Evenlode Investment View

Wise Funds

MAY 2013 – YIELD PIGS: THE BALANCE BETWEEN QUALITY AND VALUE

The Grand Disconnect

Since August 2011, with only a slight speed bump last summer, stock markets have been steadily grinding higher, now up nearly +45% over this period of less than two years. Since March 2009, when the market hit rock bottom in the middle of the financial crisis, the FTSE Allshare has risen nearly +130%.*

In stark contrast to this revived momentum, however, little progress is being made on the economic front. Nearly five years have passed since the height of the financial crisis but the global economy is stuck in a low gear. European economies remain in recession, Japan is barely growing, Chinese growth is slowing and the US economy is underperforming. The term 'Grand Disconnect' has entered usage as a way of explaining the gap between soaring stock prices and struggling economies.

Conditions in the corporate sector are healthier, but this is more a reflection of cost cutting, lower interest costs and reduced investment rates than much in the way of genuinely sustainable volume growth and/or pricing power**. Recently announced first quarter results reflect a continuation of this trend. Outside of emerging markets and the odd niche product line, underlying revenue growth of more than a few percentage points is a rarity for most global businesses.

As many commentators have noted, this drop in labour, interest and depreciation costs has led to profit margins at or close to record highs in many parts of the world. How sustainable these 'new normal' margins prove to be remains an open question. As the economist Gary Schilling put it recently, 'in a democracy neither capital or labour gets the upper hand indefinitely'. Corporations have the upper hand for now, but employees around the world continue to see their real (i.e inflation-adjusted) disposable incomes head lower. At some point this process is likely to reverse.

Mr Market isn't too bothered (for now at least!) about these economic realities. The search for yield is gathering pace as an increasing number of savers get frustrated. When you can't find yield from a bank deposit or from government and corporate bonds, all roads lead to equities. As I have said many times before, the appeal of 3-4% starting dividend yields with some inflation protection is highly compelling given the alternatives on offer. But this narrative gets even more compelling with momentum in the market. The opportunity cost of standing on the side lines is high in a stock market that is posting annualised returns at a rate of +25% or more.

Yield Pigs: The Balance Between Quality and Value

Rising markets have their own peculiar risks, just as falling markets do. But perhaps the hardest thing to do at *all* times when investing, is to remain objective. In terms of running Evenlode, the fact that the market has risen nearly +130% since its 2009 lows is not particular useful. This market rise is in the rear-window now, and tells us nothing about current valuation.

The most important considerations for us are:

(1) How much cash flow we will receive in the *future* from the stocks we invest in *today*?

(2) How confident are we in our estimates of future cash flow?

The first consideration relates to valuation, the second to quality, and it is a balance between these two factors that we are looking to retain. With this in mind, I remain very reassured by the current Evenlode portfolio. In terms of quality, Evenlode is full of companies with great global franchises, high returns on capital and strong balance sheets. In aggregate, the companies in the portfolio have grown earnings each year since the financial crisis, including 2008 and 2009. In terms of value, the current free cash flow yield on the portfolio (after both maintenance *and* capital investment) remains at 7%, and cash flow should grow nicely over coming years (just as it has over the long-term history of the businesses we invest in) thanks to a combination of modest volume growth, geographical expansion, modest pricing power, operational leverage and capital efficiency. Moreover, in many cases current free cash flow yields are depressed by heavy investments in geographical expansion, due to both operational and capital expenditures. The portfolio's current free cash flow yield would be significantly higher if management teams ran their businesses (private-equity style) to maximise short-term cash-flows, and this investment were reigned in. But as long-term investors we would far rather Unilever, P & G, Reckitts et. al. continue to reinvest significant amounts of capital in emerging markets, which look set for years of strong growth at very attractive returns on investment. As P & G put it recently, we are on the precipice of one of the greatest trade up cycles the world has ever seen.

However, as the market continues to rise, we are the first to admit our job gets harder. Seth Klarman in his great book Margin of Safety coined the phrase 'yield pig' to characterise a dangerous type of investor behaviour in bull markets. As yields steadily compress, yield pigs are tempted to take on more risk and buy increasingly low quality assets to 'reach for yield' and achieve their optimistic targeted returns. This is a strategy that can end painfully for obvious reasons. Buffett made a similar point in a television interview last week, having likened yield-chasing behaviour to picking up pennies in front of a steamroller. He was talking specifically about current investor behaviour in the bond markets, but the point is equally relevant in the stock market:

Yeah, chasing yield is crazy. You know, just because you'd like to earn eight percent, or you'd like to earn ten percent, the world isn't going to adapt to that. You have to think about what is the most intelligent thing to do and if that produces five percent or six percent, that's the best you're going to do. But to get enticed into some investment that is riskier or that you don't fully understand because somebody promises you a higher yield? I mean, you know, I can take it down to the waterfront and they'll promise you 15 percent or something. But that's unlikely to be a good investment.

So while our valuation discipline has led us to exit several stocks over the last year (Intercontinental Hotels Group, Experian, Halma, Euromoney, Diploma, ITE Group etc.) and to reduce several others, we have only done this where we can replace this exposure with holdings that offer similar quality characteristics but better valuations. We do not want to become yield pigs!

In many cases the stocks we are moving towards have been tarnished by specific problems that investors sense will hold them back in the near future. Mr Market's reluctance to commit capital to ideas that look like 'dead money' in the short term is in our view an opportunity. It tends to be the only way to buy really high quality businesses at attractive valuations.

As Joel Greenblatt (an investor who had a significant influence on the design of the Evenlode investment process) put it recently:

What people tend to avoid are companies that aren't expected to do quite so well in the next year or two. Those are systematically avoided because most managers are trying to make money now. Whether they have a long-term horizon or not, their clients typically don't.

Several stocks in the portfolio have fallen into that category at times over the last year or so. Some of these stocks have begun to see sentiment turn, while others are still languishing. They include holdings such as:

(1) **Pharmaceutical holdings Glaxosmithkline, Astrazeneca and J & J** (blockbuster drugs coming off patent, declining productivity from R & D expenditure in recent years, severe pricing pressure in Europe)

(2) **Pearson** (restructuring programme and shift to digital business model creating short-term costs and uncertainty)

(3) **Smith & Nephew** (loss of market share in hips and knees, general pricing pressure in the medical

devices industry, US medical devices tax)

(4) **Sage** (high exposure to Europe, uncertainty regarding the move to cloud software products)

(5) **Procter & Gamble** (underlying organic sales growth underperforming peer group, questions over management)

(6) **Reed Elsevier** (The Cost of Knowledge petition, the threat of open-access journals, tough conditions in legal markets)

(7) **Imperial** (Tough conditions in European markets, increasing regulatory pressure)

(8) **Microsoft** (Declining PC sales, lukewarm reception to Windows 8)

What unites these companies is that recent negative news-flow has done little to change our already conservative estimates of the future free cash-flows these businesses will generate. Relative underperformance has therefore given us the opportunity to recycle money into these stocks, thus retaining attractive quality and value credentials for the overall portfolio.

Another well know investor, David Einhorn, described the benefits of this type of patient, risk aware investment approach in his book 'Fooling Some Of The People All Of The Time':

The traditional investment horizon is too short because equities are long, if not indefinite–duration assets. When we make an investment, we usually don't have any idea how long we will be invested. If the downside of an opportunity is no short-term return or "dead money", we can live with that. In practice, some "dead money" opportunities work out more quickly than we expect. A portfolio where some investments work quickly, some work slowly, and the rest retain their value generates exciting results. The trick is to avoid losers. Losers are terrible because it takes a success to offset them just to get back to even. We strive to preserve capital on each investment. It does not always work out that way, but that is our goal.

I couldn't agree more.

Hugh Yarrow
15th May 2013

Please note, these views represent the personal opinions of Hugh Yarrow as at 15 May 2013 and do not constitute investment advice.

*Source: Financial Express. FTSE Allshare Total Return, 10th August 2011 to 15th May 2013 +43.7%. 9th March 2009 to 15th May 2013 +128.0%

**E.g. Credit Suisse, The Dark Side of Zirp, Neal Soss, November 2011, Page 12. 'Unit profits' (i.e. profits per unit of gross value added - a proxy for the aggregate profit margin) in the US rose by +72% between 2009 and 2011. Diminished interest expense amounted to 38% of the margin expansion, compared to 35% for unit labour costs. Higher prices and low depreciation expense made smaller contributors (9% and 18%, respectively).