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Rathbones
Look forward

Rathbone Income Fund

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"We always hope for the easy fix: the one simple change that will erase a problem in a stroke. But few things in life work this way. Instead, success requires making a hundred small steps go right – one after the other, no slipups, no goofs, everyone pitching in."

Atul Gawande
Better: A Surgeon's Notes on Performance, 2007

Atul Gawande is one of the more prominent figures in Western medicine. A practicing surgeon and a well-published writer, in June 2018 he was named chief executive of a healthcare partnership newly established by Amazon, Berkshire Hathaway, and JPMorgan Chase. Although details of the venture are scant, it plans to use technology and data management to both improve services and reduce cost. The choice of Mr Gawande as leader is instructive. He has a record of using empirical evidence to validate process. His focus has always been understanding how procedure in complex systems develops, how robust methodologies evolve through the reaction to failure and mistakes rather than to success and good fortune.

In late 2009, Mr Gawande wrote *The Checklist Manifesto: How to Get Things Right*, a book which has spawned several essays developing the simplicity of using checklists to deal with complex systems. Aircrew have checklists to utilise ahead of take-off, a principal input for safe air travel. Health services have been slow to imitate, which is symptomatic of environments where people frequently fail to learn from mistakes. Mr Gawande has advocated, somewhat provocatively, the use of checklists in surgical environments, only for opponents to argue the same point back to him: that simple box-ticking is ineffective and inappropriate for scenarios as complex as those seen in A&E departments. However, it is the very complexity of these environments that encourage human error – there are just too many things going on at once, too much noise. Basic errors can be eradicated by the simple process of ticking off basic tasks in the order in which they are meant to be done. Within the hierarchical structure of an operating theatre, where the consultant can intimidate and overrule, a checklist encourages humility, discipline and teamwork.

Financial markets are another example of a hugely complex system. In constructing a portfolio of investments, professional fund managers and individual investors alike are attempting to evaluate multiple economic cycles, geopolitical and political noise, movements in foreign currency and commodity prices, the dynamics within and between diverse industry sectors, as well as decisions made by individual companies. It is all too easy to blame outcomes on poor luck (rather than lack of judgement or a powerlessness against a dynamic system), and all too wrong to celebrate success as the rightful outcome of a well-thought out and executed strategy. In the end, an awful lot – and more than we perhaps want to admit – is left down to chance.

Oh dear, it seems like I have sounded another death knell for active fund management. No, of course that is not my intention, but I do suggest that we need to recognise the markets' massive complexity and, in doing so, adopt strategies to bring some order to the chaos. But to what degree should we look to reduce process to a series of finite and definitive questions, to a checklist if you will? Is it even possible, or are we potentially reducing the 'art' of investing to an exercise in painting by numbers? Conversely, you could argue that it is the very lack of a disciplined rule book that so often leads to mistakes, that exacerbates the very chaos that we are looking to tame.

We do argue the merits of a robust investment process. In doing so, we could choose to distil our trinity of risk process into a sequence of rules. Around **business risk** we might ask:

> Are cash flow returns on capital sustainable? Have they proved to be sustainable in the past, and should they be sustained in the future?
> Importantly, does management have a successful record of allocating capital on our behalf?

Then we must consider **financial risk**:

> Is the level of debt appropriate for the business, at any time, or specifically at this stage in the business and economic cycles?
> Does the business model facilitate the generation of an attractive return on equity for shareholders, without employing leverage to spice up these returns?
> Is this the type of business or industry where there is periodic recourse to shareholders for additional funding?

Finally, we consider if shares represent good investments, with a comprehension of the **price risk**:

> Are the shares cheap, fair value, or expensive?
> Are we measuring value consistently?
> What are the differences between our predictions of value and what is being priced in by the market? Is the market pricing in perfection or a tumultuous downturn in fortunes?

All of the above are pretty straightforward, but the benefit is in remembering these questions every time we review an investment idea. At the very least, they help to anchor our analysis to a consistent set of core ideals.

Although we seek to minimise risk, we do need to take risks in order to generate returns for you. When we make a mistake, it's how we react that has the greatest influence on your returns; because it's when things go wrong that the checklist comes into its own, at precisely the time when emotion and damaged pride can combine to distort logical decision making.

Mr Gawande has analysed mortality rates in the intensive care units (ICUs) in US hospitals, specifically research completed by the University of Michigan. He was surprised at their conclusions:

I thought that the best places simply did a better job of preventing things from going wrong. But, to my surprise, they didn't. Their complication rates after surgery were almost the same as others. Instead, what they proved to be really great at was ***rescuing*** *people when they had a complication, preventing failures from becoming a catastrophe.*

Atul Gawande
Failure and Rescue, The New Yorker, 2 June 2012

He sums this up succinctly. "They didn't fail less. They rescued more." The successful ICUs knew the risks of surgery and had plans ready for the most likely eventualities. When things go wrong, Mr Gawande says, there are three main pitfalls: not having a plan, embarking on the wrong plan and ignoring the problem. While I have no intention of equating the potential for tragedy in an operating theatre to the financial loss of a bad investment in a diversified portfolio, the disciplines from the former can certainly inform the latter. If a company warns on profits or suffers from some exogenous event that curtails its operations and the share price suffers, how we react is crucial. This discipline warrants great attention.

In the same way that we may have a checklist of qualities that inform an original investment decision, so we need to develop and nurture the discipline to cold-bloodedly reassess, with fresh minds unencumbered by previous biases, these qualities when the situation changes. Every investment decision we make opens us –and therefore you – up to risk. But, like on the operating table, it's when we err, when we have to make new decisions to mitigate original errors, that the difference between success and failure is most acute.

As we approach the final weeks of a challenging year, I believe that we have had more successes than failures. Our positioning has been defensive, which has served us well as investor sentiment has waned with increasing amplitude in recent weeks. In the very short term, it would not surprise us if markets enjoy a final sprint up to the year-end, as they are wont to do. However, 2019 may prove to be substantially more difficult. It is very easy to celebrate successes when markets are robust; it is a far more meaningful test of our abilities when the environment proffers greater challenges. Next year may well do just that.

Recent trades: October has been a quiet month for trading, with the only move of note being the decision to establish a new holding in **Close Brothers**.

Companies seen this month: **National Grid**, **Halfords**, **PRS REIT**, and **JP Morgan Chase**.

Carl Stick
Fund Manager

Alan Dobbie
Co-Manager

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