Peter Oppenheimer - The Long Good Buy

Peter Oppenheimer recently released his book *"The Long Good Buy"* and we reached out to him to discuss the book and related questions. His day job is at Goldman Sachs, where he is the chief global strategist. The last question provides some clues to what he does after work.

First, thanks Peter for agreeing to do this Q&A about your book, which I think is in the spirit of Richard Feynman. What I mean by that is that I think you successfully explain complex connections in an easy to understand language. Mr. Feynman was also of the opinion that when being in the process of doing that, you learn more yourself, in which I think you have been very successful.

1. **IBTB:** Please provide some background to the book. What did you learn writing the book, or where did you get more/less conviction in your previous opinions?

   Peter: This book put together in one place what I learned over my entire 35-year career. It's also a summary of the frameworks and tools that we use to guide us on timing and relative opportunities in the financial market. (The name of the book – *The Long Good Buy*, comes from research written about equities being a long good buy since early 2012.)

   I underestimated how difficult is was to write a book! I learned two things. First, I got more convinced that despite how much things are changing over time (politics, rise of technology, rates to zero etc.) we have repeated patterns in the economy and the financial markets. Secondly, I got a better understanding on how much have changed since the millennium and after the financial crisis, which I am sure we will talk about later.

2. **IBTB:** One of my favorite chapters was, number 5, *Investment styles over the cycle*. You make a convincing case that the best signals are more top down, that sector indexes are becoming less meaningful. You conclude that the best and most consistent signal is the relative performance between cyclical and defensive stocks. In the book you use PMI/ISM to categorize the cycle. When do you get the best signals, is it easier to detect the peak or trough? Is the rate of change more important than the level?

   Peter: Cycles exits, they do not have the same length, but the moves are up and down due to powerful impacts from periods of slowing and accelerating growth. One of the clearest ways this expresses itself, is in the relative performance between defensive and cyclical. When I look at the triggers at the turning points, the rate of change is the most important. This is particularly true in equities since the stock market is all about expectations of the future.

   I think it is generally the case that it is easier to identify a trough. At least you know that when the markets have fallen in fair value, even if it falls further, you are likely to be entering at a reasonable valuation with a decent prospect of a good medium-term return. The peaks in economy and the stock market happens after a period of strong growth and returns, but you have very little confidence in any time that you are early or late in the cycle, and selling to early can be costly in terms of lost performance. For example, you could have argued for a peak, many times post the GFC trough. But then the market actually experienced many mini cycles and it ended up being the longest expansion in 150 years in the US.

At the nadir, it's easier to get a sense for the turning point. When the rate of decline is slowing that is a very important trigger point, when the market tends to reassess the future. This is especially true for the cyclical part of stock market, which tends to have exaggerated moves in the downturn.

IBTB: Do you look at market reactions that are better or worse than expected, as another indicator?

Peter: I don't look at it in the book, but you raise an important point. There are times, when good news is seen as good, and times when good news is perceived as bad. This reflects the likelihood of policy change. For example, if things are bad, and news gets worse, the markets might start to price in the chance of lower interest rates or policy easing or more fiscal support. And if things are good, getting better, the market may sell – off, fearing an in increase in rates. The context of the data is very important, in essence it's not just about the data, it's about the potential policy response and to the extent it's been priced in.

IBTB: You also look at bond yields as a historic important indicator for the relative performance of cyclicals vs defensives, even looking at world cyclicals vs the US 10 year. But what if inflation arrives with rates suppressed? Do you get the same result looking at inflation, and could that be a better indicator going forward?

Peter: The price of money has become more managed. You can question signals in this environment. But in the end, if inflation goes up, and central banks lose credibility, I think bond prices will adjust. You can control the price of money up to a point, but even central banks can't determine the price of capital over time.

3. **IBTB:** Part of Stanley Druckenmillers success was his ability, to use his own words, to look at signals inside the market to get the inflection points right (he looked at trends of sub-indexes). In a recent interview he now thinks that the algos has robbed him of that method in the equity market, as has the Fed in rates. In chapter 5 you seem to agree I guess, but maybe some sector indexes like for example autos and basic resources, which have been stable over time, might still be useful?

   Peter: Lots of industries has evolved as they reflect changes in the economy. One example, many big chemical companies have moved from bulk products to specialty. Some industries haven't changed much, for example auto. But the auto sector, and many other are themselves challenged and disrupted by new tech, in auto by Tesla. Other sectors like for example retail is disrupted by Amazon which on one hand is a retailer, but also a tech company. For sure, neither Tesla nor Amazon is valued like other auto/retail stocks. This makes sector indexes less relevant.

When a sector, which traditionally has been mature and cheap evolves into one with greater growth prospects there is a potential for a re-rating and an opportunity for strong returns. One current example is the utility sector in Europe. Up until fairly recently it has been a low valued sector, but they now seem to transition and is becoming a much more interesting sector and is in the process of rerating on the back of its transition to renewable energy. Instead of looking at industry sectors, we find it more useful to look at factor sensitivity, looking at cyclicality and valuation. When growth is accelerating alongside rising inflation and rates, then cyclical value has the best environment. On the end of the spectrum, defensive growth tends to perform better on a relative basis when growth is weaker and more scarce.

4. **IBTB:** Another great chapter was *Below zero - The impact of ultra-low rates*. In some charts you show the disconnect between equity valuations (expressed as earnings yield/cash yield) in Europe and the US compared to the 10 year bond yield that has been growing wider for 15 years. You also show that the implied dividend/earnings/growth is around zero. In simple terms, market prices in what has been achieved in Japan (zero nominal GDP growth). So far, the evidence, as you highlight, is that lower rates have pushed up the equity risk premium in Japan and Europe.

   Peter: The simple point is if that if you just look at rates as a risk-free rate, and used that to discount the free cash flow, you could argue that equity valuations should be higher, but the real experience has not supported that. Dividend yields have not fallen as much, so the risk premium has increased, more in some places than others. The explanation of this rests in the reduced long-term growth expectation. If the fall in nominal rates are effectively consistent with long term growth rates, you wouldn't expect valuations to rise. This also explains the difference in valuation between the stock market in the US vs Europe/Japan, but also, the different valuations/performance of growth vs value stocks, which is at record highs. Companies which are less sensitive to the cycle, and less sensitive to the reduced long-term trend growth, have been rerating a lot, they benefit fully from the lower cost of capital AND growth forecasts that are unchanged. But mature industries have seen long term growth rates reduced, and Europe/Japan has more mature industries than USA.

5. **IBTB:** Chapter 6 might be the most important chapter, since it's about bear markets. Not easy, especially since you highlight a very interesting fact, equity investors have on average lost about the same amount in the first three months of bear markets as they would have earned in the final three months of bull markets. The cost of being early is high.

   You stress the fact that bear markets are very different, the cyclical bear, the event driven bear and finally the structural bear. Your team then went on to look for reliable indicators. The most consistent useful pre-bear market signals were measures of unemployment and valuation, with the latter rarely a trigger. This has resulted in what you call Goldman's Bear Market Risk Indicator, which is made up of six indicators. The Shiller PE, a yield curve, ISM, unemployment and finally private sector balance (you can track it on Bloomberg, GSBLBR Index, as of sept 7th, it's at 44%. It points to a low risk of a bear market. Valuation & yield curve indicates a high risk, but that's more than compensated by the all clear signals from inflation, unemployment and private sector financial balance)

You also add a discussion, regarding an increased risk for a bear market if inflation increase, which normally means a tighter monetary policy and change in the yield curve. In the scenario were FED allows inflation to increase (and not reacting as they normally do with a tighter monetary policy), what would that mean for the bear market signals?

Peter: I think it's still a good signal. If inflation is rising quickly, its associated with tighter central banks. In the current environment, and since GFC, with the prevalence of extremely low rates, an increase in inflation has been tended to be seen as a positive for risk assets (as it points to lower risk of a deflation, as one potential tail risk). But higher inflation would still be a risk over time as it could mean earlier rate rises than the market has discounted and therefore downward pressure on financial assets and equities.

Currently, however, inflation is still very low and it's a positive signal in our bear market indicator, and together with the fact that rates also are lower, it supports higher valuations. I believe that the increased focus of Fed to try and convince the market that they will allow inflation to rise - with negative real interest rates - to accommodate a period of recover for longer than normal, is a positive for equities in the current context.

6. **IBTB:** You have a beautiful quote from Howards Marks book, *Mastering the Market Cycle* in the beginning of the book, and *The Long Good Buy* is very much is in the spirit of Mr. Marks. A favorite quote of mine is *"we can make decisions on what's happening today, not what we think could happen"* and he uses that to decide if it is time to be aggressive or defensive. Please share your long term thoughts.

   Peter: One of the points of the book is that valuation does tell you something of the long-term return, but is not good for short term timing, which is a very obvious point of course. If you buy when the market is cheap you are more likely to make good returns. As a result of 40 years decline in global rates, you have seen financial assets become more expensive. Long term financial returns will be lower than they have been in the last 20-30 years. But there are opportunities, there is a lot of innovations, the tech revolution will continue, and many companies have become more asset light, helping to boost their returns on assets. The decarbonization that will happen over the next decades, will require a lot of capital and lot of innovation, which provides a lot of investment opportunities. In general, look at where risk premiums are highest, where do you get paid to take risk? Equity still offers good returns. Absolute valuation is high, but if you a look at dividend yields, vs bond yields - and you are prepared to hold for a long term - then you will get the cumulative growth of income from equity and are likely to do better.

7. **IBTB:** In part 1, *Lessons from the past*, chapter 4 you write about how the large potential has been for diversifying into other asset classes, at this point of the cycle. You also note that many investors cannot diversify into commodities, but setting that aside, is there a bit of a free lunch here? Please elaborate.

Peter: The interesting thing is that as an asset class, commodities are uncorrelated. That is why it's useful for hedging, to balance and diversify risk. And generally, it's a good hedge vs inflation, which adds an additional value. Not worth anything lately as inflation has been low, but it could potentially be very useful.

Compared to other risky assets, prices do not reflect expectations of the future. The price is a result of the balance in real time. They are also not anticipatory, but the price has to balance current demand and supply, it's a different characteristic.

8. **IBTB:** The standard 60/40 allocation strategy has worked well. Especially the 40% bond part, which has had a one of a kind risk & return for many years. The bond part provided both income, capital gains and **bear market protection, value went up when the market crashed, a zero-cost put which you even got paid to hold**.

   What can replace that combination? On the one hand I can see the merits of going 70+ equity & 30- bonds, mainly thinking of the attractiveness of equity vs bonds. However, I can also see the merits of something like 50/30/20, i.e when bonds don't give you the unique tail insurance, you have to cut equity as well in order to balance the risk of the overall portfolio. What will make up the new 20?

   Peter: A classic 60/40 in USD, has had the longest bull market ever. But that's because rates are down for a long time and that they have provided a great hedge in growth shocks with bond prices up. This will be much more difficult going forward. Investors should increasingly think of inflation protection. Equities are better because they have a higher risk premium, and we need to focus on risk adjusted returns. But I don't think cheap stocks provides a good hedge, when the market goes down, they probably will be down less, so it's a beta issue. There is attractive risk premium in illiquid assets, for example private equity and debt. Infrastructure related vehicles also provide non correlated returns. There is value in some parts of credit, and commodities are helpful.

   IBTB: Commodity stocks or underlying commodity?

   Peter: They are quite correlated, mining stocks more than oil. But because of reasons of diversification it makes more sense to have the exposure to the underlying commodity.

9. **IBTB:** Final question, what investment books have meant most for you and when did you read them? (or non-investment book that has had an impact on your thinking about investing)

   Peter: I didn't read investment books when I was young. But to mention one important book, Benjamin Graham's *The Intelligent Investor* is a must read. I am increasingly interested in behavioral economics. It's a very underexplored part. I have many examples in the book. Post GFC it has become clear the importance to better understand how psychology affects the economy and markets, but also more broadly. I like the ideas in Richard Thalers book, *Nudge: Improving decisions about health, wealth and happiness* which made me think a lot.

10. **IBTB:** Let's end on a lighter note, there is more to life than investing and books.

    If you must choose between?

- **IBTB:** Cycling: Mountainbike OR biking (with proper tight clothes of course)?

  Peter: I can say that I now have four bikes, a mountain bike, an electric bike, a hybrid bike and a road bike (tight clothes used in non-public areas). I especially like off-road biking since its technical. But I do enjoy road biking as well.

- **IBTB:** Painters: William Turner OR Banksy?

  Peter: Appreciate Turner the most, but also fond of Banksy.

- **IBTB:** Music: Abba or Sex Pistols?

  Peter: I really like both. Abba for dancing, and Sex Pistols for listening. Hugely influential in my youth.

- **IBTB:** Sports: Skateboarding or watching football?

  Peter: I am bad at both, but football doesn't interest me, but I do enjoy the skateboard.

- **IBTB:** Architecture: The National Theatre or the Shard?

  Peter: The NT, I love that building, but when I was growing up, I have to confess I thought it was very ugly. But now I really appreciate it. It links to what we talked about. Some things you can only know with the perspective of time, like art and architecture. Sometimes you need time to appreciate (also true for Abba)

  IBTB: As a native Londoner, what are some understated things to do in London?

  Peter: Lots of things. A person tired of London is tired of life. I love the diversity, people and London is really many small villages, but it hangs together. One forgotten museum is the Museum of London, which is moving to Smithfield which also is an interesting part of London today.

  IBTB: Which podcasts do you listen to…investing related and not investing related?

  Peter: I listen to many non-investment related podcasts. Two in particular, both on BBC4. They are Desert Island Discs & The Moral Maze, happy listening!

Bo Börtemark, September 16, 2020,
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