Evenlode Investment View

Wise Funds

DECEMBER 2012 – THE QUEST FOR RATIONAL INVESTING

A Good Year For Markets

With the benefit of hindsight, 2012 has turned out to be a pretty good year for global stock markets , even if it didn't always feel that way. In contrast to 2011 (when markets underperformed corporate earnings), 2012 saw markets rise more than fundamentals (the UK market has risen by +13%, whereas earnings are forecast to fall by about -3%*).

This better mood has been helped by an improved outlook for the global economy as we head into 2013. Inflationary pressures eased significantly over the summer and produced a big stimulus to the global economy. As a result, leading indicators have improved markedly in recent weeks.

Sentiment has also been buoyed by a massive effort from central banks to print money and keep interest rates pinned firmly to the floor. This commitment has come most notably from the European Central Bank and the Federal Reserve – over the last few months Mario Draghi and Ben Bernanke have effectively given unlimited commitments to print money if deemed necessary. Many other central banks are also pursuing various forms of aggressive monetary easing. Given the stifling effect these policies have had on the investment returns available from cash and bonds, shares have become 'the best house in a bad neighbourhood'. At the end of November, Mongolia (not a nation know for its credit quality and with a history of defaults), issued a ten year bond paying 5% (it also issued a five year bond paying 4%). In the same week online retailer Amazon issued a ten year bond paying 2.6% (and a five year bond paying 1.3%)**. In this context, it is not hard to see why the proposition of blue chip shares on 3-4% starting yields has become increasingly attractive to Mr Market.

Plenty To Be Cautious About…

Looking ahead to next year, there are several issues that could rear their head for investors again. An immediate cyclical risk, which has strangled global growth for several years now, is that each time the economy pick-ups, inflationary pressures are created that quickly apply a self-moderating brake on the nascent recovery. Just as the party gets started, the punchbowl gets taken away. This is just what happened in both Spring 2010 and Summer 2011, but given the recent step-up in money printing, it could be even more pronounced in relation to the current economic pick-up. Commodity markets are already starting to move higher.

Other risks include two big structural threats - the re-emergence of stress in the European financial system and a continuation of the slowdown in China. More generally, and despite central banks best efforts, debt de-leveraging pressures rumble on inexorably in the background (with the current favourite topic of conversation being the US fiscal cliff). The ability of open-ended quantitative easing (such as the Federal Reserves latest 'QE3' announcement) to overcome these pressures appears limited, and the longer-term effects remain unclear. Seth Klarman framed it well recently:

"While QEs 1 and 2 had no lasting impact, they did give a short-term boost to the stock market. But because that boost was ephemeral, it's hard to comprehend why anyone would believe that QE3 will turn out better. QE3 is bold in its apparently unlimited determination, which may be intended to demonstrate the Fed's determination rather than any actual conviction that it will work."

Even Ben Bernanke recently admitted that the Federal Reserve's extreme policy measures are a process of 'learning by doing'.

…But Let's Not Get Too Depressed

All of the above risks are valid ones in my view, and should be acknowledged.

This year's rally also increases the need for caution, as valuations of an increasing number of businesses have become difficult to justify on an absolute basis. A subtle shift in investor psychology is underway. A year ago investors cared more about return *of* their capital, rather than return *on* the capital. Now, worries increasingly turn to missing out on a rising market. Everyone hopes they will call the top just right at some undetermined point in the future.

Our valuation discipline leads us naturally to tread cautiously as these 'animal spirits' start to build. However, in my view there remains a great opportunity to hold some of the highest quality repeat-purchase franchises in the world at attractive valuations, which we are taking full advantage of. Elsewhere, we are finding less of interest, but on a stock-specific basis there is 'always something to do'.

As a result, the quality and value credentials of the current portfolio remain more than satisfactory***:

1) The current dividend yield on the portfolio is 3.9% versus 3.5% for the UK market.
2) The free cash flow yield is more than 7% (after all capital expenditure, not just maintenance spend) versus 5% for the market.
3) The portfolio's return on equity is 34% versus 13% for the UK market.
4) This return on equity continues to be achieved with very little debt in the capital structures of the underlying business.

Given the above, combined with the fundamental endurance of the products and services in the portfolio, I have a quiet confidence in the long-term compounding potential of the current portfolio. We have a strong preference for businesses whose products are highly unlikely to experience obsolescence over the next ten or twenty years.

And it's worth remembering that some businesses are built better than others to withstand economic crosscurrents. Sam Walton was asked, back in the early 1980s, what Wal-mart was doing about the recession. His reply was that Wal-mart "didn't intend to take part in it". The current holdings in the Evenlode portfolio are doing their level best to 'not take part' in the slowdown that has been holding back the global economy since 2008. The current portfolio grew aggregate earnings by the following amounts over the last five years:

2007: +8%
2008: +19%
2009: +8%
2010: +10%
2011: +8%

For 2012, once all is said and done, I expect earnings for the portfolio will notch up growth in 2012 of something in the region of +5%, a slowdown on 2011 (reflecting the corresponding deceleration in the global economy), but progress nonetheless. I expect dividend growth for portfolio companies to come in a little higher than earnings at +6-7%.

The Quest For Rational Investing

As I look to next year, I'm sure they'll be plenty of volatility along the way and character-testing moments. But I remain committed to the Evenlode 'project' which is, quite simply, to deliver long-term compounded dividend and capital growth by investing in high quality, attractively valued businesses. I include a quote from US investor Glenn Greenberg below, which I have used before, and which I feel sums up our investment approach very eloquently:

"Few people are willing to concentrate their investments in a small number of businesses that they know thoroughly and believe will grow their net worth at an attractive rate over the long-term. Many days this work is just plain boring. Other days (and sometimes months), the market totally ignores your handful of precious stocks. A portfolio of predictable, reliable businesses does not make you the most exciting person at the cocktail party, nor does it give you flashy sales promotion material. I have come to believe the quest for rational investing is appealing only to a handful of us. But at least we sleep well at night and live well by days – and our clients do as well."

A very Happy Christmas to you all and I hope 2013 treats you well, whatever it may bring....

Hugh Yarrow
18th December 2012

Please note, these views represent the personal opinions of Hugh Yarrow as at 18 December 2012 and do not constitute investment advice.

*Source: Financial Express (Total Return), Oriel Securities
**Source: Grant's Interest Rate Observer, December 2012
***Source: Wise Investment, Financial Times, Cannacord Genuity Quest - FCF yield and ROE figures for the market exclude financials