Evenlode Investment View

December 2014: From Macro To Micro - by Ben Peters

EVENLODE
INVESTMENTS FOR LIFE

Physics to finance

I started my previous life as a physicist studying astrophysics. That's the jumbo form of the science, dealing with how the largest structures in the universe behave. Latterly I became interested in the physics of the very small, quantum mechanics and nano-physics. The problem that physicists have is that the large and small branches of the very same discipline seem theoretically and behaviourally to be like distant cousins rather than the same person. A large part of the effort of modern physics is to determine how to join the very big picture with the very small. It must be possible, the big picture is just lots of little pictures joined together after all.

I have been struck recently how we can face a similar challenge in investment. The news is full of the jumbo form of finance, the 'macro'. People from pub-goers to politicians, to finance professionals love to discuss stats like interest rates, GDP, current account balances, capital formation rates and all manner of other stuff. However, we invest in individual companies, which follow their own particular microeconomics; all of these companies stuck together form the corporate sector, an important part of the macro picture (the others bits being governments and households). Often questions are posed with causality the other way around as well – "how does xyz macro factor affect the companies in your portfolio"? How we deal with the macro whilst operating in the micro at Evenlode is the topic at hand.

An economist's idea

We have had a large dose of the big picture recently. The oil price is plummeting, commodities-based economies slowing, conversely the powerhouse of the US economy showing signs of strength, Greece's surprise election renewing concerns about the Eurozone, and persistent low growth and disinflation on the Continent and in Japan. People naturally wonder about these factors, and throw in the extraordinary measures taken by central banks in expanding their balance sheets it seems that there must be consequences for the economy and, by extension, investment markets and individual companies.

I recently went to a fascinating talk by Richard Koo, chief economist at Nomura and authority on balance sheet recession. A balance sheet recession is the sort we have experienced recently. It is caused by the key corporate and household sectors (and in some cases governments too) retrenching and saving money having previously overstretched themselves with too much debt. Balance sheet recessions are usually much more severe than the other sort, which might be caused by more 'normal' cyclical factors such as destocking of inventories for example. They are more severe in part because companies and individuals must repair their financial situation, which takes time, but also because people get scared of ever borrowing again (or at least for a long time). Mr Koo attributes the latter as an aggravating feature in Japan's sorry economic state of affairs.

In response to severe recession, we've had extraordinary monetary policies, such as quantitative easing (QE). After the talk I got a free copy of Mr Koo's latest book "The Escape from Balance Sheet Recession and the QE Trap". Without getting into the details, you can tell by the title that this economist for one doesn't think the unwinding of enormous bond and equity purchases by central banks will come easily. Interest rates could be in for a pretty wild time in his model.

I'm mentioning this not because I think that this is the most likely path for the future (although the arguments are compelling), but because of something that Mr Koo said during his talk. He said that there have been hundreds of academic papers written about getting into QE, but not a single one about how to get out. Well, I guess there's one book about it now. But the point is that no one really knows what is going to happen as a result of this monetary experiment.

I'm going to take that statement further. We at Evenlode don't really have any detailed foresight on how the economic future will pan out, balance sheet recession and QE or not. And that has consequences for how we try to deal with macroeconomics in the Evenlode portfolio.

Complex problems

Predicting an economic path is clearly a complex problem. It might be easier if the various economic measurements that can go into a model were statistically well-behaved, but they're not; the existence of 'fat tails' is well-known. Unfortunately for economists, they're equally well known for having a terrible track record of forecasting.

But let's not single out economists. Almost every field of forecasting is littered with failure, investment analysis included. It really is a wonder why we bother at all.

One of the reasons why we bother is because we think we have to. In investing, we are always dealing with the future. If you are going to value a company, you need to know what its cash flows are likely to be. Economic factors are going to impact those cash flows, as well as a menagerie of other influences including management strategy, changing customer demands and just plain old luck. If it's hard to know what the economic path is, and luck or otherwise is definitely impossible to predict, then it seems like we have an intractably difficult challenge facing us.

Simple solutions

However, to my mind there is a way through. The world is full of situations where decisions have to be made under conditions of extreme uncertainty. People can and do make good decisions. Some, through diligent application of a sensible process, are successful at investing.

The psychologist Gerd Gigerenzer has developed the concept of 'fast and frugal decision making'*. Essentially this involves selecting a small number of factors that are important to the problem being tackled, and pre-defining the way you're going to deal with them. Gigerenzer's solution is based on the idea that "when there is a high degree of uncertainty, simple diagnostic methods tend to be more accurate".

For our style of dividend & growth investing, we have identified six key factors that we are looking for in a company before we'll invest:

1. High profitability relative to the asset and equity base.
2. Low capital expenditure requirements
3. Low leverage
4. Existence of an economic moat
5. Ownership of intangible assets
6. Likelihood of having pricing power

The framework is then, if the company exhibits all of these factors, we can invest at the right valuation. If not, we won't invest at any valuation.

How does that help us with the issue of the economic environment? All companies get constantly hit by economic waves. Sometimes they take the company up. Sometimes down. But we want companies that are unlikely to sink. We might in that way 'win the loser's game' of avoiding huge errors. All of the points above, especially 3, 4 and 5, help to tilt our portfolio towards more robust companies that can deal with tricky as well as benign economic and industry climates. Whilst we must form a view on each company, especially for the qualitative factors (4, 5 & 6) where there may be a broad theme or take on the future**, there is little in the way of precise prediction needed to assess these points. Factors 1 & 2 enhance the probability that the dividend can be maintained and grow, key to us for longer-term returns.

The consumer goods sector is one that contains many resilient companies that tick all of the boxes, including holdings like Unilever, P&G and Reckitts. Although more sensitive to the economic winds, the high quality engineers that we look at, for example Spectris, Domino Printing and Rotork***, have low leverage and capital requirements, which help to provide a buffer against lean times. The same can be said for all of our key sectors.

The second part of the process is valuation, and that unfortunately does require an estimate of what might happen in the future. I'll write in more detail about this at a later date, but we try to forecast whilst making as few assumptions as possible. We don't worry about being right on any one year's earnings (we'll almost certainly be wrong). We limit the assumptions we can make. And we think that the first step outlined above (finding the right sort of company through a checklist exercise), helps to lessen the requirement to be dead right on valuation – we can be fuzzy on our valuation forecasting.

Finance – more difficult than physics?

The horrifically complex system that is the global economy looks more unsolvable than any physics problem, even the fabled Theory of Everything. We deal with this by systematically grabbing what we perceive as important, and putting the rest of the information to one side. By doing that, the problem becomes much simpler. It's more a Theory of a Few Things.

A consequence of operating in a highly uncertain environment is that there is always the likelihood of being wrong. We think that the factors we've chosen to focus on will help avoid disasters, and in aggregate will lead to decisions that are good for the sort of dividend & growth investing that we favour. Those same factors avoid the need to make detailed or short term economic predictions, and help insulate the portfolio from the economy.

I should say that it may well be possible to construct a different set of criteria that look to take advantage of economic gyrations, but that's not what we are trying to do. Our performance will likely lag in strong economic upswings, but we hope we'd do better when conditions are more difficult. As we look out towards the next year we continue to 'prepare for the worst and hope for the best', and wish you a merry Christmas and happy New Year.

Ben Peters
Investment Director
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Please note, these views represent the personal opinions of Ben Peters as at 15th December 2014 and do not constitute investment advice.

*If you're interested in this field, Gigerenzer's book "Gut Feelings: Short Cuts to Better Decision Making" is worth a read.

**Hugh's wrote about some of the long-term themes in his September view: http://www.evenlodeinvestment.com/evenlode-investment-view-september-2014/

***We don't currently own Rotork, although the share price action recently is making it increasingly appealing on valuation grounds.