# Investment Report Nº·49

Our aim is to protect investors' capital and to increase its value year on year.

## Buying the Future

*"The tastes of youth change because it is hot-blooded; those of age remain unaltered through force of habit."*
François de La Rochefoucauld, Maxims

Investing in stocks inevitably involves forecasting the future. Yet over-optimism and extrapolated trends so often do great damage to returns. One criticism of our investment approach is that we should focus more on anticipating future trends. Over the years I have been chastised at investor meetings for not doing what seemed so obvious at the time. Why not 'buy into' the Chinese penchant for luxury goods? Or why don't we 'get exposure' to the shale boom in the United States? Isn't biotechnology a great way of 'playing' ageing demographics? These phenomena were all real enough but jumping on bandwagons, often long after they have left town, is not our way of doing things. Today's big winners frequently become tomorrow's losers. When high values are ascribed to growth it invites fresh competition and disappointment will usually ensue as extraordinary profits are eroded away. We look instead for evidence of longevity and pricing power, not in themes but in companies. Only then can we be confident that future cash flows will be delivered.

The introduction of Microsoft Excel in the 1990s has much to answer for. Spreadsheets helped analysts dissect financial performance but spoilt analysis of the future by offering apparently exact answers to vague questions. Anyone with a basic knowledge of arithmetic can build a complex valuation model in a spreadsheet. In our experience, however, it is preferable to be roughly right than precisely wrong. Investing is more art than science and we do not spend our time modelling discounted cash flows (DCFs) to generate specific share price targets. This is not a matter of idleness but is, rather, an endeavour to avoid overconfidence that we have the perfect answer. We place greater store on more rudimentary valuation methods that stand the test of time, such as price-to-earnings ratios, free cash flow and dividend yields. Yet when we analyse companies even these indicators are superseded by judgments about the sustainability and predictability of business models, the value of brands, the quality of management and the durability of funding structures. We look for bright futures when companies are misunderstood or ignored and we become enthused when investment banks (the 'sell side') are bored or investors (the 'buy side') are uninterested. We are long-term investors. The qualities we seek are permanent rather than temporary and compounding over decades trumps short-term 'catalysts'.

## The Milkybar Kid

Following each company's year-end and the subsequent 'results season' we meet the management of the businesses we invest in. These meetings have their merits but in my experience the benefits can be overstated. Some managements may give a rose-tinted view of their business and are less likely to point out weaknesses or risks unless they are already well known. Some see it as their task to market their shares to investors rather than aid the advancement of our knowledge. One erstwhile Chairman cynically described to me the post-results investor relations roadshows as "*doing his bit for shareholder value*". There is always the danger of getting too close to management by becoming emotionally attached to a stock. Objectivity must be retained; shares do not know that you own them! Nevertheless, a meeting may provide insights into long-term strategy and, importantly, how the management chooses to allocate capital. In a recent discussion with representatives of Nestlé, a company held in Troy portfolios since 2009, we talked of M&A activity and the poor value currently available to investors (both institutions and corporates). We were reassured to learn that they share our view that today's asset values are unattractive, notwithstanding the availability of cheap debt to fund deals.

We seek to invest in companies that are strong enough to endure pain without incurring long-term damage to their businesses or even their share prices. 2015 was a difficult year for Nestlé because of underperforming business units in the US and Asia as well as dramatic fluctuations in many of the currencies in which they do business. This was exacerbated by a high-profile health scare that forced the withdrawal of its Maggi Noodles from shelves in India where Nestlé enjoys 80% market share. The episode cost $67m to put right and resulted in countless lost sales opportunities. Maggi was relaunched in November after it emerged that the tests responsible for the recall were "highly unreliable" but it will take time to rebuild the brand across such a large and complex retail market. The overall damage to Nestlé was minimal — temporary share price falls of a few percentage points at the time of the product withdrawal and a steady recovery thereafter. Whereas lesser companies would have stumbled, Nestlé's broad portfolio of brands, financial strength and robust management meant a crisis passed with no lasting effects.

## Having a Break From Fashion

Some of Nestlé's peers are apparently chasing foodie fashions. Millennials' spending patterns are erratic as they swap kale for kelp and low carbs for gluten free. Changes in consumer tastes will come and go and cannot form reliable foundations for a business. As fads fade, revenues fall and brand equity withers. Far better to continue to invest in enduring brands such as *KitKat*, *Nespresso* and *San Pellegrino*. When poor performers emerge from within Nestlé's group the answer is rarely to slash costs. On the contrary, the lesson from the recent turnaround of several of Nestlé's North American frozen food brands is that when products falter investment in research and marketing should be redoubled not retrenched.

This is a very different attitude from the one advocated by many other companies. In a world of sluggish economic growth, radical 'zero-based budgeting' is *en vogue*, a process which asks employees to justify the smallest expenses. Investors aid and abet this by craving earnings expansion at all costs, even if it makes managers turn their attentions from 'non-productive' administrative fat towards the muscle and bone of R&D and advertising. In contrast, Nestlé believe innovation and entrepreneurial spirit are the correct response to lower growth. One of the company's more robust geographies has been Japan where sales grew 4% last year despite a contracting national population that led to 500,000 fewer consumers. New products such as green tea flavoured *KitKats*, tasting better than they sound, and premium-priced *Nescafé Barista* coffee have gone down well. If Europe 'turns Japanese' and suffers from a lost decade of deflationary funk, Nestlé will know what to do. We also see no fault in a business such as this that carries a little extra in terms of expenses. Costs will certainly be addressed by the company but never if it compromises longer-term prospects.

Similarly, we think a credit rating of 'AA' is a badge of honour to be worn with pride not an indication of financial 'inefficiency'. Over the past decade the company has generously returned CHF105bn in buybacks but the Board has decided to prioritise flexibility by suspending its programme to buy back its own shares. The emphasis remains on growing the dividend, and our preference is always for progressive dividends over price insensitive buybacks (*see Investment Report N°.48*). Nestlé's Board follow a long history of prudent management at the company, a major reason why Nestlé is still going strong as it prepares to celebrate its 150th birthday.

Management's conservatism, which we support, flies in the face of the more assertive fashions of the day and irritates some investors. As many companies drift into a period of slower growth, siren voices are luring businesses towards the rocks of ever higher indebtedness. Lessons are learnt the hard way as aggressively incentivised management and financial engineering have their limits. Valeant Pharmaceuticals' shareholders have discovered this to their cost in recent months.

## Buy High, Sell Low

In our regular discussions with companies, we spend what may appear to be an inordinate amount of time on capital allocation. We do so because that is the area where management decisions can create or destroy the most value for shareholders. This is not merely an effort to steer them away from the excitement of takeovers, so often the most spectacular waste of money. Poorly timed share buybacks are an even more insidious way in which returns can be diluted. Many management teams have a dismal track record of investing pro-cyclically, making acquisitions and returning cash to shareholders at the top of the cycle only to come back with a begging bowl as their share prices languish. Just think of RBS's decision to buy ABN AMRO before the onset of the financial crisis or the wave of debt-financed share repurchases in 2006-2007 as valuations peaked. There are very few virtuous exceptions to this rule — companies which bided their time in the good years to buy back their stock as the market bottomed in 2008-2009. At a time when many others were forced to suspend buybacks to conserve cash, a few thoughtful capital allocators such as Nestlé and Colgate-Palmolive entered the market on behalf of long-term shareholders.

## The Hurt of Low Interest Rates

It is reasonable to hope that management's decision to repurchase shares is always informed by special and rational insight into the value of their companies and their prospective returns. Yet management's motives can be more mundane and self-interested, usually resulting from the simple availability of cash and EPS-based compensation agreements. This too is cyclical. Recent buybacks have artificially inflated earnings per share growth by depriving assets of the ongoing investment they require. The portion of cash flow spent on capex by non-financial S&P 500 corporates has fallen from 63% in 1990 to 45% today. Over this time, the portion spent on buybacks has risen from 8% to 27% (Source: *FactSet*). It is no coincidence that the age of US capital stock is at a record high and, according to the American Society of Civil Engineers, it would require $3.6trn of investment by 2020 just to reach a good state of repair.

The impulse to do share repurchases appears to be reaching a point of exhaustion for this cycle *(see Figures 1 & 2)*. Low interest rates have been a defining characteristic, as cheap credit enabled corporates to fund their buybacks. As long as the earnings yield available on equities is above the company's borrowing rate, so it is reasoned, buybacks made sense – they are 'earnings accretive'. This mathematical truth, also touted by analysts armed with spreadsheets, ignores the fact that buying back shares at excessive valuations, whatever the cost of financing, will generally yield unattractive returns on the capital invested. The error not only impairs future growth and lowers corporate returns on capital, it also contributes greatly to the clear deterioration in balance sheets *(see Figure 3)*. An increase in corporate borrowing rates and/or a decline in profitability will render these debt levels less affordable, hurting earnings all the more. Such is the outlook for equities at a point when valuations are at cyclical highs. Investors are being asked to pay more for less.

## The Dangers of Relative Investing

It is not just companies that risk misallocating capital by overestimating the relative merits of their equity. Institutions and private investors are encouraged to favour equities over bonds or cash merely because of the yield 'spread' on offer. However, as a paper by my colleague, Charlotte Yonge, highlights (see Special Paper No.2, *Common Sense Versus Common Practice*), equity investors may be falling into the trap of drawing false conclusions from a comparison between low yielding assets. Low yields are informing us that growth is likely to be depressed for a considerable time. This, in turn, makes the prospects for growth in revenue, profits and dividends all the less likely. When I began my career, it was axiomatic that dividends would grow but given the sheer number of cuts we've seen in recent years the integrity of this is being called into question. There have been 16 such cuts announced since 2014 by FTSE 100 constituents and, with more expected, the UK market for dividend futures are indicating that by 2020 stock market income will fall back to levels of a decade ago (*source: Bloomberg*). Investors will need to tread with extreme care; equities are being priced as if they are bonds, but (unlike bonds) equities do not have finite lives nor fixed payments.

## Investment Trust Seminar

We will be hosting a seminar for shareholders of the investment trusts we advise and manage, Personal Assets Trust and Troy Income & Growth Trust, on the afternoon of Thursday 14th July. If you would like to register your interest please contact Katie Sellors by emailing ks@taml.co.uk.

Sebastian Lyon April 2016

## Share buybacks exceed 2007 peak

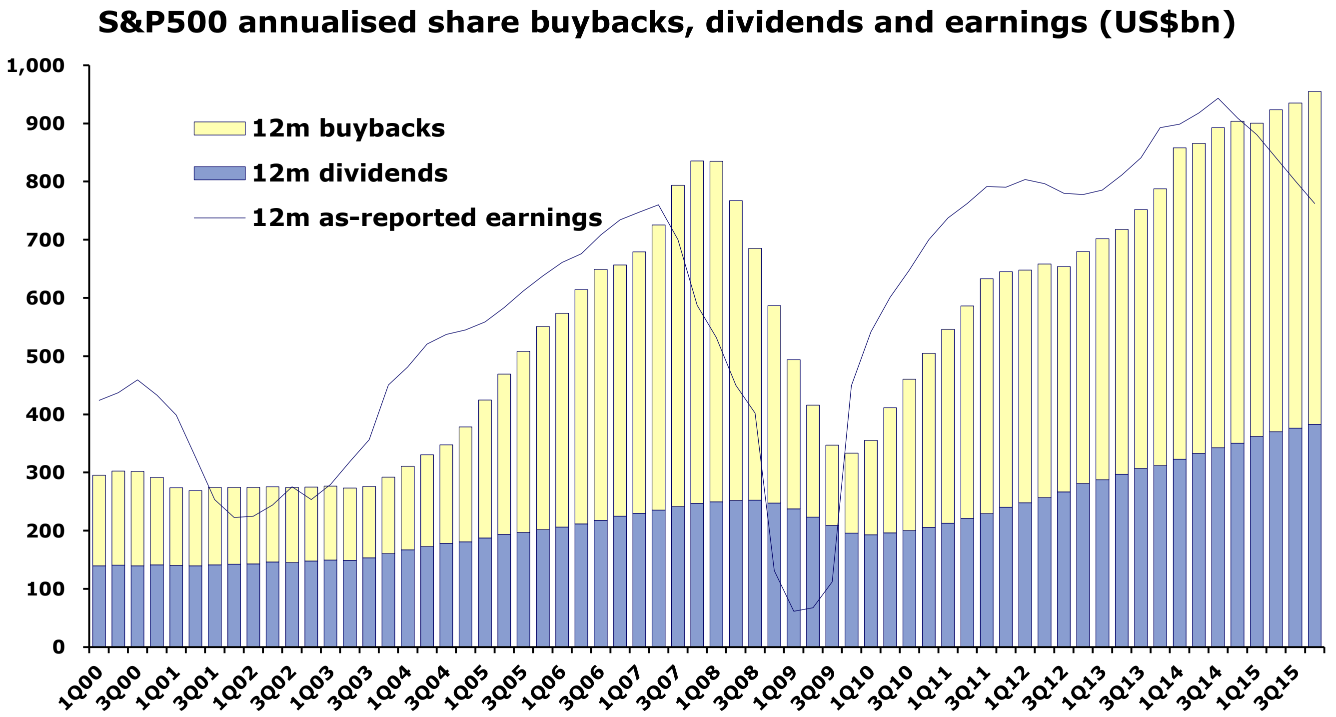


*Figure 1* *Source: CLSA/S&P Dow Jones Indices 31 December 2016*

## Who will buy when companies no longer buy back stock?

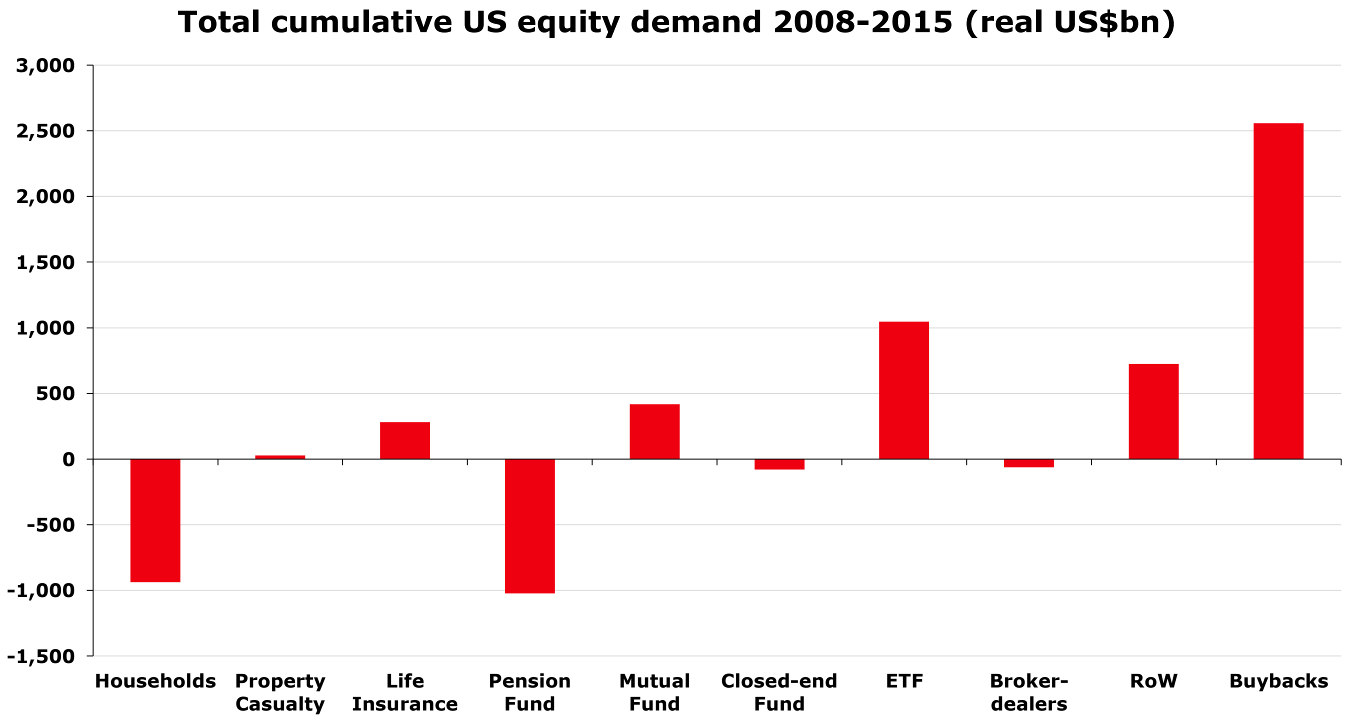


*Figure 2* *Source: SocGen 31 December 2015*

## US corporate debt levels have risen

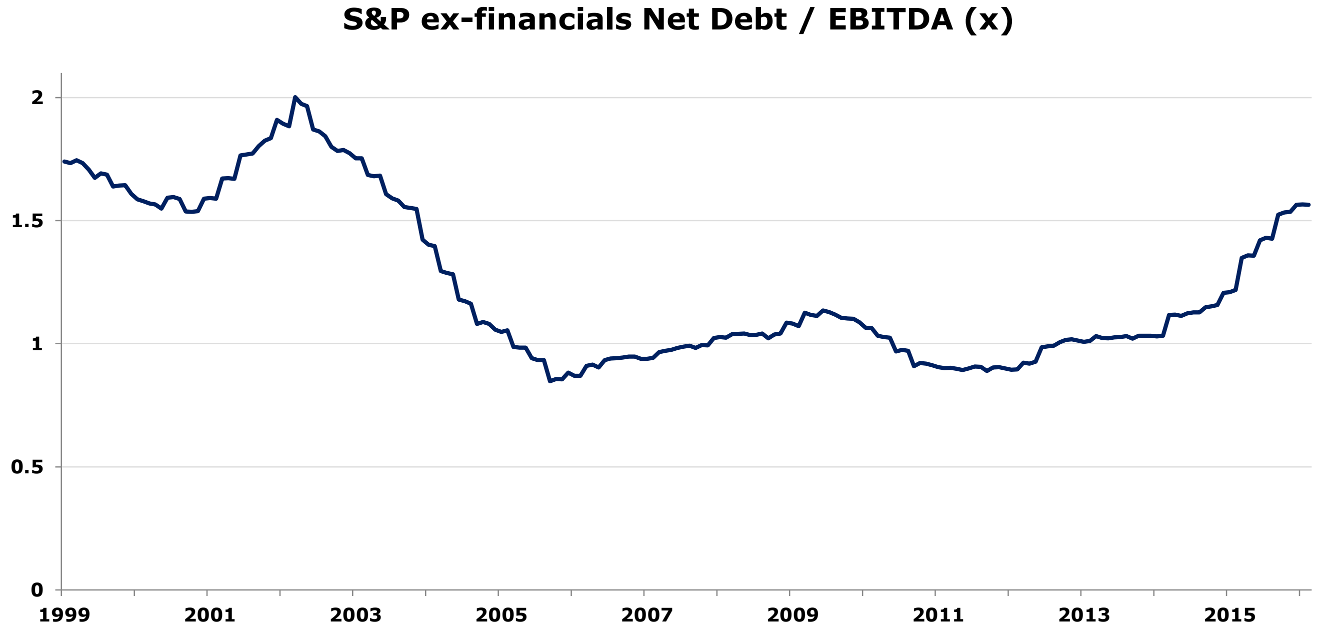


*Figure 3* *Source: Bloomberg, 26 January 2016*

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