



Investment Report N°60

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

The Legacy of Chainsaw Al

"The only valid purpose of a firm is to create a customer." Peter F Drucker

In February, Albert J Dunlap the renowned turnaround executive died. Also known as 'Chainsaw Al', Mr Dunlap was famous for reversing the fortunes of a number of poorly performing businesses in the 1980s and 1990s including Scott Paper and Sunbeam. Although Scott Paper was sold successfully to Kimberly-Clark, Sunbeam, an appliance maker, ultimately declared bankruptcy following a six-year turnaround attempt. This demonstrated a longstanding truth that business models focused purely on cost cutting have their expiry date. Experience informs us to be wary of the law of diminishing returns from such a strategy.

Our preference is to invest in business builders and we are sceptical of aggressive cost-driven practices. The names engaged in this have changed over the years. This cycle 3G, the shareholder-managers of Burger King, AB InBev and Kraft Heinz, has been the posterchild of 'zero-based budgeting'. This approach to cost-cutting was first developed in the 1970s but it has been widely espoused in the 2010s.

Deferred gratification

Occasionally old lessons must be relearned. A couple of years ago I attended a meeting with the management of The Kraft Heinz Company. We have never been shareholders in the company but we have longstanding investments in international peers such as

Unilever and Nestlé. At the time, the shares of Kraft Heinz were close to their all-time high of \$90, a few months prior to making the audacious and short-lived bid for Unilever. The Anglo-Dutch company's CEO subsequently referred to this approach as 'a near death experience'. Fortunately for us, as long-term shareholders, the barbarians were seen off on this occasion.

Today's share prices of these two companies tell very different stories. Kraft Heinz's has fallen by two thirds from its peak, weighed down by high debts, poor revenue performance and finally reaching the limitations of aggressive cost-cutting. In contrast, Unilever's share price has risen more than 20%. With the benefit of hindsight, Kraft Heinz needed the deal in order to continue to grow its business. Business models reliant upon M&A and cost-cutting thrive over the short term, as with conglomerates of the 1980s, but ultimately run out of road without further deals at attractive prices.

Slash and Burn

There were a number of interesting aspects to the meeting with Kraft Heinz's management. The first was the amount of 'management speak' used to denote the most important aspects of the business. Plenty of time was spent on the level of 'synergy' benefits provided by the merger of Kraft and Heinz and how they were to be delivered. Marketing budgets were to be slashed and departments closed as unproductive cost centres. Remarkably, at no time during the hour, was an existing product mentioned or a new product launch discussed. It was assumed that



revenues would grow but no demonstration was provided as to how. Most importantly, no reference was made to customers. However, investors at the time were enthralled by the story, which was promising instant gratification by way of rising earnings in the short run.

Operating margins at Kraft Heinz rose from 14% in 2015 (normal for a packaged food business) to 26% in 2017 (source: Bloomberg). The shares nearly doubled in two years. This placed huge pressure on other consumer goods businesses to adopt the same rule book and raise margin targets. Global staples companies were told they were on notice to 'get fit or get acquired' according to Citi Research (Global Staples Margin Upside in a 3G World – Jan 2016). Many followed and even Unilever and Nestlé have raised their guidance for margins and increased the debt on their balance sheets.

Baked Bean Counting

The answers to long-term investment success are rarely found in a spreadsheet. Companies are organic ecosystems that survive, thrive or fail. Cutting marketing and product development are easy wins for the bean counters, flattering short-term financial performance, but they run the risk of starving future organic growth and sustainability. Only by focusing on products and customers are you likely to end up delivering decent long-term returns to shareholders; concentrate on the former and the latter will take care of itself. Equity is fragile and attempts to enhance its value in the short term have the paradoxical effect of undermining longevity. Greater 'financialisation' of earnings especially via the increase of cheap debt to fund buybacks and M&A, brings forward returns, but only at a cost of increasing vulnerability and reduced manoeuvrability for management.

Kraft Heinz is no exception to the rule. Companies in consumer goods have warned that the gradual increases in margins this cycle are reaching a level of resistance, with Henkel's and Beiersdorf's profit warnings driven by margin resets in recent months. With the limitations of a cost-driven model revealed, we are already seeing a greater focus on prioritising top-line growth. Those that did not jump so aggressively on the margin treadmill have seen their shares hold up better.

At Unilever's investor day last year, outgoing CEO Paul Polman defended the company's focus on long-term growth:

"It is a better model to run your business on growth in consumer goods than just ruthlessly focus on cost cutting and shareholders only, which by the way is a very easy thing to do. Every benefit that you get in cost cutting is totally different than the long-term benefits you get from investing behind your brands, people or market development. Those are the investments that ensure the long-term cash flow that you should be interested in."

Unilever, P&G and Nestlé have enjoyed resilient performances so far this year and sales growth remains robust. We will continue to favour companies which look beyond short-term gains in earnings.

Two-tiered

On the whole, equity markets today offer an invidious choice: overvalued quality on the one hand and value in 'cheap' stocks on the other. Those which fall into the latter category tend to be either cyclically or structurally challenged. Valuation discrepancies with cyclical businesses are explicable on the basis of where we are in the economic cycle. Earnings for financials, airlines, housebuilders and miners may well be close to cyclical peaks, while structurally challenged businesses are to



be avoided, as on any medium-term timescale they will likely prove to be wasting assets. High yields are often an indication of future poor returns, not bargains. We prefer to eschew these murkier parts of the market.

Risks remain in assets which have seen their values elevated by liquidity. Prices have risen in recent months, without much improvement to earnings, a sign of investor insensitivity to valuation risk. For those investing for short-term outcomes that may be all well and good. For the prudent, long-term investor, the prospective rewards look somewhat less compelling when compared with the risks. Our preference will remain for companies which invest to sustain good returns rather than those which endanger their franchises for short-term gains. We also seek to avoid structurally-challenged businesses which are struggling to progress in a rapidly changing world.

A Sigh of Relief

The relief rally in stock markets 2019-to-date seems disproportionate to the (lack of) improvement in fundamentals. The recovery may prove temporary as shifts in the US government bond market towards a flat yield curve (3 month to 10 years – see *Figure 1*) implies weaker future economic activity. Corporate earnings have been mixed. While the stock market may cheer lower rates, for now, the less emotional and more rational bond market is more reliable and less swayed by short-term sentiment.

The prevailing view in the equity market is that *'it is all about the discount rate'*. As long as bond yields remain low, then all will be well. This is fine in isolation, but you need the earnings first. World trade has just incurred its largest contraction in year-on-year growth since 2009. Interestingly industrials, usually

the first to suffer from flagging demand, are experiencing declining revenue growth, especially in Europe and Asia.

Melt-up

In January 2018 there were forecasts of an equity market 'melt-up', just prior to a severe correction the following month. Once again, after the rally in the first quarter of this year, similar predictions have been made. The term is generally used to denote a momentum-driven rally that is both sudden and substantial. Today it would mark a further divergence from fundamentals. The most recent equity market melt-up was in 1999, during the technology bubble. A repeat of this cannot be ruled out but it is worth noting that this has occurred within living memory for the majority of stock market participants.

One very material change in markets since 1999 has been the decline in secondary market liquidity over the past decade. Owing to changes in regulation after the Financial Crisis, investment banks have withdrawn capital from equities and credit. Inventory has fallen as capital requirements have risen. Combined with an increased prevalence of Exchange Traded Funds, the holders of which expect continuous trading, and a strong rise in algorithmically-driven strategies, this makes for a highly fragile market structure. Air pockets are more likely, as was evident in some of the gaps down in stock prices in December. The shocking experience of the last three weeks of 2018 should not necessarily be viewed as an anomaly.

The First Cut is the Deepest

It is important to question how much damage the tightening of interest rates, which began in December 2015, has done to the US economy



and whether the Fed is 'behind the curve' in reversing this. If Jay Powell's laudable attempt to normalise rates has failed, then short rates may be heading downwards. This should not necessarily be a cause for optimism. It means that we remain stuck in a world of unorthodox monetary policy, which may well have to become more unorthodox in the next downturn. The tightening cycle was very modest – from 0.25% to 2.5% - but, expressed as a percentage move, it was the most material in the past 50 years (see *Figure 2*). In percentage terms, short-term interest rates have risen by 225 basis points or 900% from the 25 basis point low (based on the upper bound range). This compares to 4.75% to 15.25% from 1976 to 1980, a mere 221% increase from the low. The rise during the last cycle in 2004 to 2006 from 1.0% to 5.25% reflected a 425% uplift (source: CLSA).

The assumption remains for now that valuation multiples can expand in a low growth world. However, falling rates are not necessarily good for equities. Cast your mind back to 2002 or 2008 when interest rates were being cut aggressively; these were dreadful years for equity returns (See *Figure 3*). For now there are few firm conclusions that can be drawn but relying on the 'Fed put' to save the day in all conditions may prove a thin reed to lean on. Whilst the 'pause' has been cheered, a future cut will not necessarily offer cause for celebration.

The financialisation of earnings has made companies increasingly reliant upon bond markets to meet expectations. The cost of corporate borrowing, currently near historic lows in developed markets, is not in the gift of the Federal Reserve to control. Corporate credit spreads over treasuries fluctuate with economic confidence. By assuming a more accommodative stance, the Fed has quelled concerns over the economy for now. It will,

however, unlikely be able to stem outflows from the corporate bond market when confidence falters and buyers capitulate. Spreads, which widened in December, have since recovered; company balance sheets have not. Increased borrowing costs have led the market down before. They may do so again.

Sebastian Lyon

May 2019



Figure 1: A flat yield curve has returned for the first time since 2007
US 10-year Treasury benchmark yield less 3-month Treasury bill yield



Source: FactSet 28 February 2019

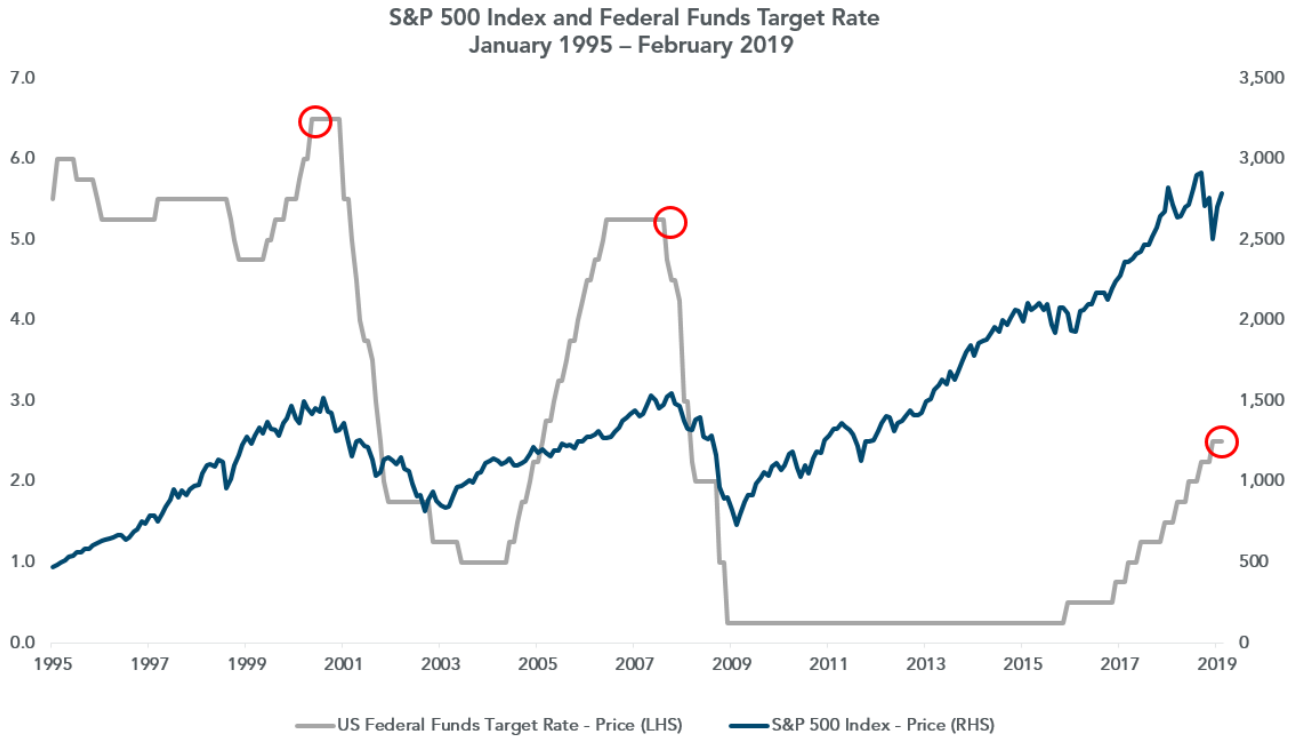
Figure 2: Changes in the federal funds rate target during tightening cycles

Tightening Period	From (%)	To (%)	ppt Change	% Change
Mar-71 to Aug-73	3.50	11.00	7.50	214%
Mar-74 to Jul-74	9.00	13.00	4.00	44%
Dec-76 to Mar-80	4.75	20.00	15.25	221%
Aug-80 to Jun-81	9.00	20.00	11.00	122%
Dec-86 to Feb-89	5.88	9.75	3.88	66%
Feb-94 to Feb-95	3.00	6.00	3.00	100%
Jun-99 to May-00	4.75	6.50	1.75	37%
Jun-04 to Jun-06	1.00	5.25	4.25	425%
Dec-15 to Dec-18 (Upper)	0.25	2.50	2.25	900%

Source: Federal Reserve Bank of New York, CLSA



Figure 3: Be careful what you wish for...
Lower rates do not always lead to higher stock prices



Source: FactSet 28 February 2019

Past performance is not a guide to future performance.



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