



Holland Views

Mr Market's broken machine

Booms come and go and you just never know where the next one will surface. Who would have thought it would be in boring compounders, but that it seems, is the market we are faced with today. Seemingly, all investors are now Munger-like quality compounding fans, so much so they will pay almost any price to be part of the club. We are advocates of compounding franchises, but not advocates of paying multiples that discount perfection. As for Munger, well we note the last stock he bought in size was...Wells Fargo!

The market can remain irrational for longer than you can remain solvent – John Maynard Keynes

The above quote is fun to read, but at the very moment in time it might have some relevance to an investor they are rarely in the mood for quotes. By definition they will have reached a point where their backs are against the wall likely being forced to defend their positions, style or even whole investment philosophy. The layman might assume that such occurrences only exist at market troughs, indeed use of the word 'solvent' suggests as such. However we observe that many professional investors are already in this position today. Many are facing great scrutiny on their style of investing and why they are persevering with it when other styles 'have done so much better for years now'. They are also experiencing outflows thus being forced sellers of the undervalued shares they love.

We are not in Kansas any more

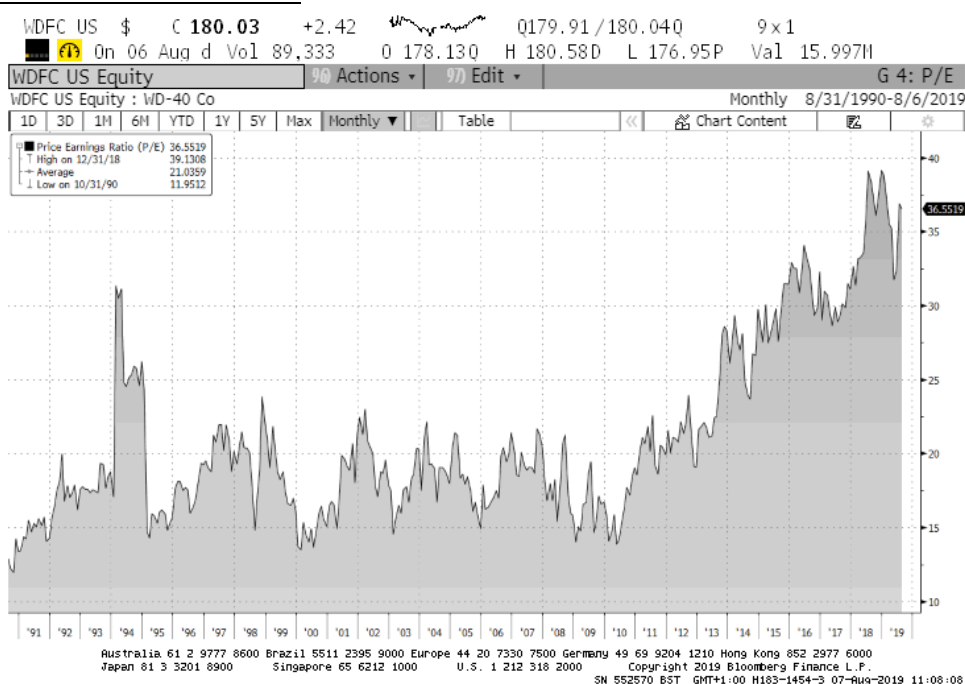
This note is about franchises, compounding, margins of safety and a few non-conventional stocks that we think get thrown up by hard rational thinking on such matters.

Later in this piece we will look at some examples of company ideas we think a careful approach to compounding throws up, but today's markets we think deserve a little more considered thought. Indeed, were we to mention some of these company names too early on very many investors might not read any further, such is the love affair with well-loved stocks. Most investors today love chalk and we might as well be recommending cheese.

Telling professional investor readers that quality shares are expensive and cheaper looking shares are, well, cheap, is not news. It was not news in 2016 either. At that time we wrote a piece suggesting what we called a 'Billy Beane' portfolio might outperform a franchise all-stars select team. We are proud to say that our team did outperform, but arguably that was due to some canny individual idea selections by us, rather than a turn in market sentiment against the all-star loved 'quality compounder'.

Around that time we laid out the case of WD40* using it as the simplest analogy for the market conditions we observed. It is a pure play, high ROE, single product company whose growth has changed little over very long periods of time. What has changed a great deal however, is the valuation Mr Market has put on it.

Fig.1: WD-40 P/E ratio 1989-2019



Source: Bloomberg

Re-visiting this same company again today is very instructive as to a wider understanding of today’s stock market as nothing changed. Indeed, the PE multiple just got higher still. The WD40 graph also gives a framework for the scale of today’s different valuation approach in a very long historical context. As the saying goes: “we are not in Kansas anymore!”

Why?

Why is this occurring? Well that we can all answer easily, here are our reflections from 2016:

“Many an investment bear believes that the rise in markets of the last 5+ years has been in some way false, with higher market levels only a result (direct or indirect) of money printing. We can see this point of view, but do not see market prices as in any way false or manipulated. All that has really occurred is a repricing of all related assets to today’s record low global risk free rate (Global Long Bonds – which are now either a bubble or at best return free risk). Corporate bonds, Property and Equities have all performed royally as a result with the best gains handed out to those seen to be the lowest risk (prime property, investment grade bonds and top quality companies)” – Farnam St Capital, letter to shareholders Sept 2016

That seems to sum up the last 10 years, and the last three since we wrote it, pretty well. Simply put the PE of risk-free cash used to be 20x (100/5% Bond Yields). Then it was say 30x (100/3.3% Bond yields), or 50x (2% Bonds). As such the PE for other cash flow streams over and above boring risk free cash should be at least as good as these multiples.... or so the story goes.

Pre-1997, 30-year Treasury yield was circa 6-7% and the corporate tax rate was 35%. Now they are 3% and 21% respectively. So \$1 of pre-tax earnings in 1997 was ‘worth’ $(1-0.35)/.06 = 10.8x$. Now that same \$1 of pre-tax earnings, on the same basis is worth $(1-0.21)/.03 = 26.3x$. Is that too simplistic?

Indeed very few of the companies that have been re-rated in this way you will find us telling you are ‘bad businesses’, but the shareholder returns they have produced way outstrip the growth in their earnings power. Returning to our WD40 example with the EPS compounding at c.10%pa and a starting PE multiple of 19x seven years ago and ending multiple of 33x today makes for some compelling numbers (stock price up to \$180 from \$50). That is an IRR of 20% over the 7 years. Imagine if you had 20 of those in a portfolio, you would be feted and loved by all.

Follow the money

Well some people have had just that portfolio and they are truly loved for that reason and have been sent lots and lots of money to invest. Please do not get us wrong, we too admire these people and think to a point Mr Market has done the right thing in making sure that the better quality companies (high ROIC compounders) are rewarded with higher ratings. However all good things come to an end sometimes. Today’s higher starting prices do not suggest an end in themselves, but they do make past investment performance of such strategies impossible to replicate (to some investors we worry that this might be ‘news’).

This freight train however has a real head of steam all of its own now. Managers who are today’s winners pride themselves on only buying certain types of stocks, a small basket of the very best businesses that have high returns and good compounding characteristics (no cyclicals and definitely no financials).

But let us stop for a minute to think how this has panned out from a money flow perspective. Just looking at Asset Managers in the UK, the combined AUM of Ballie Gifford, FundSmith, Franchise Partners and Lindsell Train has risen exponentially in the last 10 years. Where has this money gone? It has been invested it into exactly the same type of companies thus pushing the PE multiples of such companies up even further.

We reiterate we are not in any way critics of such investors. They have called the last 10 years brilliantly and deserve all the credit they get for the performance they have achieved on the investors’ behalf. But what started as a good idea (i.e. better businesses getting higher ratings) is becoming a cult. As students of past stock markets, and having lived through many a cycle, we find this phenomenon of great interest. We are also noticing a number of investors in the wider market feeling the need to play along with this game:

“What the wise do in the beginning, fools do in the end.” – Warren Buffett

The invisible hand that drives momentum

Let us introduce three investors: Mr Genius, Mr Smart-but-wrong and Mr Sheep.

Mr Genius: A successful franchise investor when given another £10bn to invest, buys stocks with characteristics he favours (his marketing department telling clients he never buys anything else) but at higher and higher PE’s. The rising resulting PE giving him (and those like him) both improved performance and a re-enforcement bias that he is right to be paying up.

Mr Smart-but-wrong: Meanwhile is a good but more value-centric investor, but one who has not ridden this wave and thus struggles to catch up. He has owned some value shares (that have compounded their earnings too), but they have been de-rated so many times he has lost the faith in his ability to hold them long enough for Mr Market to change his mind. The result, he holds off buying an unloved compounder on a PE of 10x, which he might have done previously and

instead buys something ‘better quality’ and higher priced that is more likely in his mind (a mind that has been altered by recent market conditions) to rise.

Mr Sheep: Passive and ETF investors are just jumping aboard which ever bandwagon is working and that is now proven for 10 years to be quality compounders/and or the ‘Market’ for index funds.

The other important factor is money flows. What started as a trickle of money flowing away from the Mr Smart-but-wrong to Mr Genius and Mr Sheep is now a flood. This further pulls money out of ‘value’ reinvesting it in ‘momentum.’

Mr Market we all know does not exist: he is the pseudonym of all the actions of all the players added together. He is partly the successful franchise PM with £10bn of inflows, he is partly the struggling value manager who is now moving up the quality curve in search of the performance he so desperately needs and he is partly the ETF manager chasing whatever is working. So in short Mr Market is only really buying one stock (or one type of stock) WD40. There is of course a small problem with all of this, paying higher and higher multiples requires greater and greater confidence in the future using that ever reliable tool – the crystal ball.

Later we recommend an interesting recent piece by Ray Dalio. A quote from it we liked goes as follows:

“There’s a saying in the markets that “he who lives by the crystal ball is destined to eat ground glass.” – Ray Dalio, July 2019

Do investors really understand compounding?

This may surprise some investors, but the analysis of quality companies and their ability to compound is not new. Indeed Munger has talked about it for five decades and one of your authors nearly went to work for Holt in 1994. (The system it uses has hardly changed since focusing on high ROIC companies).

Some years ago we wrote a piece called a ‘Better get a bucket¹’. It was all about franchises and compounding and suggested the purchase of shares like Becton Dickinson. We devoted a lot of time at that point in our careers to developing an ability to carefully model companies according to variety of factors that included their return on capital, most likely level of growth and future uses of capital. We learnt a great deal about different type of businesses according to their capital intensity and capital deployment and how fast each might compound intrinsic value as a result. We shared this work with investors as the years have passed.

“Price is what you pay value is what you get” – Warren Buffett

However an obvious additional driver of ultimate shareholder returns is of course the price paid for the shares. When redoing our website 5 years ago we used the following example to expand on Buffet’s maxim.

¹ <http://www.hollandadvisors.co.uk/cms/resources/research/holland-views-better-get-a-bucket-0710.pdf>

Great business are not always great investments

A well-respected global company that many investors would accept as a franchise today makes a return on its tangible capital of 15%. The intrinsic value of this company is likely to rise, we assess, by c.11% many years into the future, therefore it is an interesting company. What we believe makes it a compelling investment today, however, is its starting price of 10x current earnings (PE). We think it is wrong that an investment which can compound at c.11% for many years can be purchased for 10% earnings yield and therefore, in time, its mispricing will be corrected by markets. So, a move to a justifiable PE of say 13x in 3 years' time, added to an 11% compound annual return, results in an investor IRR of c.21% over the next three years. However, the exact same company shares purchased at, say, a PE of 20x earnings that then falls to a multiple of 15x 3 years would make an annual return to the investor of less than 1%

Source: Holland Advisors²

We are proud to say that the company mentioned was JPM and the IRR of 21% was largely achieved in the period that followed. However it is the latter part of the paragraph however we feel that is being ignored by too many blinkered investors today. In our mind they are failing to acknowledge the importance of both the current price they are paying for a share and the future price of the entity at the point they will sell it. That the entity might itself compound at a good rate if their crystal ball gazing is right we will accept, but the starting price matters, a lot.

The reason a margin of safety culture is built in to so many successful investors' approaches is because predicting the future is a very, very, hard thing to do. Maybe those adding new money to this area of investment might do well to ask themselves why the 'founders' of the school of compounding are not joining them. Munger (and Buffett) are only buying two sectors, the two we think the most mispriced by Mr Market's broken compounding machine: Banks and airlines.

"In paradigm shifts, most people get caught overextended doing something overly popular and get really hurt." - Ray Dalio

Following Taleb's lead

"Don't tell me what you think, tell me what you own" - N.N. Taleb

So what do we own? We own shares like Ryanair, Wells Fargo, Lloyds Bank, and Citigroup. In addition we own a variety of other businesses that we think have compounding characteristics but are just not valued as such. Companies such as Exor, Fairfax Financial or JD Wetherspoon. In short we are interested and invested in the two areas that Mr Market current mantra seeks to avoid at all costs... these we call ABB and ABC.

These acronyms for us represent all the things that today's Mr Market sees as toxic:

- ABB – Anything but Banks
- ABC – Anything but Cyclical

In earlier research pieces to clients we have outlined the compounding characteristics we think businesses like RyanAir and Wells Fargo possess. Our enthusiasm for such shares is a function of a variety of factors combining together to drive what we think can be 3-5y investor IRRs of c>20%pa.

² <http://www.hollandadvisors.co.uk/ourapproach.php#great-businesses>

The common drivers are:

- A strong market share position that would seem to secure a level of good future compound growth
- A strong likelihood of good or excellent capital allocation, mostly to cancel their own shares with excess cash
- That such cancellations are likely to occur at highly accretive, low market valuations
- That each company has a degree of self-help (less fare discounting at Ryan and cost reduction potential at Wells) with strong upside operational gearing to such inputs
- That a recovery in profits may well lead to a justified change in market sentiment towards these companies (i.e. higher PE rating than the current c.10-11x)

Much as these are our chosen picks to highlight, quite a high number of companies that sit in these sectors also exhibit some or most of these traits.

As a result we favour companies like **JPM, BAC, Citi, BONY, Lloyds and RBS**. We also favour **Ryanair** but also **easyJet** (probably IAG, but have yet to do the detailed work) and the US airline sector.

Aside from these sectors and the other mispriced compounders we write on, we also look for old economy businesses that might do well in the new economy. **Disney** is an en vogue example, but we think **Liberty Media/Formula 1** is another. Also, we look for self-help stories: mostly these are depressed in value in today's markets also. Finally, we always look for an aligned owner-manager.

[Conclusion – no one said it was easy](#)

Re-visiting the original quote that opened this note we are very well aware that a portfolio of such shares has underperformed for quite some time now, but that is the whole point of investing. If we cannot trust our analysis and our independent view of the intrinsic value we assess and we only use Mr Market's wind direction as our compass we are sunk.

We referred earlier to a recent very interesting piece from Ray Dalio – the link to it is here.³

“I did long distance running at school and you only succeed by doing a huge amount of training. Then having great stamina, understanding other people are also feeling tired, so when you feel tired, that is when you should accelerate. That is when you start winning.

I've learnt that with developing new technology, when you feel like giving up, it is precisely the point when everyone else gives up. So it is at that point that you must put in extra effort, you do that and success is literally just around the corner.” Source: James Dyson, **How I Built it**, Podcast

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³ <https://www.linkedin.com/pulse/paradigm-shifts-ray-dalio>

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