Norway Moves to America

Mean reversion and industrial revolutions

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Growth stocks have been outperforming value stocks for years and American equity markets have been outperforming European equity markets for years. Many investors are expecting these trends to mean revert and have positioned their portfolios accordingly. But, the world's biggest equity investor, the Norwegian Oil Fund, has indicated in a recently published report, it now expects to reallocate up to $100 billion from European equities into U.S. equities. We think this is the right decision.

Here, we explain why investors are hard-wired to expect mean reversion and why we think this is the wrong instinct in the current environment. We expect growth stocks to continue outperforming value stocks and U.S. markets to continue outperforming European markets for many years to come. In our opinion both the growth vs value and U.S. vs Europe trends are driven by a new phase of the industrial revolution and industrial revolutions are not mean reverting processes.

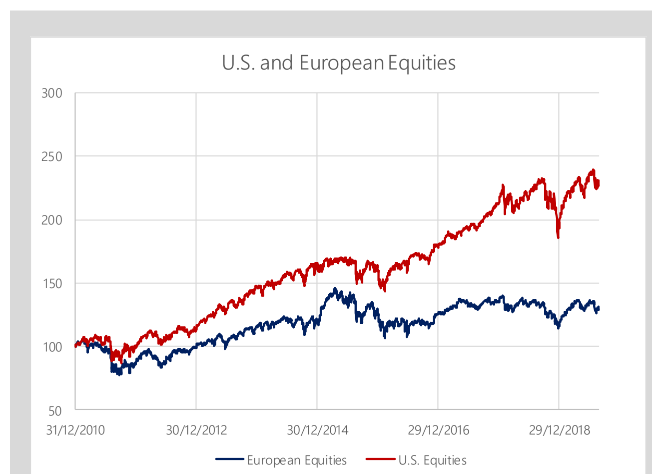

Figure 1: In recent years U.S. equities have significantly outperformed European equities.

Source: Bloomberg, Bloomberg European 500 equity index vs Morningstar MStar US equity index.

The Anchoring Bias

We humans tend to assess the value of assets with respect to their previous prices and we have an unfortunate tendency to view historic prices as somehow more 'correct' than their current value. This effect, known as 'the anchoring bias', causes us to fixate on the price we originally paid for an investment. It means that we tend to view assets that have risen in price as expensive and assets that have fallen in price as cheap. We do this regardless of how the fundamentals of that investment may have changed.

The anchoring bias is problematic because it acts against us regardless of whether we have good or bad investments. If we have bad investments, it tells us to stick with them or buy even more of them as they fall in value. If we have good investments, it tells us to sell out of them quickly once they have made only a modest profit.

The anchoring bias pushes us to sell our winners and stick with our losers. This is especially problematic when investors engage in relative value trades – when they sell one asset to buy another, or, for benchmark investors, when they go underweight one asset and overweight another.

Once an investor establishes a relative-value trade they must monitor the performance of each 'leg' of the trade. They chart the performance of the overweight and underweight positions against one another, in the hope that the line recording the overweight position rises faster than the line recording the underweight position. As the two lines diverge, which they almost invariably do, the anchoring biases kick in. The anchoring bias tells us to expect the stronger asset to underperform and the weaker asset to outperform. In relative value trades the anchoring bias manifests itself as a mean-reversion bias.

Figures 1 and 2 show, respectively, the outperformance of U.S equities versus European equities and U.S. growth equities vs U.S. value equities, since the start of the decade. Both charts show similar persistent divergence.

Historically, the Norwegian Oil fund made a strategic decision to bias the geographic allocation of its equity holdings toward Norway's largest trade partners. This decision meant the Oil Fund became strategically overweight European equities relative to U.S. equities, when measured against a standard market capitalisation weighted benchmark.

The decision to bias the Oil Fund's holdings toward European equities was reasonable, but with the benefit of hindsight, unfortunate. As shown in Figure 1, since the start of this decade U.S. equities have outperformed European equities by almost 100%.

A report published last week suggested the Norwegian Oil Fund will now begin adjusting the regional bias of the Fund's equity allocation to bring it closer in line with a normal market capitalisation weighting. The report officially cited the rationale for making such a move was that the NOK-EUR currency relationship had proven less important than earlier anticipated. The report also, discretely, states that the U.S equity markets have outperformed the European equity markets over the last 25 years. We believe the Norwegian Oil Fund is seeking greater

exposure to the high growth U.S. companies, believing the European equity markets are unlikely to catch up.

Once completed, the rebalancing of The Oil Fund could mean as much as $100 billion being reallocated from European equities into U.S. equities: [Norway wants to add up to $100 billion in U.S. stocks.]

Interestingly, at about the same time that Norway's Oil Fund announced its strategic review the European Commission began floating the idea of launching its own sovereign wealth fund, the European Future Fund, to invest €100 billion into European technology companies. The stated purpose of the European Future Fund being to help incubate European competitors to the American and Asian technology companies: Apple, Google, Facebook, Amazon and Alibaba, which have been largely responsible for the outperformance of their equity markets.

In the next few years we could have a situation where the Norwegian sovereign wealth fund is divesting $100 billion from European equities in order to get more exposure to U.S. growth stocks while the European sovereign wealth fund is investing the same amount into European equities in the hope of creating its own growth companies. The purpose of these two opposite flows are not entirely incompatible. The Norwegian sovereign wealth fund would be investing to maximise returns whereas the European sovereign wealth fund would be investing, potentially as a loss-leader, to stimulate European economic growth.

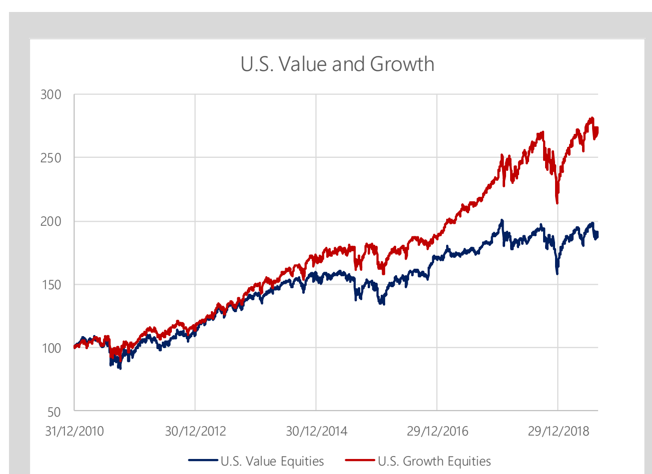

Figure 2: Showing the performance of State Street's Growth and Value SPDR exchange traded funds

Source: Bloomberg

A new industrial revolution

In our view the outperformance of U.S. equities vs European equities and growth vs value stocks are not separate phenomenon rather they are simply two different ways of observing that a relatively small number of high growth companies are transforming the global economy and those companies happen to be disproportionately located in America.

Every way we look at the global economy we come to the same conclusion: the world experiencing another phase of the industrial revolution and the pace of the revolution is accelerating.

Arguably the first phase of the industrial revolution began with the development of steam technology in what became the industrial heartlands of Northern England and Southern Scotland. The key breakthroughs were Thomas Newcomen's invention of the atmospheric steam engine in 1712 and then James Watt's invention of the much more efficient condenser engine in 1776. Those inventions provided the spark to ignite the first phase of the industrial revolution triggering a rapid process of mechanical innovation which is still ongoing today.

Steam engine technology proved to be an enabling technology for a whole host of other inventions in what became a vibrant cluster of innovation in Northern England.

In 1947, at the Bell Laboratories in New Jersey, William Shockley, John Bardeen and Walter Brattain made the first transistor. A decade later Jack Kilby, of Texas Instruments, built the first integrated circuit and shortly afterward Robert Noyce, who founded both Fairchild Semiconductor and Intel, demonstrated the first monolithic silicon integrated circuit – the first silicon chip.

Those American inventions provided the spark for a second phase of the industrial revolution – a digital revolution – becoming enabling technologies for a myriad of other industries which are still emerging today. We believe this digital phase of the industrial revolution is still in its infancy.

The development of steam engine technology triggered economic trends that are still ongoing today. Those trends have never and will hopefully never mean revert. Similarly, the emergence of digital technology started a series of trends that show no signs of mean reversion.

As investors, we humans are wired to expect mean reversion. This was probably a useful bias for most of our evolutionary history, but it is not a useful bias in periods of industrial revolution.

When the processes driving markets are not mean reverting, the markets should not be mean reverting.

Nothing is set in stone; the U.S. could lose its leadership in the digital revolution just as Britain lost its leadership in the mechanical revolution. Nevertheless, once they have become established, innovation clusters appear to be both persistent and powerful. Investors positioning themselves for an outperformance of value stocks versus growth stocks or for an outperformance of European stock markets versus U.S. stock markets may be positioning themselves against an industrial revolution with decades yet to run.

We remain heavily invested in growth companies most of which happen to be in the U.S. We reserve the right to change our mind but don't expect to do so anytime soon. ■

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