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The golden rules of investing

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Executive summary

- **The latest inflation figures from both the UK and the US were better than expected by the markets.**
- **Along with other data and statements from central banks, this provided reassurance that there will likely be no further interest rate hikes.**
- **It has been an extraordinary time for investing in recent years whereby most asset classes have fallen because of high inflation and rising rates.**
- **If recent trends in inflation and rates continue, hopefully, we can see a return to normality and the "golden rules of investment" will reassert themselves.**
- **By this, we mean diversifying to spread risk, buying stocks when they're cheaper and selling when more expensive, and investing in smaller innovative companies which have the potential to outperform the larger inefficient firms.**
- **We believe capitalism works, as competition allows good companies to thrive whilst others fall by the wayside. It may be tempting to leave money in cash right now, however over the long term, bonds have historically outperformed cash and equities have outperformed bonds.**
- **The final golden rule is being able to control the cost of investing - something we are always conscious of and look to reduce where possible, as evidenced by our recently negotiated discounts in platform costs and some of the funds we invest in.**

This week, the latest inflation figures in both the US and UK came in marginally ahead of expectations.

Even though the figures were only 0.1% better than what the markets had anticipated, they corroborated other information and pronouncements from central banks that implied interest rate hikes are over. As a result, there was a sharp rally in many asset classes, notably government bonds, real assets like property and infrastructure, and small and mid-sized company share prices.

These areas have been hardest hit by high inflation and rising interest rates. If inflation continues to fall and interest rates have truly stopped going up, then logically these assets could do very well going forward, in our view.

However, there is no doubt that the past couple of years have been tough for investors. During this time most of the asset classes we can invest in have fallen, including most types of equity, bonds, as well as assets like property or infrastructure.

As we mentioned in our recent quarterly report and videos (equilibrium.co.uk/investment-reporting), we believe much of this is attributable to the extraordinary economic period we've witnessed – firstly, a global pandemic, and then the cost-of-living crisis which followed. The result was interest rates and inflation rising from near zero to highly elevated levels in a very short period.

The recent data adds to our expectation that these things will normalise, and recent market movements confirm our suspicion that if it does, then certain assets could perform very well.

This could bring some much-needed relief after a tough couple of years. We don't view our investment portfolios as numbers on a spreadsheet; they are your hard-earned savings that you have entrusted us to look after - a responsibility we take very seriously.

Long-term investors will have experienced similar drawdowns in the past, and unfortunately, they are an inevitable part of investing. However, this one perhaps feels different, partly because it has been more drawn out.

Because of the extraordinary period we've seen, some of the usual strategies we rely on have not helped as much as in previous market falls. A return to normality should hopefully see the normal rules reassert themselves.

Golden rules

We have a set of "golden rules" to which we always refer back to when making investment decisions.

At heart, we are evidence-based investors. Investment decisions must be made on cold hard facts, not on feelings. Always looking forward, not backward, and always with the long term in mind.

Luckily, there are decades worth of academic research that we can draw on to help us. There's a multitude of studies showing that:

• **Diversification matters**. The most reliable way to control investment risk is to spread your eggs across several different baskets.

• **Valuation matters**. Over the long term, buying assets when they are cheaper leads to superior returns compared to buying expensive assets. Often, this means we buy things that have fallen and sell things that have risen.

• **Growth matters**. Over the long term, small companies tend to outperform large ones because they can grow more quickly. Stocks exposed to higher levels of economic growth tend to grow profits more quickly.

These rules have served us very well over the long term, but in the past couple of years, they haven't worked as well.

For example, diversification didn't help very much in 2022 when nearly every asset class fell at once. Smaller companies and emerging markets (which have higher economic growth) underperformed the wider equity markets.

In 2023, bonds and real assets have again struggled, but equities have generally made positive returns. However, here the gains have been very concentrated in a small number of stocks.

Rather than a diverse portfolio of different assets, regions, and currencies - with a tilt toward small rather than large, cheap rather than expensive - this year, you needed the exact opposite. The way to make money in 2023 has been in a concentrated portfolio of very large, expensive stocks, in one single industry, one single country - mega-cap US tech stocks.

As we showed in our quarterly update, pretty much all the gains of the US (and by extension the global) equity market have been driven by these seven or eight stocks.

So, should we change our approach?

It is very tempting to follow the crowd and put a sizeable proportion of portfolios in these companies. But that would be breaking many of our golden rules, basing this decision on past performance, and going against decades of research to the contrary.

Capitalism works

We strongly believe that capitalism works. Competition means good companies prosper, and poor companies fall by the wayside. There are always new and innovative firms waiting to sweep away inefficient incumbents. That's one reason why small tends to beat large over time.

With interest rates at current levels, it might be tempting to stop investing and keep your money in cash instead. But again, the long-term rules of capitalism say that might not be the best strategy.

For example, if cash pays around 5% (gross), then for companies to borrow money, they have to offer potential returns to lenders that are higher than 5%. Otherwise, why take the risk of lending them your money?

This means that the corporate bonds of relatively strong companies (called "investment grade") currently offer around 6.5% p.a. in terms of yield. High-yield bonds (which are riskier forms of company borrowing) offer around 10% p.a. (Source: Equilibrium Investment Management / LSEG Eikon / the various fund managers we invest in). By buying these bonds, we are lending companies money at a rate of return higher than cash.

If an investor can earn 6.5% from lending money to a relatively strong company – a debt which is usually at least partly secured on assets - then they will need an even higher return to participate in that company's equity. Who would buy shares in a company whereby, if the company fails, the holder loses everything, unless there is the potential for a much higher return? Say 10% or even 12% p.a.?

It is for this reason that over the long term, bonds have outperformed cash, and equities have outperformed bonds. If that is not to be the case in the future, it is because capitalism no longer works.

We firmly believe this is not the case. Of course, it can be reformed and improved, but from an investment point of view, these rules must re-assert themselves over the long term. We should therefore stick with our golden rules.

Costs matter...

There is another golden rule of ours we didn't mention which is that...

- **Costs matter**. We can't control market returns, but we can control the cost of investing. To put it another way, how much of the gross returns we can keep rather than pay to someone else?

As a company, we focus on reducing costs wherever possible. As communicated recently, we have negotiated discounts on platform costs. These are fiendishly complicated so we will demonstrate what this means for you personally at your next meeting!

On the investment side, we have recently negotiated discounts on some of the funds we hold, focusing on those which are more expensive, and hold a bigger position in the portfolio.

We have also sold a couple of our more expensive actively-managed funds, switching into low-cost index trackers – such as an equal-weighted US index tracker rather than one focused purely on the mega-cap tech stocks – and defined returns.

This was driven by investment reasons, but cost is always a factor. The upshot is that we've reduced the cost of the underlying funds we hold in a balanced portfolio from around 0.6% p.a. in November 2022 to around 0.44% p.a. today (Source: Equilibrium Investment Management, estimate based on data from Financial Express and the fund managers themselves).

While this is a small difference, our philosophy has always been to try and make lots of small differences consistently over time, which over the long term can really add up.

Past performance is for illustrative purposes only and cannot be guaranteed to apply in the future.

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