Evenlode Investment View

Wise Funds

OCTOBER 2011 – A LESSON FROM HENRY SINGLETON

It's Grim Out There

The current worry-list for investors is a long and rapidly changing one. When the stock market began to fall at the end of July, much of the focus was on the US - specifically its debt ceiling and the loss of its AAA credit rating. Ironically, however, US Treasuries and the US dollar have rallied hard since the US debt downgrade at the beginning of August, as investors' fears turned back again to Europe, and specifically Greece. I wrote the following, on Greece, back in April 2010 (*Headwinds Return and The Case for Quality Revisited*):

"Probably the best outcome for Greece's (and the euro's) long-term future would be an immediate debt restructuring – looking back through the history of emerging market credit crises, countries that restructure early are the quickest to recover and return to international lending markets. An orderly restructuring would also signal a political body in control of its destiny and help stem contagion risk, which currently looks like an open wound ready to spill more blood. However, both the Greek government and the EU seem resolutely against this outcome. As a result, the 'solution' is a rescue package that kicks the can a little further down the road, and austerity measures that sound good in theory, but will be very difficult to execute (given the lack of will in the Greek public to accept these measures). Even if a bailout package is enough for Greece to fade into the background for a while the basic problem – too much debt and not enough income – remains. Another worry is that the European banking sector is very highly exposed to the sovereign debt of southern Europe – this presents a clear risk of deflationary consequences for not just the European economy, but also the global economy."

Here we are, 18 months on, and little progress has been made. The Eurozone *as a whole* is not actually in terrible shape – debt to GDP ratios are lower than the US. The problem remains two-fold: a lack of fiscal unification, and a lack of political will to admit that a handful of countries are insolvent (Greece, Portugal and probably Ireland). A restructuring of these countries' debts is essential, combined with policymakers doing everything in their power to build a firewall round the remaining, solvent Eurozone nations. Only time will tell how effectively policymakers grapple with these key issues in the coming months, but it will be a steep, uphill climb for them.

In September a third worry, concerning a Chinese (or more generally emerging market) slowdown started to flash on Mr Market's radar. Resources stocks and emerging market growth stocks fell accordingly. This risk is one that we have been concerned about for some time. However, if these worries intensify, and all things 'emerging market' are abandoned in the process, there should be some good opportunities to deploy capital in some excellent long-term growth businesses.

A Lesson From Henry Singleton

When things look miserable, like they do today, it's worth remembering the old city saying that 'you make your money in a bear market, you just don't realise it at the time'. This point has never been made more clearly than by a man called Henry Singleton. He attempted to buy back his entire company in the torrid market of the early 1970s, to great effect for shareholders. I retell his story here because of its relevance to today's tough market conditions. It is a reminder that, for self-sufficient businesses (i.e. those able to fund their own operations from free cash flow), a low stock price is an opportunity rather than a reason to panic.

Warren Buffett once described Singleton as 'the man with the best operating and capital deployment record in American Business'. A scientist and electrical engineer by training, he was one of the great polymaths of the US corporate world of the 1960s, 70s and 80s. It was said that he could read a book a day and play chess blindfolded. In 1960, age 43, Singleton founded his investment vehicle, Teledyne. As its share price soared over the next decade, he took advantage of Teledyne's highly rated stock price to raise fresh equity and amass 130 acquisitions, in the process building a conglomerate ranging from electronic components to high fidelity speakers. It was a motley assortment of businesses, but the key that united them was an unending, razor sharp focus on one idea – the rational allocation of capital at an attractive rate of return. In a Forbes magazine article from 1979 Singleton outlined this approach:

"Everyone at Teledyne now understands that all new projects should return at least 20% on total assets. When leveraged up, return on equity can be 30% to 50%. This is so ingrained that few lower returning proposals are ever presented anymore. We hardly ever discuss one".

Now, the most interesting bit of his story starts in 1972, when stock market and economic conditions started getting very depressed. Singleton simply looked around at the best opportunities he had to deploy capital in the business, and concluded that buying back Teledyne stock was the most attractive option. Singleton's great share buy-back is recounted by Forbes:

"Maybe because of his unusual background, Singleton had an uncanny ability to resist being caught up in the fads and fancies of the moment. Like most great innovators, Henry Singleton is supremely indifferent to criticism. During the early Seventies, when investors and brokers alike lost their original enthusiasm and deserted Teledyne, Singleton had Teledyne buy up its own stock. As each tender offer was oversubscribed by investors of little faith, Singleton took every share they offered. When Wall Street – indeed, even his own directors – urged him to ease up, he kept right on buying. Between October 1972 and February 1976 he reduced Teledyne's outstanding common by 64%".

Helped by this monumental buy-back, Teledyne earnings per share rose +1226% between 1969 to 1978 – more than 30% per annum. Given the economic conditions over the 1970s, and given that Teledyne was already a big business in 1969, this was no mean feat. And it wasn't the end of it. Singleton continued to buy back Teledyne stock right up until 1982, with the world on the threshold of a great 20 year bull market for equities, even if it didn't feel like it at the time. By this point only a quarter of the Teledyne shares outstanding in 1972 remained.

A Thought Experiment – How Microsoft Could Eat Itself

Henry Singleton died in 1999, but for the purposes of a thought experiment, let's imagine that he were put in charge of one of the big corporations of today – Microsoft, for instance. He could, I suspect, produce some rather spectacular results over the next decade or so.

Singleton might first turn his attention to the $50 billion of cash sitting on Microsoft's balance sheet. He might look to use the company's AAA credit rating to borrow money against this cash to buy back shares. This was exactly his approach at Teledyne during the early 1970s. Raising $50bn and putting it to work would dispense of nearly 25% of Microsoft's issued shares. This would leave a business with an equity value in the region of $150bn, generating close to $25bn of excess cash flow for shareholders each year. Even if $10bn of this were paid out to shareholders as dividends each year (giving a healthy 6.5% yield versus the current 2.5%), Singleton could still put $15bn to work buying in more Microsoft stock, thus increasing the economic value of each share to continuing shareholders.

If we took the above example to its logical extreme, we could imagine, come 2021, Microsoft ending up with just a single share in issue, having bought back the other 8 billion or so over the decade. Doubtless Singleton would be left as the last remaining shareholder. Let's also imagine that, in 2021, the business made what it does today in after-tax earnings – more than $22bn. As the last remaining shareholder, he'd be entitled to all of it! He'd have seen earnings grow from $2.70 per share today to more than $22,000,000,000 per share in ten years' time, quite a return! Singleton could sit back with pride – Microsoft would have successfully eaten itself.

Now, we're the first to admit that things are unlikely to work out as above. Even the mighty Singleton failed to make it down to one Teledyne share. Along came 1982, the market realized he was onto something, and the share price soared. Also, Microsoft isn't run by Henry Singleton. The risk of capital misallocation in this stock is one that we, as shareholders, are watching carefully – Singleton, for instance, would not have approved of the Skype takeover offer back in May (8x price to sales ratio).

However, there is a general point here, and it applies to many of our current holdings – particularly in the technology, media and healthcare sectors. They are resilient businesses, generating very healthy cash-flows relative to their share prices, despite the tough economic backdrop of today. These low share prices can be used to the shareholder's advantage - and many of the businesses we own are buying back stock at quite a rate.

So, things might look horrible at present, but we'll leave the last word to Henry Singleton - *"I don't believe all this nonsense about market timing. Just buy very good value and when the market is ready that value will be recognized".*

Hugh Yarrow
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Please note, these views represent the personal opinions of Hugh Yarrow as at 10 October 2011 and do not constitute investment advice.