What Goes Up Must Come Down: Must It Not?

I've just read Howard Marks' book – "The Most Important Thing: Uncommon Sense for the Thoughtful Investor". Marks is chairman and co-founder of Oaktree Capital, a recently-listed $6bn market cap US investment management company. Oaktree has a wonderful long term record of contrarian value investing and I recommend the book for its great clarity and uncommon good sense.

Nonetheless I by no means found myself in full agreement with Marks' text. This is not so surprising, because, although we maintain that we too are "value" investors, Lindsell Train is far from being a contrarian value investment house. Even allowing for this difference in emphasis though, there is one strand to his analysis where I kick back particularly strongly. Indeed, where I think that he is profoundly wrong and wrong in a way not just related to the pricing of capital market securities, but wrong as regards the past and future trajectory of human history and society - if I may be so bold and so pretentious.

What I disagree with is found in this sentence. "The more time I spend in the world of investing, the more I appreciate the underlying cyclicality of things." (Marks, Most Important Thing, 2011, p67 and for subsequent quotes, pp67-72).

By contrast, to put the case at its starkest, the more time I spend in the world of investing, the less convinced I am that there is actually any such underlying cyclicality.

Or, again – Marks claims: "Ignoring cycles and extrapolating trends is one of the most dangerous things an investor can do." But I say – ignoring tendentious analysis of cycles and extrapolating trends is the best way to make serious money in stocks.

Marks expounds on his conviction – "The underlying principle is that things will wax and wane, grow and decline. The same is true for economies, markets and companies: they rise and fall." And he concludes – "In the end, trees don't grow to the sky and few things go to zero. Rather most phenomena turn out to be cyclical."

I acknowledge that such an apprehension of the world - that it ebbs and flows in an organic, natural fashion - is a common enough mental model. I also acknowledge that this mental model may be useful for a certain type of investment approach. One that says – buy the dips and sell the peaks, one that warns – beware the hype and only act when there's blood on the streets. But just because a given mental model may be helpful in certain hands, doesn't mean that it is a true map of the world.

I say, contra Marks – that some trees do grow to the sky. For instance, the FT All Share Index launched in April 1962 at a starting level of 100 and today stands at 2805. What's cyclical about that? Of course, there have been fluctuations on the way, but, surely, the All Share more resembles an oak tree (the name of Marks' business, you recall), than a snake eating its tail?

Or this: In 1892 it cost $9 in 1892 dollars for a five minute ATT call between New York and Chicago. Today it's free on Skype. In the context of this inexorable trend any oscillations (cycles) on the way are barely of interest even to a historian of telephony and certainly not to someone, say an investor, wanting to understand how the world actually works.

Meanwhile, lots and lots of things go to zero. How about the UK's quoted textile industry, still an important sector when I came to the market as late as 1981, or the embarrassing debris from the UK's 1998-2000 attempt to emulate Silicon Valley – dozens of prone Baltimore Technologies or Infobanks? You'll have to wait a long time for their next cyclical upswing.

So, what I say is that while there is obviously change in the world, that change is not cyclical. Or it is not cyclical in any worthwhile meaning of that word. And here I must give an account of what I understand by "cyclical". I'll start with the Concise Oxford English Dictionary definition – a cycle is:

"a series of events that are regularly repeated in the same order."

That "regularly repeated" is crucial. For a cycle to be a cycle it has to exhibit characteristics that are regularly repeated. And I'd add two further requirements, arising from this intrinsic quality of regular repetition: cycles ought to display fixed or predictable periodicity and a tendency to revert to, or at least approach, the status quo ante. If the phenomena do not exhibit these qualities, then they are not cycles. And to repeat – my claim is that the change we experience in the world is not cyclical, because there is no predictable regularity in its change. And, even more important, it is not cyclical because things do not go back to the way they were before.

As an example of where we differ, Marks illustrates his proposition – that everything waxes and wanes - by offering this famous quote from E H Simmons, the President of the New York Stock Exchange, from January 1928. Simmons said – "I cannot help but raise a dissenting voice to the statements that... prosperity in this country must necessarily diminish and recede in the future." Of course there is enjoyment to be had from our hindsight awareness that these words were uttered a few months before a spectacular crash and economic crisis and, doubtless, Simmons was somewhat intoxicated by the long bull market of the Roaring Twenties. But I'd note two big extenuations for him. First, the reason he didn't predict the 1929 Crash is precisely because such events are not cyclical. If they were they would be regular and therefore predictable. Occasional crashes do not, in other words, prove that everything is cyclical. But, second and much more to my point – from our vantage spot of the early 21st century, even in the circumstances of our own Great Depression, we can see that Simmons, far from being a figure worthy of derision, was actually absolutely on the money. It took time, but the prosperity of the United States did not permanently diminish and recede, as the worrywarts of 1927 predicted and as the adherents of Karl Marx both predicted and craved. Instead, the purported cyclical economic catastrophe of the 1930s saw the arrival, as Wikipedia lists it, of Birdseye Frozen Food (1930), Flip the Frog (the first colour cartoon, 1930), the Long Playing record, LP (RCA Victor, 1931), FM radio (1933), 3M's Scotch Tape (1933), Kodachrome (1936), BBC TV broadcasts from Alexandra Palace (1936), the VW and Radar (1938). By 1937, 40% of Du Pont's sales came from products that did not exist in 1929 – notably rayon. The arc from Flip the Frog to Buzz Lightyear is not a cycle – it's a progression. And they and other innovations ensured that more wealth and more wealth per capita was created in the US and indeed worldwide over the subsequent 80 years than ever before in its history or the history of humankind.

Trying to formalise my instinct that Marks is wrong to argue the "underlying cyclicality of things", I find I have four substantive objections (not, I hasten to add, because I harbour any animus at all for Howard Marks, if anything it's admiration. It's just his words sparked these thoughts.)

1. First, as suggested above, I am sceptical that there is actually cyclical change in the world, at least as I have defined it. One way to test my scepticism is to grant a certain persistent cyclicality; but this immediately begs the question: why is anyone ever surprised by shifts in asset prices or economic performance? And there is no doubt that people are often very surprised. Surely, the fact that security prices do move so markedly in response to new news is actually strong evidence that this new news is unrelated to any regular cyclicality? Unless we posit that market participants are blockheads, unable to learn from past experience. For instance, were buyers of commodities and commodity extractors in 2004 being wilfully blind to History - RTZ's shares went from £10 to £50 by 2008? Commodities are notoriously cyclical, but they soared not because punters were cynically or foolishly trying to play a normal cycle, but because unanticipated Emerging Market demand created the circumstances for a new paradigm, at the very least a Supercycle. A cycle so different from preceding cycles is not exhibiting cyclicality.

Chicago University economist Deidre McCloskey, from whom more below, puts it so: "If economists were so smart as to be able to predict recessions they would be rich. They're not. No science can predict its own future, which is what predicting business cycles entails."

2. Second, Marks' dictum: "economies, markets and companies: they rise and fall" - is inadequate. Sometimes they do, sometimes they don't. The proposal is an example of an insidious and entrenched element in the thinking of many 21st century market participants. This is the belief, or even the attempted statistical demonstration, that there is a reliable force called "reversion to the mean". However, reversion to the mean – the tendency for extreme values to be succeeded by less extreme values - is just that, a statistical tendency. It is not a law and it is not reliable. And anyone investing on the basis that it is a law soon gets into a pickle. To be specific, followers of reversion to mean are routinely tempted to sell out of long-term winners and buy into clunkers that may or may not enjoy a brief twitch of life. This is not obviously a winning investment strategy.

Think about the irrelevance of reversion to mean in the context of one of the most important capital market calls of the last 20 years – that of getting Apple right (not, I must admit here, that we even attempted it). Apple opened the 1990s at a price of \$9.30. By April 1991 it had reached \$18.2. It then fell steadily, to a trough of \$3.23 in December 1997 – an 82% decline. It took until Q4 1999 for Apple to decisively breach \$18, its 1991 previous peak, only to fall back to \$6.56 in 2003. The share price today, 9 years later, is \$567, up 175-fold from its low of 15 years ago and with a market cap of \$531bn is the biggest company on the planet. What does this extraordinary roller-coaster convey? It says that however else one describes the Apple saga, adducing it as an example of cyclical reversion to mean is not credible. By the way, this is not just a company-specific point. Bears of US equities have been fretting for years that the S&P is vulnerable because corporate profit margins are at a "record high" and will, inevitably, be subject to "mean reversion" (both quotes, Montier, GMO, March 2012). But, surely the advent of Apple – and multiple other IP-driven entities – makes the comparison between 1950s and 2012s' corporate margins of dubious value? I can see reversion to mean makes sense in a static/closed economy. But that's not the real world.

3. Third, I want to introduce the compelling and stimulating argument of the economist already cited – Deidre McCloskey (formerly Don McCloskey, but that's another story). McCloskey has a radical view about business cycles, one that creates real difficulties for the view that everything is regularly cyclical. First, McCloskey notes that the business cycle is a relatively new phenomenon so far as homo sapiens is concerned. A cycle only becomes apparent during the 18th Century. Prior to that, she argues, "ups and downs in the economy were dominated by wars and

harvests" (McCloskey, Bourgeois Dignity, 2010). Those kinds of ups and downs are random, not cyclical. Since 1800, however, there have been, by her count, three dozen business cycles – the business cycles of the Capitalist era. Economists have sought to explain and predict these cycles and, particularly latterly, politicians have sought to mitigate or abolish them. Neither class of actor has succeeded, because, says McCloskey, economists and politicians have been looking in the wrong place:

"The very word "cycle" embodies the scientific hope that the ups and downs could be seen as a pulse."

But the fluctuations of Capitalism are not regular, like a pulse. And they cannot be found in, say, the study of the ebb and flow of the corporate sector's demand for working capital. And they cannot be controlled by the issuance or rationing of fiat-created government money. Instead:

"A more reasonable diagnosis...is that booms and busts arise from uncorrectable optimism and pessimism about novelties - the Housing and Auto boom of the 1920s, the Merger boom of the 1890s, the Railway booms of the 1850s and 1840s, and the Canal boom of the 1830s."

According to McCloskey, the "central peculiarity of Capitalism" – its defining feature - is not the accumulation of capital or capital stock. After all - "The Romans built roads and the Chinese canals" – but we do not thereby regard the Roman Empire as a Capitalist economy. No, the central peculiarity of Capitalism is Innovation. For reasons we don't fully understand, after 1800 the pace of innovation accelerated. And people's engagement with this innovation – in their day-to-day lives and in their investment behaviour - is the defining feature of the Modern Era:

"The ups and downs happen because people sometimes make mistakes. In fact they usually do....Busts are not getting worse...Because they originate in human optimism about innovation they cannot be eliminated without damaging the engine of innovation."

If McCloskey is right – if business and capital market cycles are driven by the inherently unpredictable development of innovative ideas (and let's add the 1995-2000 Internet boom and recent Mortgage-backed Security boom to the mix) - if this is right, then it is no surprise that statistics-based economics fails to predict their occurrence, magnitude or duration. For the same reasons playing the economic cycle, as conventionally defined, makes little sense as a long term investment strategy, because it ascribes primacy to factors – say, the trend in interest rates - that are irrelevant to wealth creation and economic progress.

To be clear, what I take from McCloskey is not that things don't go up and down; of course they do. But that they don't go up and down in a regular cyclical pattern and they definitely don't go up and down in accordance with the narrative of the "economic cycle" that informs most investment bank market strategy research and, apparently, drives much institutional asset allocation activity.

4. My fourth and final objection to notions of cyclicality is that they tend to encourage an unwarranted and unhelpful pessimism. I was taught at school about two opposing interpretations of history – Whig and Tory. The Whigs saw history as an arrow; the Tories a wheel. Whigs view the past as an inevitable progression toward greater liberty, enlightenment and economic well-being. By contrast, Toryism, in the words of A J P Taylor – "rests on doubt in human nature; it distrusts improvement, prefers the past to the future..."

Howard Marks' claim: "We conclude that most of the time, the future will look a lot like the past, with both up cycles and down cycles" - is classic Tory pessimism. The human condition is seen as a kind of Sisyphean curse, whereby after any painstaking progress the boulder inevitably rolls back down the hill and we have to start again.

A moment's reflection and we know this not to be the case. Again McCloskey gets to the heart of the matter:

"The course of Capitalism has been jagged. But it has been jagged markedly upward. The optimism of the upswings has left us with real innovations, such as the steam railway or hedged mortgages, which we do not want to lose." (As the FT pointed out in 2010 – perhaps 6 million people extra in the US now own a home thanks to subprime innovation, even after the crash.)

Thomas Babington Macaulay - arch-proponent of the Whig arrow – asked this still pertinent question in 1830:

"By what principle is it that when we see nothing but improvement behind us, we are to expect nothing but deterioration before us?"

If one attempted answer to that question is – because everything is cyclical, then that attempt fails. It fails not just as historical analysis, but also as a reliable basis for making money in Equity.

Coda

We have been alerting our clients to the long-run dividend histories of the companies in our UK Equity representative portfolio. For instance, since 1988 – the default start date for UK dividends on Bloomberg – and to pick a representative of each major theme within the portfolio, Pearson's dividend has grown from 8p to 42p (5-fold), Schroders' from 1.8p to 39p (21-fold) and Unilever's from 7p to 77p (11-fold). The average, weighted increase in dividends across the portfolio since 1988, or from maiden dividend payment if later, is over 10-fold. Almost all of our companies increased their most recently announced dividend payment in real terms. Meanwhile, since 1988 the FT All Shares' own dividends have grown just under 4-fold, while that index has just about trebled in capital value, even after the "lost decade" of the noughties (a return worth reminding those pessimistic today about the outlook for Equity).

These dividend histories are not cyclical. What goes up must not necessarily come down.

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