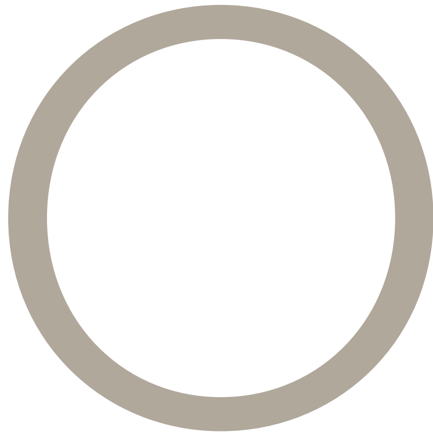

# SIR JOHN TEMPLETON INVESTMENT ROUNDTABLE 2016

London | 25th May

John Templeton Foundation | OXFORD METRICA

## ABOUT OXFORD METRICA

Oxford Metrica is a strategic advisory firm, offering informed counsel to boards.
Our advisory services are anchored on evidence-based research in risk and financial performance.
Our work includes statistical analysis and index construction for banks and insurers, risk and performance analytics for asset managers, due diligence support in mergers and highly customised services for corporate boards.

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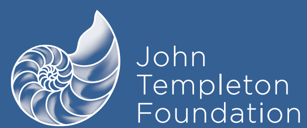


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# THE PARTICIPANTS

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**Charles Brandes**, Chairman, Brandes Investment Partners
**Richard Bruce**, Founder, Trinity Street Asset Management
**Julian Gould**, Fund Manager, Intrinsic Value Investors
**James Hunt**, Chairman Investment Committees, Tocqueville Asset Management
**Bill Kanko**, President, Black Creek Investment Management
**Kenneth Lowe**, Portfolio Manager, Matthews International Capital
**William Priest**, CEO & Co-CIO, Epoch Investment Partners
**Hugh Sergeant**, Head of Equities, River and Mercantile Group
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**Jennifer Simpson**, Chairman, John Templeton Foundation
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**Harvey M. Templeton III**, Trustee
**Dr Josephine Templeton**, Trustee
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**Udayan Roy**, Financial Controller, First Trust Bank
**Dr Andrew Serazin**, President, Templeton World Charity Foundation
**Doug Scott**, Chief Administrative Officer, John Templeton Foundation

**GUESTS**
**Mark Deal**, Associate, Dechert
**Jane Siebels**, Founder, Green Cay Asset Management

# FOREWORD

**TROUBLE IS ALWAYS OPPORTUNITY**

I am pleased to present the proceedings of the 2016 Sir John Templeton Investment Roundtable, the annual forum in which investment managers invited from around the world by the Templeton Foundations debate the threats and opportunities for financial markets.

I write this foreword four days after the UK voted by a decisive margin to take the momentous step of departing from the European Union (EU). At the Roundtable, participants had already devoted considerable time and prescience to debating the possible impact of such a decision. In general, they stressed the downsides – the risks of market uncertainty and of a domino-style collapse of the EU – rather than any potential upsides, either in benefits to Britain or as a wake-up call to the EU. Looking beyond a Brexit, they highlighted the underlying financial structure of the EU and especially of the Euro as ominous long-term flaws.

A parallel upsurge of populist dissatisfaction, rooted in similar causes, was identified in the US in the shape of the surprise rise of Donald Trump's candidacy with all its attendant uncertainties. While developed economies like the US had offered richer investment returns in recent years relative to the emerging markets, participants felt opportunities there were likely to be more constrained in future.

The problem was felt to spring in large part from widespread inflated multiples and unrealistically high valuations both in the US and elsewhere, despite a backdrop of continuing low earnings. A root cause, as participants saw it, was ongoing low interest and unrestrained QE policies pursued by central banks, laudably intended to head off the spectre of deflation but which had become a substitute for implementing necessary fiscal reform. Paradoxically, inflation – long seen as an evil – was viewed to a degree as a potentially welcome development.

Nevertheless, and in line with Sir John's contrarian philosophy that trouble spells opportunity, various individual opportunities were glimpsed through the gloom. Although China was generally felt to have become more problematic given its banking and monetary challenges, and the increasingly authoritarian and centralising tendencies of its current president, China's long-term potential was thought to be undisputed. Other opportunities were identified elsewhere in Asia, Latin America and – somewhat ironically – southern Europe.

Opening the Roundtable, the keynote speaker, Charles Brandes, made a spirited case for the virtues of long-term, highly concentrated value investing. This in turn sparked a vigorous debate, firstly on the issue of fees but then on the true nature of Sir John's philosophical legacy of value investing and the merits of agility *vis-à-vis* those of consistency.

Perhaps significantly, only a limited number of major new product or technological opportunities emerged from the Roundtable's discussions. It may be that, in the light of this and also the current landscape of flat earnings, we are entering into an era of generally low investment returns in which we cannot automatically look to a rising tide to lift all boats. If so, the future may demand not just the steady-as-you-go value investing of the past but instead a highly targeted, nimble and super-focussed value investment strategy.

The views expressed in the Roundtable, it should be emphasised, do not necessarily reflect the views of the Templeton Foundations, their trustees, officers or employees. I would like to thank all the participants, colleagues and in particular Charles Brandes for his keynote address.

Dr Rory Knight,
Moderator

Dr Rory Knight is Chairman of Oxford Metrica and he serves as a trustee of the John Templeton Foundation.
He was previously Dean of Templeton College, Oxford University's business college.

# KEYNOTE ADDRESS BY CHARLES BRANDES THE ESSENCE OF WEALTH CREATION

Charles Brandes is the founder and chairman of Brandes Investment Partners LP. Starting in 1968 as a trainee broker, Mr. Brandes dedicated his practice to value investing. He founded Brandes Investment Partners in 1974 and has never wavered from his value approach, building portfolios one company at a time through the firm's equity and fixed-income strategies to help clients pursue their long-term investment goals. Brandes' accomplishments in financial services have led to his receiving two lifetime achievement awards: from the London Value Investor Conference and from his alma mater Bucknell University for outstanding achievement in a chosen profession.

I should like to begin by commenting briefly on the situation in the investment and the economic world today before moving on to the problems that are obvious to all of us. In spite of these problems, we need to look back over the past one hundred years, and recognise the tremendous growth in wealth and individual income that has taken place, and acknowledge how that progress is continuing today. Real growth in income and wealth over the past one hundred years has increased by some seventeen times. And this despite recessions, depressions, world wars and other political problems.

So how can we best continue to do good to the world and invest wisely so that bodies like the Templeton Foundation share in that growth and use their wealth to help make the world a better place? I want to focus today on basic principles. We tend to get far too involved in the day-to-day and lose sight of the fundamental principles governing economic growth and investment. I want therefore to pose three basic questions.

My first question is this: where has all of the wealth and growth that we have seen over the past one hundred years actually come from. What fundamentally creates new wealth in a free enterprise economy? It derives of course from improvements in productivity and the creation, production and distribution of new goods and services. Simple stuff, but sometimes forgotten.

If so, which vehicles should we employ? Again, there is no question about that. Equities have outperformed over the long run. A hypothetical $100 invested in December 1977 in the S&P 500 would have become $6,415 by December 2015. If, on the other hand, you had invested in alternatives like commodities, gold, bonds and US housing prices on an unleveraged basis, the rates of return would have been very much lower.

### THE MOST EFFECTIVE STRATEGY: VALUE INVESTING

I believe that the Benjamin Graham philosophy of value investing has proven to produce better returns than both growth investing and indexation. Look at the hypothetical growth of a $10,000 investment made in December 1974. Invested in the Morgan Stanley World Value Index versus its World Growth Index, the value index has done twice as well as the growth index.

I first met Benjamin Graham by chance in 1974. He walked into my office, wanting to open an account to buy a security. It was a stock by the name of National Presto Industries that went on to form an example quoted in his book *The Intelligent Investor* - by the way, one of the best books ever written about investing. Graham passed away in 1976, but he has to be considered the dean of all Wall Street security analysis. His 1934 book *Security Analysis* is a bible of our industry as far as investing goes. He is also the father of value investing and the teacher of Warren Buffet, probably the greatest investor of all time.

### ACTIVE INVESTMENT VITAL

Investments, it goes without saying, should be allocated efficiently to businesses that create wealth - businesses with the right environment, capital, people and incentives to create growth and not to some other alternatives. What I am leading up to is something I believe has been going wrong in the investment world for a very long time, especially recently.

If you are not a professional investor but want to participate in the growth of economy, you might want to index a portion of your assets. Even Ben Graham himself said that, if you are not an enterprising investor, you would at least be better off investing in the economy than not investing at all. However, professional passive investing is almost immoral because it makes no attempt to identify the best companies that grow wealth over time. Professional investors have a responsibility to direct capital towards such companies in a free enterprise economy.

Also, basic index investment principles are mistaken: that the higher the price of the company goes, the more you buy of it. That makes absolutely no sense to me. It has often been said that active managers as a body do not outperform indexing but it is obvious that if you lump all active managers together in this way, they *are* the index. By definition they cannot outperform one other. Let us take the UK premier football league as a parallel. Put all the teams together and the overall result is going to be zero. It will have become a zero-sum contest. No one team will have won anything. I should be very surprised if Manchester United opted to index. They would be replacing the opportunity to compete with a 50/50 outcome and have given up trying any longer to be an outstanding world team.

### LOOK LONG-TERM

If you are going to need money in three or four years' time, you are right to worry about immediate risks. However, one of the biggest problems that I have encountered in the investment business in my 46, going on 47, years has always been the same: excessive short-term thinking. Sometimes, if you need the money you need to think short-term. But if you are a foundation like the Templeton Foundation, you have the power to think very long-term, and that is what you should be doing and by so doing in order to take the greatest possible advantage of the growth in new wealth.

### A MISCONCEPTION OF RISK

I proceed to my second question: how should investors properly view risk. What is the true nature of risk? The answer is of course the permanent loss of capital at a fundamental business level. However, in today's investment world most thinking does not define risk in that manner but rather as volatility - stock price volatility. The obsession - which I think absolutely wrong – is, especially since 2008, to dampen volatility within a portfolio. It is a very short-term and wrong way of thinking about investing and about what has maximised wealth in the world over time. They are obsessed with measurements. But all they are doing is measuring stock market volatility, and that is all.

If you are only worried about short-term stock market fluctuations and not the long-term, basic fundamentals of wealth production, then you are little better than a speculator, a gambler. You should not be thinking about anything other than the fundamental economic value and long-term wealth production capacity of the businesses you own. Value investors rightly separate this from short-term market movements.

### STRENGTH IS NOT IN NUMBERS

Standard deviations, Sharpe ratios, information ratios, up and downside captures – all these concepts spring out of the theory of the 'Efficient Frontier' propounded by Harry Markowitz in 1952. Harry is a brilliant mathematician but not equally brilliant at understanding the investment world. I have talked to him recently, and learned that even he is starting to think that maybe some of our maths cannot really be applied to investing because it is a social science not a pure science. So even Harry Markowitz - the efficient market frontier and the efficient market guru of 1952 - is starting to change his mind!

Today we have all these new products and new things on Wall Street that you are supposed to be into. The consultants tell the investors: "Look, the board members of the institutional funds are really bothered about at this stuff now", and the investors nod their heads and say: "Yeah, this is something we really have to do". I am referring to things like risk parity. Do you know what risk parity is? It is leveraging up your bond portfolio to make it as volatile as an equity portfolio - which is ridiculous.

Then we have macro hedge funds, liquid alternatives, liability-defined investing, some smart beta, non-correlated diversification hedging with derivatives. All of these things depart from what is really important regarding basic investments in businesses that create wealth over time. Albert Einstein, incidentally, agrees with me. He once said: 'Not everything that can be counted counts'. I say all these measurements do not really count in true investing. You cannot put mathematical equations on them. Sure, you have to do a lot of basic fundamental analysis from the standpoint of accounting and that type of measurement, but that is as far as it goes.

### CONCENTRATE YOUR PORTFOLIO

What kind of portfolios will best take advantage of all the new wealth that is going to be produced over the next ten to twenty years? In my firm we have a 100-year plan, and I am hoping to be around for most of that time, although I am not really too sure about that! How then to build a portfolio that is going to be outstanding, outperform the indices and do better than the average investor? The answer is simple: in order to outperform you have to think and act differently from the majority. You cannot be too concerned about the conventional wisdom, the day-to-day concerns and doing what everybody else is doing. How are you going to outperform if you are doing exactly the same thing as everyone else?

In building your portfolio, you need a high active share, if you want to outperform the index - which means that you will not be indexing or even getting close to the index. Concentrated portfolios are therefore vital. There is absolutely no question about that. A term that gets bandied about a lot is high tracking error, which means that your portfolios are not doing exactly what the index is doing. This can create problems because there will be periods when you underperform the index. If you do not want to be an outstanding investor, then you shun that risk. On the other hand, if you want to be an outstanding investor, then you should be prepared to accept it, because it is only a short-term risk.

### THE HERD INSTINCT

This leads me to my third question: is there a behavioural component to economics and investing? The answer is: yes, of course. I should like to make two points about this. Firstly, it is very difficult for us, as human beings, to think long-term, to think in terms of, say, twenty years from now in our investment programmes. Most of us think about the next six months, the next year, the next two years, or maybe, even if we are really long-term thinkers, three. That is not long enough. This is one of the reasons value investing works because it is contrary to this short-term thinking. My second point is that it is very difficult to be different. All human beings like to be part of a group. That is built into us. But if you are going to be part of a group, you are not going to be better than the group.

#### A WORLD OF OPPORTUNITY AWAITS

I should like to conclude with a few comments about where I stand as a value investor in today's world. We all know that emerging markets have been very volatile. Emerging markets have not been performing as well as developed markets, especially not the US market. But what does that really mean? It means that there is a great opportunity in emerging markets. According to price to book measures emerging markets are about as cheap they were in the depths of the global financial crisis, the Gulf War crisis, the Latin American crisis, the Asian currency crisis. If you look at some of the very good companies around the world in emerging markets, the valuations are absolutely outstanding for the long-term investor.

Russia is the cheapest among emerging markets and China is also cheap. However you have to be cautious because the index in China, including the five biggest banks, are trading at about five times earnings on average. We suspect that they are not acknowledging the actual losses in their portfolio. Other opportunities in the Chinese market are limited today from a valuation standpoint. They are not as cheap as we should like to see them. While there is no doubt that over the next ten to twenty years China is going to do very well, and there will be great opportunities to invest there, today you have to be careful given prices.

India is another area that we as value investors are finding now is a little too expensive, so we are not investing there to any great degree. We are investing in a few companies, but we will be holding back for ten to twenty years for major opportunities in that growing market.

The US market at 17.3 times earnings is quite high, and the S&P 500 developed small cap index is also very high. We are not finding value in the USA, and as far as our portfolios go, our allocation to the USA is about as low as it has ever been. It is not the case that the USA is suffering from a bubble in our opinion. It is not that high. That said, the CAPE there – the cyclically adjusted P/E ratio - is quite high at 26 and a half times earnings, where its average is more like 16 times. So you should be cautious about investing in the US.

In the current cycles value investing has not been doing as well as growth investing for quite some time, and because of that the valuation differences between the growth stocks and the value stocks are about as high as I have ever seen them in my career. There is a great deal of evidence why that has taken place. You may have your own opinions about that, as I do. But, looking ahead, all sorts of unforeseen factors will undoubtedly change the world situation. Personally I believe that, although not the situation right now, the historic pattern will eventually and inevitably reassert itself.

# QUESTIONS AND DISCUSSION

### THE NEGATIVE IMPACT OF FEES

The keynote speaker's football metaphor is somewhat misleading, Dr Knight commented. It is not a zero-sum game if fees are being taken out, it is a negative-sum game. Whereas it is not immoral to provide an index fund and not charge much in the way of fees, it is immoral to say, 'I can do better than that', charge large fees and then not perform. A participant added that he had found that roughly 85% of mutual funds do not beat the benchmark after fees.

The question, Dr Knight continued, is: how many of you are John Templetons? How does the Foundation make sure it has the best managers? In all honesty, the evidence in the last few years points against active management. Recently, two leading investment octogenarians, Warren Buffet and John Bogle of Vanguard have spoken out against active management generally, not just value investing, particularly regarding fees. John Bogle said that the hedge fund industry earns $84 billion in fees on $2.8 trillion whereas Vanguard charges $1.6 billion on $2 trillion. The speaker stated low prices were the reason value management is not doing well. The question then became: Is this just a cycle or a trend, and will it change? When will returns increase again?

Mr Brandes responded that in his experience the situation had not fundamentally changed over the past 40 years. There is no question, he said, even on the basis of academic evidence, that the deep value managers outperform and saw no reason why that was going to change. There are also some fundamental growth investors, he added, who have performed well over many years. These are also ones that the Foundation needs to find and stick with. It needs to be patient. Speaking personally, the Foundation in his view had done better than almost all the other institutions he managed.

A participant commented that one development today compared to thirty years or forty years ago is the vast IT capabilities and computational power we now enjoy. Any value investing methodology that can be reduced to numbers can be replicated by a computer today and done very cheaply. So why pay fees for it? The keynote speaker responded that this would not be the case because again of the human behavioural element. Companies identified in this way would not be felt irrationally to be good investments. One would not be following what the group was doing. Behaviourally, we have not changed at all as we saw in the internet and technology bubbles. In value investing, capacity and actual behaviour are two completely distinct things.

The Foundation only exists today, a participant said, because one individual had a clear approach to investing that delivered over many years and generated significant wealth. So there are clearly individuals and processes that can do that. Although it may be hard to identify those individuals, the values articulated by the speaker have clearly delivered superior returns over time. However it has to be admitted that the investment industry, like all industries, has exploited the behavioural biases of individuals that wanted to allocate capital at the wrong time simply because everyone else is allocating capital. A lack of education is one of the issues confronting the industry and one that fund managers need to grapple with more vigorously.

Dr Knight reverted to his basic question: should we be tempted away from these labels like value investing? They were not terms that Sir John himself used a great deal. He was actually very nimble. Dr Knight recalled hearing Sir John once say, 'If you've been doing something for seven years, even if it's doing well, you will want to change it.'

Every individual and every fund manager is always learning, another participant responded, and constantly enhancing their philosophies and processes. That said, one should never step back from exploiting the factors that over many years have generated clear returns. You certainly do not want to change direction 180 degrees just for the sake of it. You might do it at completely the wrong time, when the pressure is at its most intensely distorting, and that could prove very costly for your investors.

#### ATTITUDES TOWARDS VOLATILITY

There is an asymmetric payoff curve in investments, a participant commented. If you're a 65 year-old individual, you care a lot about the potential downside. On the other hand, if you are an institution like the Foundation you can afford to take a longer-term outlook. In the long run equities as an asset class make a lot of sense. They actually are a positive-sum game because they mirror both the GDP growth rate and compound it. With compounding, even a small increase, say of 3%, will results in the doubling of an investment in 24 years. There is no other model that allows the game to be played with such positive outcomes. So it all comes down to the individual's viewpoint. Is your horizon three to five years? In which case equities might not be the best investment. But if it is 20 to 30 years, equities present a very powerful instrument.

Mr Brandes agreed but added the qualification that even with a 20-year retirement horizon, while you should probably be more conservative at the beginning of that period, as you age you should be more aggressive to take advantage of gains. You should be thinking, not about yourself, but the heirs and institutions that are going to benefit after you. You have a responsibility to increase value for them.

The participant replied that in his experience short-term anxiety was a pervasive factor. Over the past 88 years the market compound of the S&P 500 has been a big number: almost 9.5% annually. But if an investor said 'On a year-to-year basis I want 95% confidence around that.' all one could respond, given the standard deviation rate, that: "It is 9%, plus or minus 35 percentage points." The VIX has been some 17% over time. With a bell-shaped curve and 95% of the observations exposed to two standard deviations, the annual estimate is 9% plus or minus 35%. But over twenty years, compounding will kick in and makes that level of risk acceptable. So the time horizon really matters.

#### PORTFOLIOS – CONCENTRATE OR DIVERSIFY?

The Foundation has a mandated 5% spend annually, said a representative. How does that relate to non-correlated diversification? It might seem you should have to have some non-correlated diversification to dampen the volatility of equities. You might well need to be diversified to a certain extent, Brandes replied, but he was convinced that, as an overall strategy, the value of diversification was greatly exaggerated.

#### BOOK VALUE A QUESTIONABLE MEASURE

Price to book value does not actually tell you a great deal, commented one accountant participant. Accountancy, he quipped, is a bit like a bathing costume: more important in what it conceals than what it exposes. Share buy-backs, of which a huge increase has taken place worldwide, exemplify this. In share buy-backs cash is credited and treasury stock debited from retained earnings. Given that markets are currently selling way over book value, the minute you buy back stock, you effectively reduce book value. As a result the price to book goes through the roof although the actual value of the company has changed very little. It really is no more than an accounting artifact.

Could today's low interest rates and low inflation expectations be a factor? asked one participant. Another participant added that in emerging markets one reason that book value is so low is because returns have fallen substantially.
For many years, returns were higher than in the developed world but now they are low: only about 6% or 7%. Liquidity in those markets at the moment is also tight. Yet those markets are so myopic and momentum-based that an uptick in returns will trigger an unseemly rush and one forcing its way through some very narrow doors.

Brandes commented that in today's technology companies book value is largely meaningless. Once upon a time you started a business, built buildings and factories, acquired trucks and equipment that appreciated over its useful life, and your book value grew in line with retained earnings and investments in bricks and mortar. But if you are a drug company today, an intellectual property company or any sort of software technology the investment is simply upfront expense. So the price to book for Microsoft is not really measurable and does not have any real meaning. He added, though, that as a value investor he had bought Microsoft stock three years ago, when it was way down, trading about 10 times earnings. Bill Gates was at that time no longer the richest person in the world, the PC business was shrinking, the cloud was on the horizon, and everybody was very negative about Microsoft. But bearing in mind the company's pervasive worldwide presence he had bought shares, and they had performed very well. Bill Gates, incidentally, is now once again the world's wealthiest guy!

#### FUTURE PROSPECTS

What does all this mean for the future? asked Dr Knight. McKinsey has recently published a study concluding that growth is not going to be 9% over the next 10 to 20 years but only 4% to 6%.

In reply, one participant pointed to the paradox that, while industries worldwide are being challenged competitively as never before, multiples have gone up when they should really be coming down. Another participant added that, speaking as a recovery value investor, the big difference was that deflation was evident nearly everywhere in the world. When you have deflation, or zero inflation and global GDP that is only 3% in real terms or maybe even lower, it is very hard for low value-added value companies to achieve top-line growth. Whether a value or growth investor, if earnings and cash flow are not increasing, the stock is not going to go up unless you paid a very low price indeed initially. And even then, the fundamentals look bad because today's world is very challenging for these lower quality businesses to recover. They need the tail wind of GDP growth plus some points of inflation. Without that, the outlook is going to remain very tough for them.

The ultimate requirement for global investment advisors should be patience, a participant concluded. Why is there all this emphasis on short-term returns and portfolios? Fund management is basically nothing more than stock picking. Nor should investors be afraid of short-term volatility, because short-term panics actually provide opportunities for long-term investors. If everyone were a long-term investor, we would never be handed the opportunity to pick up the stocks that build value.

# MACROECONOMIC CONSTRAINTS

### THE GLOBAL FLIGHT TO SAFETY

We are in a crisis with no name right now, Dr Knight commented, at least regarding price to tangible book value. Is that an aspect of the pessimism that has intermittently dogged the global economic order since World War II? Markets are increasingly integrated now, and the flight towards the US market might be evidence of the search for a safe place where there is a large internal market able to translate productivity into high growth businesses. Might we therefore have touched a new low in the integrated global economy that we have enjoyed since World War II?

The keynote speaker agreed. Markets are still very concerned about 2008, he said. Time has passed, but everybody is still running for safety - more than they should be doing in his opinion. Emerging markets are also very volatile and considered very risky. But that is the wrong way to think. One should rather assess those markets from the standpoint of the individual companies they contain, how they are growing and what prices you have to pay for them. What might encourage investors to move from paying ever higher prices for safety, he asked, accept more uncertainty and take advantage of some very compelling valuations? Again, it would come down to the human behavioural element. Some of these companies have started to perform very well since February. Russia is also performing extremely well, as have some of the other emerging markets. Since, behaviourally, everybody likes to be part of a crowd, these changes will eventually be recognised, and people will want to jump into these markets. However it might take some time. Historically, that is always the way of it. Everything behavioural operates in cycles. All these companies are eventually going to be sought out.

### INTEREST RATES - A DISPLACEMENT ACTIVITY

A dominant factor overhanging the world economy, Dr Knight said, is the policies of central banks in imposing negative interest rates and introducing a great measure of quantitative easing. In this connection he noted that Wolfgang Schäuble, the German finance minister, had recently made a direct, almost personal attack on Mario Draghi, and also highlighted the way negative interest rates are hampering Japan. How do these interest policies affect investment? It is safe to say that we have never been here, a participant responded. We have never been in a world of such low or negative interest rates. They are of course an attempt by the central banks to keep us out of the last crisis and avoid deflation. But they also represent an attempt to avoid much-needed reforms, a desperate last ditch monetary attempt to get higher growth without reforming fiscally.

In a world of low interest rates governments are the winners and savers the losers, especially in Europe with its ageing populations, he added. There is an element of that too in the US and Canada and certainly in Japan. So long as there are easy monetary policies like these and intentionally low or even negative interest rates, it tends to dissipate any real sense of fiscal responsibility. What one should fear are the unintended consequences of negative interest rates. Are people going to keep money under their mattresses or spend it? No-one really knows how people are going to react to this situation, because it has not happened before.

Regarding growth, we will undoubtedly see more of what we are already seeing. The basic driver - world population growth - dropped from 2% in the 1960s to 1.8% in the 1980s. It is currently just over 1%, and by 2050 could fall as low as 0.8%. Paralleling lower population growth, growth in productivity has also fallen around the world. We will be looking at a world with very low growth prospects for at least the next five to ten years, and governments have not yet accepted that. Instead of implementing the necessary fiscal reforms, they are trying to achieve higher growth via monetary policy, and that is not going to work.

Do low interest rates distort valuations? Dr Knight asked. It creates a perverse pressure to inflate multiples, a participant replied, a pressure that has become apparent over the last two years. In the markets the result has been that cash has gone up in value and valuations have been distorted. The result is frustration. And with all the volatility there are only very short windows, tiny windows, of opportunity now. They opened a fraction in February, and moments like those were brilliant, but it is necessary to wait months to get these few days of opportunity. Distortion is going to be the case over the next five, ten or fifteen years. We have never been in a condition like this and, if it continues, it could end very badly.

Central banks are wrong, the keynote speaker said. Throughout history they have been wrong, and they are even more wrong now than ever. It all comes down to politics, agreed a participant. There is a general crisis of leadership. You see it in the central banks and in politicians, and reflected at the grassroots in the way people are reacting and voting.

Japan is the poster boy for what might happen, commented a Foundation representative. Demographics and productivity are terrible there. Arguably, they are the way the developed world is heading, because there are these negative trends everywhere - poor population growth, not much growth in the workforce outside countries that have immigration and poor productivity even by the inadequate standards by which we record it.

The question is: who in their right mind would buy an eight-year German sovereign bond today? The yield is zero! You would only do that if you thought interest rates were going to fall even further. And it would be mistaken to think zero is the bottom line. The bottom line which central banks might set is some unknown negative number. Unilever was actually offering bonds a few weeks ago at zero rates. One day we are going to wake up and find the ECB buying up corporate bonds – and that will be an interesting moment!

### UNCHECKED QE – ANOTHER DAMAGING FACTOR

Another distorting factor having an impact since the global financial crisis is QE, unrestrained quantitative easing, said a participant. In assessing the value of a stock, only a few key things matter: dividends, dividend yield, earnings growth, plus changes in P/E. Bizarrely, QE has significantly brought down the discount rate for all financial assets with result that their market value has gone through the roof. According to the World MSCI, the cumulative return over the last four years has been 53% - a high number one might think, but four-fifths of that comes from the distorted expansion in P/E ratios. 20% of dividend and earnings gains in the MCSI have actually been negative over the last four years.

What would a security analyst doing their best to forecast earnings come up with today? Nothing. Apart from the increase in dividends, the huge increase of value has generally come from expansion in multiples - which is almost directly attributable to the impact of quantitative easing. Is this situation temporary or permanent? That question cannot be answered, but it is almost inconceivable that a case could be made for further P/E expansion without some gain in earnings or unforeseen advance in the accuracy of diligence.

### THE SPECTRE OF DEFLATION

The biggest single fear remains deflation, said the keynote speaker. Of the OECD's 34 members, 31 have inflation at 2% or less, 27 are at 1% or less and ten are below zero. That is the spectre of deflation writ large and what policy makers most dread. We are probably going to be stuck with low interest rates for some time. They are bound to have an impact. If you are thinking about buying a car today, and know tomorrow it is going to be cheaper, would you buy? And for an economy, that is catastrophic. So, we are in a situation where savings are huge but investment opportunities small.

The cause of deflation is clear - the credit crunch and subsequent central bank policies to correct it. The knock-on effect of re-capitalising the world's financial system has been deflation. Because of the readjustment of bank balance sheets, which had become significantly overinflated, we now have four times the amount of equity in banks that we had ten years ago. China's poor allocation of capital over the last few years has also been a factor helping induce deflation - although they are now recognising the need to focus on improving their return on capital. We have also had a commodities shock over the past few years that has been very deflationary, although that is now bottoming out. So there are many causes conjuring up the spectre of deflation.

But is deflation totally negative? asked a participant. In the last ten years we have been targeting 2% inflation but why is 2% inflation necessarily considered a good thing? 2% inflation was once considered high. It is possible to have real economic growth in a deflationary period. Historically, we have had deflationary periods in the world, when real incomes also grew. When people talk about deflation, they are really thinking about the 1930s and total economic collapse. But you can have a small degree of deflation and real economic growth.

### INFLATION COULD BE OPPORTUNITY

There may be reasons to be optimistic about the future in terms of inflation over the next five to ten years, the keynote speaker said. Since 1982, bonds have been in a bull market and inflation has fallen. What are the prospects, however, today? That is the key question now facing the investment world. As investors we need to think about the next, not the last, ten to twenty years.

The greatest risk from inflation is the erosion of capital, commented a participant. Inflation is a form of insidious attack. It debases the debt that governments put on their balance sheet. But erosion of capital is only one aspect of risk, said another. The fundamental risk is the loss of earnings from income. As long as earnings keep coming, capital can go down because price and the range ratio fluctuate and value can come back. So risk has more to do with the underlying growth of earnings that drive capital one way or the other. Generally, businesses in an inflationary environment can deal with that. Revenues go up if margins stay the same - but of course only if businesses create the goods and services that overcome the inflation problem. If there is much higher inflation over a longer period, valuations will contract. But, if inflation then falls, valuations will expand again. As long as earnings are still there, adjusted for inflation, value will return in real terms. So real risk is loss of earnings in whatever asset you are investing, whether real estate, bonds or equities.

If we did indeed shift from deflation to inflation, what would be the opportunities? Dr Knight asked. The point at which the switch occurs is the key consideration, a participant replied. When it does there are huge anomalies today waiting to be exploited. Everything that is not excessively priced because of low bond yields or uncertainty will do amazingly well given a return to inflation. Not so much in North America, because that is a market that is already quite fully valued but large parts of the Eurozone look attractive, where profits are depressed, as does the

financial sector with the average bank around the world trading at 0.6 - 0.7 of its value. You can buy Japanese banks for yields of 6%, which is clearly higher than their inflation rate or their bond yields. So there are inviting opportunities. You could buy emerging markets stocks that add value with good quality businesses. That said, the switch to a reflationary world could take a few years. The current consensus is clearly all about pricing in deflation. But we all know that over time consensus is often wrong. The consensus will be wrong again about this within the next five to ten years - and fortunes to be had betting against it.

### CURRENCY QUESTIONS

How far do currency factors affect your investment decision making? Dr Knight asked. Since currencies have no intrinsic value, a participant replied, predicting them is a fool's game. However, there are some ways to sense where they might be tending. When everybody is on one side of the currency boat, you can almost be certain from a contrarian position it is going to tip the other way, at least in the medium term. Another thing bottom-up investors can benefit from is conversations with the management teams of exporting businesses, in order to try to understand how the value of their home currency is affecting their businesses and competitiveness. When exporting companies complain about the value of their domestic currency that is a pretty good indication. At a more basic level currencies bottom-up investors should build the numbers into their processes if only to understand the effect of how revenues and cash flows are denominated.

Will the dollar weaken? asked Dr Knight. 'I believe that it has seen its strongest moments, at least in this cycle,' the participant replied. 'If it does weaken – and it does not have to weaken much, just not get any stronger – that will have positive top-down implications for some of the areas we have been talking about. It will create a better backdrop for commodities and emerging markets.'

# GLOBAL CHALLENGES

**WHAT FUTURE FOR EUROPE, POST-BREXIT?**

'The IMF has identified a Brexit as a major risk,' Dr Knight commented. 'It has stated: "Brexit could do severe damage to the regional and global economies by disrupting established trading relationships". Do you agree?'

'As with most things in the investment world, we are dealing with a future that we simply do not know,' one manager replied. 'And, because we do not know, there are inevitable risks. If Britain could get 25 years hence in the blink of an eyelid without the pain, then it might be worth its exiting. But, given the degree of uncertainty and the three to five years' economic cost involved, it may not be worth it. The worst thing will be ten years renegotiating trade deals. Do you know how many trade negotiators there are in the UK? Zero! It has not struck a trade deal since 1973. All have been channelled through the EU. So, given the logistics and the time needed to set up the bureaucracy, there could be huge risks.'

Looking at a post-Brexit future for the UK, another participant foresaw a stony path: 'The EU is not going to make its life easy. Why would they strike a sweet deal? The Brexit camp say Britain could leave Europe and still enjoy access to the Single Market. But it would not necessarily be in the EU's interests to allow that.'

A fundamental problem in the view of many participants was the EU's financial architecture. 'Brexit is not the existential threat to Europe, the Euro is,' one manager commented. 'Whether Britain stays or goes, the Euro issue will have to be resolved, either through unification – closer fiscal integration - or some kind of fragmentation. That is unlikely to be addressed immediately. Only now has the EU got round to sorting out debt forgiveness for Greece.'

The Roundtable felt that the biggest risk of a Brexit would not be the disruption to trade flows but the threat to the entire future of the European project. The EU might fragment into a core and a periphery, predicted one manager. The core, the French-German axis, is still strong, but even in France there is a powerful right-wing, anti-immigration movement under Marine Le Pen. Anti-Europeanism is on the rise, he added. Polls show hostility to the EU in France to be high as 60%, and there is growing impetus for referendums and exits in several other EU countries.

Popular attitudes towards security and open borders were identified as a major challenge overshadowing the EU. 'People resist the idea of complete open borders and take pride in their nation,' a participant commented. 'And they feel wrongly stigamatised for that.' 'One of the problems with immigration today is assimilation,' added another manager. 'Previously most immigrants were eager to assimilate. Nowadays many want to keep their own values intact inside a relatively small area, one whose values they do not necessarily embrace. This is beginning to be a problem in the US but, given demographic trends, is much sharper in Europe.'

'As long as there is no security and no economic growth in Europe, it is inevitable the EU will break down,' one participant gloomily predicted. 'There are already Trump-like candidates emerging in Austria, Sweden, Germany and France. The UK vote will not be the end. If open borders remain a problem and economic growth remains poor, there will be similar votes in other countries.'

Much of the problem was put down to the gulf between the EU's political and bureaucratic elite and the mass of the people beneath them. This was felt to be a problem that impacted both at European and national levels. 'In the US we call it the Beltway problem – the sense of having no feel for where the rubber hits the road,' an American participant commented. 'The Brussels problem is an even more severe version of that. It might possibly improve, but not if things go on as they are doing.'

However another participant took a more sanguine long-term view of the prospects for the EU: 'I am pro-free trade and free movement. The EU has stood for those two fundamental building blocks over time. But sentiment is shifting from increasing centralisation to a different view. Europe takes a long time to shift but it eventually does shift.'

The gulf between governments and governed was not the only problematic divide in Europe, participants felt. 'The younger generation is much more in favour of staying in Europe,' commented one manager. 'They think: "I have got more at stake here. I am going to be here longer and therefore my vote counts more."' Dr Knight saw potential perils lurking for the long-term within this division: 'The danger is where all this ends, and how it deepens the despair and sense of worthlessness of a huge proportion of the young not just in Europe but throughout the world. The conclusion, logically, could be widespread social unrest.'

### THE USA: WILL TRUMP TRIUMPH?

How dangerous is Donald Trump? Dr Knight asked. 'He is a freakish kind of accident,' one participant said. But there is a reasonable chance he will get elected, he added, due to the sense of income inequalities and the perception of job losses. But actually we are creating jobs in the US, he continued, and are almost the only nation in the developed world doing so. However, given that Hillary is one of the most unpopular people in America, Trump is seen by some as the lesser evil of two evils.

Certainly there are many things that need to be shaken up in the US such as tax, offshoring and healthcare, stated another participant. But a Trump victory would not be good. Whether regarding trade or building walls, it would roll things backwards. If Trump does what he says, he will rope back global trade, which could cause a global depression. Short of that, an unintended consequence of the US pulling back could be a rise in the cost of financing and equity globally, which would be bad for asset prices.

A further Trump threat, added another participant, would be to the institutions that have governed international relations since WWII and the US's role as an intermediary in foreign relations and protector of the free economy around the world. It could spark a process of re-alignment, and there is no way to anticipate where that might end.

But maybe we are being too pessimistic, a participant argued. The US President does not control everything. Historically, the presidency, whether Democrat or Republican, does not really make a lot of difference to the economy. To date Trump has been running a reality TV, Kardashian-style campaign to get attention and win the election, but if elected he may not turn out as badly as we fear. He is an unknown quantity – nothing he has said so far makes much coherent sense - but he does have a proven record of business success.

And Hillary may yet be elected given her lead in the national opinion polls, said a participant speaking from another angle. And despite all the attention being given to the Trump-Hillary contest, both Senate and House will probably go Democrat. Disagreeing on the impact of this, another participant pointed out that at least 60 Senate votes would be needed to pass anything commercial. The media, which is very left-wing, creates the impression the Republicans are dying off, but that is not the case. Their grassroots are strong, with record numbers of governorships, state legislatures and House members. Because so many large states are Democratic it is a lot easier for a Democrat to be elected President, but not so easy to exercise power at state level.

### CHANGES IN FOCUS

We have been US-centric in our investment orientation for some time, reflecting the higher growth rates there commented a manager. Comparing the S&P 500 to the MSCI over the last four years, it is up 72% to 53%. But that situation is probably coming to an end. We will also face another dilemma. In a world of continuing low rates, what would you pay for a regulated business like a utility that has a 3-4% yield and the same underlying growth rate? What will that mean in terms of the ability to buy into a regulated industry that might offering an attractive 7% return versus 2%? Regulators will eventually realise they can lower the return on that investment.

### EMERGING MARKETS – NOT IDENTICAL

Over the last decade many emerging market investors made the mistake of conflating commodity price increases with economic growth – the error of which was starkly revealed when commodity prices went into reverse, said a participant. But you cannot treat all emerging market countries the same. Some are more investible than others. Moreover, there is a significant discount in emerging markets compared to developed markets. If you take the long-term view, buying into emerging markets at 12 times, prospectively or historically, starts to look interesting. However one thing to watch out for in emerging markets is the reform policy deficit particularly on the monetary side. The key question is: what point has a particular country reached in its reform process? How hard is the economic gun being pressed to its head? Because that is normally only when reform happens.

Regarding individual countries, Mexico has so far tended to go under the radar. It is not a particularly cheap market, but its government has made some really tough, politically unpopular reforms. Indonesia is also trying to reform under its new President, and has made some progress. Argentina has been a country that was un-investible over the last 15 years but is now much more investible, said a manager close to that market. It represents a terrific reform story, he continued. The pace at which Macri has been instituting much needed reforms has been incredible, although some have undeniably been undemocratic in their implementation. From a macro standpoint that has not yet been reflected in sovereign bond prices or other measures used to value assets. The trick, as always, is identifying the right securities. There is a lack of high quality, publicly traded stocks. So, Argentina is attractive top-down, limited bottom-up. By contrast, he added, Brazil is far more contentious. The diversion of the Olympics aside, it suffers from political instability as well as crippling social security burdens - people there can retire at 55! Maybe the example of Argentina will pressure Brazil to make the necessary reforms and provide a roadmap.

Russia is right up there on the revulsion index, one manager commented. As a market it remains very opaque. But even there opportunities present themselves. 'We invested in Russia – small,' he reported. 'We didn't make a huge commitment. We had had the Ukraine crisis. Then the price of oil had gone down dragging the rouble in its wake. Nevertheless we figured that at two and three times earnings, some of those earnings and cash flows were real, and we have done extremely well.'

#### BUBBLE TROUBLE?

Are there any bubbles forming up out there? Dr Knight asked. Bubbles relate to depressed bond yields, and bond proxies - high quality stocks and consistent deliverers of earnings on very full valuations, replied a participant. Assets around the world are currently at a 500-year high, and if you're at that point, you must, by definition, be approaching a bubble. There are clearly areas of excessive pricing, another agreed. However if you have the right medium to long-term time frame, there are opportunities. There are stocks, which though very uncertain, are trading very cheaply and are now being bought up very quickly. These include parts of the Eurozone, Southern Europe in particular, where profitability has been depressed historically and is now starting to pick up. You could buy Greece's entire market cap for 10 billion Euros, he said. 'Buy it all!' exclaimed another participant, hearing this.

There are examples of opportunities around the world to exploit maximum pessimism in line with Sir John's philosophy, a participant stated. Take financials, where valuations have been generally compressed, because of very low interest rates and bond yields. Or resources. According to the Bloomberg commodities index they never been lower. In terms of the pricing of resources and the companies that extract them, such as BHP, they have very competitive assets, often trading at half of their medium-term intrinsic value. Considered as capital businesses, they represent some of the best assets in the world.

#### CHINA - MAOISM RESURGENT?

Asian companies have tended to suffer from falling profitability, Dr Knight asked. Why? It is largely a structural issue, a manager responded. Most income still comes from an older generation relying on their savings or yields on assets that have been wildly compressed. Wages have not grown despite the fact that there are high applicant to job ratios. Temporary workers fill the gaps, and the seniority system remains firmly entrenched.

China as well as Japan faces those challenges, a manager pointed out. The country is not reforming to the degree laid out three years ago. President Xi Jinping is a far more authoritarian and Mao-oriented figure than any other recent leader. Whereas in the last thirty years of liberalisation there were multiple inputs into the reform process, Xi now dominates most policy committees.
The required reductions in capacity in steel and property and reforms in state-owned enterprises are not taking place, nor the necessary changes in professional management and incentive structures. Questions still hang over areas like banks, and energy and resource companies where a lot of the ROE compression is evident. In China it is rather like a game of Whack-A-Mole. As soon as you whack one mole where the market is overinflated, it pops up again in the property market and then again in the commodity futures market. What could get ROEs bouncing back? There should be a drive to diversify asset bases. It will probably eventually come from creative disruption and from businesses being forced out, so profit margins can rise. But that is not something we are yet seeing.

What is the outlook for the renminbi? Dr Knight asked. According to the rhetoric from Trump who is anti-trade, it is over-valued, a manager replied. However about a trillion dollars has come out of China recently, he added, and that has put pressure on the government to alter its currency policy. They want it to become more market oriented, moving from a US dollar to a trade-weighted base - which would be more logical. It is difficult to say what the final level will be. The savings rate there is 50%, but China is still a closed economy from a mainlander's perspective, one that you cannot get money out of easily. If liberalised, some of that liquidity would flow out, and the renminbi might well overshoot.

China's ultimate aim is for the renminbi to be a true reserve currency but they will have to reform a number of areas first, particularly the pricing of risk so that banks actually underwrite with the true cost of capital. The hubbub around the renminbi is unlikely to diminish for quite some time, he concluded.

### INDIA - BRILLIANT FROM 30,000 FEET UP

We have not spent a lot of time on India in the past, Dr Knight commented. There must be opportunities in such a large economy. A lot of optimism is being expressed on the street there now, reported a recent returnee. Elements of reform are happening under Modi, he continued, but there are many humps to get over. India is not China and is not going to develop in the same way.
China is a command economy and India a democracy, with a wide variety of states and politicians. India is also still a very poor place. Its per capita GDP is still only half China's. India has a population of 1.2 billion but a middle class of only two to three million.

Did you nevertheless spot any specific opportunities? Dr Knight asked. Prices certainly reflect current optimism, the manager replied, especially those of consumer product companies, with multiples often 35 to 40 times earnings. From 30,000 feet up, India certainly looks like the place to be, another participant commented. The consumer product companies look particularly attractive, selling at big multiples, and some of the banks like ICIC look great on paper. But corruption is endemic on the ground. Another participant disagreed: there is undoubtedly a lot of corruption but somehow things get done. People know how to work with and around the corruption there. Moreover it will disappear as India gets wealthier, although that may take some time.

### AFRICA THE UNLOVED

Frontier markets like Africa: are there any opportunities there? Dr Knight asked. Africa does not get a lot of airtime. It seems a continent fizzing with potential that never quite gets realised.

To the extent Africa was loved two years ago, it is now hated, said a participant. And it undoubtedly has some serious issues, currencies being one of the biggest, particularly in Angola, and Nigeria which run fake or dual currency systems. It is difficult to see how they will overcome their problems, unless they accept devaluation and stomach the resultant inflation and pain. But, as usual, the market barometer may have gone too far towards pessimism. Although not close enough to it to identify specific opportunities, he said, Africa looked to him a much better bet than two years ago, when oil was $100 a barrel, and they were living high on the hog from that.

They are moving ahead in Africa in ways totally different from the West, commented a manager with African interests. They are completely leapfrogging traditional fixtures like fixed line telephony and bank branches and going straight to mobile banking. His own exposure tended to be via companies in developed markets such as a company in France, the bulk of whose assets consist of logistics businesses in West Africa.

We have also been interested in East Africa for quite some time, reported another manager. It benefits from its international connections. Countries like Tanzania and Kenya have strong ties to India and large Indian populations in their business community. He also highlighted a recent massive gas find off the coast of Mozambique. So there is a lot of potential in that part of Africa, he concluded. The problem will be figuring out a way to get at it.

# STOCK SELECTIONS

Dr Knight invited managers to identify stocks that they judged to be particularly promising in the coming year. As last year, this year's selections are extraordinarily diverse, by sector and geography. Sectors ranged from insurance, pharmaceuticals and e-commerce to media and mobile telephony. There is a fairly even split among the Americas, Europe and Asia. Noticeably, all but one are traded on the NYSE either as shares or as depositary receipts.

| STOCK | MARKET: SYMBOL | SECTOR |
|---|---|---|
| AIA GROUP | HKSE: 1299 (ADR) | INSURANCE |
| ALLERGAN | NYSE: AGN | PHARMACEUTICALS |
| APPLUS | BME: APPS | INSPECTION SERVICES |
| ARCOS DORADOS | NYSE: ARCO | RESTAURANTS |
| CVS | NYSE: CVS | RETAIL |
| CITI | NYSE: C | FINANCIAL SERVICES |
| MEDIASET | MILAN: MS (ADR) | MASS MEDIA |
| MTU AERO ENGINES | FRANKFURT: MTX (ADR) | AIRCRAFT |
| TOYOTA | TSE: 7203: JPN (ADR) | AUTOMOBILES |
| VIPSHOP | NYSE: VIPS (ADR) | E-RETAILER |
| VIVENDI | PARIS: VIV (ADR) | MEDIA |
| VODAFONE | LSE: VOD (ADR) | MOBILE TELECOM |

TABLE 1. Stock Selections

# OXFORD METRICA CLIENTS

## BANKING

BNY Mellon
Credit Suisse
Deutsche Bank
Invesco
Schroders
Templeton & Phillips
UBS

## ENERGY & MINING

BP
De Beers
Exxon Mobil
Gazprom
Gold Fields
Royal Dutch Shell

## FOOD

DongA One
General Mills
Nestlé

## FOUNDATIONS

John Templeton Foundation
TWCF

## HEALTH CARE

Baxter
Bristol-Myers Squibb
Johnson & Johnson
Merck Serono
Natura
Novartis
Novo Nordisk
Solvay

## INDUSTRIAL

ABB
Aker Solutions
BAA
BAE Systems
General Electric
INI
Jardine Matheson
Kone

## INSURANCE

AIG
Aviva
FM Global
If
ING Group
Munich Re
OIL
RSA
SCOR
Swiss Life
Swiss Re
Zurich Insurance Group

## PROFESSIONAL SERVICES

Accenture
Aon
Ashurst
Blue Rubicon
Deloitte
Edelman
EY
Freehills
Hill & Knowlton
Ince & Co
KBC Peel Hunt
Kenyon International
Marsh
Ogilvy PR
OTC Markets Group
Porter Novelli
PriceWaterhouse Coopers

## PUBLISHING

Reed Elsevier

## RETAIL

Huhtamaki
Tesco

## TECHNOLOGY

Cisco Systems
Green ICN
Hitachi
IBM
ICN Telecom
Infosys
Intel
KNTV
Oracle
Xilinx

## TRANSPORT

P&O Ferries

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