Sanlam

Wealth

A monthly market outlook from the Wealthsmiths™

October 2020

The importance of careful stock-picking

Equity prices have recovered from the lows in March – a remarkable comeback amid so much uncertainty. But high valuations mean less opportunity for future returns and more risk for investors, so where do we go from here?

As equity markets rise, so does risk for investors

When we choose to invest in a company, we do so by looking at its growth potential and its ability to make money over the longer term (around 10 years). The higher a company is valued, the lower its potential return, unless its earnings growth is strong enough to compensate.

As the market crashed earlier this year, the price of great companies plummeted, and investment opportunities were abundant. Back then we forecast an average market return of 10% per year over three years, but those returns were actually realised in just six months. Such a dramatic recovery is clearly a positive outcome for those invested, but with prices now at elevated levels, investors are having to accept lower returns in the short term unless they take on greater risk.

Why careful stock-picking adds value to portfolios

When we build and manage our portfolios, the decisions we make are based on our own rigorous research, and our view on how individual companies are positioned for the future. By taking such a granular view, we can spot opportunities that might be missed if constrained by a benchmark or a particular region or sector.

Every stock we invest in must continually earn its place in the portfolio and provide the diversification that is needed to achieve growth and manage risk. For example, we recently reduced our exposure to Facebook, and reinvested in Becton Dickinson – a business with the same expected earnings potential but with a higher return potential due to a lower valuation. It's by consistently making sensible decisions based on continuous analysis of the data that we can add value over the long term.

While we monitor our performance against a variety of indices and our peers, we believe our approach gives us an advantage. That's because we can make informed decisions while insulating our thinking from the noise of the crowd, or the arbitrary construction of an index. We have the flexibility and freedom to seek out hidden opportunities, which is particularly helpful when markets are expensive and good returns are hard to find.

With markets riding high, passive investors should have low return expectations from here, although good companies can still deliver. Active investors, who make sensible decisions based on solid analysis, can still generate good returns, and that will continue to be our focus.

“The gap continues to widen between the performance of financial markets, and the subdued outlook for the global economy. It's important not to get carried away by the apparent confidence in equity markets since businesses continue to be supported by government intervention. Now, more than ever, caution is the order of the day and our key focus is on controlling risk while finding opportunities where they exist.

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53%

Growth in the MSCI World Information Technology Index between 31st March and 31st August, showing that every crisis has its winners and losers.

Source: Bloomberg

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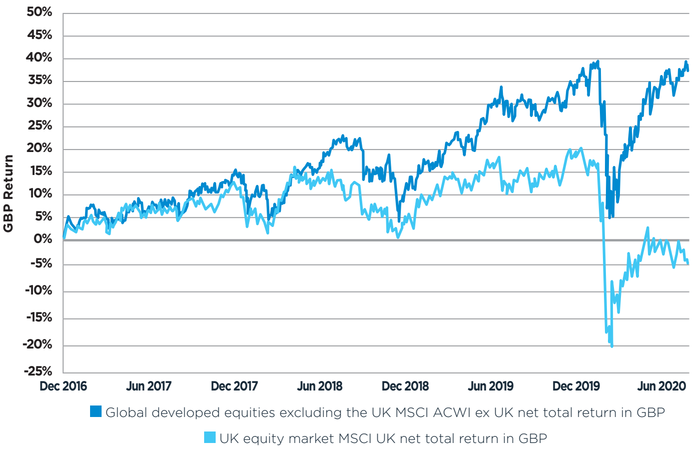
Investment view: is the UK lagging behind the global economy?

With the recovery in UK equities seemingly trailing that of global stocks, should we be concerned for the future of the British economy, or is this an investment opportunity?

UK versus global equities

As you can see from the chart below, when comparing the performance of UK versus global equities, we find an alarming picture of a country that appears to be significantly lagging the rest of the world. With Brexit negotiations still in full swing and the economic impact of Covid-19 yet to be fully realised, we wouldn't blame you for thinking the UK economy is in significant trouble. But as investors, we need to be careful not to jump to conclusions and instead dig beneath the surface to understand what's really going on.

Equity Returns in GBP



Source: Sanlam, MSCI, Bloomberg

The UK market is representative of the global opportunity

One of the reasons for the difference in recovery is that the UK market doesn't have the same level of exposure to large technology companies and high growth businesses (which have been benefactors of the Covid crisis and responsible for much of the upturn) as other parts of the world. Instead we are heavily skewed towards sectors such as financial services and energy, which have yet to find their feet. This doesn't mean the UK is in a bad place. It just means the constituent parts of the UK equity index are currently out of favour.

But is the tide about to turn? Value in the technology sector has largely been realised, and investors – like Sanlam – who are unconstrained by sector and region can now look elsewhere for opportunities. So far this year, the UK has served us well, and has been one of the best-performing regions within our portfolios. Why? Because our approach meant we could find some fabulous companies that are extremely well positioned for the future but had been swept aside amid negative sentiment.

Once the Covid and Brexit dust settles, many UK companies will be ready to flourish. So, while it may feel like the UK is out of touch and lacking relevance, we firmly believe there is plenty of life in the old dog yet.