Evenlode Investment View

Wise Funds

FEBRUARY 2013 – A GROWING INTEREST IN THE 'DULL' AND 'BORING'

The Great Rotation

Mr Market's appetite for shares has continued to build over the first few weeks of 2013. A new term has even been adopted, The Great Rotation, to help explain this new found love for stocks and waning interest in bonds. The number of Google searches for this term has increased five-fold since last summer and three-fold since the start of the year. It provides a simple narrative to explain the market's recent rise and the potential for future gains: 3-4% starting yields; growing dividends and the potential to protect against inflation all compare well to the miniscule returns 'available' in the bond market. A disclaimer is necessary however - the more investors adopt this narrative, the less compelling it will become. And as stock markets rise, dividend yields are steadily coming down.

Inflation Rears Its Head Again

There are also some new reasons to be more cautious on the economic front, just as value in the stock market is starting to drain away. The main development in recent weeks has been a sharp increase in inflationary pressures globally. We have seen this story play out before, three times in fact during the last four years: in spring 2010; summer 2011 and spring 2012. In each of these instances, just as the global economy seemed to be getting going, its very strength led to a rise in inflationary pressures, which in turn caused an inflection in the business cycle. Before 2008, it was rising interest rates that tended to end cyclical upturns. In the post-crisis world, with interest rates around the world at next to nothing, inflation has begun to play this self-moderating role. To borrow from TS Eliot, "in my beginning is my end".

I must stress that we do not base our investment strategy on macro-economic predictions. However, it is worth bearing this cyclical risk in mind – a risk that is steadily building just as the margin of safety in many stocks is simultaneously reducing.

A Growing Interest In The 'Dull' And 'Boring'

To reiterate what I said last month, we remain cautiously optimistic for the portfolio's future returns given the very high quality and good value in the fund. The opportunity set may have shrunk but as the late, great value investor Peter Cundill would have said, there is 'always something to do'. We are currently positioned, predominately, in large, stable multi-national businesses. This is where we see the most quality-adjusted value in our investable universe. As the current bull market has gradually built up a head of steam our exposure to large companies has increased from 45% (in Autumn 2009) to over 80% now. Recent price moves have led us to accelerate this process. On the sell-side, we exited Diploma last month and have exited Euromoney and Halma in February. We are in the process of reducing several other holdings where despite excellent business models and strong current trading, rising valuations make them less attractive.

On the buy-side we have recently been adding to some of the more 'dull' and 'boring' stocks in our investable universe, a selection of which have seen substantial underperformance as investors look for their excitement elsewhere. We have made significant additions to the five stocks below, for instance, all of which have been laggards in the rally since last summer:

Stock	Current Dividend Yield	10 Year Dividend Growth (P.A)	10 Year Earnings Growth (P.A)
Glaxosmithkline	5.4%	+6%	+4%
Smith & Nephew	2.5%	+11%	+13%
Johnson & Johnson	3.3%	+9%	+12%
Pearson	3.9%	+7%	+16%
Microsoft	3.4%	n/a	+11%
Average	**3.7%**	**+7%**	**+11%**

Here is a selection of high-return, financially strong businesses with ample potential to grow per share cash-flows and dividends over the next few years. But they can be purchased on very attractive forward cash returns in the current market. Furthermore, valuations compare well to history. Below are the Price/Earnings (PE) multiples these stocks enjoyed a decade ago compared to their current PE:

Stock	PE Multiple 2003	PE Multiple Today
Glaxosmithkline	17x	13x
Smith & Nephew	32x	14x
Johnson & Johnson	26x	14x
Pearson	23x	14x
Microsoft	28x	9x
Average	**25x**	**13x**

These stocks should perform just fine based on fundamentals alone. But just imagine if investors decided to re-rate them over the next decade. Then they might not seem so 'dull' and 'boring' after all...

An Afterword On Global Consumer Brands

I mentioned above that the current level of quality in the portfolio is very high. Our 'technical' definition of a quality stock is one that combines low debt levels with consistently high ROEs. However, when I talk about the quality of the portfolio being very high, I am also referring to the strength, longevity and economic resilience of the products and services these businesses sell. The current portfolio grew its earnings and dividends every year between 2007-11, which is as robust a survival test as any. As demonstrated by the most recent results season, this fundamental resilience has continued in 2012, a reassuring outcome given that 2012 was a year in which the return of animal spirits to the stock market was not really echoed in the real economy, particularly in Europe and China (as Reckitt CEO Rakesh Kapoor put it last week, the situation in Europe has recently gone from 'worse to bad').

In no area of the fund is this resilience better demonstrated than in our exposure to global consumer brand companies, which continue to represent nearly 40% of the fund. We have had results from most of the the fund's largest holdings in this sector over the last month, and they all act as a reminder of:

(a) The steady progress these business models can make, even in tough economic times.

(b) The strength in depth these businesses now have in terms of geographical diversity.

The table below sums up point (a). It shows the sales, earnings and dividend growth in 2012 for each of our branded consumer goods holdings reporting results in the last month....

Stock	Sales Growth	Earnings Growth	Dividend Growth
Unilever	+7%	+11%	+5%
Procter & Gamble*	+3%	+12%	+7%
Reckitt Benckiser	+5%	+7%	+7%
Diageo*	+5%	+9%	+9%
Coca Cola	+6%	+6%	+9%
Average	**+5%**	**+9%**	**+7%**

*(*Interim results. The others are full year results. All sales figure are organic, constant currency)*

.....and the following tables sums up point (b), showing the sales growth in emerging markets for 2012 and exposure to emerging markets for each of these businesses.

Stock	E.M. Sales Growth	E.M. Sales Exposure
Unilever	+11%	55%
Procter & Gamble*	+7%	38%
Reckitt Benckiser	+9%	42%
Diageo*	+15%	42%
Coca Cola	+7%	34%
Average	**+10%**	**42%**

*(*Interim results. The others are full year results. All sales figure are organic, constant currency)*

What is becoming increasingly noticeable in the detail of results is how the 'long tail' of smaller emerging market countries is beginning to make a meaningful contribution to overall results. It is not just about the 'BRICs' anymore. Muhtar Kent, CEO of Coca-Cola, had the following to say about this 'long tail':

Very little is normally said about the 120 or so countries that represent slightly more than one third of our total global volume – whether it's Sub-Saharan Africa, or whether it's in Asia or the Middle East and so forth. But we grew sales in these countries 9% in 2010, 7% in 2011, 7% in 2012, and we keep on growing. This is the beauty of our portfolio diversification. So while you may have a quarter where China doesn't grow or where Europe doesn't grow, we still continue to be able to deliver on our long-term growth model for volume and also for revenues.

Operational leverage is also beginning to show through as these emerging market businesses begin to reach critical scale. Diageo's emerging market sales growth, for instance, translated into a +23% rise in operating profit in the second half of 2012. Procter & Gamble have seen aggregate profits in their top ten emerging markets improve by +35% in the last six months in dollar terms, and +50% on a local currency basis (despite continuing to significantly increase innovation and marketing spend in these countries). There is no reason why this profitable growth can't continue over coming years.

While Unilever is currently the only business on the list with more than half of its business in emerging markets, the others are moving quickly in that direction. Diageo will exceed 50% of sales from high growth markets by the end of 2013, and Reckitts now expects to exceed 50% of sales from emerging markets by the end of 2015.

This geographic diversity is providing a huge runway of profitable, cash-generative growth. Although stock prices have risen over the last month thanks to good results, in general these holdings still look attractive value on our quality-adjusted basis. I repeat here what I said last March on the subject:

I'm not an advocate of breathless emerging market cheerleading or growth-at-any-price investing. However, I do want to own businesses with excellent long-term economics, and it's hard not to get excited about the potential for consumer brands in new markets over the next decade or two. We are under no illusions – these positive trends will not develop in a straight line. There will be business cycles, there will be set backs and there will be all the normal competitive pressures. However, I think an ability to 'hold the thought' on these global growth opportunities will be a crucial element of navigating the noise that will buffet financial markets over the next few years. Most stock market participants are either unable or unwilling to do this, which I believe is to our advantage.

Hugh Yarrow
20 February 2013

Please note, these views represent the personal opinions of Hugh Yarrow as at 20 February 2013 and do not constitute investment advice.

Data sources: Wise Investment, Canaccord Genuity Quest, Factset, Bloomberg.