Evenlode Investment View

Wise Funds

AUGUST 2012 – GROUNDHOG DAY

"The economic environment seems to be stuck in a rather unpleasant perpetual loop. Greece is always about to default; the latest bailout is always about to save the day and yet never seems to; China is always about to collapse but instead teases us by inching down; and I swear the Financial Times is beginning to recycle its reports! In the U.S., the fiscal cliff looms along with debt limits and the usual election uncertainties. The dysfunctional U.S. Congress continues for the time being in its intractable ways. The stock market rises and falls and rises and falls again. It is getting difficult to find anything new to say at client meetings. I, for one, wish that the world would get on with whatever is coming next."

Jeremy Grantham, August 2012

It feels like we're living through a sort of economic Groundhog Day, as Jeremy Grantham points out in the above quote. On the macro-economic front, there is little new to say since last month – at least we have had the Olympics to provide some headlines! At the margin, leading indicators for the global economy (and particularly the US) have ticked up thanks to falling inflationary pressures. In the central banking world the European Central Bank, Bank Of England and Federal Reserve have all released statements reasserting their commitment to extremely low interest rates and money printing. However, and in spite of this very loose monetary policy, the big structural problems in the US, Europe, China, Japan et al. still seem a long way from sustainable solutions.

No Rest For The Dividends

Despite this uncertain backdrop steady progress continues at a company-specific level. About two-thirds of the Evenlode holdings have updated the market in the last few weeks, and they continue to notch up reassuring results and healthy dividend growth. In the last two months, the following dividends have been announced in the fund*:

Stock	**Dividend Type**	**Dividend Growth**
Smith & Nephew	Interim	+50%
Microsoft	Q4	+25%
IG Group	Final	+14%
Nichols	Interim	+13%
Astrazeneca	Interim	+12%
BATs	Interim	+11%
Coca Cola	Q2	+9%
Unilever	Q2	+8%
Jardine Lloyd Thomson	Interim	+8%
Johnson & Johnson	Q2	+7%
Procter & Gamble	Q4	+7%
Halma	Final	+7%
Pearson	Interim	+7%
Reed Elsevier	Interim	+6%
Glaxosmithkline	Q2	+6%
WS Atkins	Final	+6%
Greggs	Interim	+3%
Reckitt Benckiser	Interim	+2%

On average, this represents a dividend increase of +11%. Stripping out the rebasing of Smith & Nephew and Microsoft's dividends, the average is still +8%. Not bad given the difficulties that the world is currently working its way through.

Self-Sufficiency In a Slow-Growth World

Many of the fund's current holdings are being helped by a combination of repeat-purchase products and strong demand growth from newer markets. Highlights included the +27% growth in Vimto's African sales that Nichols saw in the first half of 2012, the +24% growth in SABMiller's lager volumes in India over the last quarter, and the +17% sales growth that Procter & Gamble saw in Brazil over the same period. I remain extremely positive on the long-term prospects for branded repeat-purchase products in these markets. As P & G put it last week, "we are on the precipice of one of the greatest trade-up cycles the world has ever seen".

However, even for the most resilient, well-placed global business, overall demand growth is slower today than it was pre-2008 and there is little sign of improvement. Businesses need to work harder than ever to create value for shareholders with this backdrop of weak market volumes. Self-sufficiency is crucial and factors such as innovation, flexibility, efficiency, cash generation and good capital allocation have become increasingly important. Paul Polman, CEO of Unilever, summed up the mood on a recent conference call:

"We feel happy with these numbers in a tough environment. We also feel, with a certain level of confidence, but not complacency, that the company is better prepared than it ever was for an even more difficult environment. We've never been stronger but it has never been more needed. We've come along way but we also believe there are many things to do in this company. For that reason, I don't want to have any excuses from the outside – not GDP growth, not government, not an election, not a political leader, not the weather either, not Ramadan or any other holidays. Our destiny is in our own hands and we know what we need to do. It's hard work and I want to thank the 170,000 people of Unilever who do this day in and day out."

Smith & Nephew recently provided another example of self-sufficiency in tough markets. The medical devices industry was growing at 7% or more per annum before 2008. Now, with pressure from government pricing pressure and budget cuts, these markets are growing at 3-4% per annum. However, Smith & Nephew still generates prodigious amounts of cash flow. The business is becoming more efficient and with limited reinvestment requirements, profits are converted to cash flow. So, despite sales growth plodding along in the low single digits, a net debt position of $350m this time last year has been converted to a net cash position of $150m today. The dividend was raised by +50% at the latest results and I suspect shareholder returns could rise significantly in coming years given the excess cash this business generates.

Some Reforming Characters

Even some of the less than perfect capital allocators of the boom years seem to be 'getting it' somewhat more in a world of austerity:

Procter & Gamble: noted for their dubiously priced $58bn acquisition of Gillette in 2006, P & G have turned from share issuers to share re-purchasers. P & G have repurchased 13% of their own shares in the last five years and recently announced another $4bn buy-back over the coming year. I think further capital repatriation is very likely given mounting shareholder activism and management's changing attitude to capital discipline – watch this space.

Sage: recently sold its US healthcare business and rather than ploughing the proceeds back into an expensive acquisition (as may have been the case historically), new management used the proceeds to buy-back shares and subsequently increased the dividend by +25%, citing a lack of deals available at sensible prices and nothing much else to do with the cash.

Microsoft:** management rebased the dividend by +25% this year and I expect there is more to come (Microsoft's acquisition of Skype last year, however, is a reminder that old habits die hard!).

Reed Elsevier: after a big, mistimed acquisition in 2007, Reed are under new management and are in the process of disposing of several businesses. CEO Erik Engstrom announced last month that proceeds will be used to repurchase shares at what both they and we deem to be a very compelling valuation. After years of empire building, this is a refreshing change.

Glaxosmithkline: in the 1990s, the concept of capital discipline was an alien one to the pharmaceutical sector. Back then it was all about generating rapid sales growth at any cost – an orgy of M & A ensued. But since 2000 Glaxosmithkline has bought back 20% of its shares, while ratcheting up its dividend at a good rate. This trend toward capital repatriation has accelerated since 2008, including a buy-back of more than $2bn this year and a special dividend following the disposal of its non-core over-the-counter drugs brands. Moreover, Glaxosmithkline's entire R & D efforts are now run on the principle of return on capital, and they have also raised the rate of return at which they are happy to make acquisitions. These disciplines are beginning to have a material effect on Glaxo's cash generation.

In summary, the new economic era seems to be focusing the minds of many corporate management teams. The tone has subtly shifted from world domination to dividend growth, share buy backs and special dividends. This is a welcome change, and will help offset the weaker demand environment.

As several studies have demonstrated, there is no particularly strong link between the future return from shares and the prevailing rate of economic growth at the time of purchase (starting valuation and return on capital are much more important factors)***. In better times, people feel more optimistic and expect their shares to perform better. But in reality, some of the worst episodes of capital misallocation and shareholder value destruction have occurred when the economic environment has been at its most buoyant (the 1880s US railroad boom, the 1990s technology boom, the recent infrastructure boom in China etc.).

It is worth holding this thought – the austere economic backdrop of today is making organisations more self-sufficient and is improving corporate capital discipline. This is some good news that will not make the front page of any newspaper, but is just as important for shareholders as the bad economic news that does.

Hugh Yarrow
15th August 2012

Please note, these views represent the personal opinions of Hugh Yarrow as at 15th August 2012 and do not constitute investment advice.

*Source: Canaccord Genuity Quest, Wise Investment
**I discussed Microsoft's potential to return more capital in *A Lesson From Henry Singleton: November 2011*
***E.g. Dimson, Marsh and Staunton, London Business School, 2005 (GMO's Ben Inker wrote a recent note with a very good discussion on this exact point - *Reports of The Death of Equities Have Been Greatly Exaggerated - Explaining Equity Returns* available at www.gmo.com).