Evenlode Investment View

September 2016 - Weighing Returns (on Wobbly Scales)

By Ben Peters

Weighing expectations

Participants in the global economy are contending with any number of complex issues in what feels like a long episode of post-financial crisis rehab. Think of the geopolitics – an unexpected referendum result in the UK, Clinton-Trump and terror attacks in the US, an attempted coup in Turkey. Think of dealing with currencies – a US dollar that's been soaring over all, sterling collapsing thanks to the aforementioned referendum. Think of generally slow global economic growth (at least compared to much of the 20th Century) and wild swings in the price of oil and other commodities. And think of bonds, what's a company to do when it can borrow at negative rates (as Sanofi and Henkel have managed on the Continent), but lacks a strong economy to invest the proceeds into?

Despite the challenges facing firms as they operate with all these considerations and more, in the long run we at Evenlode believe those businesses who offer goods and services that people and businesses value can continue to thrive. We appear not to be alone in that view. Equity values have on the whole been on the up (with the usual smattering of downs) since we launched Evenlode Income in 2009. So it would seem that at least some in the market align with our opinion that businesses can improve their prospects through the malaise. Taking the complex geo-econo-politico picture and higher equity prices together, how do we weigh up our expectations for returns from our chosen asset class?

Weighing returns (on wobbly scales)

We estimate the value of each and every business that ticks our quality boxes* and makes it into the Evenlode investable universe. I use the word 'estimate' because, given all of the above, it would be improper to place a very high degree of precision on to the assessment of the likely cash flows to come from a business (a statement that applies at any time, not just the current juncture). Nonetheless, by also calculating a range of potential outcomes for a firm we can gain a picture of the valuation environment, and get an aggregate view on potential returns from stocks.

Before looking at specifics, the headline is that in aggregate the high quality firms that we examine are trading at slightly-cheap-to-fair-value. That's a deliberately fuzzy turn of phrase; this is not an exact science. But if a conclusion is to be drawn, it's that returns available from equities are acceptable but not exceptional. And always remember that equities are a volatile asset class, so any potential returns could well experience short term losses.

Balancing value

Having written the previous paragraph, I realise that I'm probably not doing a very good job of selling the current opportunity set. Let me look on the brighter side. Within the universe of businesses that we examine, we can tilt towards better value and away from less attractive market prices, which puts the Evenlode portfolio as a whole into the 'cheap' camp in our estimation. On a long-term view, this estimation translates to the potential for high-single digit total returns per annum. But it's important to remember in the execution of our process that the valuation of a business is one consideration amongst many. In particular, not all businesses are of equal quality, even within our slimmed-down universe of stocks.

Evenlode Income's top two holdings for instance, Diageo (alcoholic beverages) and Unilever (consumer goods), are in our view priced to deliver attractive long-term returns. However, there are stocks with higher forward cash returns in our investable universe. So why do two businesses that we accept have a lower return potential than others feature at the top of the portfolio? It reflects the confidence we have in their repeat-purchase revenues, strong brand portfolios, diversified business models and healthy, stable cash flows. All these factors equip them well to cope with any particular bump in the road and to continue to deliver a growing dividend stream to the fund through thick and thin.

Conversely, we estimate higher forward cash returns** for other companies, such as UK-focused firms Halfords (retail) and Mitie (support services). Both of these firms feature in the Evenlode Income portfolio. We assess that they are strong in their niches, and they tick all the boxes from our quantitative assessment of quality. But they operate in reasonably competitive spaces, and are less diversified than other firms we might invest in. So to prudently manage the fundamental risk that is the flip side of the valuation opportunity,

we hold relatively small positions in the fund. Mitie's profit warning this week is a real-life example of these fundamental risks coming to bear as uncertainty, not least from the referendum, presents a significant headwind to current trading.***

Weighing the risk premium

An absolute view on valuation is an interesting question in these times of unprecedentedly low interest rates. Bonds are a recurring theme at the moment for good reason; when the equity market responds vigorously to an event such as the ten-year bund yield turning positive, one knows we're in an unusual situation. When we make valuation judgments on a company's stock, we are looking at the firm on its own and compared to other businesses. We judge relative valuations after taking underlying financial leverage into account. So, as far as possible, we are not judging valuations of equities relative to bond yields.

Given the aggressive monetary stimulus we are seeing, there is the potential to distort equity valuation judgments by lowering discount rates. I believe that examining absolute valuation is particularly important at the current time to guard against valuation risk. Equities offer clear daylight between their own valuations and those of bonds (the *equity risk premium* in abstract financial parlance), but caution is required. To drag prospective returns down relative to the zero available from some sovereign debt would not acceptably compensate investors for the real world risks always faced by businesses.

This appears to be a point that market participants agree on as well. It has let the market equity risk premium widen to near historic highs****, i.e. future returns from equities have not followed bonds into the abyss. What that means is there is sufficient absolute value around to enable us to put together a portfolio with enough potential return to warrant continued long-term investment. Some stocks have undoubtedly benefitted from being dragged up in price by low bond yields, but the overall picture is fine.

Moderate expectations are a good thing

To come back to the risks presented by the long list of global worries, in a way these are positive for the equity investor. If market actors are worried about prospects for sales in emerging markets for Diageo, new drugs for GlaxoSmithKline, oilfield equipment for Smiths Group or soap in Nigeria for PZ Cussons, it helps keep a lid on valuations and enables us to continue to invest for the long term. A helpful side effect of long-term ownership is that we can strike up a constructive dialogue with Evenlode's investee firms, and get to know them very well through bad times as well as good.

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Please note, these views represent the personal opinions of Ben Peters as at 20th September 2016 and do not constitute investment advice.

*Quality according to our definition means high returns on capital, a high degree of profits converted to cash, a low requirement for investment of that cash into capital assets, and a good qualitative reason why those attractive microeconomics should continue into the future.

**Forward Cash Return is our favoured way of looking at equity valuation. It's like the redemption yield on a bond, and is the technical basis for the analysis referred to above.

***We very much acknowledge the difficulties that Mitie currently faces, but continue to view the company's longer-term cash-flow potential as attractive, given its value-added outsourcing proposition and its long-term embedded relationships with clients.

**** The equity risk premium is conceptually straight forward and notoriously difficult to pin down in practice. I base this statement on our own work based on fundamental free cash flow, and a sense check with that of Aswath Damodaran who has a crack at estimating the equity risk premium for US stocks http://pages.stern.nyu.edu/~adamodar/New_Home_Page/home.htm