Evenlode Investment View

Wise Funds

APRIL 2013 – THE GREAT, THE GOOD AND THE GRUESOME

The Outlook Darkens

Despite a very strong first quarter for stock markets, recent economic news has been quite patchy. In particular, leading indicators for the global economy have turned markedly negative over the last month, with the rise in inflationary pressures in the second half of last year starting to take their toll on global consumer confidence.

As well as the beginnings of a cyclical slowdown, some of the structural issues facing the global economy have bubbled up to the surface once again. The Cypriot banking crisis is a reminder that Eurozone policymaking remains extremely ad hoc, and little progress has been made on producing a coherent plan for the Eurozone's long-term future. Events in Cyprus also reiterate the precarious nature of putting your money in a 21st century bank. As Jim Grant put it recently, '*the scourging of Cyprus will prove to be the end of deposit complacency and the beginning of depositor anxiety*'. The likelihood of further banking runs in fragile European nations can only have risen in the last six weeks.

Elsewhere, China's issues have begun to trouble Mr Market again, as signs have re-emerged that the economy and real estate markets are cooling. The financial assets most reliant on China's construction boom (industrial commodities, heavy equipment companies, cement companies etc.) have been falling in sympathy. Below I discuss the risks that China poses to investment markets, and an important investment lesson that, in my view, China's recent growth illustrates well.

More Cement Is Not The Answer

China's dependence on fixed capital investment still stands at extraordinary high levels, representing about half of all economic activity. This reliance on construction creates a very basic problem – every time you finish a building, you have to put another one up to prevent the economy contracting. And to keep the economy *growing*, you need to put more up than you did last year. Stuck in this trap, the Chinese growth story has required more and more capital to generate each marginal unit of GDP as the years pass, and debt has increasingly financed this growth. Credit creation in China is now running at an annual rate of more than $2.5 trillion a year, and the country's debt service level is more than 12% higher than the long-term trend rate. This represents a rate higher than the peak levels seen before credit crises hit Japan in 1989; Korea in 1997; the U.S. in 2007; and Spain in 2008.*

The Direct Effects

Given these structural imbalances, the risks of a severe slowdown in Chinese growth remain, in my view, worth contemplating seriously, even if the timing and magnitude of such a slowdown is impossible to predict. We do not have any significant direct exposure to the Chinese construction/infrastructure boom. As a matter of policy, we don't invest in resources stocks, which have been the biggest beneficiaries (50-80% of demand in the industrial metals markets currently comes from China). However, several stocks in our investable universe (the specialty engineering businesses we follow, for instance) have benefited from some 'China froth' in recent years, both directly and indirectly. We are careful when valuing these businesses to remove this froth. As a result, the current valuations of most of these engineering stocks do not look attractive to us. However, if investor sentiment continues to sour towards China, opportunities will undoubtedly emerge again in this area. There are some great engineering businesses that we have been 'stopped out' of on valuation grounds for some time now, and I suspect the 'China effect' has been part of the reason for this. We wait and watch with interest.

The Knock-On Effects

The more widespread effects of a serious slowdown in China are difficult to predict. As the second largest economy in the world, and currently contributing 1% to global economic growth, I suspect the knock-on effects would be very significant, and Evenlode would by no means be immune. However, it would not all be bad news. A further fall in commodity prices, which would presumably accompany this slowdown, would rein inflationary pressures right back and therefore give western consumers a much-needed boost (*see footnote*).

An Investment Lesson From China – Growth Is Not Everything

For investors in a stock to make good money long-term (assuming a sensible valuation at purchase), the following three factors should ideally be present:

(1) Sales growth
(2) High profitability
(3) High returns on capital

Let's imagine, for a moment, that China is a stock rather than a country. It would represent everything we look to avoid in Evenlode – an asset intensive business model with low returns on capital, low profitability and growing debt levels. Its recent economic boom has had (1) in spades, with GDP quadrupling in nominal terms over the last decade. But (2) and (3), unfortunately for investors, have been lacking (just think of those empty skyscrapers and bridges to nowhere producing no cash-flow and/or utility to society). As a result, the Chinese stock market has gone nowhere over the last ten years, despite the phenomenal economic growth.

Studies of financial history show that China's example is by no means an outlier. More generally, there is no strong relationship between economic growth and stock market performance. Much more important determinants for an investor's future return are starting valuations and return on capital.**

The Great, Good and The Gruesome

Similarly, at a stock level, rapid sales growth is not a necessary or sufficient condition for the creation of long-term shareholder value creation. Slow, steady sales growth is enough for the magic of compounding to do its thing, as long as little in the way of incremental capital is required to generate this growth. Most of Evenlode's holdings fall into this 'slow growers' category. But while sales growth might be pedestrian, growth is self-funded and there is plenty of spare cash left over for owners.

In the hands of good management, these companies are enjoyable to own. It is encouraging to see the management of businesses such as Reed Elsevier, Sage, Smith & Nephew, Compass and Glaxosmithkline focusing much more intently today on shareholder returns than they have in the past (As Andrew Witty, Glaxo's CEO put it recently, '*we have a relentless focus on return on investment now*'). Dividends are increasing, disposals are being made of low returning businesses, and proceeds are being returned to shareholders. The focus has subtly shifted from revenue growth to return on capital.

Buffett summed it up in his 2007 Berkshire Hathaway letter:

"Think of three types of "savings accounts." The great one pays an extraordinarily high interest rate that will rise as the years pass. The good one pays an attractive rate of interest that will be earned also on deposits that are added. Finally, the gruesome account both pays an inadequate interest rate and requires you to keep adding money at those disappointing returns."

Our aim is to fill the Evenlode portfolio with the 'great' and the 'good', while avoiding the 'gruesome'. It might not be the most exciting investment approach, but we believe it should prove a very profitable one long-term.

Hugh Yarrow
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Please note, these views represent the personal opinions of Hugh Yarrow as at 18 April 2013 and do not constitute investment advice.

*Do debt service costs affect macroeconomic and financial stability? Bank For International Settlements Quarterly Review – September 2009, http://www.bis.org/publ/qtrpdf/r_qt1209e.pdf

**E.g. Dimson, Marsh and Staunton, London Business School, 2005 (GMO's Ben Inker wrote a note last year that has a very good discussion on this point, *Reports Of The Death Of Equities Have Been Greatly Exaggerated: Explaining Equity Returns).*

Footnote

If induced by a serious Chinese slowdown, structurally lower commodity prices would also give the global consumer goods industry a boost, reversing the input cost pressures of recent years (P & G, for instance, estimates that a representative basket of their input costs has doubled over the last decade). The below is what Coca Cola had to say on this subject recently:

We have said many times that if commodities go down, don't expect us to reduce prices. We have worked very hard to earn the price that we take in the marketplace – our products don't have an affordability problem.

This combination of pricing power and falling input costs would be quite helpful if it transpires.