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Holland Macro Views

Met Many 'Bears' Lately?

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The above title is not to suggest that we are necessarily bearish on equities but we observe that sentiment has now improved materially in the asset class we spend our lives studying. In November 2011 we wrote a piece *'Met Many Bulls Lately'*. The previous summer another piece was entitled *'Better get a Bucket'*. Like the one you are reading they were not constructed to call the level of the FTSE100 or S&P 500 but to outline a few points we did not feel were being properly considered by investors at the time.

From 'Better Get a Bucket', July 2010

- *In his 2009 Annual Report Buffett gave us a new colloquialism 'Big opportunities come infrequently. When it is raining gold reach for a bucket, not a thimble.'*
- *Against bond yields many equities look cheap. Some are likely to be deceptively so, others will be bargains. Our, and your, job is to distinguish between the two.*

From 'Met Any Bulls Lately', October 2011

> *Far too many investors are focusing their minds on the need to predict macro events and perhaps unsurprisingly the more they look the more uncertain they become. We are mindful of the risks in this trap and are more inclined to look at which companies are offered to us cheaply as a result of such widespread concern.*

This, genuinely, is not about trying to look wise after the event. It is about understanding enough about ourselves as investors and those around us to respond better in future and make more money with less risk. As such we need to look back a little to look forwards.

Our view, in the 2010-2012 years, was simply summarised to be contrarily bullish on equities when others were not and to do so in quality companies with a size of bet that mattered. We will not pretend we were alone – many wiser heads than ours also made the point more eloquently at the time. Did we execute the idea perfectly - far from it. We would do many, many things differently, given the opportunity again, both with the time we spent on certain stocks and the research we ultimately published. During the 2009-2012 period however, a rare special opportunity existed that we have outlined outlined before. i.e. investors were able to buy Great Companies at Great Prices run by excellent managers (we wrote another piece with that title in March 2010!). Today however all investors should be clear that not only is the bulk of that mispricing opportunity now behind us but that also today many new equity investors have arrived. They have greatly increased levels of confidence in the performance they think some equity investments may deliver even though current margins of safety are far slimmer.

Cheap vs. Bonds

A recent FT article got our attention. It referred to a recent wealth management conference that assembled many senior bond managers. Their view seemed almost unanimous – '*Equity is the cheapest part of the capital stack'* one summarised - a reasonable enough comment. Another urged bond investors to switch bond holdings into stocks, not utilities or high yielding ones, but preferring the likes of Coca Cola and Proctor & Gamble.

We actually do not disagree with any of these points of relative value even at today’s prices; but observe they are hardly new!

Fig.1: Relative Value – Just discovered? We think not...

	Nov-13	Nov-12	Nov-11	Nov-10
UK 10 Yr Gilt Yield	2.60%	1.87%	2.21%	3.05%
US 10 Yr Treasury Yield	2.52%	1.71%	2.11%	2.62%
UK Base Rate	0.50%	0.50%	0.50%	0.50%
US Fed Funds Target Rate	0.25%	0.25%	0.25%	0.25%
FTSE All-Share Historic PE	21.1	17.9	11.7	13.9
S&P 500 Historic PE	16.7	14.2	12.7	15.1
Colgate Palmolive PE	26.9	20.8	17.7	18.1
Becton Dickinson PE	19.1	13.8	13.9	14.9
American Express PE	19.6	13.2	12.4	13.6
Next PE	15.9	14.1	11.5	11.6
Unilever PE	18.0	20.0	15.0	16.3
Coca Cola PE	20.5	19.5	12.3	19.0

Source: Bloomberg, Capital IQ

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Fig.1 above we hope makes this point pretty clearly. That Equities are cheap vs. interest rates and bonds may be true but this has been the case for almost 4 years and is why the stock market has boomed. The unchanged long bond and Interest rates between 2010 and 2013 and markedly changed market PE’s are all shown above. The bond investor encouraging the ownership of Coke and P&G over Bonds may still be right, but amongst others, Grant’s Interest Rate Observer said pretty much the same 2, 3 + 4 years ago based on their franchise assessments, which are similar to ours, and likely the data in the table above.

Simply put, we must accept that today lower risk-adjusted absolute returns are now likely as a result of the higher starting multiples on good quality equity franchises.

Whilst obvious, we think it worth reminding ourselves of these facts to ensure we do not today slip into a level of conviction that is a function of recent (likely profitable) momentum rather than a function of the real opportunity vs. real risk that is now available - This trade-off being more compelling two to three years ago. Thus, we should be staying selective and likely be using the thimble more than the bucket. Smaller portfolios should result containing a fewer stocks that are genuinely assessed to have the quality we seek and yet still reasonable starting multiples. If the number we can find is few, consequently our cash pile should grow.

Starting Multiples

For all of the work we have done over the last few years finding franchises, looking at owner earnings definitions etc. some clients may be disappointed by our seemingly rather basic attitude towards the starting multiples we are prepared to pay for a franchise. We accept that a stock on a PE of 25x today growing its earnings at 15% pa will make investors that amount annually *if* the multiple can be retained into the future. Crucially however, we believe our margin of safety is lowered by the higher starting multiple – i.e. we stand a real chance of losing more money if something goes wrong.

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

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