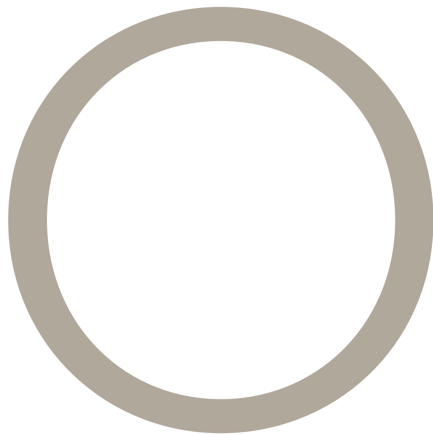

10TH SIR JOHN TEMPLETON INVESTMENT ROUNDTABLE 2017

London | 18th May

JOHN TEMPLETON FOUNDATION | OXFORD METRICA

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FOREWORD

TROUBLE IS ALWAYS OPPORTUNITY

I am pleased to present the proceedings of the 2017 Sir John Templeton Investment Roundtable which is something of a milestone for the Templeton Foundations. It is our tenth Roundtable which has been held annually in London since 2008. The series began – somewhat tentatively - in the dark days of the financial crisis. At that point and in the ensuing decade the Foundations have derived enormous value by being able to bring together a talented and experienced group of managers from around the world to exchange ideas on the investment issues of the day.

Although Sir John Templeton was well known for his aphorism "Trouble is opportunity", he always took an optimistic view of the world. In short, he could be described as an optimistic contrarian. He was a disciplined long-term value investor who never lost sight of the financial fundamentals; an internationalist who cast his net worldwide at a time when most investors were still domestically obsessed; a moral investor who prized substance over surface and valued social contribution above personal gain.

I think Sir John would have particularly enjoyed the buoyant and optimistic keynote address delivered by Lord O'Neill with an encouraging *tour d'horizon* of the world economy which both provided a positive backdrop for the discussion and stimulated much fruitful debate. He concluded that for all the setbacks globalization is still very much alive and kicking.

A stimulating debate followed on the urgent need for long-term R&D investment in combating anti-microbial resistance and the tension between that and profit-taking and CEO remuneration packages. Next, participants explored in greater depth the challenges and opportunities facing the investment industry worldwide – concerns over the EU's future and Russia and China's role as the standard bearers for capitalism – before hailing recent breakthroughs in energy and technology. They then turned to the macroeconomic threats particularly the debt bomb resulting from low interest rates and central bank policies. The discussion concluded with a spirited defence of active investing as opposed to passive indexing and a range of investment responses to issues such as the valuations explosion, the dominance of big tech and the problems of Asian governance.

The views expressed in the Roundtable 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 Lord O'Neill 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 LORD O'NEILL – THE REALITIES OF GLOBALIZATION

Jim left Government in September 2016, having been appointed Commercial Secretary to HM Treasury in May 2015.
During that time, and indeed, since Spring 2014, Lord O'Neill chaired a formal review into AMR (antimicrobial resistance) publishing their final recommendations in May 2015, which helped drive the government's strategy as well as providing key input to the UN high level agreement in September. Until October 2014, Jim chaired the Cities Growth Commission in the UK, when it provided its final recommendations, which formed the basis for the government's approach to devolution and the concept of the Northern Powerhouse. He is Honorary Chair of Economics at Manchester University.
Jim worked for Goldman Sachs from 1995 until April 2013, spending most of his time there as Chief Economist.
Jim is the creator of the acronym "BRIC".
In early 2014, Jim made a documentary series for the BBC entitled *MINT: The Next Economic Giants*.
He is one of the founding trustees of the UK educational charity, SHINE, and became lifetime President after joining government.
Jim has served on the boards of a number of educational foundations.

I first had the pleasure of being with you four years ago just after I left Goldman Sachs. On one level the world seems a very different place now, but I don't actually think it's really all that different. One of the biggest challenges we all face today is coping with a 24/7 flood of information and trying to put every little bit of news into its right perspective. Especially regarding economic development I am struck by how much of what gets reported is at odds with reality.

If you believed the media commentary about the state of the world, you would think it was performing a lot more weakly economically. But that's simply not true. World GDP growth in the past four years has averaged 3.4% - pretty much the same as the past thirty years. True, it is weaker than the 1990s, when world GDP growth was 3.7%, but still stronger than the previous two decades when it averaged about 3.3 percent.

Some parts of the world – and quite a lot of them - have grown almost exactly as I predicted. That - given how financial markets are currently priced - suggests they are not so interesting in terms of investing. They include the US and the UK, both of which have grown just over 2% - which is by and large what I expected. Similarly Japan has grown by close to 1% - which is again what I expected.

Other places have fared differently. The big example is continental Europe which has grown a little less than Japan and about half what I predicted at the start of the decade. However from an investing perspective, if I were in my old life paradoxically I might be directing my analysts to spend some more time looking about what's going on in Europe relative to the other parts of the developed world. Has Europe's growth collapsed so much that it now resembles how people think about Japan? In fact one of the big stories of 2017 is that the Eurozone is performing a lot better than expected. In that regard, it is worth pointing out that if the EU, the single biggest participant in global trade, is doing better, that should give us pause here in post-Brexit referendum UK. Over the next few years Europe's economic growth might positively surprise people – something I'll come back to later.

WHERE NOW FOR THE BRICS?

It still amazes me that people talk about so many places outside the most advanced developed countries as emerging. It's nearly sixteen years since I dreamt up the BRIC acronym, and yet this simplistic split between so-called developed countries and the mass of countries lumped together as emerging still continues - which is idiotic in my opinion.

Among the four original BRICs two that have strongly disappointed are Brazil and Russia. And just as I said I'd encourage my analysts to look at Europe, I might say the same now about Russia and Brazil particularly given how their assets appear so randomly priced. Will they be sick permanently? The answer in the case of Russia is probably 'yes, but not definitely'. Among the other two, India has grown much in line with what I would have thought while China is the only one that has grown more than I predicted at the start of the decade. Although the current consensus of the financial markets and the media is that China is in crisis, I remain optimistic about its longer-term prospects.

China may now be beginning to slow again slightly but that is because the Chinese policy makers have deliberately tightened policy. For all its structural problems China continues to be remarkably good at managing its economic cycle by the standards of many other countries. If they had managed their monetary and fiscal policy as successfully as China has, we might not have had the global turmoil we've had in the past decade.

The other important point to note about China is that the Chinese consumer is becoming an increasing contributor to overall Chinese growth. Luxury consumption – the bling economy - is not growing at anything like the same pace as in the past because of the Chinese authorities' clampdown on corruption. Nevertheless, Chinese consumption is rising much more significantly than other indicators of economic growth in China.

I like to think in terms of what I call the New China and the Old China. Old China's got problems to do with heavy, state supported, low value-added industries. And there are debt issues that pose genuine challenges. But that isn't the whole of China. There are many other rapidly emerging parts involving the service sector and consumption and other higher value-added industries that are doing very well. As I'm sure a number of you here know much better than me, the world's high-tech investors concentrate their efforts where they can get access to the best opportunities and they are currently looking at China harder than anywhere else – a powerful reflection of the scale of opportunity presenting itself in China.

THE MINTS LEAVE A DISAPPOINTING TASTE

Among the other large, emerging countries, the so-called MINT Group (Mexico, Indonesia, Nigeria and Turkey) the one that seems to be coping with life best is Indonesia - which is not what I would have predicted and find quite intriguing. Mexico was widely seen as the darling of the investing world when I was here four years ago, because it seemed to be getting so many macroeconomic things right. Its performance has actually been quite disappointing. But its efforts have been hampered by long-term core structural challenges like the black economy and corruption, with which Mexico continues to struggle not to mention the challenges thrown at it by their excitable and unpredictable new northern neighbour in the White House.

GLOBALIZATION HAS NOT PEAKED

Put all that again together, the world is largely proceeding as I expected with a number of small exceptions such as the Eurozone and Brazil and Russia that are nevertheless still worth considering from an investment perspective. The belief that globalization has peaked seems to have become the new gospel. I couldn't disagree more. While there are challenges with globalization, and always will be, the belief it has peaked is fundamentally wrong. In fact, if you look at the international trade indicators since Trump was elected, they have taken off like some kind of internet stock. In particular I follow South Korea's trade data closely. It is a very open economy that trades with many parts of the world and is the first country in the world to report its trade data every month. On the first of May they issued their figures and although they were a bit softer than in March, they still showed a 17% year-on-year increase in the value of their exports.

The same pattern is being repeated among the other countries that publish their trade data quickly. There are many reasons behind the upturn. One is that cyclically the economy in China (which for many years has been South Korea's number one trading partner) has been gathering momentum since last summer. Other reasons have to do with the weakness of the Eurozone and the fact that many commodity countries, particularly Brazil and Russia, have been in recession. Those regions are now stabilizing, which means their own involvement in international trade is starting to pick up again, and as a result the world trade cycle is normalizing

So, whilst there may be things policy-wise that can slow world trade, I am very dubious that has happened recently. The view that world trade is somehow on a downward trend structurally relative to national GDP is fundamentally wrong.

The accuracy of reported national GNP data is in any case very questionable. They don't capture what's really going on. According to statistics based on GNP, there is no increase in productivity in the world. But if you look around, you can cannot escape its reality.

Long before I left Goldman Sachs I believed that a weighted combination of the monthly purchasing managers' indicators was probably a more reliable measure than official GDP numbers. We therefore developed our own global economic indicator which we arrogantly believed would be statistically as accurate as the OECD's but faster. We ended up with about thirteen or fourteen components out of the 200 or so that we tested, and there are six of those that I still monitor. One is South Korean trade, three are from the US, and the other two from Europe. And what is very interesting - and contradicts a lot of what is said - is that since January all six have been consistently strengthening at the same time, which is quite rare and suggests to me that in the first half of 2017 the world economy was stronger cyclically than at any time since the financial crisis of 2008. Put those together with what I've already said about China, and I suspect the IMF will shortly upgrade its world forecasts, again for the first time since 2008.

I hasten to add that my indicators involve no long-term predictability. They simply tell you about what is going on now and in the three to six months to come. There is no reason to think that because they are strong now they're going to stay that way. That will depend on policy decisions and in turn the interaction of those policy decisions with the financial markets.

POLICY DEVELOPMENTS: A NEW DAWN IN FRANCE?

What is happening in France might be the most interesting development right now. I'm talking of course about Macron's presidential victory. I noticed in this morning's media that the opinion polls are suggesting that support for Macron looks to be growing ahead of the all-important French parliamentary elections in a few weeks' time. I think this is important for three main reasons. Firstly, because as everybody knows, France has struggled significantly, to put it mildly, to achieve structural reform over the past twenty years. Its underlying challenges remain a very high share of government spending in GDP, and by Western or G7 standards very high unemployment. But Macron looks like he has the energy to make a stab at actually doing something about those problems. Whether he will succeed is another matter. Succeeding will be very difficult and he is not the first president to try.

Secondly, he is without question the most genuinely pro-European French leader that we have had in a long time. He may therefore obtain a slightly better ear in Berlin concerning ambitious European structural reform than would otherwise be the case. Certainly if Macron fails, the prognostications are dire. The radical right has not disappeared from the scene, and failure on the part of Macron could open the door to power for them in five years' time. That in turn quite probably might mean the end of the EU. The Germans are very worried by that prospect and therefore likely to be more sympathetic to a French leader genuinely in favour of more positive European integration and reform. The third reason is that the Macron *démarche* is happening against a backdrop of improving economic activity - which by definition will make it easier to achieve reform.

THE UK: POLICY, WHAT POLICY?

Turning to the UK. I want to make several points. Firstly, almost nobody involved in the decision to call a referendum expected the outcome. A lot of it had to do with internal party politics, particularly within the Conservative party. It is probably true that even some of the noisiest Brexiteers still wish to this day that we had not decided to leave. And until Theresa May called the June election there wasn't really a game plan because everybody involved at the core of British policy was still trying to get over the shock of the out vote.

Personally I am still trying to make out what the philosophy of our new prime minister really is. (Like everybody else, I am assuming she will continue to be prime minister after the election, although of course I don't know for certain.) I'm not at all sure she has a clearly identifiable philosophy. Any idea of a Thatcher-style Iron Lady comparison is basically incorrect because she seems to have no underling philosophical belief, or at least not as yet. Mrs May's whole tactic until calling the election seemed to be flirting on the right socially in order to win back the UKIP vote while at the same time flirting to the left economically.

It is significant that since she called the election, the pound has gone up. Now when currencies start to fluctuate because of political events, it usually indicates that the markets have figured something out that nobody else is talking about. I suspect that the markets have concluded that she will get a big enough majority to facilitate a gentler exit from the EU without such severe consequences. Of course, that might not happen. In that case the pound will fall again – and sharply.

If Theresa May obtains a majority of 80 or more seats, there are certain policies she may pursue that the business establishment will not entirely welcome. But I will applaud them if they succeed in tackling the geographic and inter-generational inequalities in the UK.

On a larger scale I strongly disagree with the common perception that globalization is a major cause of inequality. Mr. Piketty has a lot to answer for disseminating this view promoted in his book. I believe on the contrary that globally we are living through the longest and deepest period of declining inequality there has ever been. Millions of people have been lifted out of poverty by globalization. If we continue at the same rate as the last twenty years for the next twenty, no region of the world with possible exception of parts of Africa will remain in absolute poverty.

That said, the UK suffers dramatically widening inequality across generations and geographic areas – something I have become very involved in as a government minister for sixteen months helping lay the foundations for the so-called Northern Powerhouse. Fundamentally there are two causes of inequality in the UK. One has been the increases in British house prices relative to income. The second one is linked to voting behaviour and increasing longevity. We are paying ever increasing amounts to pensioners, because they vote in larger proportions and represent a powerful force in the polling booths. But that makes no sense in my opinion. If we are all getting healthier and living longer, we should be radically changing our pattern of incentives. It is an issue that needs to be tackled urgently. The earning capability of younger generations, particularly those outside the elites of education, is terribly weak relative to other parts of society. And so are their aspirations. It is a huge, huge problem in the UK.

THE SPECTRE OF US ISOLATIONISM

Finally I reach the US, on which I have some very strong views, especially regarding its economic engagement with the rest of the world. The notion that the US should go down some harsh protectionist route because of what China's behaviour over coal and steel is nonsense. For at least two years one of America's most iconic companies, Apple, has sold more iPhones in China than inside the US itself. The idea that the US would deliberately pull back from being able to do that strikes me as lunacy. But as time passes, whether due to Trump changing his mind or having it changed for him, I suspect all the fears and noise that came out of this interesting character are going to fade away.

The single most interesting economic statistic I've seen this year can be found in China's final trade data for 2016. If you combine imports and exports, Germany's number one trade partner as of the end of last year was China. That is the reality of modern global trade today. Any Western country like the US that has the products that aspiring Chinese consumers want to buy is going to do pretty well. So, to conclude, I don't understand why people like Trump's advisor Peter Navarro, wield serious influence. Maybe they don't. Certainly they shouldn't in my view, and - given the unstoppable juggernaut of globalization - over the long term they won't.

RESEARCH OR REMUNERATION: A DEBATE

'Emerging from recent events,' Lord O'Neill went on, 'are some genuinely worrying policy issues to do with the way globalization is developing. To give but one example: there is growing global antimicrobial resistance to antibiotics – a subject on which I recently led an independent review. If we run out of antibiotics, we will not have all those cancer treatments and hip replacements that are now accepted as part of modern life. More than that, the review concluded that if we don't do something about this problem of antimicrobial resistance by 2050 we could have 10 million additional deaths a year around the world. In turn the loss of economic potential would be truly devastating: $100 trillion lost by the likes of China and India and in particular in Africa by then. To prevent this happening investment of some $40 billion is urgently required.'

RISK/RETURN EQUATIONS ARE WRONG

'Underpinning this,' he said, 'is the narrow way the financial system currently assesses risk and reward. There's no real incentive for private businesses to invest, and governments that are strapped by debt problems simply can't. I think therefore that we need to make some radical changes here.'

'Modern pharmaceutical companies are good at producing and distributing pills and managing the balance sheet,' he continued. 'That's what they basically do. But they don't do research. They wait until they see a revenue stream that might be of some longevity and just go out and buy it from somebody.'

'The CEO of J&J, for instance, has spent a lot of time trying to push a bill through Congress in support of something called a transferable voucher scheme, which would allow pharmaceutical companies to enjoy significantly higher revenues for whatever products they choose in order to develop new antibiotics. However none of the other companies are trying to produce antibiotics because it doesn't pass the hurdles within their narrowly defined business segments. These same risk/reward assessments probably go on in other global industries. A lot of publicly quoted corporations simply don't want to take genuine business investment risks because it all seems so uncertain.'

'Labour market conditions further compound the problem. We have this seemingly never-ending rise of share in global GDP of profits and corresponding fall in that of wages, which in long-term economic theory makes no sort of sense. Labour markets have become so flexible that it's become easy for corporations to hire and fire people without taking some serious decisions on capital investment. And that segues into lower productivity. The fact that reported productivity is so weak in so many western companies is actually because managers can benefit from very flexible labour conditions rather than generating real value-creating work.'

'It also has to do with the low interest rate environment that we are in,' a participant added in agreement. 'Central bank policies may be to blame to some extent by keeping interest rates as low as long as they have, has allowed managers to get away with short-term behaviour.'

CEO INCENTIVES A DISINCENTIVE TO INVESTMENT

'I have discovered,' said Lord O'Neill, 'that the three biggest US pharmaceutical companies have spent more than $40 billion buying back their own shares so far this decade. Many CEOs only hang around for three years, and their remuneration relates to the price earnings during those years. So using cash to buy back shares as opposed to investing makes sense from the risk-return perspective of senior management. There's something badly wrong with that in my judgement.

Another manager supported his view: 'The lack of investment is not only in pharma. Short-termism is something that has become detrimental to growth generally.' Referring to Kraft's recent failed bid to take over Unilever he quoted a comment made by a CEO to Paul Polman, the boss of Unilever at the time of the failed bid: "Why don't you just get the price up and retire?" 'This was actually a clash between two cultures. From a philosophical point of view Polman saw himself as a creator and not just someone who is in free trade or managing a business. If managers do not make these investments that will hurt jobs and job creation. It will hurt growth. It will hurt tax revenues. To me this is one of the biggest problems that we have, particularly in the western world.'

Lord O'Neill added that in his view the difficulties CEOs faced in their working lives had been largely exaggerated. 'Most of them go into the role without actually really wanting to take some genuine view about how to grow that company in that business.'

'We need to change in order to change the investment environment because we've had periods since 2008 when the world cycle has started to pick up and fizzled away very quickly, probably because we haven't really had any follow-through in investment spending. I'm not sure there is any other way of doing anything about it than changing the incentives as to how corporate CEOs behave and deliberately boosting wages. I suspect that probably is going to accelerate. There are inflation risks but it is the right thing to do to ensure that we have more equitable, inclusive, economic performance in Western economies.'

CONTRARY ARGUMENTS

Other participants, however, disagreed strongly with Lord O'Neill: 'I don't think big pharma is run by a lot of CEOs dominated by short term thinking,' argued one. 'It's an industry that spends a higher share of its total revenue on R&D than any other industry in the global economy. Its focus naturally is on large, current, un-met medical needs. Pathogens that may ultimately prove resistant to antibiotics may be a genuine threat but it is a distant one. When antimicrobial resistance actually surfaces, it will undoubtedly become a focus for the industry. I want to add that industry data on longevity is impressive. We're improving life span by between four and six weeks per year every year, and the most recent data demonstrates an acceleration in that trend.''

'You also indict the industry for buying back shares. But they're merely returning to shareholders' cash flows that define return on investment.'

'But isn't that what dividend payments are supposed to do?' O'Neill asked.

'No' the participant replied. 'That simply reflects a decision as to the form in which you make returns. Dividends are a more difficult cash flow policy to manage because they tend to have this fixed character. It's actually better to return that cash flow from a buyback rather than dividends.'

Another participant also defended corporate financial behaviour: '3G Capital who merged Heinz and Kraft together improved margins over a three-year period by 15 to 20%. There's clearly a lot of inefficiency they've unwound. In these very cash generative, consumer franchises with a great advantage in technology costs can build up and could be taken out. The fact that Unilever can promise an increase in margins over the next three years when they're selling the most profitable business from a margin perspective at the same time shows there's quite a lot to do.'

GLOBAL THREATS AND OPPORTUNITIES

EUROPE: FULL STEAM AHEAD TO INTEGRATION?

Dr Knight quizzed Lord O'Neill about the future shape of Europe, specifically the euro itself and how he would advise policy makers. Should they integrate fiscally within the Eurozone? Should they take a two-tier approach or simply muddle along as before?

'The euro has survived over the course of the past few years purely because of the amount of effort put into ensuring its survival as opposed to actually making it thrive,' Lord O'Neill replied. 'This kind of repeated, highly intense - let's call it super-cyclical - crisis management of the euro which has been successful since the Greek crisis began cannot continue as a regular phenomenon. It eats away at populist support given the cost to some countries. And Greece is still struggling as they've had to endure deep, structural adjustments that have had some very severe, negative cyclical consequences. I don't think it is sustainable. I believe that for the euro to be permanent there has to be more genuine integration in some form.'

'Hence the importance of Macron, whose advisors incidentally are the architects of the idea of a common European bond and who is, as I said, without question the most genuinely pro-European French leader that we have had in a long time. The Germans will also be watching the French parliamentary elections closely as Macron needs a broader mandate before taking on the powerful vested interests in France. However it will remain a difficult issue for Germany. The Germans are very well aware that if there is larger integration in a fiscal union they will have to foot the bill. I think it unlikely that Chancellor Merkel would give any hint of Germany wanting to make a move until the German elections are over.'

One of the participants took a different view: 'When Britain leaves, the EU will lose its strongest voice arguing for liberalism and free markets. Germany used to hang on to Britain's coattails in that regard, actually letting it act as the voice of that direction and philosophy within the EU. Germany itself will now have to speak up and be more visible. Despite Macron being a reformist, France remains fundamentally interventionist. His drive for full European integration will raise conflicts in northern Europe and with newcomers like Poland and the Baltic states, which want to move in a different direction again.'

'Of course you could take the view that Britain's leaving will remove some of the obstacles to fiscal union. So is the EU going to become a much more centralized or more loosely aligned as under the UK approach? It could go either way. But one thing is clear: if the EU wants to move forward it is going to have to change.'

CHINA AND RUSSIA: CREDIBLE CHAMPIONS FOR GLOBALIZATION?

'China's president, Xi Jinping, has just announced another $124 billion investment in the One Road, One Belt project on top of the $1 trillion already committed,' said Dr Knight. 'What are participants' views on this project and on its potential impact around the world? Are China, and indeed Vladimir Putin, who also spoke at the launch conference, credible standard bearers for globalization?'

'I think it's pretty nonsensical to build a railroad given today's advances in technology,' said one participant. 'Why is anyone out there still trying to build railroads? Another thing: Latin America was invited to the launch conference but the railroad will take an overland route, one that doesn't go anywhere near Latin America. So it would seem to be all about influence peddling not infrastructure.'

‘China and Russia have different views,’ said another participant. ‘With Vladimir Putin it’s all about good old-fashioned empire building. Xi Jinping, on the other hand, is trying to shore up his borders, wooing countries to the west and to the southwest *via* economic diplomacy, whereas the US’s approach has always been more militarily focused. So from that point of view it’s very smart.

‘The other point is that Chinese wages have been going up very strongly of late. China’s no longer best suited for low value-added, labour intensive industries, so they’re moving those out into Southeast Asia and building their manufacturing bases there. Also, the Chinese workforce is ageing rapidly whereas countries in Southeast Asia and to the West are still young countries. So, rather than having immigration, they are exporting their capital into younger areas.’

Dr Knight raised the issue of tensions in the South China Sea and the disputed territories. ‘If the Philippines and Vietnam can reach an amicable agreement with China there will be many new investment opportunities for the countries involved,’ a participant commented. ‘That could promote free trade even more. But it also creates problems for countries not in their consortium. So, there is both a plus and a minus.’

Another speaker contrasted Chinese and British approaches. ‘It’s striking that when Britain is focusing on insular, perhaps backward-looking problems, China is looking longer-term and building for the future. I’m impressed by how big Chinese digital businesses are going out and buying strategic, long-term assets, in India, Indonesia and Singapore. It’s almost like corporate digital imperialism, building influence networks at a time while the West is obsessed with its own internal problems.’

Another speaker drew attention to the fact that whereas the US stock market is going up, Asian stock markets have been relatively subdued. ‘What we’re seeing is good old-fashioned Marxism, in a sense: the battle between capitalists and workers. Labour income’s share of GDP in Asia and China has risen while it’s fallen in the West giving rise to political tensions there. But when Xi Jinping praises globalization, there are 1.2 billion people clapping their hands behind him because they’ve done very well out of it actually, thank you very much.’

INDIA: COULD DO BETTER

The policies Modi has tried to push through in terms of the so-called demonetization and tax reform will be helpful, said Lord O’Neill. ‘India will probably grow in absolute terms by more than China in terms of annual GDP over the next 20 years but it will not end up bigger overall because of its low initial base. As to his reforms I only wish Modi would have been bolder.’

Another participant agreed. ‘Modi has simply focused on the bit he controls, the federal government, rather than the local level. What is really needed in India is reform of land acquisition and bankruptcy laws, and above all infrastructure. Through bad transportation and warehousing India wastes as much food annually as could feed the whole of Brazil!’

'There's always been talk of India fizzing with opportunity but there always seem to be impediments,' commented Dr Knight. He asked a participant just back from India about his impressions, especially in the wake of India's roll-out of free 4G. His view was that while the digital infrastructure challenges were being very successfully overcome, massive physical ones remained an obstacle. 'With a billion-plus people registered by their irises and fingerprints, India's data consumption has gone to the top of the global charts in just one year. That's good news for government revenues in the long run and can feed into physical infrastructure projects in due course. But I was disappointed as I said chatting to managers here earlier, by the lack of specific new investment ideas.'

ENERGY BREAKTHROUGHS ARE CHANGING THE WORLD

A participant reported a very significant development in the energy area: the announcement that oil and natural gas reserves in the Wolf Camp part of the Permian Basin are three times as big as the Bakkon Three Forks deposits in North Dakota and represent the largest ever found in the USA.

'Technological advances,' he added, 'have significantly improved industry practices, increasing what is recoverable while lowering extraction costs. At a time OPEC is trying to control the price of oil by limiting supply, technological advances on the other side of the world are ensuring plentiful future supplies. In future, by reducing inflationary pressures, that will be bullish for the economy of the whole world.'

Another participant endorsed this: 'Three or four years ago in Wolf Camp, you'd drill down 5,000-foot, then maybe drill laterally because the deposits are linear not vertical. But we've learned now not only how to break up the rock better but also to see inside the hole so that, whether we make a right or left turn, we stick in the pay zone. Whereas we used to get 50,000 barrels of recoverable reserve per thousand foot of lateral drilling, we now get 100,000. Whereas we used to drill 5,000 feet laterally, we can now drill 10,000 feet. As a result a well that used to amount to 250,000 barrels of reserves now amounts to a million. And even if above-ground costs remain the same, unit costs are down by at least 50%.'

Another manager agreed: 'Companies like the Texas Pacific Land Trust are going to generate tremendous earnings. The companies we're investing in aren't your run-of-the-mill remote exchange traded funds. They're lean, mean, hands-on, all-round profitable operations. We own one company that is essentially nothing more than a raw feed company. It has only eight employees, cashes their checks, and enjoys revenue streams not only from the drilling of oil but from easements across their lands and the lease of water rights needed for fracking.'

'The US is uniquely well positioned right now because we'll be entirely energy independent probably within three years, given developments in the Western states. This is a key point. We're providing access to resources on a scale previously only the bad guys could. Downstream, this will be very good news for the developed and the emerging worlds alike. Unfortunately, though, I'm less optimistic about the ability to keep oil prices down because there are huge potential problems looming in Saudi Arabia. The next generation there is widely considered less pious and obedient. Should the king pass away – he's not young and has had several strokes already – you could wake up and find the country embroiled in a civil war. That could give rise to truly serious problems.'

TECHNOLOGY'S TRANSFORMATIVE POWER

'Of course, technology isn't just counteracting inflationary pressures in the oil industry, it's impacting on all sorts of industries,' said another participant. 'Whether it's reducing the bargaining power of labour or affecting other areas, there are plenty of incremental developments that are keeping inflationary pressures at bay. And that is very positive both for investors and for real assets, especially real assets that can grow.'

Artificial intelligence - AI - has the same potential today as the internet had in 1995. It will change some key industries profoundly. Look especially at the possibilities of machine learning and particularly the ability of neural networks to solve pattern recognition problems.

'The automobile industry will be completely transformed by this within the next decade. All of us round this table are aware of the potential of autonomous vehicles to change transportation completely. Right now Google is running an experiment in Phoenix with this very objective. They're testing 600 autonomously driven vehicles with 360-degree video fed from all the windows. With a driver continuing at present as a fail-safe, they're investigating whether and how people might employ these kinds of vehicles, what kind of trips they might use them for, and how their behaviour might change inside the cars.'

'Eventually we'll have vehicles that are not only cheaper to run but safer. And we'll come to see personal transportation quite differently than we do today, relying far more on shared vehicles than our own. Uber, by the way, is already helping make that possible. That means fewer vehicles, so just imagine the implications for leasing the real estate now taken up by car parking.'

'At the heart of it will be the ability of neural networks to blend data in order to create an environment of optimal choice for the driver. Essentially what you can receive while driving today is audio input. But if you're no longer driving, and the decision-making has been devolved to an automated process, you're just in some mobile space where you can spend your time however you want. Vehicle design will respond to that. Infotainment has already become a very significant component of car design and will become a dominant one. A vehicle will be a mobile office, a mobile living room, a mobile den – anything you want.' Dr Knight commented that the recent acquisition of Harman International, the leader in this field, by Samsung for $8 billion, Samsung's largest ever transaction, signally demonstrates the opportunity.

'Another example: retail. Look at Amazon Go, a prototype store controlled entirely by machine vision. When you walk into the store, you are immediately identified by a pixel imprint. Then as you lift down products into your basket these are identified, your Amazon account is automatically charged and you're free to walk out again. They've completely got rid of the front end of the store; no more cashiers, no more check-outs. A further example; medical diagnostics. Essentially radiologists and pathologists study scans and identify patterns but a neural network can do that far more quickly and accurately. Factories will also be transformed. There'll be sensors on tools that will monitor how they're performing, how conditions and patterns of use are changing and whether the specs remain optimal or need adapting.'

'This isn't going to happen years from now. It's taking place even as we speak. And all the people who are hand-wringing about productivity are going to be astounded just how impactful these new technologies are going to prove.'

MACROECONOMIC CONCERNS

VALUATIONS: A BUBBLE IN THE MAKING?

'Have valuations been artificially and damagingly pumped up by low interest rates?' asked Dr Knight.

'There's definitely been a widespread bubble, said a participant, 'driven by low interest rates and the 'flowmageddon' into passive strategies with their premiums on liquidity. As a result, price discovery mechanisms in the U.S. have broken down. You should stay as far away as possible from that. However, unlike traditional bubbles that suddenly burst, interest rates will probably remain low simply because the debt burden around the world is so huge it can't allow interest rates to rise. So we'll likely just muddle along for a decade or more in the S&P 500 with no real return.'

CENTRAL BANK POLICIES: A TICKING BOMB

'Central banks have pumped up their balance sheets to four or five times their size and at some stage are going to have to pump them down,' commented Dr Knight. 'What are your views on the impact of the policy of the US Federal Reserve?'

'The Fed now has $4.5 trillion dollars on its balance sheet, a participant pointed out. 'The figure's at least $15 trillion worldwide. If we counterfeited that money, we'd go to jail! It's been benign to a degree because a lot is in reserves paying only 0.25% interest. But it's a time bomb because if they find better investment options, they'll convert those reserves into loans with serious consequences for inflation. If they want higher returns why not sell off some of these bonds rather than continually re-investing them? The crux is whether to continue rolling over debt or not? I think they act to have less than more going into a potential future recession. Of course, if they raise interest rates, it could affect the yield curve. Trump as a real estate guy is an interest rate dove, and he appoints members of the Fed. But labour is tight in the US, with labour costs growing by at least 2.9% because of a lack of productivity. That generates upward pressure and ultimately could result in inflation.'

CURRENCIES: CAN WE AFFORD TO BE AGNOSTIC?

'What impact are low interest rates having on currencies, especially in Asia?' asked Dr Knight. 'Are there risks under-appreciated by the market?'
One participant was unphased. 'Currencies are not as vulnerable as they used to be. If governments raise rates to squeeze inflation out of overheated economies, it can harm liquidity. But if growth is strong, it's benign. Asian currencies are largely carrying out their proper role as pressure valves.'

'How do you assess stocks?' asked a participant.

'We calculate them in nominal US dollars over long periods rather than trying to guess the cycles of individual currencies. Given the productivity-generating ability of Asian economies, and that nominal US dollar growth ought to be faster than the global average over the next decade. Asia's the only region in the world that over the last thirty years that has closed its gap in living standards.'

A second participant strongly disagreed. 'You have to see currencies as a distinct asset class subject to extremes that can dominate the investment outcome, and build them into your assessments of returns.'

Another participant argued, though, that it's artificial to separate local and nominal US dollar components. 'It's difficult to put a currency overlay on stocks because companies have their own internal hedging mechanisms. So you can get caught up in double counting.'

VOLATILITY: HOW RELIABLE IS THE VIX?

'Does the VIX (Volatility index produced by the CBOE) under-represent volatility,' asked Dr Knight?

'It's a concern,' said a participant. 'The VIX looks low compared to stock-by-stock movements. Could we see a sudden catastrophic spike? It is calculated, bizarrely given that it is a variance swap between spot and future rates. Yet it seems to be a quite profitable trade for people who believe they understand these kinds of things.'

Another speaker tried to explain the VIX. 'The VIX is simply a derivative of the premiums for puts and calls placed around the index. Those premiums have fallen dramatically in response to observed local volatility. It isn't causal, its derivative. And the scale of capital involved in these puts and calls and the curve of the index itself are small in relation to the overall capital market. So the VIX is unlikely of itself to be a source of future volatility. Instead, it will reflect any future volatility emanating from other sources.

Now, why is volatility down? When you put together an index of stocks, they'll have a degree of correlation. The more correlative, the more they'll communicate volatility; the less correlative, the more they'll diversify and dampen its effects. The correlation coefficient between stocks in the index has fallen from around 0.7 to around 0.4 because the common factor risk linking companies together is low. There isn't anything galvanizing investors to think in aggregate rather than locally about stocks. Eventually something will come along that increases the common risk factor - interest rate rises or economic and geopolitical developments - that gets people to act more in unison rather than individually.'

'But doesn't that instil a false sense of security?'

'Maybe - but that doesn't derive from the index, rather the lack of correlative volatility between individual companies. The VIX does not drive volatility, it merely reflects it.'

GOLD: POSSIBLE PORT IN A STORM

'If inflation picks up and interest rates stay low, that's good for gold stocks,' observed Dr Knight. 'Yet does anyone in this room have more than 1-2% of their overall portfolio in gold stocks at present?' Are they a good bet?'

'Gold stocks have plummeted by some 90% from the 2011 gold price high of $1,900,' a participant pointed out. 'They've under-performed, and people have become sick and tired of them. But you can still make money in gold stocks by picking ones not understood or valued by Wall Street. You can pick winners, so it's ideal for stock pickers. With gold it's possible to win both under deflation and inflation. If a worldwide financial panic occurs in the next five years, gold stocks could quadruple in value. At present there's only one gold stock in the S&P 500; one day there could be four or five.'

'How do you lay your bets in order to manage risk?' asked another participant.

'We diversify,' was the answer. 'We have holdings across IAMGold, Kinross, and also smaller companies like Brio Gold in Brazil. We pick those Wall Street hates for one reason or another. Then the company may suddenly turn itself round or discover new lines of reserves, and our stocks go up.'

INVESTMENT RESPONSES

THE CASE FOR ACTIVE VALUE INVESTING

'There is an absolute offensive against active management at the moment,' Dr Knight commented. 'What are the implications of the current "flowmageddon" into passive investments for active investing?'

'I have some sympathy for the "index-huggers", but their positions are far too extreme' a participant responded. 'There should be greater acknowledgement of the contribution of the active sector. The case for active management, rooted in a long-term, concentrated approach to investment, needs vigorously defending. A recent Arizona State University study looked at 26,000 stocks listed between 1926 and 2015. Together, they generated $32 trillion. But over half this wealth came from only 86 stocks and all of it from 1,000. There are real risks in the belief that passive investing simply pushes all ships up gently. It encourages CEOs to be short-term and uncreative. You have to keep reinventing yourself because the world will be a very different place in the future, and if you don't, others will.'
'Passive investing paradoxically rests on the fact that there are enough active investors to keep prices fair,' said another speaker. 'If passive flows continue, it will create pricing inefficiencies - which active investors in turn will actually be able to exploit. Correction will follow distortion.'

'Sports offers a parallel. Some teams win more than others. They're simply better and more talented. A similar case can be made for the active managers to be found at the top of the distribution curve. They have unique talents. Those are the value that they contribute. Even Vanguard, the largest purveyor of passive investments, recently published a paper identifying highly active, off-benchmark managers and relatively concentrated portfolios as the two key ingredients in successful investing.'

'You have to make up your mind whether you're going to be an asset gatherer or an asset manager,' said another manager. 'If you decide to be an asset manager who wants to get a return on your clients' capital, you have to stick to your guns. Recently I met the analytical team for a large bank, and they told me my position was too large. I replied that there's a sufficient margin of safety there and we'll undoubtedly make money on it. And they instructed me to diversify and then put forward three names - all of which were concentrated within the same sector! So we parted company.'

'There may well have been too many supposedly active managers in the past,' said a participant, 'many of them actually passive managers masquerading under false pretences as active ones. Ironically we should be grateful to exchange traded funds (ETFs) if only for weeding out these people. If you're an index fund manager and charge an active manager's fee, that's a recipe for under-performance. But I wish academia would take a more positive and granular view of investment and stop saying active management doesn't add value. I get sick and tired of listening to supercilious business professors saying investors have been drinking the wrong Kool-Aid!'

'Actually we've been here before,' said a manager of long experience. 'Most of you won't remember the "Nifty-Fifty" of the mid-1970s. It was like an index. There were 50 stocks everyone - all the pension funds - had to own. But a lot of them like Xerox and Polaroid later went belly-up. And there's another study come out which shows that the deletions from the S&P 500 actually outperformed the additions by 30% over the following year. It makes you question the whole ETF approach because there was a company dropped from an ETF that found they suddenly had 50 million shares to off-load into the market and fell 30-40% as a result, only six months later to recover and get added back in. Meanwhile the ETF was bidding for 50 - 60 million shares at tremendously higher prices! Some crazy stuff that goes on in these ETFs while they're re-balancing. We actually take advantage of it. We buy the eliminations that we think are going to get added back in.'

'All respect to Warren Buffett, but there's no such thing as passive investment management,' said a manager. 'The S&P 500 used simply to be a benchmark but since 1994 it's actually been a competitor. And they game it. What used to be market cap-weighted is now market cap-weighted, float-adjusted. They create an investable product, an ETF, but are only really interested in how much money can attract and how liquid they are. They put the same selection in again and again. If you're buying the Russell 2000, you might think you're getting a broad basket but you're only getting maybe 70 names at most. And the money keeps flowing into those names making companies complacent. So, you end up with companies like McDonald's, Procter & Gamble and IBM that have not grown their top line over the last five years, let alone their bottom line. You're buying companies at 25 times earnings that really can't grow their top line. Most people buying ETFs have been sold the idea that they're buying blue chip companies but they end up after a decade with no real return.'

FEES: GRASPING THE NETTLE

'But one of the big arguments for passive investing,' said Dr Knight, 'is their low fee structure. Are you getting pressure over this? Is the investment industry changing its ways?'

'The necessary adjustments are happening,' one speaker replied. 'Pressure is felt far less among long-term investors,' commented another, 'particularly those making large scale investments. Today, these are relatively low-priced.
'Much of the fee pressure has been felt in the hedge fund industry - rightly so as it offered many grossly mispriced products,' said another. Nonetheless a further speaker highlighted a trend towards defensive mergers and acquisitions in the investment management industry due to price pressures resulting in increased concentration. 'The temptation to combine exists,' he said, but many combinations are ill-matched and not all are successful.'

BIG TECH: DAMAGINGLY DOMINANT?

'The big five US and three Chinese tech companies are already immensely powerful,' said a participant, 'and with the developments in machine learning neural networks we have talked about are only set to get more powerful over the next decade. This might well result in a very tiny, almost un-disruptable number of companies protected behind an ever-broader moat – not a good prospect for the financial investment industry. It's a matter of great concern.'

ASIAN ANXIETIES

'I'd like to take a global - yet micro - perspective on Asia and Japan,' said a manager with long experience in the region. 'Let's explore the issue of stress as it has impinged on companies Estée Lauder or Shiseido (a Japanese company) or AmorePacific (a South Korean company operating into China with very strong Chinese business, North Pacific). Their valuations were initially highly unattractive to us, and though market stress brought prices down by some 40%, still didn't satisfy us. The problem with Asian companies is governance - clean transparent governance. There's far too much complexity. Compare that with the US, where standards generally are high and justify the higher valuations found there.'

'And I'm not sure Asia's improving. Several years ago we took a position in the Chinese Expressway, a local Hong Kong-listed toll road company. It was a modestly successful investment but a thoroughly unpleasant experience involving poor governance, local government interference and siphoned-away profits.
When I went back recently I was dismayed to find the situation was even worse. So it is challenging to find the right combination of value and quality in parts of Asia.'

Another participant ascribed the wide divergence in Asian corporate governance to inherited legal models. 'Some based on English common law, others on European civil codes. Under the former - in Hong Kong, Singapore and Thailand - standards tend to be better. Under the latter - in countries like Korea and Japan - there are issues.'

'To obtain both value and quality in Asia we look at dividends,' said another speaker. 'A proven track record in dividends tells you three things: that you will not be overpaying for growth, that the company is generating cash and that they're willing to share that cash with you as a shareholder. Using that basic framework as an investigative tool can sidestep a lot of these issues.'
Another participant, though, took the opposite view. 'Asia still stands out as an area throwing up genuine bargains. It's a phenomenal time to be buying some of these companies, particularly in Hong Kong. 40% of our global portfolio assets are held there. Many valuations are at lows last seen in the 2008 or in the Asian financial crisis. Governance issues have greatly improved in many cases.
I would add we too focus on dividends but also on free cash flow, which in Asia has improved tremendously.'

'You have to accept that investing in Asia is different,' said a participant. 'A lot of the headline cheap stocks in Asia are highly cyclical - essentially they're lottery tickets which twelve months later can be worth double or nothing. There aren't aggressive M&A's to realize underlying asset values. But you can still get good returns if you're patient and picky.'

EXPLOIT TIME AND STRESS

'To me as a sort of classic Graham and Dodd (G&D) value investor, America is flashing alarming warning signals,' said a speaker. 'But do the G&D metrics matter anymore? And if you are still worried about excessively pumped up valuations, where can you hide? Typically you end up in securities or financials, commodities or retail, which don't tend to defend that well in tough markets. That's the dilemma I've been wrestling with: trying to square the circle between okay valuations and reasonable quality, when it seems that you have to either pay high prices or end up stuck in low performing cyclical industries.

'It's a slim opportunity set,' agreed an experienced advisor. 'I would offer two thoughts: exploit time and market stress. Pick a company such as Airbus with quality potential but operating in a complacent and value-agnostic market.
It's currently ramping up the A320 but still suffering from losses on the Airbus 350. The current consensus is that it's not worth jumping in, but its new management are highly adroit in managing their capital. Project forward five years, there could be a material improvement in the company's free cash flow. It won't be about newly realized R&D or the spin of the order book cycle but about sound management decisions and execution.

Another good place to fish is where there is short-term market stress. An example is Qualcomm. Currently its caught up in in disputes with Apple's contracted Chinese manufacturers. But Qualcomm has been there before with the Chinese government and came through it. The dispute could well be resolved, and Qualcomm eventually generate a good return. So my advice is be patient above all. Exploit time and stress – and time maybe more than stress, given how short-term markets are.'

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 aerospace, electronics and e-commerce to leisure and mobile telephony. There is a fairly even split among the Americas, Europe and Asia. Noticeably, all are traded on the NYSE & NADAQ either as shares or as depositary receipts.

STOCK	MARKET: SYMBOL	SECTOR
AERCAP	NYSE: AER	LEASING FINANCIAL
AIRBUS	EURONEXT: EADSY (ADR)	AEROSPACE
BAIDU	NASDAQ: BDU (ADR)	INTERNET
EMBRAER	BOVESPA: ERJ (ADR)	AEROSPACE
ERICSSON	STOCKHOLM: ERIC (ADR)	TELECOMMUNICATIONS
HAW PAR	SGX: HAWPY (ADR)	DIVERSIFIED
NINTENDO	TSE: NTDOY (ADR)	LEISURE
TAIWAN SEMI-CONDUCTOR	TWSE: TSM (ADR)	ELECTRONICS
TEXAS PACIFIC LAND	NYSE: TPL	REAL ESTATE ROYALTIES
WIN SEMI-CONDUCTOR	TWSE: 3105 (ADR)	ELECTRONICS

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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