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Beating the machines – the JOHCM Global Equity Fund process

JOHCM Global Equity Fund

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Highlights

In a highly correlated world of machine driven algorithms and passive flows into ETFs, owning these type of idiosyncratic stocks has become even more valuable and can make a powerful contribution to a portfolio both from a risk control and return enhancing perspective.

The 1984 movie classic 'The Terminator' was prescient in painting a vision of the future where Artificial Intelligence (AI) dominated, even if it was a dystopian nightmare where humanity's very existence was under threat from the machines.

For fund managers, machines (shorthand here for the likes of algorithms and quant-driven approaches) also represent a formidable opponent. They are able to relentlessly crunch data 24/7, exhaustively searching for alpha opportunities, they are devoid of the behavioural biases that plague humans beings, and they are less prone to mistakes. As fund managers, we can no longer focus our attention on merely outperforming our flesh and blood peers in active management; we have to beat the machines as well.

How to beat the investment machines? As in 'The Terminator,' we fight back unconventionally against the hardware and software we have created. For my longstanding investment partner Nudgem Richyal and I, that means we have had to change our thinking in recent years. Some approaches that worked well historically have had to be refined. In the past, having an edge meant we only had to be slightly cleverer and slightly faster than the average investment committee in our decisions about whether or not to own mainstream large-cap stocks like Toyota or Samsung. In today's world of immense computing power, there is no way we can be slightly cleverer and faster than the machines in "average" stocks.

Identify the disruptors

How human investment managers can still win, though, is through identifying the idiosyncratic disruptors, the outliers who are upending long-established business models. Machines aren't as good at picking these corporate pioneers in the nascent stages of their life cycle and therefore lacking long financial histories. This is where the human touch can come in. In part, we have had to become quasi-venture capitalists in public markets. We are increasingly backing early stage growth companies on the evidence of their revolutionary business models, rather than on the basis of years of historical earnings that can be crunched through a spreadsheet to make detailed earnings projections for the next umpteen years, as would be the more traditional, analog fund management way.

Our process has always emphasised the need for such idiosyncratic stocks, firms that tend to be disrupters, compounders or outliers with a relatively low correlation to their sector or country. In a highly correlated world of machine driven algorithms and passive flows into ETFs, owning these type of idiosyncratic stocks has become even more valuable and can make a powerful contribution to a portfolio both from a risk control and return enhancing perspective.

Where can we find these outliers or disruptors? Unsurprisingly, many of them are digitally based but not only in the Technology sector. Digital disruption is happening across every sector, throwing up more idiosyncratic challengers to longstanding business models.

A Japanese biopharmaceutical stock held within the portfolio is a great example of a disruptor in that it is changing how drugs are developed and delivered. It is also an idiosyncratic stock that wasn't on the radar screen of traditional fund managers or the AI machines when we first brought it, not long after Nudgem encountered the company in Tokyo at a Mizuho conference where the company's management team was presenting.

The company's innovative science and business model could be a game-changer for drug development. First, a bit of science to explain why. There are 22 natural amino acids, the organic compounds that combine to form proteins, and over 400 man-made amino acids in existence. When you combine amino acids you create a peptide, which is a potential drug. Until the pioneering research efforts of the company's co-founder, no one had ever been able to combine natural amino acids with man-made amino acids. This man's genius (he may yet get a Nobel Prize for chemistry) was to establish a technique that could bond the two or more different types of amino acids into a peptide, thereby opening up the potential for trillions of new compounds, many of which could be new drugs. The potential future profit pools for the company are therefore vast. Machine-based investment approaches are unlikely to have unearthed this fascinating disruptor.

Peptides drugs have a few advantages over much larger antibodies such as better tissue penetration because of their smaller sizes. The cost to produce is much lower because peptides are manufactured synthetically unlike antibodies (require actually living cells). Peptides are superior to antibodies at the physical level in terms of accepted room temperature storage. Compared to small molecules, peptides show higher target affinity, specificity and efficacy.

The company's business model is even more exciting than their science, and the world has never seen anything like it before, so the machines have nothing to go on. Instead of following the traditional biotech model of keeping this amazing research in-house and developing one or two new drugs, they sell licenses for their patented drug discovery process, effectively creating a platform, think the Uber of biotechnology. The company has already sold drug discovery licenses to 15 of the world's 18 largest pharmaceutical companies. So now 15 companies will develop, say, 3-5 drugs each, meaning many many more drugs "for the betterment of mankind", to use the words of the company's co-founder. The company receives a milestone cash payment for each drug that passes FDA (Food & Drug Administration) stage one, two and three. Furthermore, for any drugs that reach the marketplace, the company receives a royalty.

The very latest idiosyncratic disruptor that we bought is an Australian/UK/USA software company and a global leader in project management and collaboration software (ie helping global teams work together). The company's official HQ is Sydney but the company is Incorporated in UK so legally British, yet it is listed on the NASDAQ Exchange and most senior management have relocated to San Francisco. All of which shows you how old fashioned the concept of "International Diversification" has become in a highly correlated globalised world - but that is a separate discussion for another article.

JOHCM Global Equity Fund – a window of opportunity

We are pleased to report that we have recently reopened the JOHCM Global Equity Fund. Since closing to new investors in April 2016, the fund has only been available to existing investors, in keeping with the J O Hambro way of capping fund sizes in order to preserve market-leading long-term performance.

This re-opening allows new investors access to a differentiated and strong-performing fund. We are looking to target a small and select group of long-term investment partners. Liquidity in the fund remains excellent, and we believe the fund continues to offer something different in the highly competitive global equity fund sector.

A recap of our evidence-based 4-dimensional investment process

The JOHCM Global Equity Fund is a high conviction portfolio of 30 to 60 compelling stocks in our favourite sectors and countries. We continually strive to improve our long-established evidence-based 4-Dimensional investment process (1. Stocks, 2. Sectors, 3. Countries/currencies, 4. Time/change). This process recognises that different factors drive different stocks in different areas, and recognises that relationships are dynamic and change over time - the fourth and hardest dimension. Clients like our concepts of "beware good houses (stocks) in bad neighbourhoods (sectors or countries) and "don't be wrong for long – weed out the losers."

Global Equity Fund and ESG (Environmental, Social and Governance)

It's worth quickly mentioning ESG given how important this is becoming for many clients and investors generally. ESG is an excellent example of the fourth dimension at work today, as it is driving stock returns in a way that it never used to – research shows that a low ESG ranking is a good predictor of earnings risk, which means ESG is a driver of fundamentals and share prices.

We have always included an ESG element in our investment process, but 20 years ago few investors cared. Today our industry has passed a tipping point, so most clients now ask us about it, and they are delighted to hear that we can contribute to their ESG needs.