Evenlode Investment View

Wise Funds

APRIL 2014 – On Taking Flak And Remaining Airborne

There has been a mild correction in global stock markets over the last month. Little has changed on the economic front: the world continues to stumble along. Meanwhile, Russia's imperial ambitions cast a somewhat imponderable geopolitical shadow on proceedings.

The most noteworthy trend in the recent sell-off has been a reversal in the share prices of momentum stocks. Some of the best performers in the UK market over the last year or two have been falling, including the shares of smaller companies which started to under perform their larger peers in April after a long, unbroken period of out performance. This reversal of momentum has been even more pronounced in the US where fashionable and highly rated technology stocks (in sectors such as biotechnology, web 2.0 etc.) have been falling sharply.

A Careful Eye On Creative Destruction

In the Evenlode world (i.e. that of dividend growth investing), whether to invest in these emerging technology companies (many of which trade on more than 100x earnings and negative or miniscule free cash flow yields) is not even a decision for us - we will leave that question for other investors. So these companies may not seem all that relevant for the Evenlode fund. However, we think they are. The investment question for us is not so much whether these fashionable shares are fairly valued, or even how much the underlying companies will change society. The real question is how much the innovation from these new companies and industries might affect the long-term economics of the more mature, stable businesses that we follow and invest in. Recent books such as *In The Plex*, *The Second Machine Age*, *Abundance*, *The Optimist's Future* and *Big Data* are a great summary of how quickly the world is moving in areas as diverse as digitalisation, artificial intelligence, data analytics, genetic engineering, 3D printing, mobile apps, personal healthcare diagnostics and electric cars. This new explosion of innovation, described recently by *The Economist* magazine as a 'Cambrian Moment' for technology, explains much of the reason that many of these companies (rightly or wrongly) find themselves on such sexy valuation multiples. There is an undeniably clear narrative.

Our preference for companies with the following characteristics helps defend against these developments:

- A low likelihood of obsolescence
- Products and services that are bought habitually
- Embedded customer relationships and strong loyalty

As I have said before, this is one reason why we remain very attracted to consumer branded goods companies, which continue to make up more than a third of the Evenlode portfolio. The risk of obsolescence in this sector is particularly low. Other sectors we follow are more exposed to the evolving technological landscape. We have spent a good deal of time on our media and technology holdings over the last few years exploring the potential threats they face, and reading round the subject (e.g. cloud computing as a threat to Sage, SAP and IBM, tablets and smartphones as a threat to Microsoft, open access content as a threat to Reed and now Pearson). Nothing is certain, but all of the above companies do share some key characteristics – embedded, repeat-purchase customers who don't particularly want to change supplier. SAP has so far proved very capable of steadily migrating its customer base across to cloud offerings, just as it was able to migrate them from mainframe computers to PCs in the early 1990s. For Sage, the typical client is not a Silicon Valley start-up. Most small business customers will end up on cloud services, but it will take several years. And many of them will only get there because Sage suggests they move. These business models are at the slowly evolving, established, repeat-purchase end of what a technology company can be. Even Warren Buffett, not exactly a famous technophile, has a holding in IBM. This is the rationale he gave for buying the business in an interview from a couple of years ago:

If you think about it, and I don't want to push the analogy too far because it could be pushed too far, we work with a given auditor, we work with a given law firm. That doesn't mean we're happy every minute of every day about everything they do but it is a big deal for a big company to change auditors, change *law firms. We've got dozens and dozens of IT departments at Berkshire. We went around and asked them and you find out that they're very much working hand in glove with suppliers. And that doesn't mean things won't change but it does mean that there's a lot of continuity to it.*

When we think about negative threats or technological change, we like to try and think out a few years, imagining them running their course. Will each business we follow be able to evolve and adapt to the changing landscape, taking its clients with it? Even if it takes some flak in the short-term, will it still have the capability to retain reasonable pricing power and generate decent free cash flow and returns on equity a few years out?

Taking Flak and Remaining Airborne

It is of the highest importance in the art of detection to be able to recognise, out of a number of facts, which are incidental and which vital.

Sherlock Holmes, The Reigate Puzzle

On the subject of taking flak, there is a great story from World War II about the statistician Abraham Wald, who was tasked with determining where extra armour should be added to airplanes. Wald studied the patterns of bullet holes in returning planes and came to the conclusion that the extra armour should be added to the parts of the plane that had not been hit. He reached this conclusion, of course, because he also considered all the planes that hadn't returned, taking hits in the other areas that must have been fatal. I like Wald's backward thinking. Planes flying around with bullet holes in their fuselage are a sign of *strength*, not weakness. As Charlie Munger says, its good when thinking through a problem, to *invert, always invert.*

As with aerial combat, in investment it is sensible to assume that all of your planes (i.e. fractional shares in companies) will be hit by flak at some point: evolving technologies and new competitors (as discussed above); cyclical downturns; bad press; scandals; product recalls etc.. The real question is whether they can remain airborne after being hit by this anti-aircraft fire. We try and ask ourselves what really matters? What is most important for what we are trying to achieve long-term? How can we cope best with the inevitable flak that will hit a long-term investment project? I have thought about this issue a lot and I'd boil it down to two main things - business models and valuation. And this is what we spend the vast majority of our time on. As Sherlock Holmes might put it, this is what's *vital*. Much of the rest is just *incidental*.

Using the principle of inversion, the best time to add to or start a position in a quality business tends to be when it is not widely liked and/or is enduring some kind of difficulties. As we have discussed in previous monthlies, short-term news has become increasingly negative for global companies (think of them flying over the German-occupied French coast) and increasingly positive for more domestically exposed companies. The rising market has also made smaller and more economically exposed companies more fashionable and larger more stable companies less fashionable. At the margin, over the last year or two, we have therefore recycled money from small to large, and from domestic to global. We are the first to admit that we will often start building positions in companies too early. We may also sell things too early and then watch them continue to rise (we spent much of last year doing this). But this is the beauty of running a portfolio of different stocks – you will always have some ideas which are under pressure, some which are in the doldrums, and others which are working out.

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Please note, these views represent the personal opinions of Hugh Yarrow as at 15 April 2014 and do not constitute investment advice.