Holland Views – Macro

Iceberg Watch + Greed becoming fear

It seems a new generation of equity investors has once again, embraced worrying. Plus ca change! After a one-way stock market ride for almost seven years, the last six months has brought fear to many an investor's doorstep. Their fears are numerous: Market risk, cyclical risk, China risk, political risk…or just plain fear of the unknown. We comment later on what we consider a more pertinent risk that worries us far more than any of these, namely: disruptive risk. First, we revisit an earlier observation on the importance of accepting market cycles. We conclude only that fear and a polarised US market is at last giving us a longer list of companies to assess that provide the mix of quality and value we seek. Perversely, we welcome such times as for too long those two traits, it seems, were only offered in isolation. Happy hunting!

Nothing to fear except fear itself

We have written in the past about the three distinct cycles that we believe investors should observe. Much of what has been observed by markets in the last 6 months or so we suggest may be explained (or rather not!) by a market cycle working its way through. There are always new developments that investors and markets will react to, be that a collapsing oil price or a Chinese market rout, but when looked at in hindsight many often just serve as a backdrop to a new phase of a market cycle.

As a brief reminder, our three observed cycles are:

- The Political Cycle. It dominates the evening news channels that we watch, but only very rarely has a significant effect on the investing world we are considering.
- The Economic Cycle. This is what many a market observer loves to comment on or predict thus justifying a market event just witnessed, or an action of theirs about to be taken.
- The Stock Market Cycle (less prominent in many people minds but far more important to investors we think) is the longer-term changes we all see (in ourselves and in others) in the degree of greed and fear. As such, a cycle is nothing more than a collective whim of emotion that we cannot measure nor rationalise. Its affects are often underestimated.

Three legends in their own fields give perspective

> *"Not everything that counts can be counted, and not everything that can be counted counts*."
> – Albert Einstein

> *"When evaluating the market outlook there are three things I particularly focus on and one that I don't consider. The one thing I don't look at is the economic outlook, as this invariably looks great at tops and horrible at bottoms. In my experience, economic views won't help you time markets correctly. The three factors I do look at are: the historical patterns of bull and bear markets, i.e. for how long and how far we have risen in bull market and how far we have fallen in a bear market…. I then look at indicators of investor sentiment and behaviour. Finally I look at long terms valuations particularly ones like price or book and price to free cash flow*" – Anthony Bolton [Extract from page 137 of Investing Against the Tide. The full page of text on that page is worth the cover price alone)]

Another great investor gave us the following road map for market cycles – he called it the human side of investing

Fig.1: Howard Marks on "the swing" of the market 'pendulum'

Human Failings

- The swing of the pendulum

The three stages of a bull market:

- When a few people begin to feel things will get better
- When most people recognize that improvement is underway
- When everyone thinks things will get better forever

The three stages of a bear market:

- When a few people realize that things are overpriced and riding for a fall
- When most people see that a decline is taking place
- When people think things will get worse forever

"What the wise man does in the beginning, the fool does in the end." 12

Source: Howard Marks-Oaktree Capital Management presentation

Today's 'tea leaves'…. about as accurate as yesterday's

Do these insights help us interpret markets today? In truth not much, but neither does any other macro view you read recently no matter how eloquently they may be communicated. All these observations can do is provide perspective to our current thinking. We found it interesting that Bolton went out of his way to ignore the one part of top-down investing that many seem to spend so much of their time on – i.e. the economy, and yet he achieved arguably the best track record of any UK long investor. Using Bolton's approach today would not necessarily provide comfort that markets such as the US should be bought as they have been rising for many years now and on a number of measures still look far from cheap. That said investor sentiment indicators are now a way off their peaks and institutional cash levels at a multi-year highs. At a company-level however, things look far different. The two tier market created by tech (especially the so-called FANGs Facebook, Amazon, Netflix and Google) outperformance means many once loved companies (Rolls Royce/Burberry/Rotork/National Oilwell Varco to list just a few) look to be pricing a terrible future. This is where we are now spending our time.

Risks + Iceberg watching (always bigger under the surface)

Commodity prices, China or cyclical risks get all the headlines. However, the risk that worries us the most, the lurking Iceberg like below the surface near many a company we look at, is obsolesce risk i.e. when a company faces early obsolescence due to a new disruptive entrant to its market.

With huge leaps in technology and the world awash with capital it feels like barriers to entry are falling faster than ever. Once safe business niches, if targeted ruthlessly and efficiently by new

entrants, can see their long held moats quickly breached. An example is US City Taxi Medallions – a once seemingly assured monopoly that for many years changed hands at premium prices. Their value has fallen by a quarter in the last two years courtesy of the Uber threat. In some ways, this challenge to the established business model feels unprecedented and thus worrying but Charlie Munger has for a long time now asked the rhetorical question of: “is technology going to make you or kill you?” It seems more pertinent now than ever.

The crucial point is how far reaching this risk is under many sectors and geographies, hence our iceberg analogy. The fact that we are actively seeking business’s models that have moats should give us more protection than other investors (we hope!), but great care is needed. There are surely ‘holdout’ companies against such a wave of challenges. These include the likes of Becton Dickenson, Nestle, Coke or Moodys who we would assume retain their moats come what may. But there is a long list of those where a new business model suggests a threat but the extent of its likely success is still unknown. For example, Purplebrick vs. Foxtons in the UK estate agency market as outlined in our recent note. Equally, some unassailable barriers to entry may be assessed as lower than the past (e.g. some brands being grown online rather than needing a local presence) and those fighting a ‘sea change’ at industry or secular level rather than a direct attack on their specific business. An example being reported daily is perhaps the seemingly constant falling US mall and UK high street traffic and the effect this is having on store retailers. Some of those affected and ultimately displaced in these ways will have been lazy and not defended their franchise from such threats, others may just be unlucky.

> “Q: *Are there other Berkshire businesses that could be affected by technology, as newspapers have been? What about Amazon’s impact on, say, McLane?*
>
> A: Buffett: *“**Amazon could affect a lot of businesses that don’t think they will be affected**.” GEICO was affected by the Internet and at first they missed it. It was mail-based then moved to TV, and when the Internet came along, I thought that only young people would look for quotes online. That was when I was still using a rotary phone, I guess. Amazon has millions of happy customers, and could affect a lot of businesses.*
>
> Munger: *“**Amazon will be terrible for most retailers. Not slightly terrible – really terrible**”* – Berkshire Hathaway AGM 2012 (emphasis ours)

Munger + Buffett remain annoying prescient!

QE is not necessarily guilty of this crime, but perhaps others

These changes and challenges to established models seem to have all been occurring at a time when money is washing around the world courtesy of QE. It is thus convenient to link these two drivers, i.e. more new entrants are a function of more money to finance them, but that is too simplistic we suggest. The developments at Google or Amazon in the last 10 years would surely not have changed that much with 0% or 5% interest rates. However, the occasional VC fundraising we accept will have helped the odd challenger. It should be noted that many of the disrupters are in fact very capital-light business.

QE has its own crimes as there are distinct side effects of it on other industries. This we suggest can be seen in sectors like property, shipbuilding, power generation leasing, re-insurance, or even supermarkets. The impact here has been that low interest rates have either kept weaker competitors alive longer than a normal market cycle would have permitted, financed a new entrant, or enabled expansion by existing players into areas that normally might have offered only marginal returns. This is perhaps, more simply considered, old world deflation i.e. too much is built or not destroyed for too long resulting in lasting overcapacity.

If we were looking for an analytical shortcut maybe we could conclude that QE has increased competition and thus reduced returns in some asset heavy sectors. Innovation has done the same for the asset light ones. Some companies are unlucky enough to be in the cross fire of both!

Old Tricks, New Dogs

When assessing such risk as we have above it is easy to become downbeat and convince yourself how hard the task is in identifying franchises that have real resilience. As we noted in another piece "*it (investing) is not supposed to be easy - anyone that thinks it is, is an idiot*". The good news is that perhaps as franchise investors we can be very 'moat' aware thus we just need to be more objective and more open about the challenges that face each of the companies we look at. In this environment, we should also consider flexing our conviction on a franchise business and the scale of the moat we believe it possesses as the challenges to it arise and either build or fade away.

- An example of currently increased risk is perhaps Foxtons, as outlined above and in our recent work.
- An example of a reduced, or passed, risk could be that Apple Pay did not seek to replace the existing payment networks but supplemented them thus reducing the network's obsolescence risk.

Buffett has often commented that he judges the success of each of his companies annually not by the profits they made but by whether he assesses their moat as having widened or narrowed during the period. We would all do well to think in such a way, eyes wide open to the obsolescence risk that may be threatened. That he has been using this approach for 50 years tells us that the displacement risk that the companies we look at and own face is nothing new, it is merely an open, market based economy working well. Each generation challenges just looks a little different

Conclusion

As the grey hair arrives at our temples we are far more inclined to think more about Bolton's and Marks' market cycles than we are to try again to read the macroeconomic tea leaves of the day. Such contrarian thinking suggests optimism ought to be warranted in hard hit parts of the world, like Greece, China and other emerging markets. The US aggregate market level is far from depressed however, but its overall distorted by a few large good performers (FANGs). However, at a stock level we suggest there is much more fear priced in. Thus for the first time in a while a few tri-factors are possibly on offer i.e. the odd Great Company, run by a Great Manager offered at a Great Price. For a value investor that is enough alone to bring a little more optimism.

Andrew & Mark **firstname@hollandadvisors.co.uk**

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Contact:

HollAnd Advisors

Holland Advisors London Limited
1 Berkeley Street
London
W1J 8DJ

Tel: (0)871 222 5521
Mob: (0)7775 826863
www.hollandadvisors.co.uk

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