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Investment Report Nº 57

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

A Feeding Frenzy

Corporate confidence is high with mergers and acquisitions, announced for the year-to-date, at record levels. This has mixed implications for investors. M&A booms tend to peak at the top of a market cycle. Capital allocation remains one of the most important drivers of long-term shareholder returns and is probably the most important issue we raise with company management when we see them. Acquisitions made at expensive valuations, and particularly those that are debt funded, can compromise balance sheets leaving companies vulnerable. This boom of deals will not end well as malinvestment normally leads to poor subsequent investor returns. For more details on Troy's views of this, see *Special Paper Nº 5, M&A: A Feeding Frenzy*, written by my colleague Charlotte Yonge.

Compounded

The magic of compound interest was allegedly deemed '*The eighth wonder of the world*' by Albert Einstein. In investment our preference is for companies that can grow their earnings at a consistent rate. We focus on buying and holding these 'compounders' and in particular stocks that pay us to own them through dividends and share buybacks. Fortunately, for much of the time, this is seen as a dull if not an unrewarding part of the stock market. Conversely, cyclical companies enjoy the enticing 'optionality' of earnings recoveries. These often make for more compelling investment narratives. The lure of investing in negative cash flow businesses, such as Tesla, with the promise of jam tomorrow also holds little appeal for us. For many other investors, investing in food and household goods companies offers little immediate gratification when looking for a quick turn. The markets for toothpaste or mouthwash rarely set pulses racing, even if they have been proven to generate above-average long-term returns. In the investment race these 'plodders' are often ignored. This provides us with opportunity.

In the aftermath of the financial crisis the virtues of steady and growing shareholder returns were unearthed. 'Dull and boring' became 'sexy and exciting'. Following the Brexit vote, government bond yields collapsed to all-time cyclical lows. US 10-year Treasury yields fell to less than 1.5% and Gilts dropped to a Japanese-style 0.5%. It was perhaps, therefore, not altogether surprising that 'dividend aristocrats', stocks with decades of dividend growth, became ever so popular. With many such stocks touching 10-year high valuations, the Trojan Fund took profits across a number of core holdings and the Fund's allocation to equities reached multi-year lows. The cycle has now turned, reversing previous gains. Since July 2016 Gilt yields have increased to over 1.5% while Treasuries have risen to over 3% - government bonds offer higher income once more. The reversal has been a headwind for defensive stocks and, in expectation of improved economic growth, cyclicals have been favoured (*see Figure 1*).

Not So Stable?

One recurrent theme in equity investing is that few questions arise when prices are rising. By contrast, falling values are much more heavily scrutinised and we have witnessed plenty of clever rationalisation in the last few months. When falling share prices occur based on deteriorating fundamentals – think falling profits, a deteriorating balance sheet, weaker demand for products and services – disappointment is justified. However, falls may also be rationalised where the reasons for share price declines are no more complicated than '*more sellers than buyers'*. In the short term, stocks and sectors can go in and out of fashion depending on the stock market's mood. A few recent share price falls have their genesis in managements overpromising and underdelivering at the margin. This is market noise. Stock markets gyrate whilst the fundamentals remain sound with cash performance and profit forecasts largely unchanged. Exuberant expectations are re-set. As long-term investors, such corrections provide opportunity and no reason to panic.

There has been no shortage of explanations put forth to justify the recent share price falls among many consumer packaged goods (CPG) companies; disruptive channel shifts to e-commerce and discounters, a related resurgence of private label, changing media consumption affecting brand building and the changing tastes and preferences of younger consumers. These trends are condensed into the apparent loss of pricing power for many companies. However, pricing power is also cyclical. It involves the ability to recover cost and does not necessarily mean increasing retail prices just because you can. If commodity prices are weaker – as they have been in some cases – companies may choose to opt for volume growth over price realisation. Last year's revenue growth for the likes of Unilever was led by pricing. This year it is led by volumes. A cyclical slowdown in certain big emerging markets – Indonesia, Brazil, West Africa – has also been a major feature of recent trading. This has nothing to do with the threats posed by e-commerce or branded new entrants and the phenomenon is likely to prove temporary when these countries undergo economic recovery. Branded multi-nationals often aspire to higher rates of growth but they rarely achieve it. Unilever grew sales +3.4% organically in Q1 2018. This compares to its five-year average of +3.5% and a multi-decade average of just over +3%.

Whilst shorter term cyclical forces belie a less dramatic change in fundamentals, there is no room for complacency. Incumbent businesses face unique challenges as economies digitise. They must adapt and investors must be careful to select consumer categories, geographies and companies that are best placed to prosper.

Plus Ça Change

Some developments are not new. For instance, grocery retailers have always had a push/pull relationship with their suppliers. Back in the early 1990s, following a deep recession, the growth of private label in Europe was a concern for investors in branded goods companies. Marlboro Friday, in April 1993, marked a temporary high watermark for branded goods pricing. More recently, concerns were misplaced when Tesco de-listed Marmite. The impasse did not last long. No doubt tertiary brands will struggle during any disruption phase. Where the top three or four brands may have survived previously there is a greater need to be ranked in the top one or two. This is especially the case when it comes to e-commerce and discounter channels where choice is often limited. In selecting consumer stocks we have always favoured those with the strongest brands in product categories which face limited competition from smaller or weakly branded rivals. Companies with proven and resilient brand equity such as Coca-Cola or Colgate will always be represented with retailers through whatever channel they are sold.

Challenger brands are also nothing new. Recall the hype for Virgin Cola, established in 1994, which failed to gain any lasting traction with consumers. While many fail, others succeed. As Fever-Tree has demonstrated, product innovation combined with imaginative marketing will often find favour with consumers. This requires incumbents to be responsive and take decisive action. Evidence for this is found in Unilever's creation of several new brands that address patterns of emerging demand, and Diageo's array of new flavours and variants for its whiskies and vodkas. In contrast we avoid businesses that are driving margins too hard at the cost of future revenue growth. In the absence of internal reinvestment, Kraft Heinz and Campbell Soup Co. have resorted to large-scale acquisitions and aggressive cost-cutting to achieve earnings growth. This is unlikely to be a strategy that can sustain returns to shareholders.

Into a Brave New World

Past experience is no guide in trying to understand the longer-term effects of e-commerce. Amazon's purchase of Whole Foods shows a clear desire for the company to enter the food retail market. Whilst the retail landscape was always competitive, e-commerce emphasises the importance of value, especially when Amazon defines the search results. Brand loyalty is not going to disappear - if anything it becomes more important when consumers cannot experience products along a physical aisle. Bottles of Johnnie Walker and tubes of Colgate toothpaste are likely to remain popular items to put into shopping baskets, virtual or real. While consolidation in retail shows the threats from e-commerce are existential, for certain brands e-commerce is as much an opportunity as a threat. The automation of shopping can entrench repeat purchasing.

Companies cannot take customers for granted. Upstart brands such as Dollar Shave Club demonstrate that the replenishment model for branded goods can be disrupted. The acquisition of Dollar Shave Club by Unilever also demonstrates the enduring relevance of large multi-nationals that decide to invest. Barriers to entry into the industry may be lower, but barriers to global distribution remain formidable. Some more regularly purchased and bulky products, such as nappies or pet food, lend themselves better to e-commerce than others. Beverages and snacks have more dispersed sales networks because they often depend on impulse purchases that e-commerce cannot yet satisfy. Companies that benefit from emerging market growth will also be protected from some of these pressures because of a lack of efficient infrastructure required for online fulfilment. Together with more favourable demographics, this explains our preference for companies such as Nestlé which have big businesses in developing countries.

The Cost of Cash

When bargains are few, the Trojan Fund's cash levels are higher. We recognise the opportunity cost of holding liquidity. Our approach for the past 17 years has been to part with the Fund's cash only when we see compelling investment opportunities. This is an active decision. Conversely, we are not constrained from making sales because cash levels rise as a result. We have always had an aversion to the institutional pressure to be fully

invested. By holding some liquidity you live in an absolute world rather than a relative one.
While cash holds its value in the short to medium term, it suffers long-term erosion from inflation. At times when interest rates are set by central bankers at negative real rates, gold may have an additional role to play as an alternative store of value. In the short term, the volatility experienced by holders of gold may be uncomfortable, even if it proves to be a better store of value than cash in the long term. Gold may also offer a role in portfolio protection by providing negative correlation with falling equity markets.

Over the long term our aim is to maintain the real value of capital, at a minimum. This is certainly what has been achieved. But we emphasise that our time horizon is five years and beyond on the basis that, when making our investment decisions, we are looking to longer-term returns based on the initial valuation.

Allocation to cash is determined by the potential returns on other assets. In May 2009, when opportunities knocked, we held less than 6% in cash. Today that figure exceeds 29% because opportunities have become scarce. What is often discussed is the opportunity cost of holding cash and not the return on cash once it has been invested. Yet with the prospect of heightened volatility, we are preparing ourselves to reverse this direction of travel from one of gradual risk aversion to increased risk appetite. There are signs that valuations are beginning to shift in our favour.

After nine years of this market and economic cycle we believe we are far closer to the end than the beginning. Now is not the time to increase cyclical or financial risk.

Sebastian Lyon May 2018

Figure 1: Rotation out of defensives into cyclicals appear to be driven by rising bond yields

Source: Bloomberg and Morgan Stanley, 15 April 2018

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