INSIGHT

# Mythology and Fundamentalism in the Investment World


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For Wholesale Investors only.

## Key Takeaway

- ”Reversion to the mean” is viewed by many as a natural law. But the story of humanity is one of long-term progress – evolution. This will be reflected clearly in the select few companies that help drive this process. Here at C WorldWide, we believe that the distinction between value and growth is imprecise and will become more and more irrelevant in the coming years. Some talk about “Value v Growth” as though it were a boxing match between two wildly different opponents. It's not. In reality, a good investment is about finding both value and growth. At least, it is for us at C WorldWide. We think it better to spend less time on these theoretical discussions and focus instead on identifying the small cohort of companies that are capable of growing profitably over time – what we like to call compounders.

One of the wryest but most telling quotes we've run across comes from Wall Street legend and value investor James Grant: “A bubble is a bull market in which the user of the derogatory term has failed to participate” Listening to many market commentators on the seemingly crazy pricing of stocks and markets, it's worth keeping Grant's words in mind when assessing the validity of these claims. The message could well be coming from a place of emotion rather than a place of reason.

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Investment is big business, and repeated bad decisions and persistent underperformance have major consequences, which is why some are so quick to explain away things when caught out by the market. They might argue that the market is behaving irrationally and that investors will soon see the light and find the right pricing. Or that the market is being driven by momentum and that factors (such as growth or quality) currently dominating the market don't fit with their investment philosophy. Both of these excuses reflect an underlying notion that is one of the greatest myths in the investment world – that of reversion to the mean. In other words, if prices rise or fall significantly, there will be a natural tendency for an equal and opposite reaction, with the trend reversing and prices returning to the "correct" level. There is no greater danger to one's long-term economic wellbeing than subscribing to the dogma of mean reversion. Let's take a few examples:

**Myth 1: Interest rates have fallen so far that they can only rise as the economy recovers.**

The reality is that interest rates very often continue to fall after the economy comes out of a recession. Interest rates are not mean-reverting in either the short or the medium term. There are many structural reasons for this, including demographics and technology, but perhaps the most important is that recessions lead to higher levels of debt, and increased debt is deflationary, which will push interest rates down even further. Rates are currently close to zero, making it hard for them to fall further, but they are likely to remain extremely low by historical standards for many years to come. For reasons of space, we would refer you here to Dr Lacy Hunt "Hoisington Quarterly Review and Outlook, Third Quarter 2020" who has probably explained this best.

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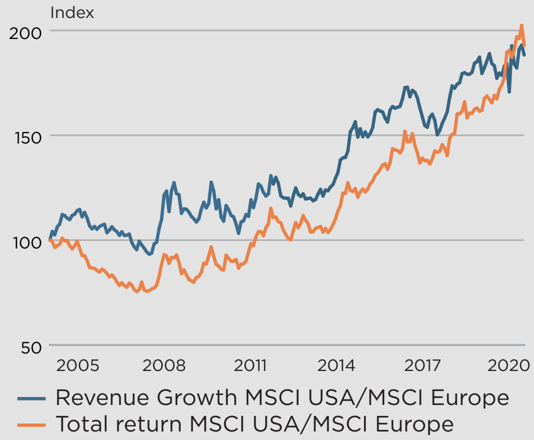
**Myth 2: Europe will now finally outperform the US as it has been lagging so far behind.**

The reality is that Europe's historical returns say nothing about the future. This myth is like claiming that sales of Nokia phones will outperform sales of iPhones just because Nokia has historically sold much less well. The reality is that the only thing that could make Europe's stock markets outperform the US would be for companies' revenue growth to be structurally higher here than on the other side of the Atlantic.

**Figure 1: Relative revenue growth drives outperformance**




Source: Bloomberg as of Dec. 2020

As the graph above illustrates, there is no mean reversion in this – it would require Europe to suddenly reverse the ageing of its population and simultaneously become a dynamic and business-friendly continent.

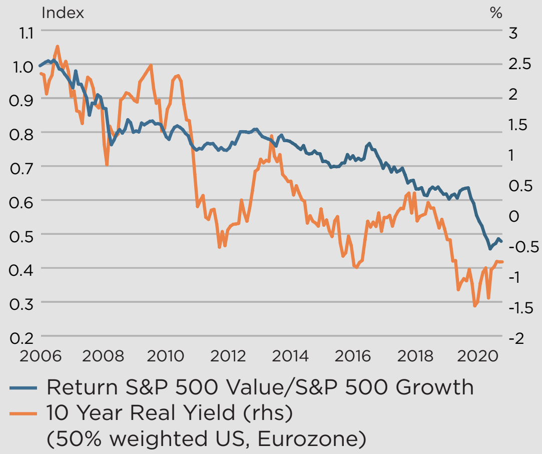
**Myth 3: Value has underperformed significantly for many years and so will now outperform growth again.**

The reality is that this is a classic that has been trotted out by value investors every year since value stocks started to underperform growth stocks in 2007. There have been sporadic attempts to change this trend since, but every time value stocks (a very hazily defined concept in itself) have tried to get back in the game, they've quickly found themselves knocked back out.

There are many reasons for this. For one thing, we live in an age where money doesn't cost anything. Central banks have created excess liquidity in our economies, which has reduced interest rates to historically low levels and pushed up the value of future cash flows, which has favoured growth stocks over value stocks, please see the graph on the next page.

Meanwhile, economic growth has been disappointing, and when growth in general is low, areas where there is growth will be worth much more. This has supported a rerating of growth stocks.

**Figure 2: Value has underperformed growth driven by falling interest rates**




Source: Bloomberg as of Dec. 2020

Finally, our economies are undergoing major structural changes. Digitalisation is accelerating and increasing the value of intangible assets at the expense of tangible assets, something which is not captured well by traditional value analysis. In very general terms, the greatest problem with traditional value analysis is that there is too much focus on valuation measures and not enough on the actual business model. Traditional value stocks are like melting ice cubes as a result of structural challenges to their business models either from developments in the economy, such as low interest rates, which are making banks less and less profitable, or from the trend towards more sustainable investment, which is fundamentally testing companies in energy, transport and tobacco – the most important value categories.

To believe in any reversion to the mean when it comes to the relationship between value and growth stocks is to believe in a sea-change in the underlying fundamentals in our economies. You would have to believe in a persistent rise in interest rates fuelled by mounting inflation, accelerating growth and employment, and investors downplaying the importance of ESG risks and sustainable investment. It is likely that the rollout of Covid vaccines in 2021 could bring something of a sugar rush, but what awaits us on the other side of the pandemic? Do we really believe that the crisis will usher in better economic conditions for structural growth in the years ahead, and that ESG and sustainability will be less important in the future?

Mean reversion is viewed by many as a natural law. But the story of humanity is one of long-term progress – evolution. This will be reflected clearly in the select few companies that help drive this process. Here at C WorldWide, we believe that the distinction between value and growth is imprecise and will become more and more irrelevant in the coming years. Some talk about "Value v. Growth" as though it were a boxing match between two wildly different opponents. It's not. In reality, a good investment is about finding both value and growth. At least, it is for us at C WorldWide. We think it is better to spend less time on these theoretical discussions and focus instead on identifying the small cohort of companies that are capable of growing profitably over time – what we like to call compounders.

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