The Disruptive Strategist Q1 2021

Marketing material for professional, institutional and accredited investors

Benjamin Graham said successful investing is about managing risk, not avoiding it. The first quarter of 2021 highlighted the way in which risk can build and emerge from the most unlikely quarters and managing it is not always easy. We witnessed one of the most severe short squeezes in retail favoured meme names championed by the Redditors and particularly the chatroom Wallstreetbets. This was most clearly expressed in the performance of GameStop, which rose an astonishing 1,625% in January. In the very same quarter, we also witnessed the total opposite as Asian fund manager Bill Hwang saw his hedge fund, Archegos, (or private family office as he termed it) decimated by the forced margin calls that drove concentrated long positions in names like Discovery, Viacom, Vipshop and Tencent Music sharply lower as banks liquidated positions in order to meet those calls on a rumoured near 10x levered portfolio of USD 10 billion underlying.

Events like these are timely reminders that in a world which is heavily pumped up on easy money, investors must remain vigilant. The quarter was also made tough by much bigger cross asset moves. Bonds sharply reversed direction and equities, while remaining well bid, saw substantial cross currents within sectors and styles. Gone was the one-way winning strategy of buying growth at any cost. Instead, the market began to focus on the world after Covid switching heavily to names and sectors that would potentially benefit from an opening up of economies, of cyclical growth and the faint sounds of a possible end to the free money era.

In the first quarter of 2021, the effects of failing to manage risk effectively were not only felt in the outlier events of GameStop or Archegos, but also in more mainstream funds targeting growth at any cost. Nowhere is this more evident than in the fortunes of Cathy Woods' ARK family of funds that has become a recognised measure of risk appetite. The ARK family of ETFs has gone from USD 3 billion at the end of 2019 to USD 34 billion at the end of 2020 and is now counted among the top 10 exchange-traded fund (ETF) houses by assets, according to Bloomberg. In the first quarter of 2021, the flagship ARK Innovation ETF rose 25% to reach its peak in February before falling 23% to end the quarter marginally down on the year. Such volatility has drawn criticism, most recently from Morningstar who cited that the strategy "lacks a robust way of mitigating its overall risk exposure"[1]. The first quarter reminded investors that, above all, the status quo can change and the effect can be marked.

Goldman Sachs maintains a group of factor indices that highlight just this point for the first quarter 2021 period. The best performing factor baskets were Most Rolling Shorts, +33.4% in the first quarter, Long Value, +32.4% and High Beta 12m Losers, +29.0%. At the other end of the spectrum the three worst baskets were IPOs, -7.7%, Stay at Home, -2.2% and Secular Growth, -1.3%. In short, value (however that is best defined) has started to take over from growth that has led the market higher for some time now. We cover this in more detail in a separate section.

[1] https://www.morningstar.com/articles/1031702/ark-innovation-etfs-approach-is-ill-timed-for-a-major-twist

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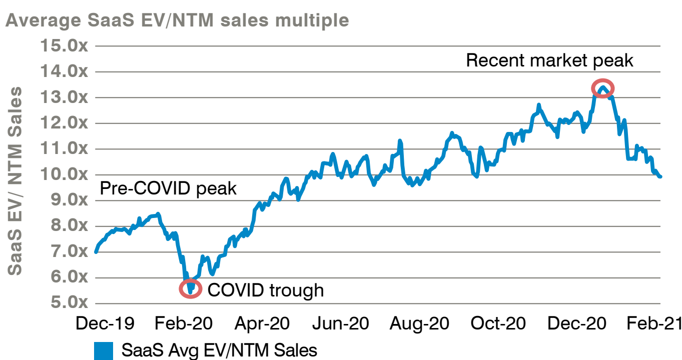
GAM Investments

Major indices also exhibited diverse fortunes, with the Russell 2000 rising 12.3% and the DAX in Germany up 10% over the first quarter, while the tech heavy Nasdaq rose just 1% and the MSCI World Growth index was flat. Part of this sharp swing was attributed to the rise in yields, with the US 10-year yield rising from just under 1% at the start of the quarter to 1.7% at the end of March. This of course benefited the key value sector of the market, financials.

These cross asset moves were reflected in individual headline names as well. Apple and Amazon fell 7.9% and 5.0%, respectively, during the quarter while Google and Facebook rose 17.7% and 7.8%, respectively, perhaps reflecting their underlying revenue driver, the cyclical and economically sensitive advertising market. High growth SaaS (Software as a Service) names across the board fell from the elevated levels reached in 2020. Chart 1 below from Goldman Sachs shows the derating in the first quarter 2021.

Chart 1: Software multiples remain above their pre-Covid peak



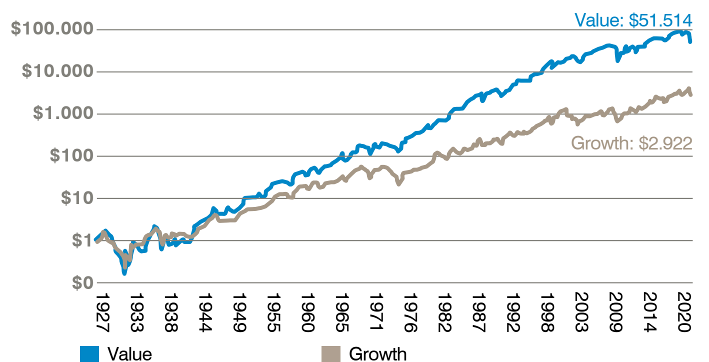
Source: Goldman Sachs as of 31 March 2021. For illustrative purposes only.

Only time will tell whether this mean reversion between growth and value has been normalised but the first quarter is a timely reminder that markets often get over-extended in absolute and relative factor terms and that should be reflected in portfolio construction and risk management.

Growth versus value – Trend change or mean reversion?

One of the pervasive debates in factor investing is that of growth versus value. Intuitively, it would seem to make sense that over time, good growth businesses should outperform mature value investments. However, using data going back to the early 1900s in the US and five decades of international data suggests otherwise. Chart 2 below shows that since 1926, value has outperformed growth by 17 times. It is no wonder then that when markets notch up a period of growth outperformance and relative valuations get stretched, the debate intensifies about an imminent reversal – when the reversals do occur they tend to be sharp and extreme. The size of the reversals often delivers performance degradation that falls outside the tolerance of most investors and therefore creates significant business risk for managers. The saying markets can stay irrational for longer than you can stay solvent (Keynes 1930s) really holds true. It is therefore with good reason that this debate rages and has intensified of late as growth comes off a multi-year period of outperformance. As Chart 3 below shows, the value drawdown relative to growth has been more extreme than at any time over the last 100 years.

Chart 2: Growth versus value from 1927 to 2020



Source: https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html. Data from December 1927 to March 2020. For illustrative purposes only. Past performance is not an indicator of future performance and current or futures trends.

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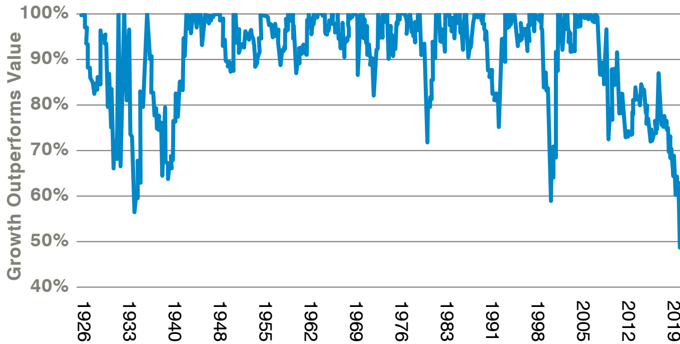
Chart 3: US value drawdown relative to growth



Source: https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html. Data from 1926 to 2020. For illustrative purposes only. Past performance is not an indicator of future performance and current or futures trends..

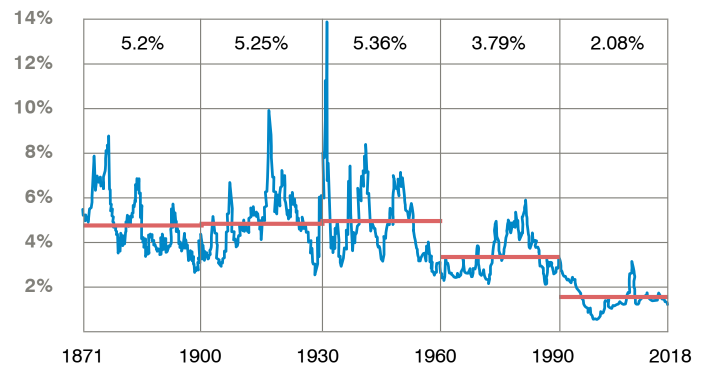
There have been many attempts and academic papers written to explain the value dominance over time but these fail to convince. Instead it is worth considering where we are today and whether there is a genuine case for a long-term rotation back to value or whether the world is so different that growth will continue to outperform and maybe reverse some of the 17x set over the last 100 years.

It is our contention that growth will likely continue to significantly outperform value over the next 10 years. We do not disagree that a post-Covid, liquidity fuelled economy is likely to drive some mean reversion in favour of value for the short term, but the longer-term trend will likely continue to favour growth.

The principle reason for this view is that we are witnessing a seismic shift in business models that is creating a polarisation between winners and losers, the like of which we have never seen before. It is no surprise to us that the beginning of this trend of growth outperformance was at the end of the great financial crisis because that was the moment when computer devices began to proliferate in the hands of the many through the inception of the smartphone. A world where 400 million desktop PCs was the extent of the global network became a world of billions of connected smartphones and with it, the power of Metcalfe's Law that together with the 40-year old Moore's Law effects, started the transformation from the old world of people centric, often capital intensive businesses, to a new world driven by technology at the core, capital lite and often decentralised. Therefore traditional 'value' investments are at severe risk of disruption in a way that has never existed before. Capital intensive bricks and mortar is challenged across the board from retail to commercial office space. With Digital 4.0 and the Internet of Everything, capital intensity in manufacture will be dramatically cut. With these trends, price to book value ratio (P/BV), one of the key 'value' measures, is no longer necessarily a sign of an inexpensive name; it is rather a possible sign of a company that has capital tied up in the wrong place.

Finally, the most difficult factor to assess is dividend yield. Dividends are very real in the chain of value. However, they have become less relevant over time – Chart 4 below goes some way to explaining the historic outperformance of value over growth; dividend yields during the period up to 1960 were a very significant contributor to overall performance. With yields currently at all-time lows, this is less important as a driver of value names

Chart 4: S&P dividend yield by month with 30-year period means



Source: Justin Czyszczewski Blog –Are Dividends Important. Data as of 2 July 2019. Past performance is not an indicator of future performance and current or futures trends.

We do however recognise that in a very low interest rate environment, dividend yield, even at a lower base level, is a genuine value factor that carries real weight, unlike P/BV and price to earnings (PE) which have potential concerns as a legitimate factor in a digitally-driven world. For this reason, we do pay attention to dividend yield in terms of portfolio construction.

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As we try to ensure continued alpha generation for clients, we monitor the growth/value factor within portfolios and when this measure is extended, we neutralise the factor.

Taking all the above into account, we believe that the right (balanced) portfolio of growth businesses could generate strong client alpha over time against even the broadest equity indices (MSCI World Equity or the S&P 500) and thus should be a consideration when forming part of any global equity portfolio.

Crypto and NFTs – The market heats up as Twitter founder sells his first tweet for $USD 3 million

Blockchain has been an important developing theme for us over the last two years and as a team we have invested time learning more about it with a focus on the way in which it will automate trust in industries like financial services, document management and signing, company administration etc. As it has transpired, outside the world of crypto it has made its mainstream appearance through the use of NFT's (non-fungible tokens) in the art world. Headline-grabbing news such as musician Grimes making millions of dollars for NFTs (USD 6 million in fact) through to the founder of Twitter, Jack Dorsey, selling his first tweet for USD 3 million, Blockchain has burst onto the world stage as a clear automiser of trust. That tweet is immutably recorded on the Blockchain so there is no way anyone can copy or forge it or indeed steal it; we can trust that it is the genuine article.

Perhaps the most astonishing sale to date using NFTs was that of Beeple's Everydays, sold for USD 69.3 million through Christie's. This extraordinary price, one of the highest ever paid for a living artist, shows clearly the value of authentication in an immutable form. People will pay a significant premium for assets that eliminate any potential for fraud – there is simply no tail risk.

NFTs are part of the Ethereum blockchain, a protocol that has been developed not just for cryptocurrency issuance but also for storing additional information allowing for the creation of smart contracts and asset repositories. In fact, anything that requires a clear proof of ownership can be placed on the blockchain.

One real world example of this could be concert ticketing. Currently rife with fraud, this entire industry could be fully trusted in the blockchain world. Every ticket issued for an event would be placed on the blockchain with its own unique digital identity. Not only would this eliminate ticket fraud, but it would allow a whole new level of event management. Using smart contracts, the terms of the ticket can also be managed, for example, it could be explicitly written onto the blockchain via a smart contract that a ticket cannot be resold and so it would be impossible to trade tickets on.

The ways of extending this are limitless and the disruptive effects will be far reaching. In the case of the ticket example above, in a blockchain decentralised ticketing system there would be no need for Ticketmaster or Eventbrite, for example. The process of placing property assets on the blockchain would significantly simplify the process of buying and selling property – the future of traditional conveyancing would be in doubt. Simply put, wherever trust is a required part of processing asset ownership, blockchain could replace the need for lawyers or trading hubs like auction houses or ticketing platforms.

We have long believed blockchain will revolutionise the process of trust in business. NFTs in the art world show what can happen when the system is created for that process. Over the next 10 years, we are likely to see huge changes in the way transactions of all types are recorded. Global Market Insights estimate that the size of the blockchain market will grow by 70% compound annual growth rate (CAGR) from 2020 to 2025, giving a market size of USD 25 billion. The growth and opportunity is clear – we believe the order of magnitude is likely highly underestimated.

Facebook regulation

Towards the end of 2020 Joe Biden became the 46th President of the US, taking control of the House and the Senate. This new Democrat led administration brought with it a fear of increased regulation and scrutiny in regard to technology companies, particularly the FAANG names (Facebook, Apple, Amazon, Netflix and Alphabet, formerly Google). Although the Democrats have a history of being more hostile to 'big tech' compared to the Republicans, it is worth noting that the Trump administration was also taking a cautious view. Over the past few years we have seen CEOs brought in front of Congress to testify on a range of issues; this pattern is continuing under the Biden administration with Mark Zuckerberg (Facebook), Sundar Pichai (Google) and Jack Dorsey (Twitter) all testifying in March 2021 about their handling of misinformation and the handling of online extremism on their platforms.

In December 2020 the FTC (Federal Trade Commission) launched a lawsuit against Facebook specifically looking at the acquisition of WhatsApp and Instagram with the aim of breaking them up. Although this lawsuit was filed after the Biden administration had taken over, it had been put together under a Republican leadership and the Trump administration. There is bi-partisan support for increased controls and regulations within the industry and therefore the topic must be given careful consideration.

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The FTC case against Facebook focuses on two key elements, i) does Facebook act as a monopoly and ii) did Facebook acquire WhatsApp and Instagram with the main aim of preventing them from becoming competitors? When thinking about whether Facebook is a monopoly of not, you have to first define the market in which the company operates. Is it the total advertising market? Is it the digital advertising market? Is it the digital display or performance advertising market? Is it the 'social media' market and what does that mean? Will you define the market in terms of revenue or will other criteria such as 'number of monthly active users' be more important?

When arguing an anti-competitiveness case, one of the key factors is to show consumer harm. This is going to be tricky for the FTC as the product (at least from a consumer standpoint) is free. Here the debate is likely to centre more around consumer rights specifically from a privacy perspective. Are users 'paying' for Facebook's products and services with their data and exchanging their privacy (against their will) to gain access?

The main concern from the investment community is whether this case will result in a break up of Facebook. Again this is not simple. The FTC would have to prove that the acquisitions were illegal and that there has been a loss to competition – they would have to show that Instagram and WhatsApp would have thrived in their own right. Comparisons will be made with Snap and Twitter, with a lot of scrutiny being placed on the robustness of each company's ad ecosystem, the ease with which each was built and their ability to grow users.

This entire process will take years. If the case is fast tracked it would take six years to play out. Although the risk of regulation is increasing rather than relaxing, it is unlikely to impact the actual operations of the company in the short to mid term and arguably is already more than discounted in the price of the stock. The biggest short-term risk is related to future M&A; while there is a lawsuit questioning Facebook's status as a monopoly and anti-competitive behaviour it will be difficult for it to engage in significant M&A which arguably stifles progress and innovation.

It would be wrong not to mention that Alphabet, or Google, is also facing litigation from the Department of Justice, suggesting the company has a monopoly in general search. Again this is going to be a long process with the trial starting in September 2023. There is also a lawsuit from the State of Texas suggesting that Google colluded with Facebook to fill network ad inventory. Google is also facing a federal antitrust investigation in regard to being the default search engine on iPhones. And in Australia there is the shift towards platforms having to pay for news. This is not the complete list of existing lawsuits and it is likely that more suits will be filed in the future; therefore this remains a negative overhang.

Outlook:

The outlook for the balance of 2021 remains very much driven by a combination of the continued acceleration of Digital 4.0 and the move to the Internet of Everything. This will likely drive opportunities across all sectors, but we are particularly excited about healthcare, industrials, transportation, fintech and the automation of knowledge work. At the same time, exiting Covid is likely to place these more pro-cyclical opportunities in stark contrast to the winners of last year that focused so much on Covid beneficiaries.

We envisage a perfect storm emerging for 2021 with cyclical recovery meeting the surge in Digital 4.0 opportunities. This will likely remove much of the growth / value risk that has preoccupied the market in recent months; the disruptive winners seem far more likely to emerge from within the more cyclical part of the market. It is for this reason that we see increasing focus on more industrial themes – the internet of manufacturing, the network effect in healthcare or digitalisation in transportation to name a few. At the same time, we see the debate continuing to rage on the value of digital currency and the deepening use of blockchain in franking assets – in a world where fiat currency is being printed at any pace, truly scarce and finite assets are more valuable.

At times of pivotal change, investors often remain stuck in the trades that have been successful over time, relying on "if it ain't broke, don't fix it", particularly when those investments continue to deliver growth. However, we believe that while this may continue to yield positive returns, there is greater potential to generate strong alpha in a portfolio built around the next wave of disruption. This is where we will increasingly focus our attention in 2021. Numerous new investment targets are emerging from the IPO process as well as the de-SPACing of slightly younger companies.

Yesterday's winners will not necessarily be tomorrow's. Now is the time to pivot.

For more information, please visit GAM.com

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