



Holland Views- FFH, DIS, LLOY, RBS, JDW, DLTR, RYA, EZY

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## What we do + Quality, with 20% IRR's

With 2018 having been such a tumultuous year for equity investors it seems logical to start 2019 with some re-assessment of what we are (and are not) trying to achieve in the work we undertake and... why.

### [What we do](#)

What we are not is either macro-economic forecasters or traders who try to time market movements. Whilst we think understanding the macro background and being aware of market cycles can be helpful to an investor, they are not our primary focus. Nor are we momentum investors seeking to find the next trend that will become popular in markets hoping to hop on and off in a timely (read 'lucky') fashion. The way we spend 90%+ of our time is to seek out great companies that we feel have special characteristics that should lead to superior long-term compounding of the earnings and value they deliver to investors. Our approach however remains opportunistic, i.e. we are looking to buy into these compounders at attractive prices. Such prices, however are only offered when others in the market feel there is something wrong. If a new client were looking for a summary of our approach it could be distilled perhaps as follows:

**Operate + Generate + Allocate**

**Great companies + Great Managers + Great prices**

In other words, we seek-out companies that are terrific **Operators** in their field, who **Generate** good or excellent returns for shareholders and who then **Allocate** wisely the capital that these operations generate. Put differently we are looking for **Great companies run by Great managers at Great prices**.

### [Why we do it](#)

Just a short word on 'why' we do it in this specific fashion. It is simply because post a lifetime of studying the great investors of today and yesterday, we found that those who achieved superior and lasting outperformance did so via this approach. They have/had a similar focus to own great compounding businesses, buying them with conviction when they are offered at compelling prices.

### [Opportunity Knocks](#)

As each market cycle comes and goes, we learn a little more about markets and indeed our own mental biases both from reading more (Bolton, Marks and Dalio) and from living through our own mistakes in painful real time. When markets are buoyant the opportunities presented to us to invest in the compounding business we are attracted-to, often come as a result of stock specific problems. Examples include JPM's Whale fiasco, Wells Fargo miss-selling, Richemont's China overstocking. or most recently, Ryanair's Pilot disputes. But when markets are falling opportunities can be a) more plentiful and b) offered more due to wider market risk aversion than any specific company problem. That is the situation we find ourselves in today.

The greatest conviction we are likely to have in such an environment is in the companies we already know well that we had previously believed to be mispriced (i.e. too low) before they then fell along with the wider market. Indeed, this is a lesson all investors have to learn for themselves (ourselves included), i.e. that no matter how cheap you think your favoured stock might be it will fall just as fast as others when wider market falls occur. In fact, it might even fall further if it is labelled as 'unusual' or 'risky' by others. It is also important when the market environment changes as it has recently to coolly (i.e. rationally) consider whether the reasons for your past enthusiasm for a company are still justified. In almost all cases we believe that to be the case for the companies we analysed at last year. However, an example of the need to reflect in this way is our enthusiasm for the US banking sector. In the face of a credit market that now is starting to price a greater likelihood of US recession we need to ask ourselves: Is the credit market right or are these shares far too cheap still? We favour self-help stories like **Wells Fargo** while we wait for/think about the answer.

### [High Uncertainty vs. High risk](#)

Before revisiting some individual company ideas, we think the distinction between High Uncertainty and High Risk is worthy of another mention. An impressive US investor brought this distinction to our attention a few years ago and now and again we find ourselves in situations that we think this phrase best describes. The current UK Brexit issue being a perfect example. We discussed this in more depth in our UK banking piece of December (re-attached). In it we observed that the key trait we felt many UK economic doomsters failed to appreciate was the entrepreneurial nature and the resourcefulness of both UK businesses and the wider population. That the EU has only a marginally benefit or detraction from UK economic dynamism is perhaps why the original vote was so close (i.e. if the effect the EU had on the UK economy was so great as to be noticeable, positive or negative, the vote would have easily swung that way). As such the damage being done to UK share prices is we believe as a result of 'uncertainty', i.e. the unknown, rather than genuine 'risk' that long-term UK economic activity will be irrevocably damaged as some noteworthy institutions have opined. In the vast majority of Brexit outcomes the prospects for many of the companies affected we believe will see only a small change to their future earnings not one that might justify a 30%+ reduction in their long term value. After all today's share prices are meant to reflect the NPV of all future company cashflows. In some cases, we feel that they are reflecting perhaps only the next year or two – hence the value we are currently being offered

Where uncertainty tips into real risk for us is in the greater chance of a Labour government controlling the economy. Such a government under the control of Messers Corbyn and McDonnell could justify some of today's share prices, particularly the UK banks (In contrast one under Blair we think would not). Our Brexit watching is through this lens and we are minded to be pretty aggressive and opportunistic in companies where we think longer term values will be only minimally affected.

### [Enough preamble – Where to invest?](#)

Current outlooks for US trade, Interest rates, China and Brexit lead many a commentator to conclude 'markets are tricky', or 'difficult to read'. As long as we have been doing this job such phases have abounded. We conclude only that if it were easy every investor would be rich. Such trite market assessments re-enforce our view to concentrate on the underlying companies we feel we understand well, continually looking for mispricing. As such, consider our New Year's preamble over!

We have recently been looking at a number of new ideas that market falls have thrown up and will communicate these to investors in the coming weeks. For now we attach a few recent research pieces and a number of spreadsheets to help clients see the now significant value that we think is

available in a number of the companies we favoured last year. We attach very simple spreadsheets on **Fairfax Financial, Wells Fargo, Lloyds, RBS, JDW, Ryanair and easyJet**. These are not designed to show off our modelling skills, merely to illustrate the level of Investor IRRs that we assess achievable.

In each case we are making what we feel are prudent assumptions of the continuing compounding of these business in their normal manner, i.e. in the banks they are assumed to make similar ROTE's to current levels and to allocate that capital sensibly. In Ryanair or easyJet's case they are assumed to carry more passengers as their low-cost model continues to take greater market share and also to see some fare improvement at the forecast period end as the competitive environment calms a little. In most cases we are also assuming a recovery (often modest) in the rating that stock markets put on these shares. With each of these companies having long quoted track records and numerous peers we feel confident that such re-valuation projections are reasonable in the face of the stabilisation in outlook for each company. In fact if looked-at in reverse - for these shares NOT to be re-rated in this way would be highly unusual. The results can be seen in each company spreadsheet and are pretty startling. In many cases we are now expecting investors to make IRR's of 20-25% in owning these shares for the next 3-5 years. It is the powerful combining of factors (low starting price + compounding + allocation) that are resulting in these perhaps surprisingly high prospective returns (Lollapalloza for the Munger fans). Investors should reach for a bucket not a thimble we conclude.

#### Under-earning and under-priced

Whilst we do not attach these projections for all the companies we have written on, we do think about each company in the same way. i.e. in order to assess the attractiveness of each we consider what future compounding is most likely to occur at the company level and whether it is appropriate (or not) for the valuation of the group to be revalued by Mr Market some years out.

In some cases, we feel that margins or current levels of returns are depressed and a recovery can drive higher earnings. Examples include:

- Our work on **JDW** suggests that in time we think its EBIT Margin will rise thus adding to its current compounding rate
- Similarly, we expect Returns on Tangible Equity to rise at **Wells Fargo** due to either cost reduction or faster than anticipated growth

In other cases we feel the business may not be under earning, but that a re-rating could ensue as the market re-appraises the company in the longer term:

- This is very much our thinking currently on **Disney** and **Richemont**. With divisional margins at or near highs it is wrong to suggest these businesses could be under earning. Our attraction to these companies comes from the assumption that in time the quality of the brands they control and the pricing power they bring will deliver superior longer-term compounding. This we believe will be re-assessed by Mr Market and a higher than current multiple placed upon their shares as a result
- Importantly, in both cases the companies have had good historical compounded growth even in slower growth periods and have been excellent allocators of capital. This should ensure that these are acceptable investments (rather than good ones) even if our re-ratings were not to materialise.

Indeed, this has been the case at **Goldman** where our long-awaited recovery in returns has still yet to materialise (and courtesy of IMDB looks unlikely to do so soon it seems), but good capital allocation and solid returns have meant Goldman has been an 'OK' rather than 'great' investment since the crisis

- **Dollar Tree** is a combination of these traits. As we highlighted in our August 18 work that we thought it could deliver an Investor IRR of 18% over the next 5 years. This was due to the combined effect of margin recovery at its Family Dollar stores with a modest re-rating to reflect its powerful business model being reasserted. We are delighted to see these shares start to deliver on that promise (today they are \$99 vs \$81 in August)
- **Fairfax** is an example of a proven superior compounding model. It has neither brands nor a great deal of pricing power. But its insurance scale and profitability combined with astute invested float we think will produce levels of per share compounding that will surprise many. A 7% ROI (easier at today's starting equity prices- surely?) becomes a 15% ROE courtesy of float. Trading at 1x Book values suggests a look through PE of 7x. We are confident of both compounding and a re-rating from such a starting point.

We note with interest the recent activist stake declared in Dollar Tree. We also read and appreciated the recent extensive Barrons article on Disney – we recommend it.

Links to both can be found here:

<https://www.barrons.com/articles/disneys-bob-iger-talks-streaming-park-plans-and-learning-from-kodak-51546599600>

<https://www.dollartreeinfo.com/news-releases/news-release-details/dollar-tree-comments-statement-issued-starboard-value>

With kind regards and best wishes for 2019.

**Andrew, Mark and Claire**

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