LINDSELL TRAIN

What's Up in 2007

February 2007

I'm sorry to alert you to the fact that, as you read this in mid February, your year is already more than 11.0% done. And yet only now have we get round to committing thoughts to paper about how 2007 may turn out, so far as the UK equity market is concerned. In fact, allowing our ideas to gestate through January may have been lazy, but it has not resulted in much of our thunder being stolen by actual events. The All Share ended January down, albeit by less than 0.5%, having pretty much spun its wheels for four weeks.

We are optimistic, though we expect a significant change in sector leadership over the next 18 months or so. Nonetheless, at outset, it is important to be clear about one aspect of the economic backdrop which has definitely become less favourable for UK equity assets. This is the relationship between UK inflation and the historic dividend yield on the market. At the end of 2006, UK RPI ex Housing stood at 3.5% year-on-year, its highest level in a decade - indeed nearly double its average for the last 10 years (1.79%). Meanwhile, as the result of another decent year for capital gains from the All Share, outpacing dividend growth, its dividend yield has fallen to 2.79%. In other words, shares today offer a starting dividend yield below the rate of inflation. This is, we think, the first time this has been so for at least 10 years. (Although the market yield was low in 2000, at FTSE's peak, inflation too was very low, running at only 1.3% in March 2000, the top for the market.) While we do not regard this shift in relationship as an infallible indicator of a top, it is well to remember the comfort equity market participants took from it in the dark days of 2002/3. Then, the fact that decent UK shares paid a starting income 2 to 3 times greater than inflation was an effective guarantor that the market was cheap, barring economic collapse. Today, we would argue that for the All Share to be significantly cheap, either inflation has to fall markedly – which is indeed the expectation of the Governor of the Bank of England, or dividend growth and buybacks must accelerate, exceeding what are scarcely modest current expectations. Perhaps the January's wheel-spinning is understandable - the month before a deluge of final dividend announcements that will set the tone for the rest of the year.

Turning to changes in sector leadership, we have three observations – each that is driving our current portfolio activity.

First, several market strategists we read expect this year and next, to be marked by a shift in investor preference, away from "value" stocks and styles toward "growth" – given the strong outperformance of the former since the 2000 market peak. To some extent, we share this expectation, although we are dubious about the definitions strategists use. For instance, surely the mining stocks are classic "growth" companies, which, by rights, therefore, should not have enjoyed their prolonged bull run?

Anyway, let me grasp this particular bull market by the horns and assert that 2006 saw the early stages of a new bull market in the classic "growth" sectors of Technology, Telecommunications and Media. Although it is a bull market as yet unrecognised by many market participants. Consider the following. Since Summer 2006, Microsoft's shares are up 46.0%, Intel up 30.0%, Cisco 65.0%, Vodafone 37.0% and Sage 36.0%. In addition, last year was the first in six that the global media sector, as measured by FTSE, outperformed the MSCI World Equity Index, gaining 24.0% compared to 18.0%. Not only does it appear that the agonising bear market for these names is over, a new bull run has begun.

Two things make this prediction persuasive to us. First psychological. We know how jaundiced many investors remain about these sectors and stocks – the pain of the bear market is still too intense to permit of renewed enthusiasm. In fact, for many advisers, a new bull market would be positively unwelcome. But, as Jeff Bezos, founder of Amazon put it wisely – "In the technology industry, people tend to overestimate the next two years and underestimate the next ten years." We believe investors are now underestimating the opportunities in technology companies.

Next and much more significant, events in the real world point to a period of accelerating change and growth driven by technology and Internet. For instance, at Davos last month, Bill Gates predicted the effective demise of free-to-air television within 5 years, as Internet delivery systems prove better suited to viewers' needs – "I'm stunned how people aren't seeing that

with TV, in five years from now, people will laugh at what we've had". In the UK last week alone Tiscali has launched an Internet TV service aimed at 10 million homes, while NTL has relaunched as Virgin Media – both hoping to catch the Gates' predicted wave. Next month, BT Vision, Carphone Warehouse, Orange and Setanta are all expected to make announcements of bundled video and telephony offerings – Setanta purportedly at "a fraction" of Sky's current tariff. Meanwhile, Sky's Easynet subsidiary is investing heavily into broadband, to fend off these challengers. Picking winners out of this will not be easy, but investors are likely to be forced to.

Perhaps what we feel most strongly is that "TMT" is an area that, paradoxically, demands attention from "value" and contrarian investors. In his recently published, co-authored book, "Investing with Anthony Bolton", the great man remarks – "My ideal is a company where things have gone wrong, but where it looks as if things may be changing. I am looking for stocks that are unfashionable and cheap, but where there is something which will capture investors' attention before too long." Reed Elsevier is an interesting case, we think – a major Fidelity holding. Last month, Reed's LexisNexis subsidiary announced that its Applied Discovery service had processed 1.16 billion pages of electronic documents in 2006, up 49.0% on 2005, as the requirement of lawyers and litigators to search digital documents rises exponentially. LexisNexis, a service subscribed to by all 100 top legal practices in the USA and by 94.0% of all Fortune 500 companies, hosts over 2 million searches a day. The point is that in 1999 such an announcement would probably have been worth 5.0% on Reed's share price – today it doesn't merit a flicker. Investors do not regard it as relevant, because it is not fashionable – but the announcement does actually signal change and growth in Reed's business and it is not hard to envisage such growth becoming much more highly valued.

A second Lindsell Train sector call is illustrated by one of our favourite quotes from last year, arising in an interview on Bloomberg with one Kenneth Macpherson. We are sure that Mr Macpherson is a sober and business-like fellow, but that didn't prevent him from gushing in this interview – "China is just fantastic!" And really, he should know, because Kenneth Macpherson is MD for Diageo in China. What excites him is the following. As recently as 2003, China was only the 34th largest world market for scotch – not much whisky was being drunk in China in 2003. By 2005, it had moved up to 16th and last year China was the 10th biggest consumer of whisky – the growth being driven, I regret to inform you, by the propensity of the Chinese to mix the stuff with green tea. What really popped Mr Macpherson's cork though, was this - last year, 2006, China looks set to surpass Japan as the world's second largest liquor market. Clearly, current consumption of both whisky and liquor in China is likely to be a fraction of future volumes. Equally clearly, however, there are few companies worldwide and even fewer quoted on the London Stock Exchange, that enjoy the combination of brand equity, distribution footprint and financial firepower to take advantage of the multi-decade opportunity presented by consumption growth in Emerging Markets. Diageo is definitely one such company, in part because it is blessed to own Johnnie Walker, already the world's #1 whisky brand (outselling the #2 brand by double – that's J&B, another Diageo property). JW is sold in 200 countries worldwide and the fact of the matter is that if one is optimistic about Emerging Market consumption of whisky and liquor, then Diageo is the only UK-listed company to provide serious access – happily it also happens to be the best play in the world on the theme.

Unilever's results last week disappointed investors. Concern, understandably, is focussed on Europe, where revenues rose a sluggish 1.0% for the year, losing further momentum. But the excitement in Unilever – and, really, it is exciting, lies further afield. Developing and Emerging Market sales grew by another 8.0%, organic, as they have done for each of the last 15 years. In 2004, Unilever's D&E revenues represented 36.0% of the total, less than Western Europe. By 2006, D&E accounts for 41.0% of the group – now the biggest geography. Again, in 2004, China was Unilever's 20th largest business, with sales that year up 11.0%. Last year, China had grown to its 15th largest unit with sales up 30.0%. At some point, D&E will drive Unilever's sales growth up out of its 3-5.0% range, profits will accelerate and those profits will be much more highly rated. Bart Becht has done a fantastic job at Reckitts, but in the end that business is not so different from Unilever's. The valuation is, though.

In summary here, we note that investors are still willing to hold London-listed mining companies on low dividend yields – BHP 1.9%, Kazakhmys 2.3%, Lonmin 1.6%, RTZ 2.0%, Vedanta 1.2% and Xstrata 0.8%. We are not arguing investors are wrong, but we do argue that Cadbury 2.3%, Diageo 3.1% and Unilever 3.5% all offer access to a similar long term growth story, but from much more generous starting yields.

Finally, we consider the forecast made in January by Martin Ellis, chief economist at HBOS - that the UK savings ratio will continue to rise. He estimates it to reach 6.2% by Q4 2007, the highest since 2000 and substantially ahead of the 5.0%

average of the last 5 years. "Households are rediscovering the savings habit" he says, noting that aggregate savings should surpass £1 trillion for the first time, with £70 billion set to hit savings accounts in 2007. One driver of higher savings, he argues, is the slowdown in house price inflation, which he expects to be 4.0% in 2007, half the 8.0% average of the last 14 years. We certainly look forward to a significant acceleration in new business growth for franchises serving the UK savings market. Indeed, for HBOS it seems to be happening already, with its Bancassurance sales up 25.0% year-on-year at its last results, IFA sales up 35.0% and its Wealth Management unit up 55.0%. HBOS' Tesco-like hold on the UK savings and mortgage market deserves a higher rating, we believe. If HBOS' growth rates are reflected across the industry, surely it is only a matter of time before Scottish Widows' profits will propel Lloyds Bank's dividend northward? Lloyds' yield is still 5.7%, more than double that of the market. The next few years could be a golden period for asset-managers serving the UK. Perhaps this is already reflected in Amvescap's 1.4% dividend yield or Schroder's at 1.9%. It is certainly not captured, in our view, in the starting income return available on your own shares, nor Rathbone, at 2.6%.

In conclusion, biasing portfolios in 2007 toward "growth" makes sense. This means, we think, identifying "TMT" businesses with a genuine growth opportunity and a depressed rating, finding those relatively rare UK companies with the potential to serve Emerging Market consumers and supporting strong retail financial service franchises, in advance of a likely prolonged cyclical upturn in UK savings activity.

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