

Tolerating under-performance in pursuit of longer-term goals

Introduction

Our investment approach always represents a relentless pursuit of long-term valuation anomalies. We exist to exploit extremes in markets. These extremes can become particularly pronounced in certain market conditions – this provides us with compelling opportunities to deliver attractive long-term returns but, while these extremes are building in markets, they can represent challenging performance conditions.

This is why we must tolerate periods of under-performance in pursuit of our longer-term goals.

The purpose of this paper is to explore some of these periods of under-performance earlier in Neil's investment career.

Neil Woodford has faced challenging periods before, yet has a stellar long-term record

Source: Morningstar, FE Analytics, Bloomberg, Woodford



Note: This chart uses independently sourced data from Morningstar and FE to form a composite of Neil Woodford's track record going back to 1990. Past performance cannot be relied upon as a guide to future performance. The value of the fund and any income from it may go down as well as up, so you may get back less than you invested.

1992 – ERM “economics of the madhouse”

Barely discernible on the chart above, because the under-performance was confined to a period of months in the summer of 1992, but this was the first real example of Neil building a portfolio that looked (and ultimately behaved) very different from the broader UK market.

After a prolonged period of consumption-led growth in the “Lawson Boom” years, the UK economy had ground to a halt. The government of the time should have been pursuing policies to revive it but instead it made things worse. The Conservative administration, led by John Major, was intent on maintaining the UK’s membership of the European Exchange Rate Mechanism (ERM), a preparatory fore-runner of the region’s single currency, the euro. As a ‘semi-pegged’ exchange rate system, all member states of the ERM had to pursue policies that would keep their currencies tied in a tight band to the deutschmark.

We often talk about exploiting market irrationality in our portfolios but this was really an example of exploiting political irrationality – Neil has often described trying to maintain Britain’s membership of the ERM with the UK economy gripped by recession as “the economics of the madhouse”. Essentially, government policy was defying economic wisdom by raising interest rates (and using FX reserves) to boost the value of sterling, when the UK economy was screaming out for much lower interest rates.

In response to this, Neil was increasingly positioning his portfolios towards domestic cyclical businesses, primarily engineering and export-focused stocks but also retailers, leisure companies and real estate. At the time, these stocks were incredibly cheap and getting cheaper.

George Soros became famous as “the man that broke the Bank of England” but essentially, Neil was shaping his portfolios to benefit from the same outcome – both of them developed high conviction views that the UK government would fail in its attempt to maintain Britain’s membership of the ERM. Neither knew how or when but both recognised the situation as unsustainable. In September 1992, on Black Wednesday, the UK withdrew from the ERM, and an immediate reduction in interest rates followed, along with a dramatic rally in the share prices of all things cyclical on the UK stock market.

The funds that Neil was managing at the time leapt from the bottom of the fourth quartile to the top of the first quartile and stayed there for some time.

“The portfolios were driven to an extreme by the extreme macroeconomic environment. That has often been the case. When you’re in an extreme environment, the opportunity set becomes very distorted. And the concentration of my portfolios will tend to evolve to reflect these macro and market distortions.”

1998-2000 – tech bubble

Whilst there were not many extremes during the middle of the decade, they began to re-emerge towards the end of the decade as the market became increasingly obsessed with the internet economy. Following a period of consistently strong market returns, investors start to forget about the critical concept of risk: they get return greedy, more and more investors and more leverage gets drawn into the market, at what ultimately proves to be completely the wrong time.

These are classic late-stage bull market characteristics and vital ingredients for an asset-price bubble.

Neil found it impossible to participate in the euphoria that surrounded internet technology at that time for several reasons. He invests on the basis of fundamentals but could see no fundamental attraction to the companies that were creating this excitement – many of them were simply concepts. He invests on the basis of valuation, but the valuations commanded by technology-related companies in these years were simply ludicrous, with investment analysts abandoning all traditional valuation metrics in their rush to show stocks in an outrageously favourable light. He invests on the basis of conviction and was simply unable to convince himself that participating in what smelt like a bubble and looked like a bubble, could in any way be the right thing to do with investors' money.

Neil was seen as some sort of dinosaur through this period because he wasn't prepared to bend to follow the herd. But in constantly questioning his judgements and repeatedly asking himself, "What is it that I cannot see? What is it that I don't understand about these businesses?", he would return to the same fundamental answers. As in any period of under-performance, he would do everything he possibly could to convince himself that he wasn't making an enormous mistake.

Nevertheless, it was a very lonely pursuit. Clearly, Neil wasn't the only person in industry that was refusing to participate in the bubble. There were a few others – Tony Dye was a prominent example. He lost his job as Chief Investment Officer at Phillips and Drew in March 2000, right at the zenith of the bubble. The FT's Lex column commented on his exit, suggesting that his strategy would in the long-term be proved right but that few employers possessed the patience to wait for that outcome.

All of the euphoria about the internet economy meant that there was a vast swathe of the market that was being completely ignored. So-called 'old economy' stocks – tobacco, drinks, utilities, food producers amongst others – became increasingly attractive, used as they were as fuel for the bubble. Neil steadily increased his exposure to these businesses to take advantage of their depressed valuations.

The tech bubble burst in March 2000 – it is not clear what pricked it but fundamentals reasserted themselves aggressively in the subsequent months. This meant carnage for the bubble participants but, for the few investors that were prepared to remain disciplined, there was a rapid reversal of fortunes. By focusing resolutely on fundamentals, Neil's funds enjoyed a meaningful period of positive performance when the bubble burst, continuing to rise in value as the market plummeted in 2000 and 2001.

"One of the things that helps to mitigate the feelings of frustration and exasperation that accompany a period when you're not performing well and you are out of sync with the market is that you feel that every day you should be adding value. The more extreme the pressure gets, the more it forces you to become extreme in making sure that you have the best value set in your portfolio. It makes you think very carefully about the stocks that you really believe in and which are the stocks that are in the portfolio that may look relatively cheap but in which you have less conviction. It is a good discipline. I wouldn't embrace it willingly, but I believe it is healthy."

2009-2010 – dash for trash

Having performed well in relative terms through the financial crisis, Neil endured a period of tough performance in the market recovery that followed it. At the time, there was a lot of talk about the expectation of a “v-shaped” economic recovery, with the market consensus buying into the idea that major economies would emerge strongly from the crisis in the same way they had done from previous cyclical recessions.

This belief drove a very rapid market rally, with the stocks that had been punished most aggressively in the crisis (banks, miners and other cyclical parts of the market), enjoying a remarkably strong recovery, in what many commentators termed a “dash for trash”. The more dependable growth stocks which dominated Neil’s portfolio during this time, lagged the market for a prolonged period.

The reason Neil did not position his funds to participate in this rally was because he did not believe that the recovery would be v-shaped – he saw the causes of the financial crisis and consequent recession as structural, not cyclical. Ultimately, that proved to be the case, and the market increasingly came to acknowledge this from 2011, as the secular stagnation thesis, became more widely acknowledged.

In the meantime, though, the dependable growth stocks that formed the heart of Neil’s portfolios at this time became increasingly attractive in valuations terms. Dependability in stock market terms equates to quality, and quality deserves a premium – yet many dependable growth at this time traded at a discount to the wider market, which represented a very attractive investment opportunity, which has now played out.

“When growth is hard to come by for the wider economy, investors should be prepared to pay up for companies that can provide growth in shareholder returns no matter what the economy throws at them. The economic outlook at this time was fraught with uncertainty, so to me it was inexplicable that the stock market was not embracing certainty or dependability where it could find it. Perhaps it was because investment horizons appear to be getting shorter and shorter, encouraging the brief bursts of risk on/risk off activity that seem to characterise markets at this time, stimulated by the latest batch of economic data. Whatever the reason, fundamentals were being ignored.”

2016-2017 – the product of the biggest monetary policy experiment in history

Ten years on from the global financial crisis, we are witnessing the product of the biggest monetary policy experiment in history. Investors have, yet again, forgotten about risk and this is playing out in inflated asset prices and inflated valuations.

The valuation stretch in the stock market has increasingly concerned us over the last couple of years – the difference between the performance of value stocks and growth stocks today, is greater than at any stage in stock market history.

There are echoes of the tech bubble today. More similar, however, to the current predicament, was the nifty-fifty bubble which afflicted stock markets in the late 1960s and early 1970s. Mark Twain once famously said, “History doesn’t repeat itself, but it often rhymes”. The market appears to be making the same mistakes again, but this time the bubble has grown even bigger and even more dangerous. In a challenging global economic environment, the few stocks that are perceived to be capable of delivering dependable growth have, like in the early-1970s, become very popular and that popularity has manifested itself in extreme and unsustainable valuations.

It is a consistent feature of bubbles that there is always a subset of the market which falls out of favour as investors clamour for the fashionable stocks of the day, providing the fuel to power the bubble on through the final leg of its journey before it bursts. In the dotcom bubble it was the old economy stocks – today, in the UK stock market, it is domestically-focused stocks which have become profoundly unloved and undervalued. The Woodford funds are positioned to exploit this opportunity.

The recent return of volatility to global equity markets, perhaps marks the start of a reappraisal of the valuation opportunity set. We may now be in the foothills of a profoundly different market environment. Fundamentals have not mattered recently but they should start to matter more from here.

“Investors should be careful chasing the zeitgeist. The temptations and excesses are right here, right now. There is always risk when markets become obsessed and extreme but there is also opportunity – an opportunity to capture assets at incredibly depressed valuations, the likes of which I have only seen two or three times during my 30-year career.”

Conclusion

The investment disciplines that we deploy are consistent:

- A strong macroeconomic view
- High-conviction, valuation-based stock-picking
- A strong focus on absolute risk and long-term fundamentals

Inevitably, these investment disciplines will result in different portfolios for different environments. Neil utilises the full flexibility of his investment mandates to build distinct strategies to suit varying market conditions, and typically, portfolios that look nothing like the UK market as a whole. After all, as Sir John Templeton famously once said:

“It is impossible to produce superior performance unless you do something different from the majority.”

We have endured another period of challenging performance over the last couple of years. As on previous occasions, we have remained disciplined, steadfastly focused on fundamentals, and constantly revisiting all of the assumptions upon which our strategy is based.

Fundamentals always eventually have a gravitational effect, which pulls share prices into closer alignment with reality. This is an inevitable consequence of the way that financial markets work and have always worked – fundamentals matter in the long run. With this in mind, we have crafted portfolios capable of delivering attractively positive long-term returns, despite a more challenging investment backdrop more broadly.