Evenlode Investment View

Wise Funds

MARCH 2012 – GLOBAL CONSUMER BRANDS REVISITED

The stock market has been in a rather ebullient mood of late. As I've said several times before, despite all the structural pressures that the world faces (mostly problems that all but the most hermit-like investors are well aware of), the business cycle is alive and well. The global economy is benefiting from the fall in inflation that began last summer, and continues to gather steam. Even leading indicators in the US housing sector have begun to turn up, and although inflationary pressures will ultimately start to put the brakes on this recovery, they are not biting yet. In combination with the European Central Bank's latest, huge, money printing efforts (the ECB now has a balance sheet larger than the Federal Reserve's), investors have been given some breathing space to enjoy this up-leg in the business cycle.

Despite current cyclical optimism, none of the structural problems that existed six months' ago have gone away. In the west, the government debt crisis rumbles on and headwinds from debt deleveraging remain. Meanwhile, the risk of future inflation builds as central banks continue to print money. In the east, the Chinese economy looks unsustainably dependent on fixed capital formation, and if anything the situation seems to have deteriorated since the start of the year (not that you'd know it from share price moves!). I doubt the inevitable rebalancing towards domestic consumption will be straightforward. Given China's important role in the global economy, this poses a clear risk to large parts of the UK market.

Global Consumer Brands Revisited

Branded consumer goods companies are an important element in the Evenlode portfolio, and if anything the recent results season has made us even more confident in their long-term prospects. In most cases our increased confidence has not been shared by other investors – the mood of the moment is to keep up with a rapidly rising market, and look for more economically sensitive investments to add 'beta' to portfolios. Stocks such as Unilever and Procter & Gamble (a new Evenlode investment this month) have, as a result, given a significant portion of their 2011 outperformance back since the start of the year.

I would echo Seth Klarman's recent sentiments regarding attempts to 'manage' short term performance – particularly in a rising market:

"We don't try to be anyone's best performing manager in a given year because such an attempt would almost certainly fail. It would distract us from our focus on risk-aversion and the pursuit of excellent long-term results, while shifting our attention toward quick gains, short-term trades and market momentum. We doubt anyone with such a focus could excel, and are certain that attempting to do so would involve heightened risk and diminished long-term returns. In frothy markets, we would rather disappoint clients than try to keep up while incurring the risk of large losses."

Our confidence in our consumer staples investments is not premised on what they might or might not do, relative to the market, over the next few weeks or months. It is instead due to the fact that our risk appraisals and valuation work suggest to us that they offer some of the best long-term compounding opportunities in the market.

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. Procter & Gamble recently compared the current emerging market opportunity with the postwar American boom in consumer goods of the 1950s and 1960s. The macroeconomic dynamic is quite similar, with steadily rising disposable incomes leading to more demand for low-ticket, branded aspirational goods. Between 2010 and 2020 1 billion individuals are expected to move out of poverty (earning more than $1 a day), a key take-off point for demand growth in branded consumer staples. Market structure, then and now, also plays an important role. Consumers enter the branded market at the value-end but gradually migrate up to more expensive products. As they move into higher pricing points, new consumers come in at the bottom of the pyramid to replace them in the value tier.

Pricing structures in the BRICs and other 'maturing emerging' markets are already quite sophisticated, and this virtuous process of value-migration is well established. Take Brazil, for instance. The oral care market has grown at +17% per annum for the last three years, and the hair care market at +27%. Even the fabric care market is growing at +20%. While some of this growth is volume growth, market development (i.e. the growing importance of premium product) is playing a huge role. Sales of P & G's up-market Pantene brand, for instance, have quadrupled over the last three years in Brazil. Meanwhile, sales of super-premium categories in China are growing at an average of +30%.

Other nations have only just begun on this journey, but as the up-trading cycle establishes itself across the globe, it's beginning to show through in company results. In Africa, Nichols grew their Vimto sales by +28% during 2011, after growth of +56% in 2010. Similarly, African sales of Diageo's Johnnie Walker are currently growing at +32%.

With all this growth, of course, there is bound to be competition. However, competition is not a zero-sum gain – competitors help to develop the market and pricing structure too, just as they did in 1950s and 1960s America (with the help of Don Draper from Mad Men!). There is also an offsetting factor to competitive pressures. As the scale of these businesses grows (at both a national and international level), and early stage investment simultaneously falls as a percentage of sales, margins begin to expand. Procter & Gamble management see no reason why emerging market margins shouldn't trend towards developed market margins over the long-term – a huge driver of long-term profitability if it comes to pass.

We are under no illusions – the positive trends discussed above 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. As Unilever's chief executive Paul Polman put it to the analyst community at 2011 results last month:

"On the emerging markets, it is indeed right that sales growth was 11.5% last year. Some of you naysayers out there have always worried about the emerging markets. I remember when I joined Unilever in 2008, all you guys loved emerging markets. Then in 2009, you all worried about competition coming into emerging markets. Then in 2010 and 2011, you all got worried about input costs in emerging markets. Then I suggested emerging markets were slowing down, and you got worried about that. I don't know what you guys do in your private time, but you're making your life incredibly miserable. We see 11.5% as good growth, and we will continue to look for opportunities as two billion people come into this world and improve their standards of living"

Finally, a brief note on valuation. Unilever currently sports a 4% starting yield, compared with a 2.4% yield for a ten year UK Gilt and a 1.9% yield for Unilever's own five year debt. Similarly, in the US, Procter & Gamble shares offer an initial yield of 3.5% compared to 2.3% for ten year US Treasuries and a 2.3% yield for P & G's own ten year debt issue from last month. P & G have paid a dividend for 122 consecutive years, and increased it every year for the last 55 years at an average rate of +9.5%. Given the above discussion, and P & G's inherent pricing power, I think the company has a good chance of growing its income stream in real terms over the decade to come. Ditto for Unilever. The same cannot be said for fixed coupon bonds, particularly if the world ends up facing a significant inflation – a possibility that can't be dismissed.

Opportunity Set Starting to Narrow

I remain positive on the absolute and relative valuations of the stocks we own, albeit less so than six months ago given the 20%+ rally in the market since then. We have begun to reduce and exit some of the better performing stocks in the portfolio where forward cash returns have come down rapidly over the last three months. Stocks we are adding to are generally the more consistent, stable ROE companies in our investable universe, particularly in the healthcare and consumer staples sectors. Considered unexciting, many have begun to lag. This is giving us an opportunity to upgrade the quality of the portfolio without taking on more valuation risk. If the current market rally continues over coming weeks and months, it's likely that this valuation-driven shift will continue.

Hugh Yarrow
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Please note, these views represent the personal opinions of Hugh Yarrow as at 14 March 2012 and do not constitute investment advice.