Tony Yarrow's Investment View

PARKING THE BUS

Wise Funds

How, when, and above all why?

Why we think the stock market will carry on going up, and what we intend to do when it has – why shares may not be as expensive as you think – why gilt prices can fall without share prices falling

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In August 2015 West Ham, a football team in the English Premier League, played an away game at Liverpool, a fixture which they hadn't won for nearly half a century. Despite being the weaker team, and having almost no possession of the ball, West Ham won the game 3-0 by playing with an extremely defensive formation, soaking up the pressure from Liverpool's attack, and scoring three goals on the break.

After the game, West Ham's manager, Slaven Bilic, was interviewed for the BBC's Match of the Day programme, and was asked about the rather negative tactics his team had adopted. He replied with these immortal words 'Well we've come, and we've parked the bus - and there's nothing wrong with that.' Referring to the goals they'd scored, he added 'We parked the bus, but we didn't put the handbrake on.'

We in the Wise funds team are also beginning to think that the time to park the bus may be coming closer. In this blog I'd like to outline in some detail how we think things may develop, and what the more defensive formation we have started considering might look like.

Recent economic and market commentary has concentrated on the many uncertainties, especially political uncertainties, that exist. You are already very familiar with these unknowns – Brexit, President Trump, the relationship between China and the US, the upcoming French, Dutch and German elections, their possible repercussions for the EU and the Euro, and much else.

We follow these events closely, but our analysis of markets and the way they are behaving leads us to the conclusion that other forces are at work as well. We believe that three events which took place last year, none of which made headlines at the time, are of crucial importance in understanding the current direction of financial markets.

Three potential turning points in 2016

Chronologically, the first of these events was **the turn in the commodity markets in late January.** The prices of industrial metals such as iron ore had been falling for five years, the longest down-market in history, and the price of crude oil had fallen by around 75% over a shorter period of around 18 months. This turnaround in commodity prices, which has continued up to the present time, coincided with a reflationary initiative by the Chinese government, which they call 'One Belt, One Road' - aiming to improve infrastructure and communication links with the rest of the world.

Rising commodity prices are inflationary. Last week the electricity and gas supplier npower announced an immediate 10% price increase for some of its customers. It is a long time since we have seen anything like this.

The second event is difficult to date precisely. It is a change in macro-economic thinking on the part of governments, central banks and their advisers. The view now is that **the policy of Quantitative Easing (QE) has run its course**. QE takes place when central banks use money that they've printed to buy large amounts of government and other debt (known as gilts and corporate bonds). QE has either fulfilled its purpose, failed, or had a mixture of good and bad outcomes, depending on your point of view. What experts appear to be agreed about is that at this stage, QE should be wound down, and economic stimulus should continue in the form of infrastructure spending. Recently, Leo Quinn, the Chief Executive of construction company Balfour Beatty, spoke of the 'tsunami of infrastructure spending' that is about to hit the UK. This programme will include more money to be spent on roads, an acceleration in house-building, HS2, the new runway at Heathrow, the London super-sewer, and the replacement of the UK's ageing electricity generating facilities. President Trump has a similarly ambitious programme for the US, the Chinese are already rolling their programme out, and others will follow. Infrastructure spending involves the use of commodities, has a ripple effect on the wider economy, and is inflationary in a way that QE isn't.

The third event can be dated with a fair degree of precision to the middle of July. This was **the downturn in the bond market** after a bull market which had lasted 36 years. In 1980, at the end of the inflationary '70s, the prices of UK government stock (gilts) were very low and their yields were very high. It was possible back then to buy stock which paid you an income of 14% per annum. Inflation fell dramatically in the early 80's, and ever since then, gilt prices have been rising, and the income they pay has been falling. QE extended and exacerbated this trend, pushing gilt prices up, and yields down, to levels never seen before. After July 2016, gilt prices fell for around three months, since when they have traded sideways. However, the fall hasn't been enough to make gilts cheap – they are still very expensive, only not quite so extremely expensive as before. For example, if you buy the 2025 gilt today, it will give you a return of 1.1% per annum for the next eight years. The thirty-year (2046) gilt, which gives the highest return of any maturity, offers less than 2%. These yields offer no protection whatsoever against inflation. In December 2016, CPI inflation in the UK was 1.6%, and it is rising. This means that, adjusted for inflation, the return on the best-value gilt is wafer-thin, and on the 2025 gilt your money is not even maintaining its spending power.

Owners of gilts

Most people who buy gilts do so for one of three reasons.

The first of these is as an investment. The UK government has never defaulted on a loan, which is why gilts are sometimes known as the 'risk-free asset', and their proceeds as 'the risk-free return'. Gilts used to offer an attractive and fixed level of income, with the certainty of your capital being repaid. But QE has put an end to that. The returns, as we have just seen, are still practically non-existent.

QE gave investors another reason to buy government stock. Yes, the prices had become unsustainably expensive, but sooner or later the central bank would come along and take them off your hands at an even higher price. This is the 'greater fool' theory of investment, with the central bank playing the role of the greater fool.

A third reason to buy gilts is because you can't avoid doing so. Many investing institutions have mandates which compel them to invest a certain proportion of their assets in government stock. These mandates tend not to change over time, even though circumstances do.

Before 2016, two of the above reasons for owning gilts held good. Those who had to own them had to, and owners could profit from central bank purchases. The only thing that was missing was the value. As central bank purchases are phased out, the only remaining reason to own gilts is not being able to avoid doing so.

This, in a nutshell, is the reason why we believe that gilt prices are likely to fall further.

Alternatives to gilts

Central bank support for gilts is declining, and inflation, which destroys the returns on fixed-income assets, appears to be on the rise. What can gilt-owners do? The most obvious alternative is investment grade corporate bonds, fixed-rate debt issued by the largest and most creditworthy companies. However, the prices of these bonds have risen in step with gilts, and they are by no means cheap. Of the large, liquid asset classes, shares offer the highest income, and are therefore in today's market the most obvious alternative to fixed interest for income-seeking investors.

During the 1980s and 90s, the stock market grew in size as many publicly-owned companies were privatised. Also, companies tended to issue shares to finance take-overs, increasing the overall stock of equity. Since 2000, when the two-decade long share bull market ended, and particularly since the financial crisis of 2007-9, companies have changed. As borrowing is so cheap, companies use debt to finance takeovers, and buy shares in, to support prices and concentrate the earnings per share. And fewer new companies have come to the market, as the cost of regulation has grown. The debt markets are now much bigger than the equity markets, and a re-allocation of only a few percent from the one to the other could move prices up a lot. This re-allocation has already begun. There is no other way to explain the resilience of share prices in the face of great economic and political uncertainty, and a raft of disappointing company results. A shift from gilts to shares, which has barely started, would be like the movement of water through a funnel, with the action at the far end of the process being more violent and dramatic than at the beginning.

In view of the above, it may be that we are in the early stages of a bull-market top in shares, which could turn into a 'buyers' panic' where prices move so far and so fast that it becomes nearly impossible for the many still on the side-lines not to be sucked in.

Most investors and commentators do not foresee this outcome, for very good reasons, of which two in particular deserve careful examination.

The first view is that **shares are already very expensive**, and therefore can't rise further. Commentators who make this statement are often referring to the US market, which is the world's largest, and also its most expensive. But we don't have to invest in the US.

The measure normally used to determine the expensiveness of companies is the Price/Earnings or P/E ratio, as illustrated in the following example.

Company A earns £1m a year in profits. Company A has ten million shares in issue, each worth £1. If you wanted to buy the whole company, it would cost you £10m to buy ten million shares at £1 each. Company A's P/E ratio is ten, because the value of the company is ten times the amount of one year's profits.

As a long-term average, a P/E of 10 times is thought to be good value, 15 times is slightly above average, and anything above 20 is on the high side, but there are many exceptions. Investors will pay a higher P/E multiple for a company with growing profits, and still more for rapidly-growing profits. Conversely, companies whose profits are flat or falling trade on much lower P/E ratios.

Now, let's follow Company A through the business cycle. At the bottom, we are in a recession. A's profits have been falling for a couple of years, and are expected to go on falling. Investors worry that A might even go bankrupt. The annual profits have fallen to just £500,000. The shares are trading on a P/E of 8 times, which makes the company worth £4m, and the share price 40p, but most analysts still think the price is too high, based on where they expect the profits to be in two years' time.

However, that moment turned out to be the bottom. A's management cut costs and boosted efficiency, and the market for its services picked up, and five years later, the company declares an annual profit of £2m. Analysts expect growth to continue, and the company is valued on 15 times this year's profit. Now, Company A is worth £30m, and the share price is £3.00.

I have long wondered why it is that shares don't look cheap at market bottoms, and don't look expensive at market tops. The answer appears to be that at the top, earnings are expected to rise, so companies will grow into their valuations, whereas at the bottom, earnings are expected to continue falling, making the cheap valuations an illusion.

Now we must return to the question of why the stock market (I will concentrate here on the UK stock market) looks expensive. Investors have remained cautious and risk-averse since the Great Financial Crisis (GFC) of 2007-9. This caution is expressed in a preference for investing in the shares of safe companies, which can be relied on not to go bankrupt, to grow their earnings every year, and to pay secure and steadily rising dividends. Investors value the superior quality of these companies, and are happy to pay up for it. In the jargon, quality companies trade on high P/E ratios.

Now, the P/E ratio of the market is an average, and averages are funny things. In an index with 100 companies in it, the P/E of the index is that of all the constituent companies added together, and divided by 100. An extreme example of how averages work was the hand-held computer company Psion. At the height of the technology bubble in the year 2000, Psion's shares traded on 1500 times the company's earnings. This was the time when Psion's shares made their brief appearance in the FTSE-100 index. On its own, Psion made the price-earnings ratio of the whole market 15 times (1500 divided by 100 = 15), before taking any of the other 99 companies in the index into account. So of course the market looked expensive back then. However, the index also contained companies whose P/E ratios were as low as five times. Such a ratio would normally be considered very cheap, but no one was buying the shares of these companies because they were all ‘old economy’ companies, which were expected to fade away to nothing in the new age of the internet.

Today’s stock market is in some ways similar to that of 2000, though not as extreme. Today’s market can be divided roughly into two, on the one hand high-quality companies, which are excellent but rather expensive, and on the other hand companies which appear to be cheap, but are considered to be of such low quality that they aren’t worth investing in.

An example of the latter is the gas supplier Centrica. On the day before the Labour Party conference in September 2013, Centrica’s share price was just above £4.00. Then Ed Miliband announced a cap on the prices which utility companies such as Centrica could charge, and Centrica’s share price immediately fell to £3.00. Labour weren’t elected, but Centrica’s share price didn’t recover because very soon afterwards, the world price of gas collapsed, causing huge problems for Centrica’s exploration division. The company had to retrench, and was forced to cut its dividend. Then problems emerged at Centrica’s Rough gas storage facility in the North Sea. Meanwhile, Centrica was losing customers to competitors at the rate of several hundred thousand a quarter. Today’s share price is £2.30, and it has been a lot lower.

In response to these issues, the company has appointed a good new chief executive, begun an initiative to improve customer service which appears to be working, as measured by a marked slowdown in the rate of customer defections, and of complaints, and has scaled down its unprofitable exploration division. The price of gas has stabilised. While for most investors, Centrica remains firmly in the ‘don’t touch it with a bargepole’ category, its shares are hardly expensive. A return to the September 2013 price would imply a 75% capital gain from here, and though that may never happen, we are being paid a 5.4% dividend while we wait (unless they cut it again!).

Centrica is by no means the only example of a company which may still be cheap. A friend of mine sent me a list a few days ago of 50 companies in the UK which can be bought for less than the break-up value of their assets.

In order to create a value portfolio, we don’t need the whole market to be cheap – there just have to be enough cheap companies for us to create a portfolio. At present that continues to be the case.

The second main argument against the view that share prices could rise substantially from here, is that the stock market always follows the gilt market, and **when the gilt market falls, then shares must follow.** This was always the case in the years before the GFC. However, things may be different now.

At the top of a traditional economic cycle, the central bank raises interest rates in order to reduce borrowing and encourage saving. The increase in the floating interest rate makes fixed interest (gilts and corporate bonds) look less attractive by comparison. Gilt prices fall and their yields rise, which re-establishes the relationship between fixed and floating rates. Then shares fall, because their dividend yields look less attractive compared to the higher returns available from gilts, and also because the rise in interest rates ushers in a period of slower growth and lower profits.

But this isn’t a normal cycle, because QE has broken the value relationship between gilts and shares. When you buy an annuity, you can choose between a level one and an index-linked one. The index-linked one is expected to rise during payment, so it starts at a much lower level. In other words, the initial payment on the rising income is much lower than on the level one. The same thing used to be true in the financial markets. Company dividends tend to rise over time, while the payments from gilts are by definition fixed. In the year 2000, a portfolio of gilts would pay you roughly two-and-a-quarter times the income you'd receive from a portfolio of shares, which made sense on the basis that over time the income from the shares would grow, overtaking the income from the gilts. By August 2016, this yield relationship had been turned on its head. For a brief period, a portfolio of shares paid over twice the income from gilts. This relationship only makes sense if you assume that the dividend payments are going to be cut, and then keep on falling. At a time of rising inflation, today's value relationship between the two asset classes makes no sense at all. Because the relationship has become so distorted, it appears perfectly possible for gilt prices to fall without share prices falling, and that's precisely what has been happening over the last six months.

Why we may need to park the bus

In the 1990's, institutional investors moved out of the cheap asset class (gilts) into the expensive asset calls (shares). They have spent the last 17 years moving in the opposite direction, and are now once again very overweight the expensive asset class (which this time is gilts) and underweight the cheap one (shares). Any rebalancing move would have a significant effect on share prices. I have tried to show that the stock market could be significantly (say 20-30%) higher than it is now, and yet appear cheaper than it does at present.

A bull market in shares is both a good and a bad thing. It's good, because we make money from our shares. It's bad, because it sucks value out of the assets we own, leaving us short of good investment ideas. In a very expensive market, which we don't think this one is yet, we should not look for the 'least expensive' or 'least worst' ideas, but be prepared to withdraw to the side-lines.

There are various things we can do in that situation. We can hold cash. It may be that the gilt and corporate bond markets will fall far enough to become attractive again (seems unlikely at the moment, but if inflation concerns keep growing, just possible). Perhaps the 'bond proxies' will get cheaper – they might be seen as 'boring' in a rising market – and offer us an opportunity. We can buy a put option on the market. We can write covered call options on our shares, which would increase the fund's yield at a time when there wouldn't be much yield available elsewhere, and in a frothy market we would be unlikely to give up much in the way of capital gain. Or we can buy funds that write covered calls, rather than doing it ourselves.

Our long-term aim in **TB Wise Income** is to provide our investors with an attractive and growing income. We use a value approach, trying to buy good assets when they are cheap, which also tends to be when their income yields are high, and holding them as they return to favour in the market.

However, there will be times when we can't do that, and one such time may be ahead. Losing capital doesn't help us in our goal of delivering a rising income. Our Flexible mandate allows us to do whatever we can to avoid such losses when our investable universe looks vulnerable.

But whatever market conditions may be ahead, we won't stop doing the research, looking out for the good assets at the attractive valuations.

When the time comes, we'll park the bus, but we won't put the handbrake on.

Please note – this blog contains the personal opinions of Tony Yarrow, and is not intended as financial or investment advice.

I would like to thank you for taking the time to read this blog, and am happy to answer your comments or questions by email:

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