Lindsell Train

The History Man

December 2008

An old friend of mine is a historian (well, he has had articles published and lectures at a proper university). He is also an active participant in the equity markets and in no doubt about the gravity of current events. In his opinion the effective bankruptcy of the Western banking system is an occurrence up there with both the erection of the Berlin Wall and its dismantling and, say, 9/11 as – "one of the most historically significant events of the last 50 years". Press him though on what the debacle really means and he becomes evasive – "we won't really know for 20 years". After a pint or two he gets expansive and wonders if we are witnessing the end of US economic and military hegemony, the emergence of a new world order.

At the risk of sounding snide and fully acknowledging that we too have made galling errors of timing this year, I can't help but note that this historical perspective hasn't prevented my friend from doubling up in M&S and RBS at inopportune prices in '08.

Generally whenever I'm confronted with overarching theories about geopolitics and economics such as his, I remind myself of a story I heard told about Leonard Licht – stockpicking genius at the old Mercury Asset Management. In the early 1980s investors were fixated by the monetarist experiment being conducted by Geoffrey Howe and Mrs T and watched the monthly monetary aggregates like hawks. Walking through Mercury's dealing room, Licht heard a hubbub – "M0 is up" a trader called. "Sell a million M0s, then", Licht snarled, before stalking off.

This was the frustration of a fundamental investor – rankling against what he saw as the nonsense of buying or selling securities on signals from a volatile economic series that may or may not have any relevance for the real world (and, in hindsight, it probably didn't). Certainly for someone like Licht, focused on book value and cash flows (famously, he is reputed to have worked his way through the Report and Accounts of every quoted UK company), macro-economic theorising is at best a distraction.

Nonetheless, we find ourselves joining the windy theorisers here, because what is happening feels so big, so much more than a periodic downturn. And what feels big is the number of share prices trending towards zero – not just small companies but former giants too. Penny-stock status is as clear an indication as you'll get that a given business model is redundant, outmoded, to be superseded. From the US auto industry via UK regional newspapers and, perhaps, the bottom 20% of all British pubs, all the way back to those gamely 30x levered investment banks – the world will never be the same again.

Woolworths has gone (with my 11 year-old one of its few mourners). As has been widely remarked, it is not so much the current downturn that bankrupted Woolies - it had been a failing franchise for a decade or longer. The current downturn simply demonstrated the utter hopelessness of its situation, confirmed it not worth saving. Stock markets are ruthless places but rational, in the long term, too. They will not forever tolerate entities that fail to deliver a return above their cost of capital. Businesses are failing all the time – being ejected from the index, but periodically there is a true Augean broom-sweeping of constituents. We are in the midst of such an episode.

The coup de grace for many corporations is debt, of course. But as investors we need to face up to why so many companies had become grossly levered on the threshold of a downturn. Some blame the greed and shortsightedness of management or the pernicious influence of the investment banks. But the truth is closer to home. Their owners asked them to gear up, whether explicit or implicitly. The companies borrowed because if they had not done so their RoEs or growth rates would not have been sufficient for them to sustain their status as publicly quoted entities. By and large the heaviest debt is found in the most disadvantaged companies, whose time as stock market constituents was running out – hock-up or sell out were the two choices their shareholders offered.

In hindsight we can now see how important the "silent" bear market between 1995/2003 was. This was a bear that marauded the "old economy". The FT Chemicals, Engineering and Transportation sectors all halved over the period, for instance. It was "silent" because, for a time, investors were making too much money in the "new economy" to notice or care. But the old economy learned its lesson. In the absence of genuine, structural growth there was only one way to improve its returns and -

if it wanted to evade the clutches of Private Equity and retain its quote on the Big Board - it had to borrow. The bull market from 2003 onward was based on an illusion.

The consequences are stark. We agree with the apocalyptic tone of a recent piece of research from Hardman, a specialist small cap research house:

"The stock markets will bounce back, but not with the same companies we have now. There is bloodletting to come at the large as well as the small…90% of the small mining stocks will disappear or go into hibernation, the IT stocks that have failed to grab their moment will be overtaken by new technology…the poorly run and the adequately managed companies that have weak business models will go under…20% of the shares on AIM do not deserve to exist, let alone have a share quote."

Perhaps it is still not too late to consider where other risk remains in the London market – where the debt is too high, or the business models are heading the way of the buggy manufacturers. We wonder about two sectors in particular, because they are both currently seen as havens of safety. First utilities. Here debt is high, apparently secured by monopoly cash flows. But surely the most dangerous time to be invested in a utility is after a period of sustained, market-beating dividend growth? Utilities are not popular with other corporations, who actually have to deal with real competition, nor with the electorate, which understands that utilities earn above average returns, despite taking below average risk. The risk to investors is material therefore - a populist adverse regulatory cycle would leave these levered entities horribly exposed.

Next, the prospects for Big Oil are sobering. The truth is that its multi-decade source of competitive advantage no longer exists. That advantage was the poverty or timidity of those countries where oil reserves are to be found. In the end, BP and Shell were agents of Western Imperial power - their privileged access to new oil discoveries underwritten by gunboat diplomacy. This heritage is now a positive disadvantage and we are not as confident as Citi's Oil sector analysts, for instance, who argue that the credit crunch will allow Integrated Oil Companies (IOCs) to enjoy renewed access to other nations' reserves.

So many billions of market capitalization hang on this issue that I reproduce the relevant paragraph from Citi's work:

"To say that the oil majors will fail to extract an economic rent from the exploitation of global hydrocarbon reserves is to suggest that only the resource holders themselves and their related National Oil Companies will be the beneficiaries of the free cash generation from such exploitation i.e. the IOC as a species is dead. However we do not see it this way. If for no other reason than the diversification of risk, the host governments will still want to utilize the services of the IOCs. The IOC's technical competence, project management track record and access to funding will still be an attraction for host governments, in our opinion."

I am not prepared to argue so extreme a proposition as "the IOC as a species is dead", but it is a surprise to read an Oil analyst air their demise, even as a possibility. What is not a surprise, I submit, is that the oil majors look cheap today. They deserve to be cheap, because there is radical uncertainty about their future access to the life blood of their industry and hence uncertainty about the sustainability of the business model.

Conclusion

Over the 10 years to end September 2008 UK Equities have returned 3.7%pa – effectively their dividends - compared to Gilts 4.9% and cash 5.0% and this before a horrific October. Before we Brits start to flagellate ourselves or blame the Socialists in Number 10 for a lost decade, note that Global Equities performed even more poorly than in the UK, generating only 3.3%pa.

The good news, therefore, is that equities have already been disappointing and today's bears risk extrapolating past returns into the future, just as optimists like me were doing 10 years ago.

The less good news is that what will make real money for equity investors over the next decade is unanticipated, "proper" growth. By "proper" I exclude the leveraging of structurally low growth companies and "concept" companies with no revenues, whether Internet start-ups or Siberian diamond mines. We have some inkling as to where that proper growth may be found, but, necessarily, we are not sure.

The 14% pa return generated by Emerging Market Equities over the same decade is at least comfort that the equity asset class still has the potential to deliver superior returns, but the iron law is that you have to take the risk of allocating capital to Bolivia

or Estonia, or similar, in order to earn the outsize return.

In the UK we must pick and choose carefully. Surprising myself - never having heard of Hardman, quoted above, before stumbling across a piece of their research - I now conclude by quoting Hardman's conclusion on UK Equities, which I could not have put better myself:

"The game is the same as it has always been, to spot the Racal of 1980, the Capita of 1990, the Cairn Energy or Chemring of 2000. The upheaval has taken place and the need now is to spot the new winners emerging out of the fog. This is not the time to be buying an index."

Good luck in 2009.

Nick Train, Portfolio Manager
Lindsell Train Ltd

NOTES: Financial data quoted in this report is obtained from Bloomberg and the companies mentioned and is subject to change without notice.

Risk Warning

This document is provided for information purposes only and is intended solely for use by professional investors and advisors. Specifically, it is not intended for, and is not suitable for, those who would be categorised as Retail Clients, and it should not be relied upon by private investors.

Past performance is not a guide or guarantee to future performance. Investments are subject to risks and may also be affected by exchange rate variations. The investment value and income may go down as well as up. Investors may not get back the amount they originally invested.

© 2024 Morningstar, Inc. All rights reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete, or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

The MSCI information may only be used for your internal use, may not be reproduced or redisseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages. (www.msci.com).

"FTSE ®" is a trademark jointly owned by the London Stock Exchange Plc and The Financial Times Limited and is used by FTSE under licence. "All Share" is a trademark of FTSE. FTSE does not sponsor, endorse or promote the content of this communication.

Opinions expressed whether in general or both on the performance of individual securities or funds and in a wider economic context represents the view of the fund manager at the time of preparation and may be subject to change without notice. It should not be interpreted as giving investment advice or an investment recommendation. No part of this document may be copied, reproduced or distributed to any other person without prior express written permission from Lindsell Train Limited.

Copyright Lindsell Train 2024.
L 000-071-2 03 December 2008

Lindsell Train Limited
66 Buckingham Gate
London
SW1E 6AU
UNITED KINGDOM

Tel. 020 7808 1210
Fax. 020 7808 1229
www.LindsellTrain.comInfo@lindselltrain.com

Please refer to Lindsell Train's Glossary of Investment terms here.