MAGELLAN ASSET MANAGEMENT LIMITED

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Five risks to monitor and why capital preservation is key

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North Korea looms as a big risk in a world where bull markets are prompting investor complacency about possible capital losses.

It's natural that after eight years of a rising US stock market and a bond bull market that extends past three decades that people forget important lessons to be taken from past periods of capital destruction. Rather than considering the risks they are bearing, investors are overlooking them as they reach for yield or for what could be termed relative returns. We are aware of the risks we take, especially whether or not we are placing capital at risk of loss.

Why is capital preservation important? First, when stock markets slump, the results are asymmetrical in percentage terms. If stock markets fall 50%, then share prices need to double from that point for investors to fully recover. If your portfolio falls much less than the benchmark, you need only to recoup much less in percentage terms to arrive back at the high point.

The other important reason to prioritise capital preservation is that market dislocations often create an opportunity to buy worthwhile assets that are significantly mispriced. Preserving capital for such a moment gives investors the purchasing power to take advantage of these bargains. So, what difference does our focus on capital preservation make?

Our focus on avoiding capital losses means that the Magellan Global Fund has outperformed the MSCI World Index every rolling three-month period over the past seven years.[1] In the past three years, for instance, the portfolio has only followed the market down for 30% of its decline on this basis. Over the past seven years, we've only incurred 24% of the market's decline. Such outperformance in falling markets gives us a substantial advantage over the long term. This advantage can be hidden during a bull market such as today's.

Five threats

Capital preservation is a worthy focus today because share markets at record highs face risks that can be narrowed down to five main ones, even if assigning probabilities to these risks is more problematic. Starting with Asia, North Korea appears troublesome. If Pyongyang were to dramatically boost its nuclear capability into an intercontinental ballistic capability that could upset the psychology of investors materially. The other risk in Asia is that China might loses it battle to prevent a decline in the renminbi, which, if that were to happen, would export deflation to the rest of the world.

In Europe, Greece's debt crisis could still lead to a Grexit and France's presidential elections could result in a Frexit if Marine Le Pen were to win. While opinion polls predict that Le Pen will lose in the second round of voting in May, the UK and US election shocks last year have shown that investors can't place too much faith in polling.

Turning to the US, investors need to monitor the pace of the Federal Reserve's tightening of monetary policy. The Fed has signalled that rate increases will occur in a gradual fashion and that's what is priced in. But should US economic growth accelerate and inflation threaten to break out beyond the Fed's 2% target, the Fed could turn decidedly more hawkish later in the year. That would trigger instability in bond and stock markets. The other risk is how President Donald Trump resets the US relationship with China. Could he rupture the relationship and enact protectionist trade policies that lead to a damaging trade war?

Overall with Trump, though, we are cautiously optimistic that his push to lower taxes for business and his goal to reduce regulations on companies will be good for the US economy. We are more sceptical about whether or not his proposed infrastructure spending will have much impact in the next few years, though such investment is crucial for the long-term productivity of the US. Overall, lower corporate taxation, personal taxation reform and repatriation tax changes would probably mean higher US corporate profitability, though any border tax could be problematic.

The AGI race

At the industry level, the development to watch is the race to invest in artificial intelligence. Obviously, not all the companies that are participating in this race such as Google's parent Alphabet, Amazon.com, Apple and Facebook can be winners. But it's important to note that these companies are not directly competing against each other in this area. Investing in artificial intelligence for Amazon is about using a person's previous searches to decide what goods are worth showing on that person's Amazon page. Google uses artificial intelligence to give users relevant materials in searches.

In the longer term, the prize for artificial intelligence will be won by the first company to master what is called artificial general intelligence, as opposed to narrow intelligence. Artificial general intelligence is when computer systems can be as, or more, intelligent than humans across an array of tasks, including thinking and understanding language, which computers can't do at the moment.

If one of these companies were to crack artificial general intelligence, it could hold substantial advantages over versus virtually any company in the world. We're probably 20 years away from a company achieving this feat. It could be sooner. It may well be one of today's tech giants is that company. It may well be some other enterprise.

[1] MSCI World Net TR (USD) to 31 December 2016. Before fees in US dollars.

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