Evenlode Investment View

Wise Funds

JUNE 2012 – THE UPWARD MARCH OF HIGH RETURN BUSINESSES

After a slightly negative month in April, May saw further falls in global stock markets. Although some of these losses have been recouped in June, investor worries remain elevated.

For a bit of perspective, it's worth remembering how quickly sentiment has shifted (yet again) from positive to negative. In mid-March, the strongest narrative in the investment community was one of recovery – particularly for the US economy (this was despite European issues remaining unresolved, just as now). But here we are three months later with the UK market -7%, and thoughts of US recovery dissipated. The market mood is back to where it was last autumn, with all eyes on Europe.

Germany Holds The Key To Europe

"To put it bluntly, we're not going to pay"

Helmut Kohl, 1998

The above quote might well have come from Angela Merkel at some point over the last two years. In fact, it came from her predecessor Helmut Kohl when Germany was under pressure to contribute more to the common European budget in 1998. In the end, despite this assertion, Germany did end up paying and therefore subsidising its neighbours, in their desire to achieve European unity.

What has become increasing clear over the last few months is the extent to which the euro's future lies in the hands of the Germans – will Angela Merkel ultimately agree to 'pay' for a continued currency union? There is now a reasonable amount of agreement amongst commentators over the steps needed to resolve the crisis. These include a recapitalisation of the banking system, an unlimited backstop from the ECB behind solvent nations (a 'firewall'), and a move toward a more federal Europe – including some form of debt mutualisation (i.e. 'eurobonds').

The problem is that pushing these measures through requires serious subsidy from the Germans. While there has been a noticeable softening of Germany's tone over the last month toward their troubled neighbours, the gap between Germany's current position and what is needed to restore confidence remains huge. As a result, this crisis still appears to be some way from a resolution. I continue to think that part of the plot denouement is likely to be large-scale debt monetisation over a multi-year period (whether the eurozone remains in its current form or not). And despite all the deflationary pressures in the world, it is worth noting that inflation continues to tick along at a reasonable rate (+2.3% in Europe, +3.0% in the UK and +2.3% in the US). In my view the risk clearly remains that these inflation rates may increase significantly over the next decade, even if they fall back before heading higher.

A Massive Stimulus Has Quietly Occurred

One of the reasons given to explain June's better stock market has been a growing sense that central banks will act to pump more money into the global financial system. While this will probably transpire, the global economy has already received a massive stimulus over the past three months – not from central banks, but from the steep fall in the oil price and other commodities. As strategist Francois Trahan recently pointed out, a combination of falling long-term interest rates and the falling oil price gave the US economy more stimulus in the month of May than at any time since 2009, and many US economic leading indicators remain very positive.

This is a counter-trend factor worth bearing in mind, just as it was in the autumn of last year. As I have discussed in previous monthlies, economic cross currents have been running at a particularly high level since the financial crisis of 2008-9, and inflection points in the business cycle have become more frequent.

The current situation in both Europe and China adds to this choppiness and it makes for a disorientating investment environment. I continue to believe that an objective, long-term approach is the best defence against this uncertainty, and a good way of avoiding being sucked into Mr Market's mood swings.

The Upward March of High Return Businesses

With all this to-ing and fro-ing, it's worth remembering just how capable high quality companies remain of producing fundamental progress, despite the inclement backdrop.

Halma last week released results that exemplify this point. Thanks to the company's strong market positions and focus on relatively non-discretionary sectors (healthcare, energy and water, health & safety regulation) the business has sailed through the last five years of economic hardship*:

Year	Earnings	Dividends
2007	+7%	+5%
2008	+10%	+5%
2009	+12%	+5%
2010	+11%	+7%
2011	+22%	+7%
2012	+19%	+7%

This record is particularly impressive given that the majority of the group's geographical exposure (more than 75%) remains in the 'old world' where economic growth has in general been hard to come by.

The Virtuous Circle of Reinvestment

Specialist engineering company Halma is a perfect case study for the favourable results that come when a business steadily reinvests cash-flows at high rates of return. It's a business run unashamedly on a long-term basis – as management puts it, very simply, "we develop market positions with a horizon of ten years or more". So, in the face of the downturn, Halma's research and development budget has nearly doubled (from £15m in 2007 to £27m this year). The company has also steadily pursued various other growth initiatives including expansion in Asia and South America, acquisitions to strengthen its product range, and a new graduate recruitment programme (not something many organisations could say they've done in recent years – just ask any graduate!). All this growth has been financed by internally generated cash-flow, and as a result Halma as a business remains virtually debt free. Not bad for a business that has also grown its dividend by +5% or more every year for the last 33 years.

We are very attracted to businesses able to make these long-term investment decisions despite the short-term uncertainty. Although it depresses operating results today, it increases the long-term compounding potential and strengthens competitive position – the strong grow stronger. In cases such as Halma and many of our consumer staples stocks, investments made in this downturn are already visibly driving operating results forward. In other cases, such as engineering consultancy WS Atkins, recent self-funded growth investments have clearly strengthened the business model. However, depressed markets are hiding this progress from reported operating performance (earnings have flat-lined since the downturn). The real benefits will only start to fully show up when the industry ultimately returns to growth.

As an aside, this constant reinvestment and expansion of cash-flows is not a characteristic that bonds and cash can boast. In a world where these low-volatility assets are highly cherished, it is worth remembering that good stocks do have this very significant long-term advantage of flexibility and evolution. An investment in Halma is an investment in a productive asset backed by more than 4,000 individuals working hard to increase future returns by adapting and evolving to changing market conditions. This is not something that could be said of 'safe haven' assets such as UK gilts or cash accounts.

The Building Blocks of Return

Despite performing well from both a fundamental and share price perspective, Halma remains attractive on our cash-flow valuation methodology. It also offers a starting yield of 2.8% with plenty of potential for long-term growth in this dividend stream. More generally, thanks to current economic uncertainties, the market is serving up some quality franchises on high starting dividend yields backed by strong cash generation. Evenlode's top ten holding are as follows*:

Stock	Dividend Yield	Ten Year Dividend Growth Per Annum
Unilever	3.9%	9%
Glaxosmithkline	5.3%	6%
Procter & Gamble	3.7%	11%
Reckitt Benckiser	3.9%	17%
Sage	4.3%	37%
Johnson & Johnson	3.7%	12%
Diageo	2.9%	6%
Pearson	3.8%	7%
Reed Elsevier	4.9%	7%
Imperial Tobacco	4.7%	14%

This list sports an average dividend yield of 4.1% and average ten year dividend growth of 13% per annum. Given the resilience of these businesses, their global diversity and their attractive economics (an average return on equity of 28% and operating margin of 26%), I think dividend growth prospects remain strong. The fact that this group of stocks trades on an average 8% free cash flow yield also suggests room for growth. This combination of starting yield and growth potential should provide two very important building blocks for total return over coming years.

When compared with bonds and cash (both assets whose real value will likely be eroded by inflation over the next decade), I would much prefer my long-term savings to sit in quality stocks (as they do). In regard to market uncertainty, as I said in January our approach is to 'prepare for the worst but hope for the best'. So far, although the year could have been worse, it has been pretty tough from a sentiment and macro-economic perspective. But the fundamentals of Evenlode companies are in aggregate ticking along quite nicely. When conditions ultimately improve, these businesses should thrive.

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

**Source: Canacord Genuity Quest*