Health Care Equipment & Supplies	Fundsmith
Pool Corp	10	-11.5	31.7	United States	Distributors	Artemis US Smallers
Rightmove Plc	18	-11.3	29.2	Britain	Interactive Media & Services	Smithson
Microsoft Corp	18	-9.4	30.5	United States	Software	Fundsmith
L'Oreal	22	-10.0	29.9	France	Personal Products	Man GLG Continental Europe
Focusrite Plc	26	-21.6	26.0	Britain	Household Durables	CFD UK Buffetology
Danaher Corp	30	-10.9	28.3	United States	Health Care Equipment & Supplies	Brown Advisory US Sustainable
Facebook	31	-12.4	19.7	United States	Interactive Media & Services	Fundsmith
McCormick & Co	36	-12.7	29.1	United States	Food Products	Fundsmith
Li Ning Co Ltd	43	-29.0	31.1	China	Textiles, Apparel & Luxury Goods	Fidelity Emg Markets Focus
Taiwan Semiconductor	46	-7.7	19.2	Taiwan	Semiconductors & Semiconductor	Schroder Asia Pacific
Housing Development Finance	46	-12.3	19.0	India	Thrifts & Mortgage Finance	Fidelity Asian Values
RWS Holdings Plc	82	-34.4	24.5	Britain	Professional Services	CFD UK Buffetology
Unilever Plc	178	-18.4	18.4	Britain	Personal Products	Lindsell Train UK Equity
Diageo Plc	178	-22.6	21.0	Britain	Beverages	CFD UK Buffetology
Heineken Holding NV	218	-16.3	17.8	Netherlands	Beverages	Man GLG Continental Europe
CHR Hansen Holding	254	-33.8	33.3	Denmark	Chemicals	Man GLG Continental Europe
Manchester United Plc ADR	359	-34.6	253.3	Britain	Entertainment	Lindsell Train UK Equity

Index Returns

Index	Region/Asset Class	29 Feb 2020	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	6,580.6	-9.7%	-7.0%	-9.0%
UK Mid Cap	UK	519.1	-8.5%	-1.3%	-5.0%
UK Small Cap	UK	5,384.7	-8.7%	-0.7%	-5.6%
Dow Jones Ind Avg	USA	25,409.4	-10.1%	-2.0%	+1.5%
S&P 500 Index	USA	2,954.2	-8.4%	+6.1%	+8.9%
NASDAQ Comp.	USA	8,567.4	-6.4%	+13.7%	+17.8%
Nikkei 225	Japan	21,143.0	-8.9%	-1.1%	-4.2%
Euro Stoxx 50	Europe	3,329.5	-8.6%	+0.9%	-3.2%
CAC 40 Index	France	5,309.9	-8.5%	+1.3%	-0.2%
DAX Index	Germany	11,890.4	-8.4%	+3.3%	-4.4%
Milan Index	Italy	21,984.2	-5.4%	+6.4%	-2.8%
MSCI Emg Mkts (£)	Emg Mkts	557.2	-2.2%	+2.2%	-4.6%
IBOVESPA Index	Brazil	104,171.6	-8.4%	+9.0%	+22.0%
IMOEX Index	Russia	2,785.1	-9.5%	+12.1%	+21.3%
S&P BSE SENSEX	India	38,297.3	-6.0%	+6.8%	+12.0%
Shanghai SE Comp.	China	2,880.3	-3.2%	-2.1%	-11.6%
Hang Seng	Hong Kong	26,129.9	-0.7%	-8.7%	-15.3%
UK All Property	UK Property	127.5	-0.0%	-5.4%	-3.3%
UK Conv Gilts	UK Gilts	4,045.3	+1.2%	+11.9%	+14.7%
UK Index linked Gilts	UK IL Gilts	5,520.2	+1.8%	+13.0%	+15.1%
JPM Glob Agg. Bond ($)	Global Bonds	521.7	+0.7%	+7.9%	+7.3%
iBoxx Non-Gilt	UK Corp Bonds	375.2	-0.3%	+10.2%	+12.1%
WTI Crude ($/barrel)	Oil	44.8	-13.2%	-21.8%	-27.4%
LMEX	Base Metals	2,606.9	-0.9%	-14.8%	-21.9%
Gold Spot ($/oz)	Commodities	1,585.69	-0.2%	+20.7%	+20.3%
S&P Agri & Livestock	Agriculture	631.50	-3.9%	-8.3%	-19.0%
£1 = US$	Currencies	1.28	-2.9%	-3.3%	-6.8%
£1 = €	Currencies	1.16	-2.3%	-0.3%	+3.0%
£1 = Yen	Currencies	138.41	-3.3%	-6.3%	-5.7%



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