Investment Conference Reflections 2023

Friday 17 November 2023

In early October we held our annual investment conference, and I thought it might be useful to share some of the key messages from the event.

The three speakers on the day were Nick Train, co-founder of the asset manager Lindsell Train, Mark Lacey, manager of the global energy transition fund at Schroders, and myself, Ian Quigley, Head of Investment Strategy for RBC Brewin Dolphin Ireland.

It might seem a little self-indulgent to start with the takeaways from my presentation, but they seem all the more relevant given continued weakness in financial markets.

To set the context for the day, I discussed two major events that have influenced markets over the past year.

Surge in bond yields

The first was the really quite staggering increase in bond yields and the profound impact this has had on asset valuations. It is remarkable to reflect that the German two-year bond yield was still negative at one-point last year and is now over 3%.

This truly historic move, in terms of speed and relative scale, has resulted in a dramatic decline in fixed-income-like assets, with a global bear market in bonds and a really challenging environment for listed real estate and infrastructure assets.

To further illustrate this point, we discussed the simple formula for valuing assets, whereby we assess the present value of future cash flows by discounting these cash flows by an appropriate required return or discount rate.

This simple formula illustrates why fixed-income-like assets, with little or no growth, have been the most challenging place to be over the past year.

It also illustrates why assets that can deliver growth in cash flows against a rising interest rate environment are much better positioned. This explains the relatively good performance of higher quality equities during this period.

Much has been written about the negative impact of rising rates on the valuation of assets and, all things being equal, this is absolutely true.

However, all things are rarely equal and higher interest rates, should they persist, are likely a function of higher nominal economic growth. The thought to take away is that if we can invest in assets that deliver higher cash flow growth in a more inflationary and higher interest rate environment, then this growth can offset the rising discount rate.

Rise of artificial intelligence

The second major event we discussed was the rise of artificial intelligence (AI) in the public consciousness and why we believe investors need to think about the implications.

In particular, I shared some insights from the book 'The Coming Wave' by Mustafa Suleyman. He is the co-founder of Deep Mind, which is a leading AI business that Alphabet acquired in 2014.

Suleyman is a persuasive author, and it is hard not to conclude that we are on the cusp of some profound changes in the global economy.

For some time, we have felt that we should allocate a percentage of our client portfolios to strategies that seek to capture future innovation, given the potential for significant changes across multiple industries.

Whilst this proved rewarding in the years leading up to 2022, it has been very challenging since, with the highly unusual business cycle and rapidly rising interest rates resulting in a much-changed environment for these strategies.

However, when I read through Suleyman's book, the initial logic of having a relatively small allocation to strategies focused on investing in new technologies remains valid, and we are reminded of the need to have a long-term horizon when doing so.

Notwithstanding this point, my primary focus was on durability, noting that it is far easier, and likely more rewarding, to spend our time trying to establish what will not change as opposed to what might.

Our primary goal should be to invest in durable assets that can prosper in differing environments, recognising that the future is inherently unknowable.

Investing in quality businesses

This really was a lead into Nick's presentation, given his long tenure of investing in high quality global businesses.

We have known Nick for a long time and many of the businesses he invests in are well known, including Diageo, Burberry, and Heineken.

For many of the attendees, however, it was not Nick's message about investing in durable consumer brands that was most interesting.

Rather, it was the message about investing in companies that can leverage AI technology to embed themselves more with their customers, with a particular focus on companies that own data.

Nick shared a fascinating framework for thinking about this, illustrating how his portfolio companies scored against a number of key criteria, with an emphasis on global businesses with market-leading data sets and strong recurring revenue.

Nick is telling us that we need to think about how the economy is changing and what type of company is best positioned in a digital age.

This is evident when we look at Nick's portfolio and the increased weighting to data and software businesses, alongside his long-standing allocation to luxury and consumer brands.

Nick's optimism and his relentless focus on the long term was also very refreshing. In a period when time horizons have become increasingly short term, with macro-economic debates dominant, it was great to hear a very experienced and accomplished investor focusing on business quality with an ownership mentality.

Energy transition

Turning to Mark's presentation, the focus shifted towards the energy transition and the technological advances of the past decade.

It struck many attendees that, despite the clear need to transition to renewable power, the sector is going through some very real challenges right now.

It almost seems counterintuitive. Surely, the sector should be booming given all the government support and the strategic importance of the transition.

Mark explained that the macroeconomic environment had become quite hostile, with supply chain challenges and the rapid increase in interest rates resulting in existential consequences for some companies.

It was clear, however, that these short-term challenges are cyclical, with demand for electricity set to continue to grow for the next two decades and significant investment required to meet this demand.

It logically follows that once the sector emerges from its current malaise, we will see a more mature industry with clearly defined leaders in a more rational market, supported by strong secular tailwinds.

Given the decline in valuations across the sector it seems like a really opportune time to be focusing on the sector.

Challenges and opportunities

Overall, it was a really interesting and thought-provoking day, especially when we reflect on the challenging investing environment of the past two years.

Whilst 2023 hasn't proven as difficult as 2022, it has not been an easy year, and this is something we discussed with our speakers.

In Nick's case, we have seen his listed investment trust, Finsbury Growth and Income trust, move out to a 5-7% discount to assets, and one of his biggest holdings Diageo is now trading at its lowest valuation multiple in nearly a decade.

Investment trust discount widening has also been a real challenge for our client portfolios over the past year, with many investment trusts trading on high single- or double-digit discounts. This suggests some panic in markets and whilst it is likely a long-term opportunity, it is still uncomfortable in the short term.

For Mark, a perfect storm of supply chain and interest rate factors has resulted in a difficult environment for the renewable energy sector and whilst he has outperformed his peers significantly his strategy is still down this year.

We all agreed, though, that ultimately our success as investors will be determined by the return our investment can generate, and if we can buy these assets at reasonable valuations we should do well over time.

In the short term, the adjustment we have seen in asset valuations, as a result of rising interest rates, has no doubt been unpleasant.

However, much is now in the price, and we see opportunities amongst the prevailing mood of pessimism today.

It is at times like this that we must resolutely focus on the long term, continuing to invest in high quality assets (including strategies managed by Nick and Mark) across diversified portfolios, recognising that challenging markets are part of the investing journey.

As always, please do not hesitate to contact us to discuss our views further.

Ian Quigley
T: +353 1 2600080
E: ian.quigley@brewin.ie

www.brewin.ie

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