Weekly Digest

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Old Dogs, New Tricks

No sooner had I sent last week's Digest off for publishing than I received a link to the latest memo from another veteran investment guru, Howard Marks of Oaktree Capital. You might recall that he has featured in my commentaries in the past, and was also interviewed by my colleague Max Richardson when markets were caving in last March. At seventy-four years of age, he is a mere stripling relative to Jeremy Grantham, who is eighty-two, but Mr Marks has been employed in the financial services industry since 1968, and has therefore been round the block a few times, gathering knowledge on the way, which he has distilled into the wisdom that he imparts in his memos. These are readily available online.

The latest one entitled "Something of Value", is exceptionally timely, as it addresses the whole concept of what constitutes "value" in a financial instrument, not least the tension between what might look cheap on current or historic earnings, but which takes little account of capital requirements or future challenges, and what looks expensive through the lens of today's (sometimes lack of) profitability, but which incorporates a belief in high future returns. And it's not as if Mr Marks does not have first-hand knowledge of the problem. He lost his job as Head of Equity Research at First National City Bank in 1974 following the precipitous derating of the group of shares known as the "Nifty Fifty" that had led the stock market boom of the early 1970s. He actually counts this as a "lucky break", as he was shunted off into the corporate bond department, which laid the foundation for his current fortune.

In a forthright exchange with his son, who is a fund manager at a venture capital outfit, he also discusses the concept of when one might sell an investment. Marks senior is very much in the "bank some profits" camp, whereas junior wants to run his winners. Of course, being a venture capitalist, the son will have a different mindset owing to the fact that his winners can more readily produce returns that are many multiples of his original stake. Neither are his investments subject to the daily vagaries of the public markets. He might also be hamstrung by the fact that there is often no ready liquidity available should he want to sell.

The key conclusion is that Mr (Howard) Marks admits that an equity investor does need to view current opportunities in the light of today's capital-light business models and exponential growth potential – although he stops short of declaring whether or not we are in a bubble currently. Everything has to be taken on its merits, cognisant of the fact that "Mr Market" will have his own opinions from day to day. You might recall that the "run your winners" approach is also favoured by another investor to have featured in this commentary last year (and also interviewed by Max), James Anderson of the Scottish Mortgage Investment Trust. SMIT's parent company, Baillie

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Gifford, was famously, until very recently, the largest institutional shareholder in Tesla.

I would make two more comments about how things have evolved. Certainly during my time in the City, valuation measures have become more, how should I put it – expansive? Flexible? Generous? When I started (1984), price/earnings (PE) and dividend yield were sufficient for most, with a relatively narrow gap between the “cheapest” and most “expensive” shares. I put those terms in inverted commas, because, in retrospect, many of the supposedly expensive stocks were, in fact, the ones one should have bought and held. Suffice to say, a PE in the mid-teens was deemed to be “nosebleed” territory.

A decade later, as valuations started to creep higher thanks to bond yields trending lower in a disinflationary world, analysts started looking for a new valuation tool that would make things look, superficially at least, “cheaper”. Enter EV/EBITDA. The firm I worked for at the time – Smith New Court – was acquired by Merrill Lynch, and our analysts were all packed off to New York, returning triumphantly with their new knowledge. By dividing the Enterprise Value (market capitalisation plus net debt) by Earnings Before Interest, Tax, Depreciation and Amortisation, the research community had a measure that provided a much clearer picture of the underlying cash-generating capabilities of a business, and the ratio, crucially, tended to come out much lower than a PE – hardly surprising, if one excludes three lines of accounting costs! I have no problem with the concept or use of EV/EBITDA, but I do believe that its wider adoption as a valuation measure was part of the process of the untethering of valuations from their previous base during the 1990s.

The icing on the cake was the widespread use of Discounted Cash Flow (DCF) modelling. Again, I recall an analyst showing me his model for British Telecom in around 1997. “Look at this. If I reduce the discount rate from 4% to 3% the share price target goes from 400p to 600p!” (or something like that). It was like magically creating value out of thin air. As we went into the Tech Boom, tweaking the discount rate lower was a handy way for analysts to justify ever higher share price targets. DCF models are also highly sensitive to growth rates. Therefore, all sorts of fancy growth rates for various new technologies were part and parcel of creating what was, in no uncertain terms, a bubble, especially when spiced with the speculative trading element and FOMO (even if we didn’t call it that then).

My second observation, and one which does, admittedly, risk falling into the “it’s different this time” trap, is the change in capital structures. I came across a fascinating chart last week (originally from the Credit Suisse Global Returns Yearbook 2020), which compared market composition in the UK and US between 1900 and the present. This is relevant, because a lot of valuation calls are made relative to long-term averages, even if the underlying drivers have evolved substantially.

In 1900, around two-thirds of the US stock market capitalisation and half of the UK’s comprised… Railways! Now, railways are not necessarily a bad investment. Indeed, Warren Buffett has historically revealed a penchant for owning them. But they are highly capital intensive, and therefore subject to the gravity of the capital requirement and the need to service it. Moreover, the assets have a tendency to rust, breakdown or (certainly back then) crash! That is not a recipe for sustainably high valuations, even if they were often the subject of speculative booms.

Fast forward to the present, and the US market is about a quarter Technology, with many of that industry’s leaders being capital-light “platform” businesses. And shedding capital and raising the return on capital has been a route to prosperity for many other companies too. If one can combine high returns on capital with a modicum of growth, the DCF approach delivers a high PE. The UK does not have anything like the same Tech exposure (more like 1%), which is why, despite looking cheap on relative PE grounds, it would be surprising to see valuations converge.

Even so, this does not rule out potential outperformance by the UK in the shorter term. This is because of the higher weighting to cyclical industries such as Energy and Materials, both potential beneficiaries of a post-vaccine return to “business as usual”. But one does have to question the sustainability of performance once the

bounce has played out. The bulls would have it that Resource industries have been starved of capital (diverted to Tech) and that we are faced with supply shortages that will lead to sky-high prices. This trend might be exacerbated by redistributive policies that take money (tax) from those with a propensity to save and put into the hands of those with a propensity to spend (and with a higher proportion of that spending on commodity-derived goods rather than services). This is a topic that we will have to return to in more detail.

And so, to circle back to the discussion about booking profits or running winners, what should we do today? As I outlined last week, we are not in the bubble camp, which would suggest sticking to our guns (which we are). However, we cannot hide or ignore the fact that short-term measures of sentiment are frothy. These include Bank of America's "Bull & Bear Indicator", which is close to a "sell" reading, and Citigroup's "Panic/Euphoria Model", which is more euphoric now than it was in 2000.

Similar models from Goldman Sachs and BCA Research tell the same story, as does the AAII Bull/Bear Sentiment Ratio.

Thus the market is definitely vulnerable to a setback, but not necessarily one worth trading for longer-term investors. We continue to view both fiscal and monetary support as unstinting in the current environment, which should limit the downside. We are also of the opinion that, whatever the dissatisfaction with the immediate pace of progress, vaccines will play their part in containing Covid (although, realistically, not eliminating it). But we also acknowledge that new variants present new challenges, not least for the infection rate. We could see some spectacularly awful case numbers in, for example, the United States in the weeks to come, and more restrictions on activity with the ensuing hit to economic data. One should be prepared for bumps.

And while there are pockets of the market that do appear to be in the grip of speculative behaviour, the better news is that, overall, levels of complacency do not appear to be as high as they were before the setbacks in 2015, 2018 and 2020. On all of those four occasions the VIX measure of Implied Volatility was in the 10-15 range, indicative of very relaxed attitudes to risk. This meant that most investors were fully committed and employing maximum levels of leverage. Hence the rapid unwinding of positions that ensued. VIX today is 24, suggesting less inherent potential selling pressure (although certainly not none).

Later this week we have the first meetings this year of our Global Investment Strategy Group and the Asset Allocation Committee. I will report on the highlights of our deliberations next week, not least if there any changes to the views expressed above.

Last week's Economic Highlights

FTSE 100 Weekly Winners

AVEVA Group PLC	7.8%
Next PLC	4.3%
International Consolidated Airlines	3.5%
DCC PLC	3.4%
Whitbread	2.7%
Johnson Matthey PLC	2.3%
AstraZeneca PLC	1.6%

FTSE 100 Weekly Losers

Just Eat Takeaway	-12.5%
Fresnillo PLC	-9.7%
Experian PLC	-6.8%
Burberry Group PLC	-6.5%
Polymetal International PLC	-6.3%
Persimmon PLC	-6.3%
Kingfisher PLC	-5.8%

FTSE 100 Index, Past 12 Months

Source:FactSet

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