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Diversity of Time Horizons

by Mark Wright, CFA

A commonly accepted definition for market efficiency is "the degree to which market prices reflect all available, relevant information". Given the speed with which news is now disseminated around the world, along with the rapid growth in algorithmic trading, one might expect markets to be reasonably efficient.

That is certainly one way to explain the wild oscillations in equity markets last year. These violent swings made the volatility associated with the Global Financial Crisis (GFC) look tame in comparison. In February and March last year, global equity markets took less than 5 weeks to erase all of the gains they'd grinded out over the previous 3 years. They then went on to reach all-time highs just a few months later in August, before bouncing higher again post 'Pfizer Monday' in November[1].

Are these extreme moves simply an efficient equity market rapidly incorporating into prices the changing economic landscape - the lockdowns that hurt corporate profits, the subsequent financial support from the governments and central banks, and then the economic boom thanks to the discovery of a new vaccine?

Probably, to some extent. However, arguably of greater significance is the myopic, irrational behaviour of market participants driven by fear (and then greed).

My colleague, Gary Moglione, touched on this in his article a few weeks back in which he cited one of Warren Buffett's most famous quotes that far too many investors forget, "Be fearful when others are greedy and greedy when others are fearful". I am going to introduce a new concept that we take advantage of called, "diversity of time horizons", a phrase coined by Lyrical Asset Management with whom we invest in North America.

I've outlined below some examples from our investment portfolio that demonstrate how irrational investors can be at times and the extent to which time horizons can diverge.

The direct UK equity portfolio we manage traded at about 5x forward earnings in the middle of March last year[2]. Granted, those earnings forecasts lagged reality at the time, but in the grand scheme of things, it meant the UK equity portfolio was effectively trading at around 5x times earnings that are achievable in more normal times. Sounds like a bargain and, indeed, it was.

Those valuations were so low that they could not have been the result of anything other than short-sighted, irrational investors, who considered only the imminent lockdowns and failed to look further ahead to the strong likelihood of central bank or government action. Not to mention neglecting to consider a return to more normal times from the discovery of a new vaccine.

Admittedly, the timing of any central bank or government financial support was uncertain, as was success on the vaccine front, but this is a great example of diverging time horizons and the sort of opportunity it can present for investors such as ourselves and our friends at Lyrical Asset Management.

Was it really unrealistic for the patient investor to assume that central banks and governments would take preventative action against the financial system imploding and the economy collapsing? Or that a new vaccine would be discovered within a few years which would aid a recovery in corporate earnings back to those achieved in more normal times? I don't think so.

Let us not forget, it wasn't much more than 10 years or so before the pandemic that central banks and governments were last put to the test during the GFC. There was also a vast amount of research being undertaken across the globe to find an effective vaccine against Covid-19; by 8th April 2020, there were already 115 vaccine candidates[3]. This was all information the market was aware of.

One could argue that share prices reflected the prospect of equity dilution, because companies would need to issue equity in order to shore up balance sheets. Therefore, even if historic earnings were achievable once more, those profits would be spread more thinly across a larger number of shares.

The reality is that, out of a portfolio of 20 names, only one of our direct UK equity holdings ultimately raised equity last year as a consequence of the pandemic. This was because balance sheets were strong enough in the first instance and central banks and governments had acted quickly to limit collateral damage. Again, this was information the market had in its possession when the direct UK equity portfolio was still trading at a paltry 7x earnings towards the end of April[4].

Turning to specific stock examples, the equity of companies such as Halfords, the cycling and motor accessory retailer, traded as low as £100m on 13th March[5] - just 2x historic earnings[6]. This was despite the company having a healthy balance sheet. Even by late March, the equity was valued as lowly as £150m[7], despite the Government having already announced its Coronavirus Job Retention Scheme on 20th March and despite Halfords having been deemed an 'essential retailer' and thus able to open its stores.

As the share price recovered, the market capitalisation of Halfords peaked at £870m[8], a nine-fold return from its lows in March 2020 when we were adding to our position. In their 2021 financial year (12 months to 31st March 2021), the company generated cash available for distribution to shareholders that was one and a half times that at which the market had valued the entire equity just over 12 months prior – a 150% free cash flow yield[9]!

As contrarian investors, we relish the opportunity to take advantage of market inefficiencies such as those witnessed last year, and we look forward to more opportunities in the future, as a result of diverging time horizons and irrational investor behaviour. In our day-to-day portfolio management, we see little evidence that equity markets are becoming any less inefficient. Long may that continue.

1 Bloomberg
2 Bloomberg / MGIM
3 The COVID-19 vaccine development landscape (nature.com)
4 Bloomberg / MGIM
5 Bloomberg / MGIM
6 Bloomberg
7 Bloomberg / MGIM
8 Bloomberg / MGIM
9 Halfords FY21 results

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