

A Note on the Future

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At the turn of the year, it pays to spend some time reflecting on the past – what has worked, what has not and why. Over the last decade, including the tumultuous year that was 2020, one of the best performing stocks (including investment trusts) listed in the UK has been the Scottish Mortgage Investment Trust. This has been a key holding in Tacit's strategies since inception. With hindsight admittedly, we did not own enough of it. However, hindsight alone can be a treacherous teacher when making decisions about the future. Trite as it is to say, future returns depend entirely on the future.

Why does it strike us as slightly absurd that one of the best performing listed holdings in the UK over the last 10 years is the Scottish Mortgage Investment Trust? Because 99% of the trust's holdings are non-UK stocks. This is an uncomfortable indictment of the performance of the UK market. Over the long term, this is not a surprise. The UK equity index is heavily weighted towards cyclicals like miners, oil & gas producers, and banks – companies with limited ability to compound wealth. The holdings of Scottish Mortgage on the other hand are fast growing compounders – companies growing rapidly and re-investing earnings at a high rate to grow even faster and capture more of their respective markets.

This of course does not mean that cyclicals are to be indefinitely labelled as bad investments. At the right price and with a catalyst, they can generate good returns. However, over the long term (10-15 years) they will lag their more growth orientated peers. This is why the UK index, as it stands, has underperformed in the last decade. Its disproportionately large exposure to cyclicals means that returns will be cyclical – periods of boom and periods of bust. One step forward and one step back, nobody gets too far like that.

Over the last decade, most of the best performing trusts and funds in the UK have had large exposures to technology, biotechnology, and healthcare companies. Looking in the rear-view mirror and using hindsight as our guide to the future, the lesson would seem to be to capitulate and invest in these types of companies. Afterall, they have performed well in the past and most of them are growing fast in a world where growth is scarce.

The naïve alternative would be to invest in cyclicals because they were cheap before the pandemic and have proceeded to become cheaper. There is some truth to both of these arguments, but they miss the bigger picture.

The third alternative is to look at what has really driven returns. Not what the headlines say has worked or what conventional wisdom dictates but what has actually worked.

If you look up the long-term share prices of Dollar General, Costco or Lowe's, you would be forgiven for mistaking them as technology companies. These are all physical retailers that have thrived while others have struggled. What set them apart? Good management, conservative balance sheets and strong competitive advantages (sustainable low prices and convenience). Passing cost savings back to customers creates loyalty and reciprocity, the strongest competitive advantages for low margin businesses like retail and one of the key reasons for Amazon's success as a retailer.

The bulk of our equity exposure going forward is biased towards these types of companies. Low financial leverage, good management, boring businesses with strong competitive advantages and low valuations that are often overlooked by the market as everyone else is enamoured by the next big thing and makes the flawed assumption that the future will be just like the past.

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