GrayIssue

Equity investing in an unpredictable world

10 September 2014
Issue no. 160

'In preparing for battle I have always found that plans are useless, but planning is indispensable.'

Dwight D. Eisenhower

When we buy shares in productive assets, we are faced with the inherent unpredictability of the future cash flows that these assets may generate. This unpredictability means that forecasts are useless, particularly when we look a few years ahead.

In spite of this, we can still invest intelligently for the long term. Embracing underlying uncertainty leads us to learn from and adopt approaches that have been used successfully in many fields from science to warfare. We approach investing statistically, plan for uncertainty, and exploit situations where markets underestimate uncertainty.

Cash flows are uncertain

Let's consider an example: You wish to acquire a store-front property on the main street in your town or suburb. You do thorough research. You find that foot traffic has been growing, vacancies are low, and rents have been rising comfortably above inflation. The town is prosperous, drawing income from diverse industries. Acquiring the property seems obvious.

A few years pass, and a sparkling new shopping centre is built a few miles away. The foot traffic on your street starts to decline and a few weaker businesses are forced to close their doors. Vacancies rise, rents fall. Property owners hold out for a better price, and property valuations slide slowly. Would you invest in that store-front property now and if so, at what price?

You know your town and the property in question very well. You know how much money it makes today. Yet its future cashflows are truly uncertain. Could there be a death spiral where empty storefronts drive away even more traffic, causing additional empty storefronts? Or will lower rents attract new business, causing foot traffic to return?

Unpredictability is fundamental and ubiquitous

Dynamics of national and global industries are even more complex. There are many more competitors, suppliers and distributors. There are emerging technologies, substitute products, regulations, changing demographics and shifting lifestyles. In a global world, there are foreign entrants, government subsidies, currencies and domestic and foreign central bankers.

The complexity and interconnectedness of the world economy make the fates of its players fundamentally unpredictable. Even if it were possible to build an intricate model of all the variables that affect a business and its industry, it would still be impossible to predict industry dynamics beyond the very short term.

Unpredictability in the medium-to-long term is inherent not only in the economy, but also in many other natural ecosystems, from plankton in the Baltic sea to predator-prey networks in national parks. Scientists suspect that unpredictability is a fundamental property of life.

A short-term focus doesn't help eschew uncertainty

Even though forecasts can be more accurate in the near term, building a successful strategy on these forecasts is exceedingly difficult. The short-term speculator is up against two powerful forces. Firstly, when accurate forecasts are possible, the average of all forecasts is more accurate than any individual forecast ('The Wisdom of Crowds' phenomenon). This means that creating a better forecast than the one that is already reflected in the share price is very challenging. Secondly, even if one could consistently make better predictions than the market, a lot of the gains would be eroded by the high costs of trading, amplified by frequency, as well as fees and taxes.

Embracing unpredictability when we invest

We are long-term investors and embrace uncertainty when we select shares in three main ways:

1. We recognise fair value as a range

Forecasts may be useless, but the act of forecasting helps us understand what is possible for a company. We look at what the 'fair value' for the company shares would be if the future unfolded in a certain way. We recognise that 'fair value' is a wide range rather than a single number. The share price is likely to hover somewhere within that range most of the time. The further to the extreme of the range of possibilities the share price gets, the more under-priced or overpriced it is likely to be.

2. We plan for uncertainty and diversify

For some companies, the future will turn out to be more positive, and for others, more negative. We cannot predict in advance which companies will be the 'winners' and which may be the 'losers', which is why it is important to hold a diversified portfolio. What we can expect is that, with our investment approach, the 'winner's' great returns will more than offset poor returns from the 'losers', resulting in attractive returns for the portfolio.

3. We exploit the market's excessive focus on specific scenarios

Humans grapple with complexity by weaving facts into stories. Most of the time, this way of thinking serves humankind well. The challenge is that markets today offer us more data than investors can weave into a story. If we are not mindful, we grab on to the points that are most vivid and oft repeated. A very negative scenario for a stumbling company can come to dominate market discourse. The extent to which this can be reflected in the share price is often disproportionate to the likelihood of the scenario happening. At Allan Gray, we are conscious of unpredictability and take advantage of these opportunities. Being mindful of unpredictability when outcomes seem certain is another way of describing contrarian investing.

Long-term, fundamental, contrarian

Embracing uncertainty is at the core of our long-term, fundamental, contrarian approach to investing. The way we invest is more than a 'style'; rather, it is based on working with our real, unpredictable world from the most rational standpoint available to us today.

This article was first published by Allan Gray Australia. Investors can access the Allan Gray Australia Equity Fund and the Allan Gray Australia Opportunity Fund via the Allan Gray offshore investment platform, or directly through Allan Gray Australia. These funds are approved to be marketed in South Africa in terms of Section 65 of the Collective Investment Schemes Control Act. For more information about these funds, please visit www.allangray.com.au

Commentary by Anna Lopatnikova, Analyst at Allan Gray Australia