Evenlode Investment View

Wise Funds

JUNE 2013 – INSULATION IS BETTER THAN SPECULATION

An Inflection Point For The Market

After a relentless rise, almost unbroken over the last year, stock markets have finally started to give back some of their gains this month. As I have discussed in recent monthlies the backdrop of rising valuations, deteriorating fundamentals and a continuation of underlying structural problems has steadily increased risks as the year has progressed. In the end it took hints from the Federal Reserve that US quantitative easing may be reigned in to unseat Mr Market's bullishness. The accompanying sharp rise in bond yields (albeit from a tiny level to a slightly less tiny level) and falls in emerging market currencies have compounded the negative sentiment.

A Maze of Mirrors

At times like these, faced with a huge number of crosscurrents, I am particularly glad that we do not 'place bets' based on a short-term view of the next market move or the next wobble up or down in global economic trends. While an extremely difficult task at the best of times, in light of the current backdrop this prediction game is analogous to navigating your way through a maze of mirrors. On the one hand the highly deflationary forces of debt deleveraging continue to rumble on in the background. On the other hand huge (and potentially very inflationary) monetary and fiscal interventions continue, notwithstanding recent noises from the Federal Reserve.

I have just re-read one of my favourite economic books, *The Great Depression: A Diary*, written in the 1930s by Benjamin Roth, a young lawyer in small-town America. It is an inimitable account of what it felt like to live, work and invest through this period. While the current economic backdrop is by no means as extreme as the 1930s (the US economy, for instance, was cut in half between 1929 and 1932), it is hard to ignore the parallels. From 1932 until the Second World War the business environment was depressed but choppy, with plenty of green-shoots, false dawns and reversals of trends. And like today, this volatility was framed by an overarching tug-of-war between debt deflation and government stimulus (via Roosevelt's New Deal). Below is an extract from Roth's diary in October 1937 which sums up the confusions. In early 1937, for all Roth knew, it seemed that the economy had finally reached some kind of 'escape trajectory' out of the terrible deflationary years of 1929-1935. But by Autumn 1937, trends had reversed yet again:

I have made no entry for several months because business seemed to be normal and it looked as though it would continue for some time. About six months ago, however, the stock market had a bad break and since then it has gone steadily downward with hardly a pause until now almost all the gains for the past year have been wiped out. There was no slump in business and no warning. Since then business has slumped and everybody is pessimistic.

And a few weeks later...

The stock market break which has continued since early in September resulted in the worst break since 1929. It is generally believed that business will be slow this winter. There is fear and pessimism in the air. Nobody seems to be able to explain why it happened. Most popular reason is that prosperity of past 2 years was a false prosperity built on government expenditures and now it has collapsed.

As it happened, business conditions and the stock market began to pick up again the following Spring, but that fact is only easy to predict in hindsight.

Insulation is Better Than Speculation

I remain of the view that both a prolonged period of recession/deflation *and* a significant pick-up in inflation are risks worth taking seriously. But I would not be willing to bet my savings on either scenario prevailing. Part of the reason I chose the approach we use to manage Evenlode is that intangible asset businesses are well equipped to cope with the full spectrum of economic conditions. In terms of deflationary episodes, this was demonstrated most recently in the 2008/9 downturn (a period for which on aggregate the current holdings in Evenlode produced positive earnings growth in both years). Asset-light, intangible businesses also performed very well in The Great Depression, producing both a positive nominal and real return between 1929 and 1935 in the US (although not without some volatility along the way!)*. But as Warren Buffett has often pointed out**, this category of stocks was also one of the best for protecting against the rampant inflationary conditions of the 1970s, thanks to both their limited needs for incremental investment and pricing power.

In Search Of Scarcity

The key to this fundamental resilience is scarcity. Businesses rich in intangible assets have by definition accumulated a complex set of characteristics over a long period of time: brand recognition, trust, deep customer relationships, reputation, accumulated research and development, highly skilled employees, intellectual property; distribution networks etc. All these traits make them very hard to replicate and therefore unique. With this uniqueness, or scarcity, comes pricing power and the ability to cope well with both deflation and inflation.

To give some real-life examples of pricing power and scarcity at work, here are a few recent snippets from some Evenlode companies:

Beverages:

Diageo's Latin American management provided an extreme example, from Venezuela this year, of the importance of owning scarce assets when high inflation strikes:

Economically, Venezuela's currency was devalued by -46% and saw +17% inflation, the highest 6 month inflationary period in the last 5 years. During this period, the prices of Diageo's imported products increased by +80%, with local products increasing by +20%. Notwithstanding these price increases, our business has maintained its leading position within the market, with a 57% value share in scotch, 50% in rums, and 26% on imported vodkas. Some of our leading import brands have hit important milestones, including Buchanans Masters, achieving 75,000 cases in the year; or both Gordon's vodka and Gordons Gin surpassing 100,000 cases.

To continue to see robust volume demand is impressive in the context of these huge price increases. It is testament to the scarcity value that consumers attribute to Diageo's brands.

Software

Software providers, particularly to businesses, become very embedded in their customer's working lives. As with the spirits industry, customers become unwilling to switch from one provider to other. This produces a perception of scarcity, and with it comes pricing power and healthy margin structures. Consider the following comments:

The software industry has not been commoditised and can defend pricing well, and that is true in our segment as well other segments of the software industry. We do not see endemic price wars. It's competitive on a deal by deal basis, but we have a good ability to defend our prices, and our price increases stick.

Guy Berruyer (CEO, Sage)

If you do deep software services and if you have things that are unique for businesses (which is a particular strength of Microsoft), the software business is an amazing business to be in, both in terms of growth and the profitability dynamics.

Bill Gates (Chairman, Microsoft)

Consultancy

This is an area we have become increasingly interested in. The best consultancy businesses provide hard-to-come-by expertise and knowledge that can help businesses manage complexity and reduce cost. Accumulated expertise and long-term relationships with customers is what gives these businesses their uniqueness. Consider the following comment this week from Uwe Krueger, CEO of WS Atkins:

Today just over half of the world's population live in urban centres – this will grow to 75% in coming years. This is happening in the developing countries, and it's very important we get it right. We shape in a responsible way how people live and work in the future in these urban centres. There are not many companies in the world that have this knowledge of urban planning, master planning, architecture, transport-oriented development, engineering and water and waste-water engineering and design. We can bring this all together, and we are finding ourselves more *and more in demand for applying this expertise.*

Several commentators have recently suggested that the post 2008/9 environment has set the scene for a big bull market in 'scarcity' (scarce assets such as market leading businesses and gold can't be created at the click of a button - monetary assets such as currency and bonds can)***. I'm not sure whether this will turn out to be true. But I would make a more general point - as long as their starting valuations are sensible, businesses with scarcity value are *always* well placed to outperform over the medium and long-term.

Where We Stand Today

As I have discussed previously, rising stock prices have meant a narrowing of the opportunity set in our investable universe. This has led us to become more selective and the number of holdings in the fund has dropped from 34 to 29 since the start of the year (with exits from Nichols and British American Tobacco completed in May). At the same time, we have trimmed back some of the better performing holdings in the fund. Proceeds have been recycled into existing holdings where we see the best combination of quality and valuation support (healthcare, media and technology stocks have been a particular focus over recent months).

The current sell-off has not significantly changed our view on relative valuations so far. However, if the current correction continues we would not be surprised if opportunities re-emerge in some of the stocks we have sold or significantly reduced over the last eighteen months. Many of the stocks in question have a high exposure to emerging markets and/or are at the more economically sensitive end of our investable universe. They might well see relative weakness in the current market.

With the early signs of some market turmoil emerging it is worth reminding our investors, particularly those newer to Evenlode, that we remain patiently disposed, objective at all times, and unashamedly focused on the long-term. I share Charlie Munger 's sentiments on how to succeed over time. When asked recently about what life lessons could be learnt from the 1930s, he replied that *the people who plugged well and just kept plugging eventually did fine.*

We continue to plug away...

Hugh Yarrow
June 2013

Please note that the above represents the views of the author as at 20th June 2013 and does not constitute investment or financial advice.

*E.g. Lawrence Bloomberg, *The Investment Value Of Goodwill*, 1938
**E.g. Berkshire Hathaway Annual Report 1983 (Appendix), *Goodwill and Its Amortisation, The Rules and The Realities*
***Dylan Grice, for instance, elegantly framed this argument recently in his article *Will The Real Peter And Paul Please Stand Up*