Ditching the crystal ball

We explore the pitfalls of forecasting and an alternative strategy for investors heading into the new year...

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There's something irresistible about a new calendar year for investors. The opportune time to reflect on last year's performance, clear the slate and realign our portfolio for the year ahead (as well as the opportunity to escape from post-Christmas duties on the pretext of Very Important Business.) But might it be time to lock away our crystal balls, take a deep breath and, in contrast to other new year's resolutions, do very little indeed...?

Before the curtain falls on 2023, let's take a quick look at the victors and the also-rans. It will come as little surprise that the technology sector topped the Investment Association (IA) leaderboard, rewarding investors with a total GBP return of 39% in 2023, according to FE Analytics. However, against a backdrop of geopolitical and macroeconomic uncertainty, fewer investors might have predicted that emerging markets would be hot on its heels, with Latin America and India taking silver and bronze with total returns of 23% and 17% respectively. Bringing up the rear (by some margin) was China with a negative return of 20%.

As enjoyable as it is to revel in last year's successes, we know that the holy grail of investing is about looking forward, not backwards. I recently listened to a 'We Study Billionaires' podcast with Jamie Catherwood on the perils of stock market forecasting. His study of the history of financial markets shows that most retail investors are not equipped to forecast markets with any degree of accuracy but continue to believe in their ability to do so. In particular, Jamie warns against the flawed logic of believing that a new calendar year imbues us with the magic power to forecast markets when history strongly suggests otherwise.

In view of this, why do we persist in trying to predict market trends? It seems our love of forecasting stems from psychological biases, fuelling an irrational faith in our prediction skills. One of the more potent combinations is loss-aversion and the 'doing something' syndrome, in the belief that a more active approach to portfolio management will reduce future losses. Coming back to recent events, technology stocks endured a torrid 2022, with investors suffering a 27% average loss for the IA sector, the second-worst performer of the 50 plus IA sectors. But investors who resisted the urge to panic and reduce their US mega-cap exposure should have comfortably recouped their losses in the subsequent rebound last year.

What implications does this have for our investment resolutions for the upcoming year? Well, understanding our psychological traits can help us become better investors. Top of my list is to resist the urge to tinker on the back of often spurious forecasts and trust the mantra of 'time in the market, not timing the market'.

And the data backs up the benefit of a more patient approach to investing. Looking at longer-term average returns by IA sector, the tech sector undoubtedly remains the runaway success, delivering a fifteen-year total return of more than 900% (as at 02/01/2024). But investors may be cheered to know that the average returns of more than 35 IA sectors would have doubled their money over the same period, from the UK to China and bonds to commodities. And that's based on the sector average, with the top-performing funds delivering returns well in excess of this.

A diversified portfolio often goes hand-in-hand with this 'buy and hold' approach, delivering blended returns without the challenge of timing investments to capitalise on a sector's moment in the spotlight. Actively-managed funds also provide an opportunity to piggyback on the forecasting and stock-picking expertise of fund managers, although it's worth taking the time to find the funds that deliver superior returns over the longer-term.

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One example is **Pantheon International (PIN)** which invests in a global, diversified portfolio of private equity-backed companies. PIN has a track record of outperformance, delivering a ten-year NAV total return of 274% compared to the Morningstar IT Private Equity (ex 3i) peer group index return of 139% (as at 01/01/2024).

Although historically a 'fund of funds', PIN now invests more than half of its portfolio directly in companies, complementing its indirect holdings in private equity funds. As my colleague **recently noted**, PIN's valuations have been conservative, with investments typically sold at a premium of around 30% to asset valuation.

Private equity investments may appeal to 'buy and hold' investors, as they aim to generate superior returns over the long-term but can be cyclical over shorter time periods. They also provide exposure to smaller, higher-growth technology businesses that can be harder to find in the listed UK equity universe. Although there is no guarantee of future returns, PIN's current discount of c. 36% may provide an additional safety margin for investors.

Another interesting option is **Law Debenture (LWDB)**, which offers the unique structure of a UK equity portfolio combined with the provision of independent professional services (IPS). The IPS business is highly cash-generative and funds more than a third of the trust's total dividends, underpinning its impressive 44-year track record of having maintained and/or increased its dividends.

This diversified income stream also enables the managers to invest in high-growth companies with lower dividend yields that may not be accessible to other UK equity income trusts. With UK equities sitting at low valuations relative to their long-term average, managers James Henderson and Laura Foll believe there is an attractive pool of high quality, undervalued companies.

LWDB has delivered a ten-year NAV total return of 113%, against an average return of 88% and 68% for the Morningstar Investment Trust UK Equity Income sector and FTSE All Share Index respectively (as at 01/01/2024). Due to this strong track record, it is currently trading on a small discount of 0.4% and a dividend yield of c. 3.8% (as at 03/01/2024).

Given the macroeconomic and geopolitical turbulence in the last year alone, the only certainty seems to be continued uncertainty ahead. With that in mind, perhaps it's time to ditch our crystal balls for good and heed the advice of billionaire investor John Paul Getty: "The big profits go to the intelligent, careful and patient investor, not to the reckless and overeager speculator."

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