Evenlode Investment View

Wise Funds

OCTOBER 2013 – MR MARKET'S MYOPIA

Markets have wobbled around over the last month, not helped by the two week US government shut down and some serious brinkmanship in Washington as politicians left it to the midnight hour before finally reaching a compromise agreement on lifting the debt ceiling.

Meanwhile, the economic picture looks reasonable, though mixed. The US and other western consumers are currently enjoying a much-needed boost to their disposable incomes in the form of falling commodity prices. In the 'emerging world', on the other hand, many economies have been slowing over the last six months. This is particularly the case in more commodity-related nations such as China and Brazil (if you can still call these nations 'emerging'), but more broadly the build up of several years of strong wage growth and buoyant conditions has placed some inflationary pressures on several significant fast-growing economies and have put a dampener on consumer and business confidence. As a result, many global companies have announced slowing sales during the third quarter (although the picture remains very mixed, with pockets of strength here and pockets of weakness there).

The New Narrative

As a result of the above developments, a clear narrative has emerged for the investment community; buy developed markets (and more specifically buy developed market exposure with economic sensitivity) and sell developing markets. While this trend has benefited several significant holdings in Evenlode (e.g. Hays, WS Atkins and Halfords), many of the consumer branded goods companies we own have suffered share price falls as emerging market exposure has turned from an asset to a liability in the eyes of Mr Market . Unilever has been particularly weak over the last few weeks not helped by issuing, at the end of September, slower than expected revenue guidance for the third quarter.

Mr Market's Myopia

While it's never fun to watch the share prices of equities you own (and cherish) such as Unilever falling in price, it comes with obvious benefits. We value equities based on our (hopefully conservative) estimate of each company's lifetime potential to generate excess free cash flow. These cash-flows are a multi-year stream, and for most of the long-term compounding businesses we follow it's more appropriate to think of them as a 'river system' than a 'stream', with new tributaries constantly joining the main river (as new investments are made at high returns on invested capital)*. For a company's cash-flows, the next couple of years is a very small proportion of this 'river system', but most investors spend their time focusing almost exclusively on the immediate future. When people talk about valuations, they almost always refer to the *current year's* price-earnings ratio, or the *current year's* free cash-flow yield. But this is just the starting point on the long journey of what might be wonderful value creation or humdrum mediocrity for shareholders. So as analysts feverishly move earnings forecasts up and down, the average stock price in the UK fluctuates over a range of more than 30% a year. Unilever lowers its sales growth guidance to +3.5% versus expectations of +4.5% for the third quarter of 2013 and panic ensues. Meanwhile, our estimates of fair value hardly move from year-to-year, let alone from quarter-to-quarter. This is particularly the case with our investable universe of 80-odd stocks, as we deliberately favour stocks whose long-term value is easier to estimate due to well entrenched franchises and consistent, long-term records. It's quite a simple equation for us. The *higher* the future free cash-flows , and the *higher* the confidence in our estimates, the more attracted we are to an investment opportunity.

Our quality approach aims to take advantage of Mr Market's myopia. History shows that *investors persistently fail to value high quality business at an appropriate premium to the market averages, and as a result they persistently outperform the market averages over time***.

While this is normally the case, there are counterexamples. It took the 'nifty fifty' stocks of the early 1970s an awfully long-time to grow into their huge valuation multiples. Likewise, US quality stocks such as Coca-Cola, Johnson & Johnson and IBM have suffered from a decade–long hangover thanks to their eye-watering valuations at the start of the millennium (the businesses on the other hand, have performed perfectly well). So this is why we also think a valuation discipline is important, and use it as a filter for our quality approach.

Unilever Through The Valuation Filter

Returning to Unilever, the stock's valuation increased at the beginning of the year as the share price rallied. We brought Unilever down from a weighting of nearly 10% of the fund in 2012 to a low of about 6.5% in May as the price headed upward. However, based on our current estimate of intrinsic value (a value which is likely to grow steadily over time) Unilever would need to be trading more than a third higher than it does today for us to feel uncomfortable owning it. As the share price has been under-performing we have incrementally added to the holding. It is now back to 8% of the fund.

The Emerging Market Story is Dead – Long Live The Emerging Market Story

I'd also note that our investment thesis for the consumer branded goods holdings is not premised on the idea that the demand for consumer branded goods in emerging nations will increase with a straight-line certainty that you can place a ruler over.

Our view on Unilever's long-term opportunities in emerging markets remains unchanged – namely, the potential for growth and value creation is huge *but there will also be character-testing deviations along the way.* Business cycles are inevitable and the current slowdown is a reminder of this. However, spend-per-capita on consumer goods in these nations remains at between a tenth and a twentieth of the levels seen in developed markets. Unilever's emerging market exposure is also extremely diverse now – their exposure is by no means just to the BRIC nations. And when slowdowns come along, the strong grow stronger. As Coca-Cola CEO Muhtar Kent put it recently, *history has taught us that when we invest through difficult times, we emerge even stronger.*

A Perfectly OK Time To Own Equities

Warren Buffett was interviewed on CNBC last Wednesday, the morning before the debt-ceiling compromise. In his inimitable way, he totally brushed aside questions regarding central bank tapering, debt-ceilings, government shutdowns and equity market bubbles. Quite simply, he said, *it's a perfectly OK time to own equities.*

Note his use of the word *OK*. He didn't say it's a *good*, or a *great* time to own equities. OK is *average* or *fair value*, and his comment chimes with our analysis. We think markets are generally fair value to a little over-valued currently. The investable universe (i.e. the 80-odd stocks that we follow closely and do detailed valuation work on) are nearing fair value too, which means we have had to work harder to make sure the portfolio continues to offer a decent margin of safety (which is does, trading on a weighted average 28% discount to fair value, compared to 8% for our investable universe). But as Buffett went on to say on CNBC:

The stock market compared to most assets – all of the big asset classes in my view - is the most attractive place to have your money over the next twenty years. Whether it is over the next twenty days or twenty weeks I don't know, but we have our money in businesses. We own all of some of these businesses, and parts of some businesses (which we call stocks). We think that's where the value lies....good businesses held for a long period of time are certain to deliver good results.

I, like Buffett, am in favour of equity. It is an intrinsically appealing financial asset class. Companies are, at heart, systems comprised of humans, and humans are flexible creatures, well adapted to changing with the times. Good companies are also, at heart, claims on productive assets that provide an enduring utility to society. As such they have a way of coping with the great waves of inflation that come and go from time-to-time, or at least cope less badly than cash or bonds ever could.

What stocks won't give you is a smooth ride. The market for partial shares in businesses gyrates as investors try to second-guess the business cycle, or the next move in inflation and interest rates. Individual stocks bounce up and down as quarterly earnings beat or miss expectations. Talented managers leave, new investment projects fail, scandals come and go. Or investors simply decide they favour one sector or another for periods of time.

But as long as you are happy to tolerate these constant minute-by-minute and week-by-week gyrations in quoted value (it's by no means always a stress-free experience!), patience tends to reward the long-term owner of good stocks.

Hugh Yarrow
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Please note, these views represent the personal opinions of Hugh Yarrow as at 18 October 2013 and do not constitute investment advice.

*Evenlode is named after our local Oxfordshire river, partly because of this analogy. It flows past our office, into the Isis at Oxford and onto the Thames....
**Several studies have demonstrated this effect over long periods of time. One is GMO's as referenced in my investment view last month: *Profits For The Long Run: Affirming The Case For Quality, Chuck Joyce and Kimball Meyer, GMO, June 2012.*. Another is Robert Novy-Marx's US study looking at NYSE firms between 1963 and 2010 and international firms between 1990 and 2009. He found a high persistence in both fundamentals and outperformance for quality stocks. As he put it *more profitable companies today tend to be more profitable companies tomorrow. Although it gets reflected in their stock prices, the market systematically underestimates this today, making their shares a relative bargain – diamonds in the rough.* Hat-tip to my friend Dah Hui Lau for leading me to this study. Another is *Power couple: Quality and value are strong drivers of long-term equity returns (Mead et al. 2013)*