Evenlode Investment View

Wise Funds

SEPTEMBER 2012 – MORE MONEY PRINTING & WEETABIX: A CASE STUDY

Mr Market is currently in fine form. Emerging from the all-pervasive gloom at the end of May (at which point the Eurozone economy looked days or weeks from a major crisis), the UK stock market has risen +13% in just over three months. In particular, the 'risk on' trade has returned to fashion, with economically sensitive stocks leading the market higher.

Some signs of improvement in the global economy (particularly in the US) have helped sentiment, with falling inflationary pressures over the summer helping on this front. Leading indicators suggest that this improving backdrop may continue over coming months.

More Money Printing

However, the big boost to investor sentiment has come from the European Central Bank (ECB) and the Federal Reserve – both seem to be preparing the ground to print huge (effectively unlimited) amounts of money to kick-start their respective economies if necessary.

In Europe, Mario Draghi noted at the end of July that he was prepared to do 'whatever it takes' to save the Euro. This month, he followed up with an announcement that the European Central Bank will embark on a new programme of government bond buying which is unlimited in scale. This move is a clear short-term positive, particularly when viewed in tandem with other policy developments in Europe over recent weeks*. However, the breathing space that these initiatives give European governments can't be wasted – structural change is still desperately required and if policy makers now rest on their (rather skimpy) laurels, the same problems that haunted them over the summer will come right back again.

In a similarly extreme move, Ben Bernanke announced last week that the Federal Reserve will embark on a new programme of quantitative easing (QE3) and simultaneously promised to keep base interest rates in the US between 0 and 0.25% until at least mid 2015 (!). Unlike the first two rounds of quantitative easing, this QE is effectively open-ended, and leaves the door open for as much money printing as is considered necessary to get the economy going.

No Magic Bullets

Paul Volcker, a man I greatly admire, was Federal Reserve chairman in the early 1980s and should be given considerable credit for taming the high inflation of the 1970s. Now 85, he is generally very careful about the comments he makes on monetary policy, but he had the following to say about QE3 this week:

"It's certainly new terrain, and that was obvious in the midst of the crisis. They went into new terrain because the economy was in new terrain. The Federal Reserve has limited tools. They've run out of really strong action and are approaching the limits of their ability to deal with the situation. There aren't any magic bullets there.

*I think people think the quantitative easing helps pep up the stock market and may reduce long-term interest rates a little bit. But I don't think it does enough to make a really significant difference in the basic outlook, which remains one of limited job creation in the private sector, but not really enough to reduce the unemployment rate at all rapidly. There is slow progress toward deleveraging—and that's the outlook."***

In his understated way, Volcker is articulating what others have expressed more vehemently – it is not clear that past rounds of QE have had any significant positive effect on the real economy, or that the latest round will either. Given the possible unintended consequences this policy could end up producing, it's a gamble of grand proportions - Ben Bernanke is going 'all in'.***

Weetabix – A Case Study In Long Term Compounding

"The best response when seas are choppy is to focus on completing the long-term voyage and not think about whether the next wave is going to push the nose of the boat up or down".

Howard Marks

The current tension between on the one hand, very sluggish trend economic growth and a higher frequency of recessions, and on the other hand extreme policy intervention and money printing, is creating some big 'waves' for investors to navigate through. Sentiment is liable to lurch from one end of the spectrum to the other in short order, as the last three months have shown.

As a result, many market participants (as always, but even more so than usual!) are fixated with trying to second-guess the next market move, the next economic data-point, and the next policy intervention. In the context of this backdrop, it feels worth sharing some total return figures on Weetabix shares I recently came across. I think they serve as a reminder that tuning into short-term stock market noise is not always terribly useful.****

Weetabix was first introduced to the British public in 1932 (in total we now eat 3.2m Weetabix biscuits a day), and I take up the Weetabix investment story in 1989 when shares could be bought for £6. Weetabix grew at a good rate over the next few years, thanks to a combination of pricing power, market shares gains, and some adjacent acquisitions (the business ended up owning several other brands, notably Ready-Brek and Alpen).

While in 1998, Mr Market's mood swung wildly from positive to negative (sometimes excited about the technology boom and US economic growth, at other times nervous about the Asian crisis and Long-Term Capital Management) it's amusing how humdrum, in contrast, the highlights of Weetabix's year were, as some quotes from the 1998 report and accounts demonstrate:

"We launched Fruitibix this year and prospects look good for the new bite-size cereal"
"Alpen consolidated its position as leader of the muesli sector"
"Considering the mildness of the winter, it was good to see Ready-Brek sales ahead again"
"Weetos has enjoyed record sales this year, up 26%"

Despite a more difficult period from 1998 as supermarket price pressures took their toll, Weetabix earnings held up well and the business was eventually acquired by private equity at the end of 2003 for £54. When all was said and done the capital return came in at approximately 17% per annum over the fourteen year period between 1989 and 2003. With dividends included, the total compound return was 21% a year - not bad compared to a total return of slightly more than 10% for the UK market over this period. Some of Weetabix's return was thanks to an increase in its valuation multiple, but the majority came from the fundamentals of the business – if the business had ended 2003 on its 1989 valuation, the total annual compound return would still have been in the mid-teens, thanks to earnings growth, dividends and dividend growth alone.

Weetabix shares by no means moved in a straight line during this period. Sometimes they were fashionable, at other times (at the height of the tech boom, for instance), they were deeply out of fashion. However, Weetabix (whatever you think about the cereal!) had five things going for it as a business, which are the crucial factors we look for when selecting businesses for the Evenlode fund:

1) Strong intangibles assets (in this case its brands)
2) Resilient, repeat-purchase products
3) An asset-light business model (and as a result high excess cash-flows and high returns on capital)
4) A strong balance sheet (Weetabix had net cash for the entire period between 1989 and 2003)
5) Sensible management

Weetabix provides a great example of the difference between trying to invest in the 'stock market' as some kind of homogenous globule, and patiently owning a share in a business that can grind our good fundamentals over the long-term.

As I have said before, investing in steady compounding businesses is like sowing seed on fertile, rather than stony or thorny, ground. It makes our job similar to that of a good gardener – tending to our plants, occasionally planting new ones, trimming back here and there when valuations look stretched, but most importantly letting them grow without much disturbance. Debt crises and central bankers will come and go, but over time I expect it to be the attractive economics of the portfolio's underlying businesses that drive the bulk of Evenlode's compound return.

Hugh Yarrow
17th September 2012

Please note, these views represent the personal opinions of Hugh Yarrow as at 17th September 2012 and do not constitute investment advice.

*Notably the German constitutional courts sanctioning of Germany's participation in the European Stability Mechanism and the European Commission's blueprint for joint European banking supervision.

**Volcker's full interview is available at the following link - http://www.thedailybeast.com/newsweek/2012/09/16/paul-volcker-on-greedy-bankers-the-ryan-plan-and-the-fed.html

***William White's recent paper is worth a read on these possible side effects: Ultra East Monetary Policy and The Law of Unintended Consequences - http://dallasfed.org/assets/documents/institute/wpapers/2012/0126.pdf

****Thanks to US investor Thomas Russo for Weetabix compound returns.