Evenlode Investment View

Wise Funds

OCTOBER 2012 – REINVESTMENT OPPORTUNITIES TO OUTLAST THE CRISIS

Better Cyclical News….But Same Old Story

Global markets have been enjoying several months of calm. The end of May feels like a long time ago – at that point the European financial system was on the brink of failure and the risk of widespread depression loomed large. Along with the breathing space that Europe has been given thanks to monetary policy action, perhaps the most helpful feature of recent months has been the improvement in the US economy. Falling inflationary pressures over the summer have helped boost consumer confidence, the housing market is improving, retail sales are strengthening and the recent increase in US oil and gas production not only reduces the trade defecit, but also helps keep inflationary pressures at bay.

Despite these incremental positives, however, none of the world's structural problems have gone away. In the west, deflationary pressures from deleveraging rumble on inexorably. Europe remains mired in recession and the situation in southern Europe is awful. In the east, China's economy remains unsustainably dependent on construction and infrastructure investment, and its slowdown has become increasingly widespread over recent months.

It's Confusing At Times – But This Recovery Is Going To Script!

In the face of all these cross-currents (some positive, some negative) it is worth remembering that although the current global 'recovery' from the 2008 /9 recession feels quite alien to anyone who has spent most of their adult life in the developed economies of 1980 onwards, it is actually closely following the longer-term historical precedent. Economists Kenneth Rogoff and Carmen Reinhart published This Time Is Different in 2009, a study of previous banking crises and subsequent recoveries, going back more than 200 years. Their analysis showed that these recoveries tend to be far more muted and drawn out than those from inventory recessions (the sort more common in the developed world since the Second World War). And as Rogoff pointed out in a recent interview, this crisis is panning out pretty much perfectly to script:

"Carmen Reinhart and I have been very careful to frame our work as looking at historical benchmarks and not making predictions. We haven't made predictions. But we can say that we're tracing the historical benchmarks in this crisis if you look at an array of statistics from unemployment to housing, equity, debt – and you look at the crisis centre countries, some have done a bit worse, some have done a bit better. But it's very, very typical relative to the benchmarks."

….and Rogoff's benchmarks suggest more of the same dull plodding might well be in store…..

"It wouldn't be surprising if global growth was a per cent lower than normal for another six or seven years at least. It's possible that growth in emerging markets will make up for that, but there are big headwinds from the overhang of debt. It's not going to happen in a year. We're way out in the future here."

…..but as Rogoff also notes, this subdued environment doesn't stop market participants and policymakers getting very excited now and again!:

"Wall Street and central bank economists during the crisis again and again – once there was a little bit of good data - would say 'we're off to the races, we're going to start booming now'. At first they said the economy was going to grow very fast then, after a year or two, that it would grow a little slower. Then, every time the data got a little bit better they'd say it was going to be a V-shaped recovery. Of course it's possible: there are uncertainties here. But they've been repeatedly overly sanguine, just as some of the doom-and-gloom types have said every time there's some bad data, that we're about to have a giant recession. That's an overstatement too."

This 'over-projection' by Mr Market – in both the optimistic and pessimistic direction, is becoming a signature note of the post-crisis era. At the moment, we are in a more optimistic phase, with stock markets having risen by a decent amount over the last year or so. As a result volatility is low and the Pollyannas are beginning to find their voice. But inevitably, the Eeyores of the investment world will have their moment in the sun again too.

Reinvestment Opportunities To Outlast The Crisis

Our strategy does not involve attempting to make predictions of this sort. For long-term investors, I return to the point that I have made several times over the last three years – provided stocks are bought and held at sensible valuations, it is the fundamental economics of the business that will drive the bulk of stock performance as time goes by, not fluctuations in price and valuation. As Benjamin Graham said, the stock market is a voting machine in the short run but a weighing machine in the long-run.

So, for instance, a purchase of Reckitt Benckiser 20 years ago (in 1991 – still Reckitt and Coleman at the time) would have done very well. The stock has given shareholders a +900% total return versus +433% for the UK market. This very attractive return (of which any fund manager would be proud!), has come despite the fact that the stock's no more expensive than in was then, so no benefit from a re-valuation (in fact valuation is slightly lower today – the PE multiple is 15x compared to 16x in 1991*). As valuation is the only 'psychological' element of investment return, Reckitt's stock performance therefore has had nothing to do with prevailing investor sentiment over that period (whether consumer staples have been in or out of fashion etc.). All the return has been purely down to fundamentals (i.e. cash-flow growth and dividends).

How did Reckitt's achieve this performance? A strong brand portfolio and increasingly global footprint is the short answer. These factors have given the business steady volume growth, the ability to raise prices over time, and the ability to reinvest at high rates of return. Shareholder's equity (i.e. the total amount of shareholder capital invested in the business) has increased by approximately 8x over this 20 year period as the company has invested in physical assets, working capital and acquisitions to drive the company's growth. But – and this is the really important bit – the return that Reckitt's makes on this capital base has averaged nearly 30% over the period, and remains at similar levels today, despite the invested capital having grown by such a large amount. A business that can grow its capital base at a good rate while maintaining high returns on capital is a rare and valuable thing. In our view, such stocks should be cherished and deserve considerable patience (along the winding road of character-tests they will inevitably take you on!).

I continue to feel positive about the number of long-term reinvestment opportunities in the portfolio today, and therefore the prospects for fundamental returns. The clearest example is for consumer branded goods holdings in emerging markets (including Reckitts, but also Unilever, Procter & Gamble et al). As I have said before, all these businesses have been investing heavily in building their distribution and brand portfolios in these regions, which are now home to 6 billion of the world's consumers, versus 1 billion in developed markets. Unilever's capital expenditure, for instance, has increased from 2% to 4% of sales over the last five years – almost all due to emerging market investment – and is likely to stay at this elevated level for some time. Some of these emerging market footprints are now very well established. Unilever's distribution network in Indonesia, for instance, is bigger than that of the Indonesian Postal Service. And Hindustan Unilever's Shakti scheme in India is the biggest direct to-home retail operation in the world, with more than 50,000 Shakti women selling Lifebuoy soap etc. to c500m people in rural areas. Other distribution networks are yet to reach critical mass, but in all cases the long-run potential for rising revenues, margins and returns on capital is compelling. Growth will not be in a straight line, but there will be plenty of it. The number of washing machines in emerging markets is set to more than treble by 2020. Over the same period, the number of toilets and microwave ovens are set to double. If you own the royalty stream to brand leaders in repeat-purchase categories such as washing powder, toilet cleaner and ready meals, you're well placed to benefit.

Most other businesses in the fund share a similar potential for compounding cash-flows in some shape or form – mainly by way of expanding geographic footprints and product offerings. Experian is steadily expanding its data analytics services into new regions and new sectors of the economy. Pearson has years of compounding growth available to it. As management recently put it 'this is a once in a lifetime opportunity to build a market leading business in global education – the growth market of this generation'. In the last 12 months Pearson has invested $450m just on organic development of its education programmes. This is more than the amount spent by its 3 major competitors combined. Even cyclical businesses such as Hays, WS Atkins and Severfield-Rowen continue to invest meaningfully in future growth, despite current difficulties in their respective industries.

The benefits of these reinvestment opportunities won't always show up in the next quarter or two, and there will also be the odd poor allocation of capital along the way. But it's worth remembering that the snowballing effect of reinvestment works quietly away in the background for these businesses, and what might seem like pedestrian progress on a monthly or yearly basis can add up to very satisfactory returns as time goes by.

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

*Full interview can be found here – http://www.emergingmarkets.org/Article/3102673/Economics-and-Policy/KENNETH-ROGOFF-Heres-why-this-recession-lasts-so-long.html (quotes edited lightly by me to make it more readable).

*Reckitt's average PE multiple over this 20 year period was 18.3x. Source: Factset.