Kevin Cousins

How patient, bottom-up investing capitalises on big market cycles

Kevin is Head of Research at PSG Asset Management and has 23 years' experience in investment management. After working at BoE Asset Management from 1993 to 2002, he co-founded Lauriston Capital, a specialist hedge fund manager. Kevin then worked as part of the hedge fund management team at Brait (now called Matrix Fund Managers). Kevin joined PSG as an Investment Analyst in 2015.

Economic and market cycles are a given

Despite regular academic assurances that economic and market cycles can be mitigated, managed or will even stop happening 'from here on out', the world is still beset by major financial panics. Most recently, we navigated the global financial crisis in 2007/2008 and the emerging markets collapse, which reached a low point in early 2016 (illustrated by the charcoal line in Graph 1). In the words of Howard Marks, co-founder of Oaktree Capital Management in the US: "In the world of investing, nothing is as dependable as cycles. Fundamentals, psychology, prices and returns will rise and fall, presenting opportunities to make mistakes or to profit from the mistakes of others. They are the givens." [1]

Cycles happen because progress in finance and economics is often not cumulative

In fields like the natural sciences or medicine, progress is cumulative. In other words, it is built on the foundation of a historic body of work. This may occasionally result in prior beliefs being refuted or refined. However, the vast majority of work stands to guide and support future innovations.

Unlike the hard sciences, progress in the fields of finance and economics appears to be cyclical, rather than cumulative. It seems that each generation of market participants, investors, business leaders and policymakers only learns from painful personal experience, rather than benefiting from the wisdom of those who have gone before. 'This time is different' is often the rallying cry, until events conspire to set them right.

Economist JK Galbraith said it best: "There can be few fields of human endeavour in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the wonders of the present." [2]

Using a top-down view to predict economic and market cycles can be problematic

Many investment managers do extensive macroeconomic research to develop a top-down view of the return prospects for each asset class – equities, bonds, credit, property, foreign assets and cash. They then determine the weightings of the respective asset classes in their multi-asset funds based on this view. In our experience, attempting to predict economic and market cycles using top-down research is a poor allocation of resources and hardly ever improves performance or lowers risk. In fact, it can be inherently dangerous if it raises confidence levels about forecast outcomes.

The truth is that cycles cannot be forecast. Market tops and bottoms can never be observed in real time – only with hindsight. An investment manager that devotes considerable time and resources to developing a top-down view generally feels obligated to use it. The manager may become increasingly confident of its forecast accuracy just as a market cycle matures and approaches an inflection point. Fortunately for their clients (and for us, but for a different reason, as we will see) their mandates or processes normally specify tight ranges for exposure to each asset class. The research therefore merely determines small relative positioning shifts within each range.

How we benefit from big cycles as bottom-up investors

The realisation that we cannot forecast future market moves and anticipate market tops and bottoms can be quite liberating. It frees us up to focus on what has consistently delivered favourable returns for our clients: buying stocks that meet our 3 M criteria (Moat, Management and Margin of Safety) at attractive prices, and selling them when we no longer consider them sound investments. (This is ideally because the price of the stock has increased to such an extent that it has eroded the margin of safety we require.)

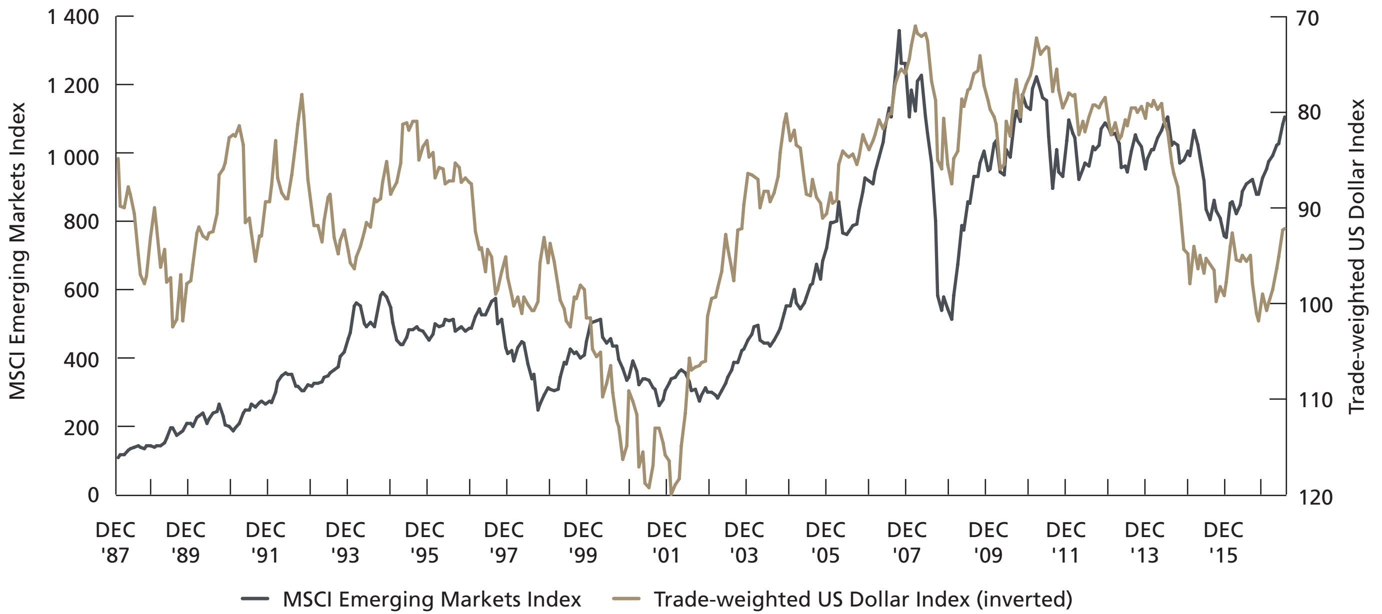
Not devoting time and resources to top-down forecasts doesn't mean that we ignore the big cycles. In fact, they are an important component of our ability to deliver long-term returns ahead of our mandate targets.

Our default position of cash means we are ready to take up opportunities that arise

Our default position in our multi-asset funds is cash. As stock prices rise through the cycle, it becomes more difficult to find investments that meet our criteria. Conviction levels for our remaining holdings also tend to decline, dictating smaller positions. We will then exit or trim our equity positions, and our cash balance will gradually grow to a substantial weighting, ready to be deployed when the market once again offers attractive opportunities.

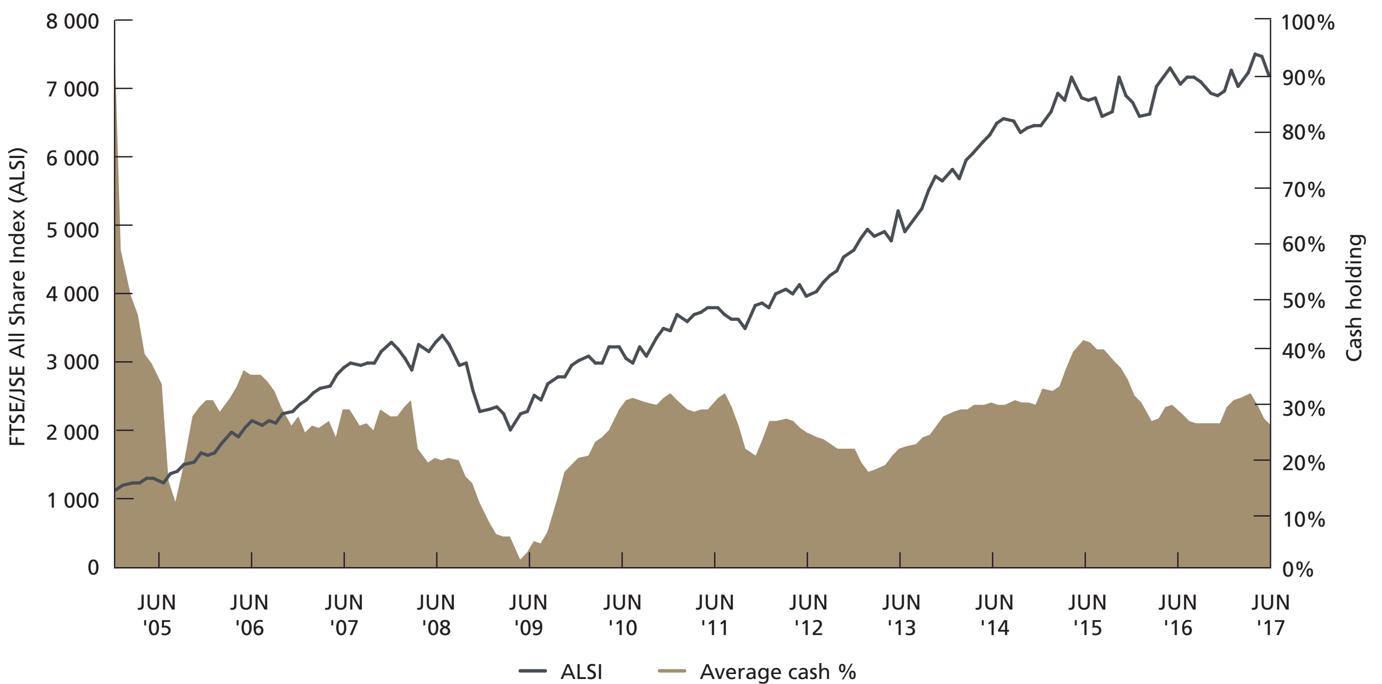
For example, the PSG Flexible Fund has held as much as over 40% in cash, as shown in Graph 2. The size of this cash balance is entirely determined by the results of our bottom-up process; it is not an asset allocation decision. That said, a high and growing cash balance, together with a narrowing gap between market prices and our intrinsic value estimates for our buy-list stocks, give us good insight into where we are in the market cycle. Importantly, this in no way forecasts the timing of a market top – a crucial distinction.

Graph 1: Big market cycles (January 1988 - August 2017)



Source: Bloomberg

Graph 2: PSG Flexible Fund cash holding since inception versus the FTSE/JSE All Share Index (November 2004 - June 2017)



Sources: PSG Asset Management, Morningstar

Cultivating the ability to buy low

Accumulating cash performs a vital role for our funds: it expands our investment opportunity set from the asset prices currently available to those that will become available in the future (increasing our 'intertemporal' choices). A substantial cash position is not an indication of risk-averse conservatism. To the contrary, our goal is to aggressively buy stocks – but only when they are available at attractive prices. We are prepared to wait patiently for the cycle to work its magic. When fear or even panic prevails, we will once again find an abundance of opportunities at low prices.

This may sound like a simple, common-sense strategy, but it is extremely difficult to implement. Firstly, it requires immense discipline to execute in real time. Accumulating cash in a strong bull market inevitably dilutes short-term returns. This means our funds are likely to lag fully invested competing products for a period – a difficult experience for any manager.

Secondly, there are always credible reasons for the fear or panic that causes price declines, whether company-specific or related to the market in general. Conventional wisdom will strongly support selling in such an uncertain environment, and our purchases are likely to be seen as reckless. Therefore, a crucial part of our investment philosophy and process is cultivating this ability to buy low during uncertain times.

Finally, our mandates deviate from industry norms in allowing us to accumulate such large cash holdings. As mentioned earlier, most multi-asset funds have tight pre-set allocation ranges for each asset class. Cash is typically minimised, given its lower long-term average return. Few other investment houses appreciate the substantial intertemporal value of cash and they do not have mandates designed to take advantage of it.

We back management that understands market cycles

There is another important way in which a bottom-up investor can benefit from big cycles. This is by backing management teams that have demonstrated a deep understanding of these cycles and have configured their businesses to take advantage of cyclical extremes in asset pricing.

Brookfield Asset Management, a portfolio holding across our funds, is an excellent example of a management team that adds substantial value by taking advantage of the cycle. It is the world's second-largest alternative manager, with some $250 billion of assets under management, and specialises in real assets such as infrastructure, real estate, renewable energy and agricultural land.

Over the past few years, Brookfield has raised substantial funds in developed markets. This has included placing long-dated debt and perpetual preference shares at low yields (for example, it has just placed $550 million in 30-year debt at a yield of 4.75%) as well as selling property investments in high-priced markets like London, Sydney and Manhattan.

As a global player, Brookfield also seeks out distressed or liquidity-constrained markets when looking to invest. For example, in 2016 it agreed to buy Nova Transportadora Sudeste (NTS), a gas pipeline business in Brazil that was a carve-out from the heavily indebted and scandal-ridden oil producer Petrobas. NTS is a long-life asset, connecting both the Bolivian and Brazilian deep-water gas fields with Brazil's three most populated regions. It has long-term, inflation-indexed, take-or-pay contracts with its customers that are not volume dependent. This sort of asset only becomes available at a reasonable price in an environment of extreme fear, which was the case in 2016. By early 2016, the Brazilian real had halved in value in little over a year, and the local debt market had effectively stopped functioning.

In its 2015 Annual Report, Brookfield made the following statement: "The pricing of opportunities in Brazil today has discounted almost every negative scenario. We are buying at fractions of replacement cost and therefore believe we have enough margin of safety that we will be fine in almost any reasonable economic scenario. Our upside cases are based on modest recovery of the country over the next five years. Should we be fortunate enough to see more than that, returns could be exceptional."

Putting cycles to work requires a disciplined approach

A disciplined approach to buying low and selling high – regardless of prevailing market sentiment – allows patient, bottom-up investors to capitalise on market and economic cycles. In addition, when evaluating the management teams of potential investments, we also look for the rare ability to act contra-cyclically.

References:

[1] 'It is what it is', Memo to Oaktree Clients, (H Marks), 2006
[2] 'A Short History of Financial Euphoria', (JK Galbraith), Penguin Books, 1990