Evenlode Investment View

Wise Funds

APRIL 2012 – THE 'NEW NORMAL' IS A LOT LIKE THE 'OLD NORMAL'

As noted in previous monthlies, the post-crisis world of the last three years has been characterised by lower trend economic growth, shorter business cycles and more frequent recessions. 2010 and 2011 were both highly unusual years for developed economies (relative to the thirty years before them) in the sense that both saw two inflection points in the business cycle (a peak earlier in the year followed by a trough later on). In this context, it's not surprising that investors are reacting even more nervously than usual to every economic data point. Stock market falls over Easter following the release of US unemployment data are a case in point – no-one wants to miss the next turn in the cycle.

Bond investor Bill Gross has dubbed the current economic era as 'the new normal', and the phrase has entered the investment vernacular. From a very long-term perspective, however, current levels of trend growth and economic volatility are by no means unheard of – only when directly compared with recent history do they look abnormal. As the Economic Cycle Research Institute recently pointed out:

"Starting in the early 1980s, we got three relatively long expansions (8 years, 10 years and over 6 years) back-to-back so many people think that's the norm. But we now have extraordinarily low trend growth, and the Great Moderation of the business cycle is history. More frequent recessions should not be a surprise, nor is it unusual. For example, from 1969-82 the U.S. had four recessions in less than 13 years. Going back a bit further, from 1799-1929 almost 90% of expansions lasted three years or less."*

Perhaps it's more appropriate to describe the current era as the 'old normal' – back to muddling through, coping with uncertainty, and facing down more frequent recessions. For a time-travelling investor from most of the last two centuries, it would all feel quite familiar, and not too terrible.

Creating Shareholder Value In A Slow-Growth World

In this harsher climate, Evenlode businesses have generally experienced slower demand growth than in the pre-crisis years. However, this revenue slowdown is by no means disastrous. For most of the businesses we focus on, the impact has been fairly small (thanks to economic resilience but also thanks to sizable exposures to higher growth rates in emerging markets). As Procter & Gamble recently pointed out, global fast moving consumer goods markets were growing at 4-5% per annum pre-crisis. Since 2007, the trend growth rate has dropped, but is still running at a quite healthy 3-4%.

For other businesses the impact has been more severe but, in aggregate, the current stocks in the Evenlode portfolio have demonstrated they are well equipped to withstand the new economic era. In particular, they have benefited from two positives that go a long way to offset lower volumes. First, weaker competition has in some cases dropped by the wayside. Second, cut-backs and an increased focus on capital discipline have resulted in a decline in new capacity for many industries. There is less volume to chase, but there is also less capital chasing it. This has been particularly evident in more cyclical markets where, for instance, businesses such as WS Atkins and Severfield Rowen have been able to make big market share gains as competitors have steadily withdrawn.

Weighted average earnings growth for the current portfolio over the last five years has been as follows**:

2007: +10.7%
2008: +22.1%
2009: +6.2%
2010: +10.5%
2011: +7.9%

Crucially for shareholders, this growth has been self-financing – the companies in the portfolio generally spin cash off rather than suck it in thanks to their intrinsic intangible qualities (brands, reputations, intellectual property etc.). Very respectable growth in shareholder value is the result. It's a boring grind at times, but we are confident that progress will continue to be made by this collection of businesses.

Some Thoughts On Managing Through The Business Cycle

As I have already alluded to it seems that the current economic environment is, more than ever, giving weight to the idea that a successful investment strategy must make a regular and accurate stab at predicting the next twist or turn of the business cycle. But I'm not sure that's a very helpful way to look at things.

I recently read the book *There's Always Something To Do*, based on the diaries of the great Canadian investor Peter Cundill. It spans a period from the late 1960s to the 2000s, and is worth a read. In general it's a reminder that consistently applying an objective, patient, risk-averse investment approach is a sensible way to navigate all sorts of varying economic conditions. As a first person piece, it also highlights how difficult it ever is to see the economic wood for the trees – even during 'The Great Moderation'. Cundill, for instance, wrote the following in his diary in July 1991:

"I find myself thinking about buying things but world events, plus the economic uncertainties, could in reality spell 'crash'. I am alert to both danger and opportunity and I can't decide which it is. Everyone else is depressed."

Even in the foothills of one of the greatest ever bull-markets for equities it was not exactly easy to see what lay in store. It is even harder today.

In my view, our best bet with Evenlode is to stick to our guns. We are trying to invest 'one stock at a time' in businesses with excellent long-term economics. The changes we make to the portfolio are in the main incremental, and are attempts to manage valuation risk, rather than attempts at market timing.

Charlie Munger, Warren Buffett's business partner, was the main inspiration for our investment process, and I'll leave the last word to him:

*"A standard technique that applies to a lot of investors is called 'sector rotation'. You try to figure out when oils are going to outperform retailers etc. etc. etc. Then you just kind of flit around, being in the hot sector of the market making better choices than other people. And presumably, over a long period of time, you get ahead. However, I know of no really rich sector rotator. Maybe some people can do it. I'm not saying they can't. All I know is that all the people I know who got rich did not do it that way. They made their money owning high-quality businesses"****

Hugh Yarrow
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Please note, these views represent the personal opinions of Hugh Yarrow as at 16 April 2012 and do not constitute investment advice.

*Full presentation available here: http://ecri-prod.s3.amazonaws.com/downloads/ECRI-Frankfurt-Yo-Yo-Years.pdf

**Source: Wise Investment, Collins Stewart (EPS growth)

***From *Poor Charlie's Almanack, Third Edition, Donning Publishers, 2008* (quote is my edit)