THE SCOTTISH Investment Trust

The CONTRARIAN

SUMMER 2020

ANALYSIS AND INSIGHT FROM **THE SCOTTISH INVESTMENT TRUST**

Death of the Bull?

> "The formal bullfight is a tragedy, not a sport, and the bull is certain to be killed."
>
> Ernest Hemingway,
> Death in the Afternoon

A bull market is typically defined as a rise of at least 20% from a previous trough, just as a bear market is a 20% fall from a peak. The bull market that ran from 2009 was one of the longest on record.

The end was nigh

Even before Covid-19 struck, there were ample indications that this bull was on its last legs – the yield curve had inverted (a reliable indicator of looming recession), US-China trade relations were fractious and short-term lending markets were stressed. Covid-19 delivered the matador's final thrust.

However, few could have foreseen the pandemic and the economic shutdown that entailed. More predictable perhaps was that, as the strain on the global economy increased, the bull market's demise would meet a frantic response from central banks.

Central bank saviours

Over the past decade, central banks have rescued the bull from the jaws of the bear on several occasions. Markets diced with death in 2011, when the European sovereign-debt crisis erupted, and again in 2018, when global stockmarkets suffered sharp, though not sharp enough, corrections. But whenever the bull looked unsteady, central banks revived it with new support.

The extraordinary rally was sustained by these massive experiments in monetary policy.

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ABOUT

The Scottish Investment Trust

At The Scottish, our experienced team actively manages a high conviction, global investment portfolio with the aim of generating above average investment returns over the longer term for our investors.

Our contrarian approach is benchmark agnostic and aims to benefit from profitable opportunities in any market environment.

Founded in 1887, the trust has a long tradition of providing shareholders with an accessible, low cost way to invest in companies from around the world, whilst further boosting returns through the provision of a growing dividend.

The Scottish has grown its regular dividend every year for the last 36 years. Our independently managed, closed-ended fund structure allows us to be patient with our investments.

Death of the Bull?

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'Quantitative easing', 'yield-curve control', 'Operation Twist' and 'negative interest rate policy' all entered the investment lexicon.

Initially, many economists considered such measures heretical, but central bank actions achieved their primary objective – the economy did not collapse, and asset prices rose.

Misallocation of capital

For investors, this created a new paradigm in which central banks provided a safety net for those looking to take risk. Many, it seemed, paid more careful attention to monetary policy than to more traditional economic or corporate fundamentals. The result, in our view, was a massive misallocation of capital.

Some of the most egregious examples came from Silicon Valley. Take Theranos, a blood-testing company once valued at $9 billion. It had no working product, merely a well-told story, which turned out to be false, and the promise of growth. Starry-eyed investors ploughed huge sums into its shares before the company was exposed as a fraud.

Then there's WeWork, which simply sublets office space. But by posing as a technology firm, it managed to achieve an eye-wateringly high valuation of $47 billion – before coming close to bankruptcy when reality called.

WeWork's 'tech veneer' was significant, because technology stocks benefited most from investors' appetite for growth. Several such companies have attracted trillion-dollar valuations. With interest rates so low, investors have had little compunction about backing any company that might be the "next big thing".

Will value reign again?

Over the course of the long bull run, such growth investments did not always have the upper hand. Initially, 'value' investments led the rebound from the global financial crisis. But as extraordinary monetary policy became entrenched, the baton passed to 'growth' stocks.
The relative fortunes of the two 'styles' has now reached new extremes. At some point, the valuation premium that investors are prepared to pay for growth will peak, leading to a change in market leadership. When the pandemic subsides, it may be time for value investments to reclaim the ascendancy.

What next from central banks?

The recent rebound from the lows of March suggests that the 'Powell Put' – the Federal Reserve's willingness to intervene when markets fall – remains very much intact.

Despite the unhealthy side effects, central bankers appear content. So much so that they embarked on an even larger round of easing in response to the Covid-19 crisis. However, the pandemic is very different to the 2008 financial crisis and monetary policy can only go so far in compensating for the closure of the economy.

That is unlikely to deter authorities around the world from embracing ever more radical monetary policy options. Speculation is rising that the US Federal Reserve may adopt negative interest rates. Jay Powell, the Fed's chair, has issued a denial, but markets are already pricing in the possibility. There has even been speculation that the Fed may follow Japan in buying exchange-traded equity funds.

“Despite the unhealthy side effects, central bankers appear content”

Ultimately, government spending and more extreme monetary policy is inflationary, causing fiat currency to break down as a store of value. Central banks have vastly increased the amount of cash swirling around the world, but this hasn't changed what assets are ultimately worth, merely inflating their price in less valuable currency. That is one reason we maintain exposure to gold.

Ready for the recovery

As suggested in the title of this piece, after a huge plunge, markets have already entered a new bull phase. We remain mindful that such rallies can peter out, but stand ready to invest in the companies that we believe can lead a revival.

June 2020

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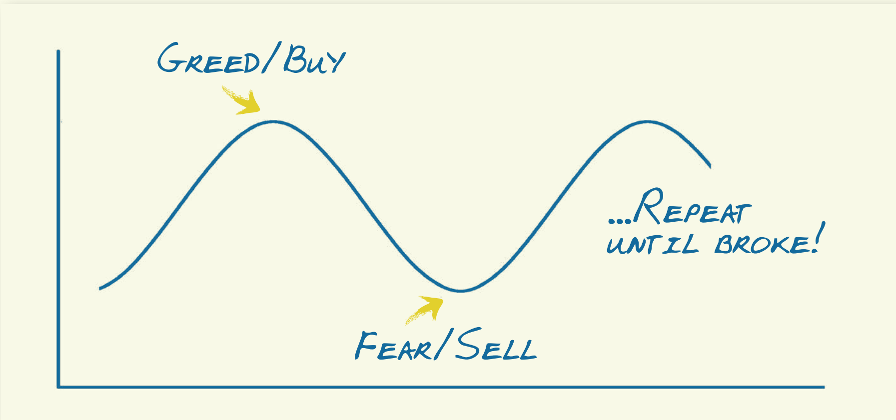
Lessons in life - taking the contrarian view

> “If you can keep your head when all about you
> are losing theirs and blaming it on you,
> if you can trust yourself when all men doubt you,
> but make allowance for their doubting too”

So begins Rudyard Kipling’s famous poem, ‘If’. Intended, in its day, as life advice for young men, it also contains an important lesson for investors – one that’s at the heart of every potentially damaging boom and bust cycle. The poem highlights the value of calmness in the face of adversity, and in having the faith to stand apart, instead of merely following the herd.

Kipling published those words in 1910, but human nature hasn’t changed at all since then. In stressful situations it is easy to lose objectivity and give in, quite understandably, to fear-based decision making. We saw this most recently when news broke of the Covid-19 pandemic. Investors reacted, en masse, to the fear of the unknown – and the possibility of a permanent loss of capital. This phenomenon is a result of the human tendency, hardwired into us, to retreat to the perceived safety of the crowd.

But all too often this impulse leads to groupthink, with investors buying or selling assets at precisely the wrong time. Behavioural economists commonly refer to this as the ‘cycle of emotion’ which we think is quite nicely demonstrated in the chart below…



When all’s well with the world, and assets are appreciating, people tend to feel optimistic and invest more. The ‘fear of missing out’ can then take hold, which leads to even more investing in, what are starting to be, very popular investments. In this phase, optimism can turn into euphoria and may characterise the peak in the market or even an asset bubble. Yet investors continue to buy, heedless of the warning signs that the most advantageous time to do so has passed. And of course, when sentiment eventually fades, the process goes into reverse and bullishness is replaced with fear, and eventually panic. At this point, investors will have a tendency to sell, even if it’s not necessarily in their best interests to do so. We’ve seen this cycle repeated time and again, because investor behaviour, far from being correlated to the facts, can be irrational. For a recent example of this, look no further than investors’ extraordinary partiality for Zoom Technologies, based it would appear on little research. Shares, in Zoom, soared as they were snapped up by investors thinking that this was the company made famous by the surge in demand for video conference calling, widely used in our shift to working from home. However, it turned out that what they were actually investing in was a completely unrelated Chinese stock. Buying the name, and the wrong one at that. Needless to say, there was an equally swift dash for the exit.

Being caught up in the hype of the crowd is one side of investing that our contrarian philosophy seeks to avoid. We like to take our time and objectively analyse the market to unearth the hidden gems that are underappreciated by others. It’s about seeing a spark for improvement that others have missed. That could be a change in management; the balance sheet strength that will see the company through hard times; or a sustainable dividend yield, all of which can be indicative of a company’s future wellbeing.

The financial health of companies is more important now than ever. Not all will emerge from the pandemic unscathed and the fallout from the economic slump will be long lasting.

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The Covid-19 pandemic will trigger huge change in the way we live, work and think. Adaptation will be required including, for example, in the organisation of global supply chains, where goods and services may well be sourced closer to home in future (ie. 'nearshoring'). Ultimately, we expect the economy to recoup with equity markets likely to lead that recovery.

It is our view that patience is key to riding out the heightened volatility we are seeing in markets at present. As investors, we do always look to learn from past experiences. Sir John Templeton, once noted that, "the four most expensive words in the English language are 'this time it's different'". It never is – circumstances change, but hardwired emotional responses lead to patterns of wealth and loss. The key to successful long-term investing is to carefully research and have a clear rationale behind each decision.

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Please remember that past performance may not be repeated and is not a guide for future performance. The value of shares and the income from them can go down as well as up. You may not get back the amount you invest.

YOUR LEARNING HUB

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Five 'behavioural blockbusters' for your 'Zoom' meeting bookcase

As contrarian investors we pay a lot of attention to human behaviour and understanding what makes the world, as well as the markets, go round. Standing out from the crowd can be challenging but, rewarding.

Considering the unprecedented government and central bank response to the extraordinary pandemic we find ourselves in, and given many are reassessing the world order, indeed the future of global capitalism, it seems like a good opportunity to revisit the insightful thinking of some well-known writers and behavioural experts. The idea is to see our current predicament from a potentially different perspective and to also look at whether any lessons from the past can be useful for the investment journey ahead.

Visit **www.thescottish.co.uk/learning-hub** to see the five books we have chosen to get the ball rolling.

Though they may well raise more questions than answers, we hope you will find they are written with both vision and humour, designed to be enjoyable and thought-provoking. We'd love to hear from you if you have any other interesting books in mind and would like to share, you can tweet us **@ScotInvTrust** or/and tagging **#ContrarianReads**

If you'd like to learn more about how the pound in your pocket is related to the actions of global central banks, then try out our easy to watch, three-part video series with Young Money Blog founder, Iona Bain - also in the Learning Hub.

Staying in touch with The Scottish

Please be assured that we are operating as normal during this Covid-19 pandemic.

Our latest company announcements are published on the Regulatory News Service and our website **www.thescottish.co.uk** If you have any queries you may contact us by telephone, email or post, and if you'd like to hear from us more frequently, please subscribe for our monthly email.

Our monthly factsheet, contrarian thoughts and market commentary - directly to your inbox.

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