From the desk of Amit Lodha

Portfolio Manager
Fidelity Global Equities Fund

June 2020

A year coloured by what I have read

I love reading. It is something I have always liked. The first book that I remember was a *Famous Five* mystery novel by Enid Blyton – a gift for a long rail journey from my grandmother (the distance from Mumbai, India to my home town of Jodhpur in Rajasthan was about a 23-hour train journey – enough time to finish a book or two). Since then, travelling and reading have been my two constant companions. Over time, I have learnt that for me reading is the most reliable source of serendipity – an essential ingredient to creating your own luck!

In this period of lockdown with no physical travel, I have continued my journeys through revisiting some old companions and picking up some new ones. This note is part travelogue and part sharing of those serendipitous experiences which inform my long-term strategic thinking (rather than the near-term tactical viewpoints).

2020 is a year of destiny. While COVID-19 (and Google) has made us all amateur epidemiologists, if we are to navigate the years ahead successfully, I think a few more areas of expertise might be required to answer the questions at hand. For example, to cite just two:

(1) **Is the economic glass half-full or half-empty?** Paraphrased – While most professional investors are cautious, is there a reasonable case to be made for being wildly bullish, and how does the future world look?

(2) If COVID-19 is a virus that afflicts the body, aren't **rising inequalities** the viruses that afflict the hearts and minds? What's the diagnosis, and is there a cure?

These are some of the difficult and complex questions ahead, where the compute power of an ordinary human brain struggles. Indeed, one wishes for that fast-learning computer program in the cult 1999 movie 'The Matrix', where Neo asks Trinity if she can fly that B-21-2 helicopter and she says nonchalantly, 'Not yet'. She then calls up the computer operator 'Tank' who remotely downloads the learning program into her brain.

While we wait for that piece of science fiction to become a reality, we might have to approach the answers to these questions the old-fashioned way – by reading widely and deeply.

Question number 1: Is the economic glass half-full or half-empty?

Paraphrased – while most professional investors are cautious, is there a reasonable case to be made for being wildly bullish?

This topic requires us to step away from the high-frequency indicators which populate popular commentary and step back to take a wider perspective. Getting lost in books allows that.

***Fully Automated Luxury Communism*, by Aaron Bastani.** I came to this book while researching socialism. The rise of Jeremy Corbyn in the UK and Bernie Sanders in the US made this a topic of real importance. Given the current more 'socialist than Corbyn' policies of Boris Johnson's conservatives, the book is worth revisiting. Bastani pushes forward on the arguments made in ***Abundance: The Future is Better Than You Think*, by Peter Diamandis,** imagining a future where a new paradigm has emerged. New technologies will liberate us from work, providing the opportunity to build a society beyond both capitalism and its alter ego, scarcity. Automation (the replacement of labour with cheap capital), rather than undermining an economy built on full employment, is instead the path to a world of liberty, luxury and happiness for everyone. The book charts abundance in energy (through the move to renewables) and food (through new methods of farming and protein consumption and is where I first read in detail about the food revolution). Ultimately, he reimagines Karl Marx's philosophy in the form that true sustainable development is only possible if labour's cognitive and physical effort becomes a route to self-development rather than just a means of survival.

For me, the **key investment implications** of reading this book were:

(a) An appreciation that **cheap energy** is possibly the biggest future growth dividend for emerging markets like China/India. The 18th/19th century industrial revolution and subsequent dominance of the West was powered by fossil fuels. If we are sunsetting one, could we also be sunsetting the other and **heralding emerging markets as the best investment for not only this decade, but as the start of the Asian century** (and possibly the UK markets, as so many of the FTSE constituents face east)?

(b) Greater interest in the thematic of **sustainable food/ farming** and the merits behind the vision of the likes of Beyond Meat and Impossible Burger and its ilk, and links to climate change.

(c) An outside-in perspective that **'my search for pricing power'** works only in a capitalist mindset built on scarcity. However, if money is not scarce anymore, will our investment process (seeking pricing power) continue to work? For now, the market continues to reward companies who are trying to democratise access to knowledge, information and computational power (one narrative to justify the heady valuations of the high-growth software cohort).

(d) The second but last chapter of the 2019 book *Reforging the Capitalist State* makes some interesting concluding points relevant for the long-term intersection of **politics and economics:**

i. Contrast between universal basic income (a subject which has been dealt with in great depth by Geoff Crocker in his book ***Basic Income and Sovereign Money***) and universal basic service (free services provided to everyone with a progressive taxation system). This is possibly the most pertinent issue as the CARES Act in the US (US$600 per week in every unemployed bank account) is a live case study of what the future might look like under this scenario and an area which I think deserves a lot more work. Wartime measures last for much longer than we think. **Could universal basic income be the 'no liquids greater than 100ml, please' response to this crisis?**

ii. Making the point that one of the biggest criticisms of the old Soviet economy was its command and control infrastructure – how is today any different, with central banks around the world trying to 'plan everything'? (In fact, could this be one justification as to why quasi-sovereigns like Apple/Microsoft/Google/LVMH/ Nestlé/Amazon deserve ever-higher valuations, as they are exceptions to the rule that everyone requires central bank/government support – both the debt and equity markets are hence rewarding them with a lower cost of capital).

iii. Markets are supposed to serve the economy – the reverse seems to be true currently (at least as apparent from central bank actions which deliver socialism for the rich and market capitalism for the rest. Or the pithy version: **profits remain privatised yet losses are nationalised**).

iv. Is GDP the right metric to evaluate successful economic management in a world of deflation? The yardstick may no longer apply in a world where technology has made information free, automation has reduced the pricing power of labour, new energy technologies and use of more renewables will continue to reduce the marginal cost of food/energy and central banks are now well on their way to making money free!

v. The Utopian hope is that in a world where problems seem exponential, the solutions can also be exponential!

(e) The key unanswered question when a world dramatically different from our own is both inevitable and near at hand is: In whose interests will it be created? **Technology has moved fast to transform work and improve people's lives, yet we have been slow to create the appropriate social and political institutions to adapt to this new world, which has led to deepened inequalities.**

This neatly segues in to:

Question number 2: Inequalities – Why is David losing to Goliath? What's the diagnosis, and is there a vaccine or a cure?

In my last note, ***Groundhog day ends, the real movie begins now,*** I talked about the markets as a reflection of the real world.

Markets are a mirror to the real economy. Inequalities have only accelerated in this crisis, whether we see this in the real world with regards to concentration of wealth (OECD GINI Coefficient), or in terms of the narrowing of stock performers in the global financial markets (see the charts below from Goldman Sachs on the concentration in FAAMG stocks in the US and GRANOLAS in Europe). When will government regulation (Department of Justice investigations?), political uprising (Luddite movement, anyone?), geopolitics or higher taxation unseat either of these trends?

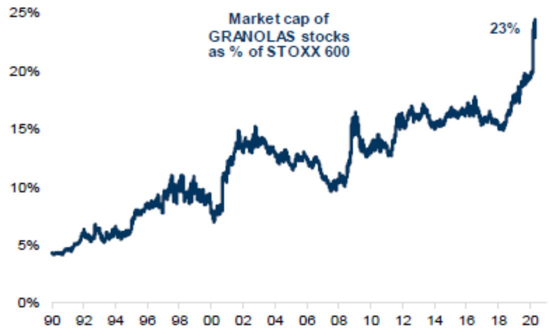
Figure 1. FAAMG leadership

FAAMG: Facebook, Amazon, Apple, Microsoft and Alphabet's Google

Source: Goldman Sachs Research, Refinitiv Datastream, May 2020. Reference to specific securities should not be taken as recommendations. For illustration purposes only.

Figure 2. GRANOLAS leadership

GRANOLAS: Glaxosmithkline, Roche, ASML, Nestlé, Novartis, Novo Nordisk, L'Oreal, LVMH, Astrazeneca, SAP, Sanofi



Source: Goldman Sachs Research, Refinitiv Datastream, May 2020. Reference to specific securities should not be taken as recommendations. For illustration purposes only.

While there has been a lot written on this subject (see the **Pew Research Centre** or the Brookings Institution websites, or the Fed's excellent **Liberty Street Economics blog** and the most-cited ***Piketty's Capital in the Twenty-First Century*** – which I must admit I was unable to finish), the book I have found the most eye-opening on the subject is **Professor Daniel Markovits's *The Meritocracy Trap***, possibly because it hits close to home.

The Yale professor uses a wide ranging inter-disciplinary approach to make the following points on merit and social mobility:

(a) The culture of meritocracy or a society governed based on achievement is the single biggest obstacle to equal opportunity.

(b) The book argues the case for a substantial underlying privilege in merit to show that parenting and the education system is stacked in favour of the elites, guaranteeing their offspring human capital. This, he argues, is even more important than inheriting financial assets because in a knowledge-based economy this investment in elite education reaps long-term dividends (which, according to his calculations, should earn an individual over US$10 million over their lifetime), allowing them to continue to perpetuate this cycle.

(c) Interestingly, the book is also somewhat compassionate towards the work ethic of the white-collared, where they have become slaves to time and need to work harder and harder to afford the underlying privileges of education for their progeny (most of whom, despite everything, will still find it difficult to get onto the housing ladder).

(d) Inequality is hence justified by the phrase, **'I work harder than everybody else, so I deserve it'**. However, the unfortunate implication of this is that this leads to a 'politics of humiliation', where the inability to pay the rent or get a job is seen as a personal failure rather than a structural flaw of the system. The suppressed anger this generates, in turn, opens the door to reactionary populist narratives that vilify meritocratic elites for rigging the game in their favour (for example the **'Ref, You Suck' movement covered by Michael Lewis in his podcast 'Against the Rules')** and explains some drivers of the success of President Donald Trump's famous line: **'I love the poorly educated.'**

Mirroring the COVID times we live in, while the diagnosis in both books is spot-on, the vaccine/cure seems to be far away. The conundrum that they are unable to solve is how do we evolve a system based on non-meritocratic ideals when the institutions which shape these narratives are run by meritocrats (again explaining some of the popularity of 'drain the swamp' populists like Donald Trump).

The simple investment implication of this would be that our elite education system needs a complete overhaul for it to be open and democratic. **Any company which can democratise access to higher education like 'Google democratised basic knowledge' is likely to be tremendously successful.**

However, to my mind, the inequality debate goes further and has implications of how we evaluate companies, their purpose and their 'ESG' credentials. (For example, isn't it time that the amount companies spend on lobbying in Washington becomes a top agenda item for the ESG conversation?)

The pandemic has also pushed forward the Darwinian impulse of the strong becoming stronger and the weak withering away or being kept alive by government support. **How long before society demands changes in the rules of the chess board to level the playing field in favour of David?**

Investment implications:

(a) In most cases, successful investing is about creating the right decision tree (with all the branches) and making sure the right probabilities are assigned to each branch so that you have a better-than-fair probability of success.

(b) Whilst we may focus on the COVID-19 virus, the global economy and political system supporting it is at a major crossroads, with several potential outcomes.

(c) **As Robert Shiller covered admirably in his book *Narrative Economics*, narratives follow price** (we seek justification in hindsight of the fact), not the other way around.

(d) With that in mind, the contrarian bull case that equity markets are clearly thinking about (but few professional investors want to discount as the data is not apparent) is in some way or form linked to:

i. A vaccine/cure found within the next three to six months and the virus will be a distant memory as we enter 2021.

ii. The scale of central bank monetary support combined with a supercharged fiscal stimulus (together upwards of 10% of global GDP) giving us the catapult effect from this crisis where everyone realises that things are not so bad, and we need rush orders to satisfy demand.

iii. Given extensive support from the government and transfers designed to keep the savings rate constant (due to limited opportunity to spend during lockdown), the **US consumer** continues to behave solidly and accelerates spending out of this period **(as their balance sheet is counter-intuitively in a better shape post-crisis due to the government transfers).**

iv. Government stimulus focuses on sectors like renewables, clean energy and infrastructure, which have a significant multiplier effect and will join technology as the leaders of the continuing bull market.

v. The US-China geopolitics is all talk but will have no real negative implications for global trade over the medium to long term. (Indeed, what if China finds a vaccine and shares it with the rest of the world, including the US, before the November 2020 US presidential elections?)

vi. Confidence that the unprecedented pace of accommodation from policymakers will continue in the foreseeable future as everyone is aligned towards one goal – to make sure unemployment does not rise and the global economy recovers.

vii. **US monetary/fiscal stimulus provides a global umbrella** for policy accommodation to everyone (therefore currency volatility has been surprisingly so well-behaved of late).

viii. Growth remains tepid but equities offer much better **relative** value than bonds (**there is no alternative**) as the yield differential stays in favour of equities with the equity risk premium or the yield you get on treasuries versus equities being too high versus history.

Valuation metric	Aggregate index: Current	Aggregate index: Historical percentile
US market cap/GDP	207%	99%
Forward P/E	23.2x	98%
EV/Sales	2.5x	98%
EV/EBITDA	13.1x	95%
Price/Book	3.4x	87%
Cyclically adjusted P/E (CAPE)	26.7x	87%
Cash Flow Yield (CFO)	7.2%	84%
Free Cash Flow Yield	4.2%	50%
Yield gap vs 10-year UST	367bp	26%
Median metric		**87%**

Source: Goldman Sachs Research, Ben Snider.

ix. In real terms – that is, relative to gold (as money has lost a bit of its nominal value due to so much being printed) – **the equity markets in the US are back to their 2016 levels and the global markets to 2014 levels.** Where is the bubble?

Figure 3. 10-year chart: S&P 500 Index (in gold terms)

Source: Fidelity International, Bloomberg, 30 June 2020. SPX, MXWD and XAU currency indices have been used.

Figure 4. 10-year chart: MSCI ACWI Index (in gold terms)

Source: Fidelity International, Bloomberg, 30 June 2020. SPX, MXWD and XAU currency indices have been used.

x. Central banks manage to calibrate growth without causing too much inflation (2% is good, 5% not so good), given the unlimited monetary toolkit available to them.

(e) On the other hand, the narrative for the cautious professional equity market investor runs something like this:

i. Echoes of the first wave suggest that we are still not out of trouble with the virus and having a working vaccine/cure within the next 12 to 18 months is a low-probability event.

ii. **The virus and subsequent recession have flung open Pandora's box of issues** (too much debt, too little growth, overbuild in several areas, significant job losses in service-related employee-centric industries).

iii. Many industries (for example, business travel, office space) have been forever changed by the pandemic, never to recover again, and the domino effect of these changes will continue to reverberate through bank balance sheets and the global economy.

iv. **Consequently, while liquidity has been solved, the solvency challenge both for the consumer and the corporate lies ahead.**

v. Corporates have significantly increased their leverage over this period even as earnings expectations have come down, making the system even more unstable and leverage dependent than it was six months ago.

vi. As the furlough schemes/job support schemes/payment support schemes expire (CARES Act unemployment benefits scheduled to expire in end July, though expectations are that they will be reinstated), the bandage will be off, and the real pain will be apparent only then.

vii. Unemployment will soar the minute corporate forbearance ends as we exit the virus phase (many companies have said they will need to right-size over the next 12 to 18 months).

viii. The extreme end of the bear case believe that a great depression is still possible if either the policy maker support is removed as the consensus visible in Washington falls off for some reason (even for a short period of time) or a mutation or a more virulent strain of the virus leads to another enforced global shutdown.

ix. So far, bad economic news has been good news for the market (given all the fiscal support). Is the reverse likely to be true? That is, if the news is 'too good' (vaccine cure, V-shaped acceleration), doesn't it risk the removal of the monetary accommodation which has been supporting the markets?

x. China is one of the few areas of bipartisan consensus in the US. This is negative for globalisation and its beneficiaries and we are still to see the domino effect of this on global trade and manufacturing.

xi. If things really start improving, inflation is a significant risk around the corner which the credit markets are not thinking enough about.

xii. Related to the above, if it's all change from the deflation of the past twenty-plus years towards inflation, rarely has been there a seamless transition from growth stocks (like Amazon) to value stocks (like Arcelor Mittal) without significant market upheavals.

xiii. The central bank money printing and support seem to all propel inequalities further – which suggests revolution/war lies in our future as protests like Black Lives Matter are not just the tip of the iceberg, but the first wave of the oncoming tsunami.

Investors, company CEOs, politicians and central bankers must all decide which outcome is the most likely, with the complexity that their behaviour will have a **Sorosian reflexivity impact** on the decision tree. To navigate this path, one needs to keep an open and flexible mind and be open to challenge even the basic assumptions which underly our decision making.

As most great investors keep reiterating in different ways – it is hard in investing to do the right thing, it is nearly impossible to do the right thing at the right time. To be successful over the long term, you need to be prepared to have the courage to look wrong for a period of time.

My **investment process**, for example, has focused on finding those companies which have a confluence of great management teams in growing industries where the valuations are reasonable. With the way the markets have behaved, if you focused on the first two factors and weighted them at 80%, the growth took care of the remaining 20% valuation argument. **I think it's probably time that we need to start thinking about an equal weight model of the three factors.** When the market focuses less and less on valuations, this is when we should increase its weighting in our decision trees and thinking.

One last thing which I have covered in some of my past few notes: I think what is going to distinguish successful investors as we navigate the next few years is not going to be only our investment expertise (on which there are a ton of Warren Buffett books you can read), **but how we learn to integrate what is happening in the markets with what is happening around us and its impact on us.** As we travel on that particular journey the book I cannot recommend enough would be ***The Boy, The Mole, The Fox and The Horse* by Charles Mackesy.** It is simply an exquisite read and possibly the best companion I can think of.

If there is only one book recommendation you take away from this note, I hope it will be this and that you enjoy reading it as much as I have with my two daughters during this gift of time with family – which has been the silver lining of this COVID-19 crisis.

Postscript: Other books that I have enjoyed reading/revisiting during this time:

***The Levelling – What's Next after Globalization* – Michael O'Sullivan** – an excellent read on the end of globalisation and what needs to be done to reimagine a new world order (see my note **here** – which discusses some of the investment implications of the China/US spat on investment decision making).

***Humankind: A Hopeful History* – Rutger Bregman** – A well-researched and argued case that, deep down, people are decent. **The instinct to cooperate rather than compete, trust rather than distrust has an evolutionary basis and by thinking the worst of others, we bring out the worst in our companies, politics and economics.** We can and must do better.

***Grow the Pie – How Great Companies deliver both purpose and profit* – Alex Edmans** – How great companies deliver both purpose and profit, in some sense arguing that companies should target social values as a primary goal and that shareholder returns are a secondary outcome. Our colleague **Dhananjay Phadnis** has written a detailed piece on his thoughts on the book and case studies relevant for Asia, and our colleague Wen-Wen Lindroth has put out a piece on **Sustainable Capitalism**, with echoes of some thoughts from the book. For me, it was a useful read **as we try to calibrate how much weight we must put to each factor of the ESG matrix as the matrix also continues to constantly evolve.**

***The Partnership – The Making of Goldman Sachs* – Charles D. Ellis** – The reason to revisit the book was to reread the chapter on Sidney Weinberg and his friendship with Franklin D. Roosevelt and Henry Ford II, which helped to not only cement the leadership of Goldman Sachs but also tells an interesting story of what **wartime corporate leadership may need to look like and how one manages the increasing presence of government in the corporate sector.**

***Justice: What's the Right Thing to Do* – Michael J. Sandel** – So far, policy makers have pretty much succeeded in satisfying everyone. **However, it is my view that, as every work-from-home parent knows, at some point the candy (or iPad) needs to be taken away from the kid and tantrums (tough choices) lie ahead.** This book is about various case studies and the process by which tough choices can be made, while serving the cause of natural justice, in a multi-layered problem. With the rise of ESG, and as morality (and religious beliefs) now move from private matters to public debate and we sit in judgement of what is happening around us, this is a good refresher of the process that one must follow to appreciate both sides of the coin.

***Alchemy: The Surprising Power of Ideas That Don't Make Sense* – Rory Sutherland.** Rory is the Vice Chairman of Ogilvy in the UK (a nice, vague title that has allowed him to run a behavioural sciences unit in Ogilvy). I came to this book due to my interest in consumer behaviour and the realisation of how difficult it is to anticipate, let alone forecast. Rory's central thesis, that **conventional logic leads to conventional outcomes, is as applicable in marketing as it is in investing.** Two of my favourite quotes from the book:

i. 'A change of perspective is worth 80 IQ points.' – Alan Kay

ii. **'It doesn't pay to be logical if everyone else is being logical.'** – Rory Sutherland

---

If you have any questions or feedback about this content, please contact our Equity Investment Specialists Team.

fidelity.com.au