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Viewpoint

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UK EQUITIES - VOLATILITY IS HERE TO STAY
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Volatility has been a key characteristic of markets recently and a good deal of column space has been devoted to discussing the drivers of this volatility and wondering when it might end. These discussions have been conducted by investors whose experience is dominated by the low volatility conditions of the 1980s and 1990s. However, these two decades were in fact a departure from the longer-term norm of choppy markets and intermittent corrections. If we are now back in this long-term trend, what are the implications for investment strategy?

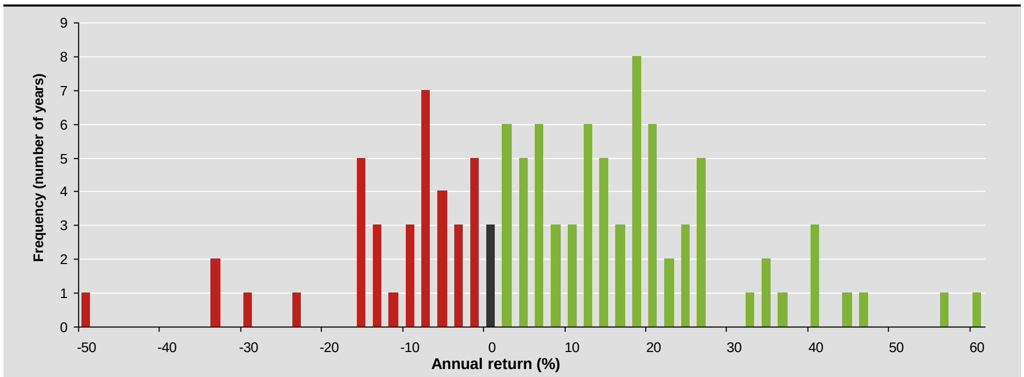
Looking back over history, negative real return years are not unusual and there have been decades, such as the 1910s and the 1960s, when there were more down years than up. The shock of the 2000s was compounded by the fact that the previous two decades had been unusually prosperous, with just two years of negative real returns between 1980 and 1999.

This was a time of geopolitical stability, of popular share ownership and consumer capitalism. It was also a period in which central banks became more proactive and got on top of inflation, delivering the “NICE” (non-inflationary consistent expansion) conditions popularised by Mervyn King. If these benign conditions seem a long way off today, they are also very different to the environment that persisted for most of the 20th century. And yet, despite challenges and periods of intense volatility, equities have still outperformed other asset classes, delivering an average annual return after inflation of 5% since 1900.

Not normal

A frequently-overlooked feature of markets is that their annual returns do not follow a normal distribution. Most investors expect annual returns to display a smooth, bell-shaped distribution. However, the chart below shows that, over the past 111 years, there is a wide, flattish peak in returns, with just as many +25% returns as +8%, zero, -10% and -15%. There have also been lots of outlying years in which the return has been either significantly positive or eye-wateringly negative.

Distribution of real annual equity returns



Source: Equity Gilt Study of 10 February 2011

Trying to call these outlying years in advance, and be in or out of the market accordingly, is virtually impossible. So, if we are to accept that we are back in a more typical environment of ongoing volatility, there are two potential ways of investing.

Short-termism is in vogue

The first is to take a shorter-term, reactive view in an attempt to take advantage of choppy markets. This trading mentality has grown in popularity over the past ten years, leading to higher turnover in funds and shorter average holding periods, with a proliferation of algorithmic strategies and electronic trading.

There are two problems with this approach. One is that higher trading volume results in higher trading costs, which can wipe out any advantage gained from excessive dealing. Another is that algorithmic models often work very well for long periods but, when they go wrong, they tend to go very wrong, losing investors substantial sums and causing unnecessary market dislocation such as the "flash crash" of May 2010.

A more considered approach

We would suggest a more considered approach based on detailed research of long-term company valuations, resulting in high levels of conviction that allow managers to see past short-term distortions. We do not necessarily know the one-week outlook for a company's shares but our investors pay us to develop a confident three-year view. If we have spent a number of years getting to know a company's management team and business model, we can accept that share prices go up and down and use any periods of weakness to add rationally to our positions rather than being forced sellers. As long-term investors, we make no apologies for buying stocks when they go down.

This approach actually turns volatility to our investors' advantage without raising trading volumes, as we are merely using short-term volatility to exploit our long-term valuation views. Indeed, the conviction built by our research can reduce trading costs by helping us to avoid being "busy fools" - investors who invariably end up on the wrong side of big market moves.

A recent example of this approach is the UK-listed cruise ship operator Carnival, which operates in a duopolistic industry with very high barriers to entry. We have done a lot of work on this company and have a good idea of what the shares are worth. However, during the summer, concerns about global GDP, discretionary consumer spending in the US and the high oil price saw the shares dip. Our analysis allowed us to look beyond these near-term worries and focus instead on longer-term factors such as the global diversification of the business, the end of a phase of capital expenditure and the resulting likelihood of improving cash flows. This gave us the confidence to buy more shares at around half our expected three-year valuation.

Our approach does not eliminate the scope for short-term underperformance at the stock level. However, the bedrock of detailed research allows us to explain stock underperformers to our clients as well as giving us the conviction to take advantage of any short-term reversals.

Conclusion – nothing to fear

In summary, the conditions of the past two years represent a return to normal rather than a departure to a new and dangerous era. Volatile markets should not be feared, and neither should they be a trigger to panic and adopt an overly myopic approach. By remaining dispassionate and rational, focusing on detailed company research and maintaining a clear view on valuation, we aim to harness current and future volatility and turn it to our investors' advantage.