MUNRO

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Every crisis has different reasons to be the same

In 2020 the UK economy is expected to shrink more than in any year for the last 300 because of the Covid Crisis. Three centuries ago the UK was over-indebted after years of wars but the financial world was about to be transformed by a clever scheme that became known as the South Sea Bubble.

For a while it looked like Britain's financial problems could be solved simply by some clever financial engineering. Today even more advanced financial schemes have kept the UK stock market only 20% below its all-time high and the US market is at its highest level ever despite the massive impact the Covid Crisis has caused. So what's the problem?

Well, in the US investors are saying companies are worth more even though their earnings will be lower. Right now investors value companies at about 30 years of average earnings, which is optimistic when historically analysts reckoned 10 to 15 years of earnings was a reasonable valuation.

So what has changed from previous crashes?

Two things have. The first is the continuing and seemingly never-ending fountain of cash from central banks. Governments, through their proxies the Bank of England and the US Federal Reserve have discovered they can literally print money at will. It is effectively free money. But like most things that are free it is not worth much. Lend that money back to the government and you get a return of just 0.2% on a ten-year view. The constraints of any form of external control, such as a gold standard, were ditched way back in 1914 in the UK and 1974 in the US when both countries were engaged in that most expensive of national activities; going to war. Just for good measure governments have also introduced legislation requiring pension funds to hold large amounts of sovereign debt to provide guaranteed returns for their members. Thus making sure this avalanche of cash can find a home because it can guarantee a poor return rather than hope for a good one.

This waterfall of cash is therefore looking for a more profitable home and where better than the stock market which is where the second biggest change has occurred. The development of index funds that allocate cash solely on the basis of the market value of a company has provided an easy and simple way for money to be channeled into higher risk, and hopefully, higher reward, assets. No research is needed to invest in this way, no analysis of balance sheets, cash flows or profitability, just popularity.

Fortunately, this development has been aided by another "innovation". Executives of major companies are now rarely the largest shareholders as was the case a century or more ago.

Now they are professional agents acting on behalf of the new principals. These modern capitalists are largely the pension funds of the newly enriched masses but also individuals looking to save for their retirement by navigating the complexities of the financial services industry.

Agents typically just get paid a fee for their services. But the advent of executive remuneration plans, with their share incentive schemes, means that mechanisms now exist for executives to be granted partial ownership of the businesses they run in return for meeting a set of targets that are set by committees of their peers. While the targets are invariably complex and hard to measure by outsiders, they are met more often than not. Another way of viewing the exercise is that the executives fire the arrow and the remuneration committee paints the bullseye where it lands. In any event the process gives executives' substantial shareholdings of the companies they manage who then have a few years at the top of the greasy pole of management to ensure the share price rises enough for their options to be in the money. Whether that encourages short-termism is another debate.

The dilution that might be caused to the principals, the shareholders, by this equity issuance is easily ameliorated by the last piece of wood in the Jenga tower of agency capitalism; share buy-backs. Every year companies seek authorization from its owners to spend company funds (shareholders money) buying back shares it has recently issued to its avaricious but apprehensive, executives. And these days corporate debt growth is aided by the voluminous flow of free money from the authorities. When the so-called risk-free rate of sovereign debt is so low the rates charged for corporate debt are hardly onerous.

Now the circle is complete. Free money from central banks feeds dumb money from market capitalisation based index funds investing into the companies that can spend the most on buying shares issued as part of lucrative compensation packages.

The South Sea company relied on selling new shares at a steadily rising premium to restructure the national debt in a glorious debt for equity swap. Today's corporations are doing the reverse. They are taking on debt to buy high priced equity from their executives. In 1720 the bubble burst when the flow of newly issued shares overcame the demand from over-leveraged speculators. Sagacious long-term investors had already sold as they realized the share price could never match their expectations. This time round that level of discrimination is missing as market capitalisation based

Index funds rely on the belief that the market is efficient. Is it really?

Robert Davies

Lead Manager and Business Developer for the VT Munro Smart-Beta UK Fund

VT Munro Smart-Beta UK Fund
Valu-Trac Investment Management Limited. Authorised and regulated by the Financial Conduct Authority (FCA), registration number 145168. Head Office: Orton, Fochabers, Moray, IV32 7QE Telephone : +44 (0)1343 880217
Registered in England No. 2428648 Registered Office: Level 13, Broadgate Tower, 20 Primrose Street, London, EC2A 2EW.
Visit our Website at https://www.valu-trac.com/administration-services/clients/munro/
Direct contact details for Robert Davies: Telephone: 01360 771921 Mobile: 07889 690369