For Professional Investors and Advisers Only

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Thoughts and Reflections on Thirty Years in Fund Management

RWC Equity Income

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Portfolio Managers

Ian Lance, Nick Purves and John Teahan have managed funds together for over 10 years. Their loyalty and experience is leading within the industry and has awarded them a number of accolades. Ian, Nick and John joined RWC Partners in 2010 to establish the Equity Income team and now manage c. £3 billion for their clients.

The team's approach fully integrates conviction led, value-based stock selection with a distinctive and technical approach to stablising assets, with the aim of delivering investment solutions that both grow investors' assets and protect the purchasing power of capital and income.

Thoughts and Reflections on Thirty Years in Fund Management

Two months ago I proudly watched the comedian Sanjeev Bhaskar (Chancellor of Sussex University) hand my daughter her Economics degree.

By strange quirk of fate, it was almost thirty years to the day that I had also graduated with an Economics degree and after a few weeks island hopping in Greece with my girlfriend (now wife), I stumbled into the fund management industry unaware that I would still be doing the same job some thirty years later.

The last three decades have been mostly enjoyable, sometimes stressful, often frustrating but always interesting. There are, however, some things that I would not repeat if I had my time over again and other things that I would have begun sooner. So what follows are a few observations from thirty years in the industry that will hopefully also serve as advice to anyone entering the industry today.

Early Career Advice

- The first thing I would say is 'Congratulations' because you have chosen a potentially fabulous career and one that I have found endlessly fascinating for several reasons. Firstly, I have enjoyed the disparate nature of the business which requires some knowledge of economics, accountancy, business studies, history, psychology, maths and these days quite a bit of politics! Secondly, I have enjoyed the variability; the investing world is constantly changing and no two days (let alone two years) are the same. In the last thirty years I have had a ring side seat for momentous events from the Asian crisis to the Dot Com bubble, and the Housing Bubble to the Global Financial Crisis. Companies have come (Facebook and Apple) and gone (Enron and Worldcom). This constant state of change means the job is never boring. Finally, I have met and worked with many interesting and very talented people. So this is a career that has the potential to be highly stimulating.

> "In my whole life, I have known no wise people (over a broad subject matter area) who didn't read all the time – none, zero."
>
> CHARLIE MUNGER

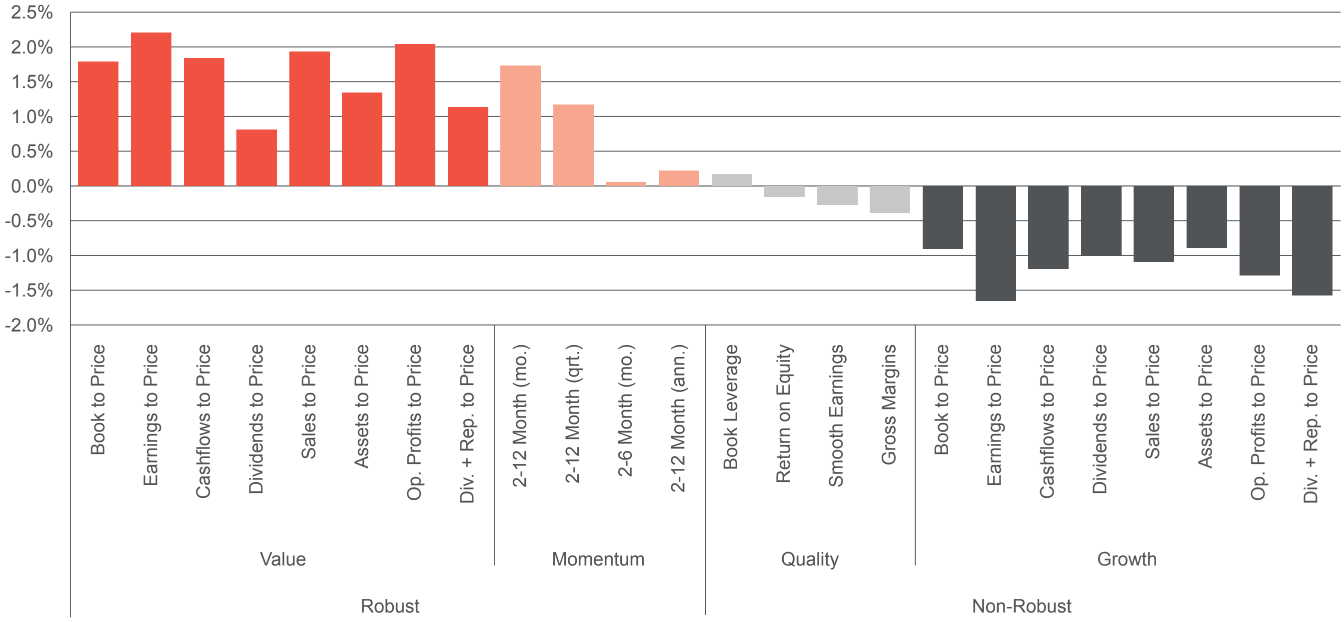
- The best way to develop yourself in the early years is to try to get yourself in a position where you are working alongside some outstanding investors and then learn by listening to them, watching what they do and asking questions. If you have the choice between a better paid job with people you have little time for or a worse paid one with people you respect, choose the latter every time. You will enjoy going to work each day and in the long run it will pay off and make you a better investor.
- The next best thing you can do to develop yourself is read. Lots. Having spent the last ten years of your life taking exams, it's quite disheartening to know that you are now expected to spend the next three years taking the CFA most of which you will forget within minutes of leaving the examination room and never use again. Whilst this might make you more marketable from a career standpoint, I am not convinced it makes you a better investor and therefore an alternative is to spend the time reading books about investing. I have had the luxury of a two hour daily commute for the last thirty years which means I have had ten hours a week to get through plenty of books (as my wife will testify given the extent to which they have over run our house!). I would recommend you try to read about a broad range of investing issues; financial history, the methods of successful investors, behavioural finance but also try to include non-financial reading in your list to give you a broader knowledge base. Of course these days, you can also listen to some

great podcasts and watch video interviews that take you inside the minds of successful investors as well. As Charlie Munger once said "In my whole life, I have known no wise people (over a broad subject matter area) who didn't read all the time – none, zero." And finally never stop reading, learning and trying to improve your knowledge (I am currently reading a book by the Spanish value investor Francisco Garcia Parames and how he applies Austrian economics to investing).

- Figure out early on what works in investing and what doesn't. Spend your time on the former not the latter and become expert at it. There are plenty of studies of what works but to help you the chart below (Figure 1) is representative of most of them which will tell you that value works, momentum or trend following works and size works. Quality doesn't and growth doesn't because no stock is so good that you can pay any price for it and expect to make good returns.

FIGURE 1

Long-Only Portfolio Value-Add versus Cap-Weighted Benchmark, 1967-2016

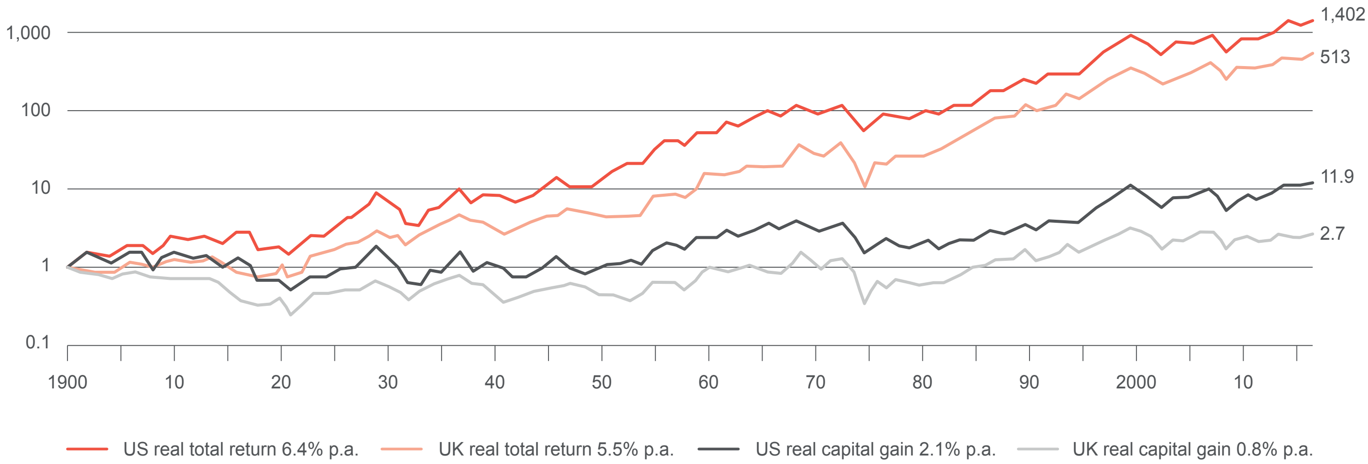


Source: Research Affiliates, LLC, based on data from CRSP and Compustat.

- Two of the most important concepts to learn about are the power of compounding and the impact of reinvesting dividends. It's worth getting a copy of the Triumph of the Optimists or similar early on. Most people regard these as too dull to be worth bothering with and yet they are some of the most important investing principles to learn (see Figure 2).

FIGURE 2

Impact of reinvested dividends on cumulative US and UK equity local-currency returns, 1900-2016



Source: Elroy Dimson, Paul Marsh, and Mike Staunton, Triumph of the Optimists, Princeton University Press, 2002, and subsequent research.

- Next think hard about your objectives and priorities – what do you actually want to achieve throughout your career? The second part of the study above concludes that, despite generating the best long-term returns, value investing is the strategy most likely to get you fired because of the variability in those returns. If you want to achieve the greatest risk adjusted returns for your investors over the long run, become a value investor. If you want to minimise your chances of losing assets and getting fired, then choose another investment style. This is an example of the principal agent problem that is common throughout the industry – what is in the best interests of the people who own the assets is not necessarily in the interests of the people they hire to manage them. Self-preservation goes a long way to explaining why so many fund managers in the industry end up as closet trackers.
- Even if you convince yourself that value investing works, you need to consider whether you have the right personality to practise it; not everyone does. You need to be patient, inquisitive, modest but bold at the same time. Humans are hard wired to run with the crowd, and very few have the mental fortitude to zig when everyone else is zagging. Value investors have a terrible habit of romanticising their experiences, when the reality involves long periods of watching glamour stocks soar to the skies whilst the boring old value stocks you own go nowhere (or down). This can go on for months (if not years) and can be very dispiriting especially when others start to question your investing acumen. This is another reason why so few people choose to follow a value style despite its long term merits. There's no disgrace in admitting it's not for you.

So you want to be a value investor

If, despite all my warnings above, you still decide you want to become a value investor, the following guidelines may be of use to you.

- Have a healthy respect for the markets as they represent the collective wisdom of millions of people, some of whom are very smart and therefore much of the time they are brilliantly efficient. The collective wisdom of the crowds can sometimes understand the implications of certain events far quicker than I and most individuals can (the FTSE soaring on the afternoon of 16 September 1992 when UK interest rates hit 15% as the crowd had worked out that the government had 'lost' to the forex markets and would be forced to withdraw from the ERM, devalue sterling and cut rates). Don't let markets become your master, however, for there can also be a collective loss of sense when herd mentality takes over. Knowing when the market is being brilliantly rational and when it is being ludicrously irrational is something that cannot be learnt in a book but is rather gained from experience.
- One of the main things is to figure out is how unpredictable the future is so that you don't waste large amounts of time trying to forecast the unforecastable. This will seem very strange since most in the industry spend their time confidently making predictions about the future. I rarely hear a fund manager on Radio 4's Today programme say "I really don't know" in reply to a question on his outlook or admit that his recent outperformance was down to a) luck or b) the waxing and waning of investment styles. Robert Rubin once said: "Some people are more certain about everything than I have ever been about anything" and that is exactly how I feel after thirty years. I have seen interest rates at +15% and -1%, the oil price at $10 and $150 and the FTSE 100 at 6400 and 3500 in the same twelve month period. Many things that I felt sure would happen have not come to pass and there have been things that have occurred that I never would have predicted in a million years (central bankers printing money to buy equities, fund managers buying negatively yielding bonds). Once you have accepted that it's difficult to make predictions, especially about the future, you will be more inclined to build an investment strategy that is robust to a range of outcomes.

> "You can put yourself at a fundamental advantage by thinking and acting longer term than the average market participant and thus exploiting their extrapolation and over-reaction."

- Investing is always going to involve some sort of forecasting but once you have acknowledged how unpredictable most things are, you should realise the futility of using thousand line spreadsheets to forecast a company's earnings five years out. My approach to forecasting changed when someone I worked with gave me a paper called Intuitive Prediction: Biases and Corrective Procedures by Kahneman and Tversky (long before the 'Thinking Fast and Slow' and 'The Undoing Project' became best sellers). This taught me that the accuracy of predictions can be improved by pulling them towards the class average and hence using base rate rather than singular data.
- Many value investors proudly boast that they 'completely ignore the macro' and in some ways that makes sense. Getting the timing and direction of inflation, currencies, interest rates etc is hard enough without then trying to fit a portfolio of stocks around that view. Companies' profits and share prices are, however, impacted by cycles (credit, commodity, and business) and it is investors' overreaction to these cycles that periodically throws up opportunities. It is crucial, therefore, to know which cycles impact a potential investment and where we currently are in that cycle.
- You are going to make lots of mistakes along the way, I certainly have and will continue to do so. Try to admit your mistakes, learn from them and move on. Hopefully that way you won't repeat them. Try not to succumb to hindsight bias – was it really obvious that Trump would win the election and the US stock market would explode higher for two years or are you re-inventing history? To overcome this it helps to record the reasons that you took investment decisions as you can then re-visit them later.
- You can put yourself at a fundamental advantage by thinking and acting longer term than the average market participant and thus exploiting their extrapolation and over-reaction. When a company

or industry is doing badly, investors often struggle to see a future in which conditions have improved and thus price in a permanent state of decay; the reality is that companies adapt and by a combination of reducing costs and retiring capital, the outlook usually improves.

- Probably one of the most important things needed for a value strategy to be a success is the right clients i.e. those with a long-term orientation and a focus on process over outcome. There's no point trying to be a long-term contrarian value manager if your investors are short term performance junkies. You can help by writing to your investors and helping them understand what you have been up to and why (this is the reason I have been writing these letters for the last eight years). When things go sour (as they inevitably will) they are more likely to stay with you if they agree with your logic and reasoning. Your viewpoint could end up being right but if you have lost all your money, this becomes largely academic.
- Performance over short periods of time is almost meaningless and yet plenty of people will place great weight on it. There is almost nothing you can do to change this mind-set, believe me I've been trying for 20 years. This is particularly problematic for the value investors whose cautious approach often sees them missing out on the highly speculative tail end of a bull market. We have now resigned ourselves to losing a portion of our assets at the end of every cycle and usually just before our style comes back in to favour.
- The longer you do this job, the more questioning and cynical you become and I believe this is a very important character trait to evolve. This is a natural function of repeatedly seeing over-optimistic promises by brokers, fund managers and corporate executives subsequently disappoint. It's probably a good thing to acquire this cynical nature earlier rather than later.
- Remember that if the future turns out as you expected, but that has already been priced in by consensus, you might not make any money. In horse racing, you don't make money by betting on the favourite all the time but rather on the horse that has been incorrectly handicapped and the same is true for investing. The company you are looking at might be high quality and with fabulous growth prospects but if the market can also see that, it is probably priced in. Now ask yourself what happens if they disappoint that cheery consensus. No-one would dispute that Microsoft has been a fabulously successful business but if you bought it in 2000, you had to wait sixteen years to get your money back simply because you over-paid for it on day 1.

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- Beware leverage in all its forms, debt is an absolute killer. Nearly all of my worst investments have involved companies where a decline in profitability combined with a vulnerable balance sheet. The same is also true at the macro level. After we came close to blowing up the world's financial system through excessive use of leverage, one might have thought a lesson would be learned and leverage would have been reduced. Instead, the lesson that was learned is that central banks will always come to the rescue of the reckless business or investor and hence the quantity of debt has significantly surpassed 2007 whilst the quality has simultaneously declined.
- Don't be afraid to do nothing. We work in an industry where frenetic dealing activity is somehow taken as a sign of confidence and ability. Doing nothing is sometimes the hardest thing to do but frequently the best.
- Much has changed in the last thirty years; availability of huge amounts of information, algorithmic trading, centrally planned financial markets etc but one thing that hasn't changed is human nature. The forces of fear and greed, hindsight bias, loss aversion are still there and they still cause the over-reaction which provides the opportunity for the contrarian investor. If you are clear what you are looking for and disciplined in its application, then volatility is your friend.

Some personal advice

- Try to remain humble. As investing is a fascinating and potentially lucrative career, it is competitive and those who do manage to get into the industry tend to be high achievers who are already quite self-confident. Many fund managers therefore have an inclination towards arrogance but particularly those who have enjoyed recent success even if this is a function of being in the right place during a bull market rather than any individual brilliance. One well-known fund manager went to press this year to compare the Prime Minister to Adolf Hitler, whilst another well-known growth investor is sounding off to anyone who will listen about 'the death of value investing'. Pride comes before a fall and this sort of hubris is often a sign that things are coming to an end and best avoided. People in this industry have long memories and a sense of schadenfreude; if you act like a jerk you are likely to find that it will come back to bite you one day.
- Enjoy your career but don't let it take over and try to achieve an appropriate work life balance. No one lies on their death bed wishing they had spent more time at work so try to get that work life balance sorted early on. Markets can be all consuming and sometimes it is hard to switch off.
- Never forget your responsibility to the investors who have entrusted you with a portion of their hard earnt savings. When the perma-bull strategist at a bulge bracket investment bank is telling you to eke out the final few points of a rampant bull market even though there could well be 5% upside and 50% downside, try to think about the man or lady who has worked on the checkout at Tesco for years in order to put something by for her retirement. How would they feel if they knew what you were doing? How would it affect them if you did lose half their money?

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- Try to do something good for society along the way. This industry currently has quite a poor reputation for over charging and under delivering whilst making super-normal returns. In addition, the current crisis of capitalism can in part be traced back to city short termism and fund managers have played their part in this by pressurising corporate executives to maximise shareholders returns over those of other stakeholders. You have the ability to be better than that and to try to do some good for society. There is no shortage of fund managers pressurising business to cut investment, lay off employees, buy back shares and gear up just so that they can make their quarterly performance target. A less common but more responsible approach is to support management and encourage them to think and act long term to the benefit of all stakeholders in the business. The irony is that this route almost certainly doesn't sacrifice any long term returns but should earn you more respect from both your investors and the companies you invest in. You will probably feel better about yourself as well.

Conclusion

I hope that the advice above does not come across as lecturing or patronising as that was certainly not my intention. As I stated earlier, I have made plenty of mistakes and this is my attempt to help others avoid them. It's been a great thirty years and I have been very privileged to be able to do it. Here's to the next thirty!

CONTACT US

Please contact us if you have any questions or would like to discuss any of our strategies.
E invest@rwcpartners.com | W www.rwcpartners.com

RWC London
Verde, 4th Floor
10 Bressenden Place
London SW1E 5DH
T +4420 7227 6000

RWC Miami
2640 South Bayshore Drive
Suite 201
Miami
Florida 33133
T +1 305 602 9501

RWC Singapore
80 Raffles Place
#22-23
UOB Plaza 2
Singapore 048624
T +65 6812 9540

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