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There's Nothing Obvious Out There Right Now

Q and A: Sandy Nairn

Sandy Nairn, the CEO of Edinburgh Partners, has been a regular contributor to Independent Investor over the years, making some highly prescient calls along the way. Any investor who took note would have every reason to be grateful. He was extremely cautious in November 2007, just as the markets were starting to anticipate the full extent of the banking crisis, and bullish once more in March 2009, when the equity markets finally bottomed out after the severe 2007-09 bear market. In this latest interview, he explains how he sees the world today.

IMPORTANT INFORMATION

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A year ago you said it was the right time to buy cheap equities and that proved to be right. Since then we have had a strong equity market rally, dismissed by some as a "dash for trash. Where do you think the market is now?

I think markets are on the expensive side of fair value, but not so extended that one can predict a sustained fall. Volatility will remain high, and a strong constitution will be required to navigate one's way successfully through the next few years.

If I was to rationalise what has happened to market valuations it would be as follows. At the end of 2007, the equity market was clearly expensive, given the almost certain onset of recession. After the dramatic market declines of 2008, it was equally clear that so long as the global economy avoided falling into a depression, or deflation, there were plenty of cheap stocks around. At the time, there was so much fear around that even a vicious recession was deemed by many to be an optimistic forecast!

That was also of course why stocks had become so cheap. There were many high quality companies in this category and they have since appreciated strongly. In my view therefore it is wrong to characterise the moves as just a 'dash for trash'. The only grain of truth in that phrase is that more exposed, highly geared companies did perform better because of investors' relief that the risk of a total wipeout was seen to be reducing.

Why were you so confident about the recovery back then?

The policy responses that were being put in place a year ago meant that we were likely to see an end to recession within 18 months. Everyone's obsession seemed to be discussing which letter of the alphabet the recovery might resemble, but although it was an interesting debate, in my view it was largely beside the point. Why? Because to come out with a definitive conclusion required you to predict not only the immediate policy response, but also the policy responses to that policy response and so on, through several iterations. That is way too difficult to spend too much time on.

In any event the important point was that once you were no longer looking at deflation/ depression, you knew that it meant there was a recovery of some description coming, even if that recovery was likely to be anaemic. On that basis there were clearly cheap stocks around. The cheap stocks were not just in the so-called "trash" category. In fact, as far as I am concerned, the only stocks that were not obviously cheap at the time were the so-called defensive stocks.

It depends of course what you mean by defensive....

Yes. Defensive means different things to different people. From my point of view, the main issue is future profit, or earnings stream. If a company has a predictable earnings stream with little variability, then it is sensible to term it 'defensive'. Note however that the 'defensiveness' refers to its profits rather than its qualities as an investment. An expensive defensive can just as easily lose you money as any other stock, whereas so-called "trash" can also make you a lot of money if it happens to be cheap at the time you buy it – as we have seen in the last 12 months.

What happened in 2008 was that companies with transparency or predictability of earnings had already become substantially more expensive than others. Telecoms and pharmaceuticals companies, and the consumer staples such as Unilever or Coke, would be the obvious examples. To us, none of them looked particularly cheap, either in absolute terms or relative to some of the other opportunities that market negativity was creating. We were much more interested in the many companies which had good growth prospects, albeit with a degree of cyclicality, and whose share prices were down 50%, or even 80%, in some cases.

By definition, though, more volatile should also mean more risky?

Not necessarily. Earnings risk does not necessarily mean investment risk. It depends very much upon the valuation starting point. In this case, a big valuation gap had opened up between the so called 'defensives' and those with more cyclical influences which all looked cheaper. There were two main categories of cheap however; stocks that were safe to own and a second group that were less so. The principal difference between the two was the condition of their balance sheets.

Many US technology companies for example had cash on their balance sheet and a leading position in their industry. By buying Cisco or Applied Materials, the judgment you were making was not about their survival, nor their ability to obtain financing. It was simply that there would be some form of economic recovery in which their clear leadership position would be sustained. The valuations in historic terms were as cheap as I can remember for those companies, and the risk in owning them was low.

When it became clear that we weren't facing depression/deflation and share prices started to recover, the biggest gains were in companies that had financial leverage and would have gone bust had the recovery not happened. That, if it means anything, was what the "dash for trash" was about. They were not necessarily trash companies. It was the nature of their business and the condition of their balance sheet that meant they went up more. But very high quality companies with excellent balance sheets and strong growth prospects also performed well.

Most companies were unable any longer to raise money in the debt markets…

Yes, since the banks and bond markets were both going backwards, the only choice that companies with finance problems had was to raise more capital in the equity markets. Their cost of capital depended upon the price at which they could issue equity. If markets remained low, the level of dilution was potentially huge. If markets went back up, the dilution would be less. What happened was that the discount being applied for solvency risk was removed when investors started to realise that equity issuance was achievable at a reasonable price. Companies were announcing rights issues and their share prices were going up, not down!

The one argument I would subscribe to on the "trash" issue is that there was an element of good fortune in this outcome. If companies had not been able to refinance, they would have been on a knife-edge. To that extent, as a professional investor you were still right to be wary, which is why we preferred to stick in the main to companies with good balance sheets. It has always been the case that even if you get your judgments right, other stocks will go up more than the ones you own. It is all about risk and reward.

Nobody prudent would want to make an all or nothing bet on recovery?

It is wrong to put your portfolios in a position where you are facing a simple binary outcome, win or lose, with nothing in between. Your knowledge is never sufficiently certain to make that kind of judgment. What you should try to do is ensure that if your judgments are wrong, clients don't suffer too badly, and if your judgments are correct, clients are rewarded.

The analytical task is to recognise how much you know relative to the market and adjust the portfolio accordingly. That is ultimately down to the experience of your team. Putting all your money into trash can never be prudent. Fund management is not a sprint. It is a marathon. You don't want a hamstring to go after 20 yards!

So much for 2009. Where are we now in the markets, in your view?

What has happened is that the obvious valuation gaps have disappeared. Having been demonstrably expensive and then demonstrably cheap, in aggregate terms we have reached at a stage where we can see nothing clear-cut in equity market valuations. Our judgment is that we're probably on the expensive side of fair value.

As far as the general investment environment is concerned there are a number of important distinctions to make. The first is that whilst the collapse in the financial system had global implications and hence a global policy response, the impact on specific institutions was largely limited to developed markets. As a consequence, in those markets we face an environment of slow growth with fiscal retrenchment and restricted credit expansion.

In the developing markets, however, the issues are different. Fiscal and monetary expansion has not been constrained by the same circumstances and hence here we are seeing inflation beginning to take root. The final piece of this jigsaw is the attempt within Europe to deny the economic realities which face some of the peripheral economies, with

Greece being the most obvious of more than one possible example.

Although markets are currently focusing on the level of external debt of Greece, the real underlying problem is the current account deficit which signals the country's total lack of competitiveness. Realistically this is most likely to be solved by the reintroduction of the drachma, allied with effective EU subsidies in the form of debt guarantees/losses. In order for this to happen this EU has to buy time and this may well be what is happening at the moment.

Overall, therefore, we are looking at a world of subdued growth with consumption growth in the West on an inexorable downward path. Sovereign bond issuance will squeeze capital availability; hence cash generation within businesses will be critical. Although the near-term economic outlook may well surprise on the upside, the longer-term will disappoint. This contrasts with the emerging markets where consumption will rise and whilst short-term growth may disappoint, the longer term remains better balanced.

Do you think that the risk of deflation has gone?

With so much liquidity being thrown at the banking system, I don't think we will get generalized deflation. But you need to be careful that what people mean when they say "deflation". It means different things to different people. There is a technical economist's definition of debt deflation, which I don't think we will get generally, though it is likely in some individual countries. But if you just mean low or mediocre economic growth that is another matter. In developed economies, I regard that as an almost certain outcome.

The world has changed since the 1930s. If you go back to the last periods of deflation, the gold standard was very important then, because it forced economic adjustment through wage mechanisms, which doesn't happen easily. Allowing banks to fail, causing a huge contraction in the money supply, was a second element, and trade restrictions, the Smoot-Hawley Act and so on, were a third. We haven't seen anything like that this time round. If you think the gold standard was a good idea, just look at the Euro and think of the adjustments you would need to make now if the gold standard was still in place!

How do you see the Greece-euro situation unfolding?

The focus of markets at the moment is on debt levels relative to GDP and the timing of refunding. Important as this is, it is only part of the picture. In the case of Greece total Government debt is not particularly great when compared with the funding capability of Europe. If this were the only problem, it could easily be solved. The more intractable problem is the complete lack of competitiveness. According to IMF figures, Greece has a current account deficit equivalent to 10% of GDP.

The simplest adjustment method for this is currency devaluation, an option closed to

Greece so long as it remains in the single currency. Absent a devaluation, a prolonged recession and more likely, depression seems the inevitable outcome. This is all a matter of politics. My guess is that the support package is intended to buy time to allow Greece to exit the single currency. For example, if the EU were to take on half of total Greek debt and then redenominate it in drachmas, Greece's debt position would not worsen when its currency depreciated.

Assuming the new drachma dropped by one third, then the cost to the EU for exiting Greece from the Euro would be around 50bn Euros, not much worse than the cost of saving a single large bank. Some EU countries might consider this a good deal. The alternative of forcing nominal wage decreases seems to me much less plausible.

Is the slowing Chinese economy a threat or an obstacle to future inflation?

One big reason for the long period of low inflation in the developed economies was that prices on all products produced in China and other emerging markets were constantly falling. Western consumers felt better off since, even though their wages weren't rising, so many cheaper Chinese products were coming in. That process is going to end.

Chinese wages are increasing and it is not clear that this is being matched by productivity. Combining this with a rising exchange rate suggests that increases in spending power in the West will no longer be driven by the falling cost of imports. For those who say if only the Chinese would revalue their currency, I say "Be careful what you wish for. You may not like what happens when it does!"

The imbalance in the global economy can only be corrected by reducing consumption in the West and increasing consumption in the East. Much of this consumption will be satisfied by local production, but one should also expect imports to rise. Whilst fiscal deficits in the West demand action and inevitably slower growth, China has to tread a careful path since it has no such constraints. Increasing consumption and inflation can be hard to contain once ignited. Consumption is much less easy to control centrally than investment and this adds a political dimension to the equation.

A rising exchange rate and the accumulation of wealth in China also implies that China is increasingly going to reinvest its wealth outside China by buying assets. These assets will include intellectual capital as well as physical assets. One should not expect that the surpluses will <u>always</u> buy US bonds. One can also surmise that the West will not always react well to the physical evidence of this relative shift in economic power.

Are we then in for a two speed world?

I would describe it as an extremely unbalanced world which is now being forced to readjust. The West overspent and now must save. The East has saved and will now spend. Aggregate global GDP will be lower than recent history and Western GDP growth lower still as the fiscal imbalance gets correct. We in the West are a lot poorer than we realise and the converse holds in the East. Correcting this will require a meaningful period of two speed growth during which the opposing forces of deflation and inflation will both be present.

Given a more or less fairly valued market in aggregate, do you see any striking valuation anomalies within it?

Valuation gaps generally have been closing over the past year or so as markets recovered. If you look at how our portfolios have changed over the past two years, we've gone from having 50% or more in companies with high visibility earnings, such as the telcos, pharmas and some of the consumer staples, down to 20% now. Emerging markets have gone from close to zero to almost 20%, although we have taken that back down again recently.

The technology stocks that we thought a year ago were cheap have since appreciated nicely and as a consequence we have begun to reduce our holdings. The one area where we've made a significant increase recently is in Japan, where we've gone from having 4% of our global portfolio to more than 15%. The percentage could easily go up further.

What is the rationale for Japan?

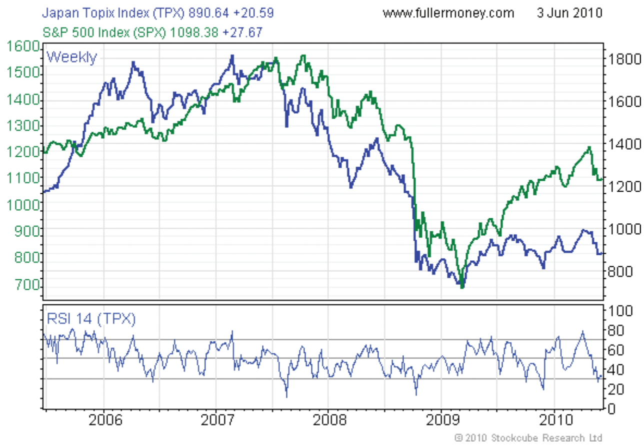
There are several strands to it. We started off with some of the export-oriented manufacturers whose margins looked pretty miserable and which have been criticised for not taking out more cost. As we went through the numbers, however, we came to the view that while their margins were not improving, the companies had in fact taken a lot of cost out. The lack of margin improvement was principally down to the economic situation and the constant appreciation of the yen. That meant that if either of those conditions were to change, in our view those margins and profitability could go up substantially.

Although we started off looking just at the big export companies such as Sony and Fujitsu, we soon found that there was a whole range of companies that met our valuation criteria. We put fairly tight limits on the prices we are prepared to pay for stocks and we have managed to buy some, but not all, of the ones we think are cheap.

We have even ended up investing in construction companies in Japan, which is not an obvious area for us. Revenues in construction have shrunk dramatically since the late 1980s/early1990s, but profit margins are relatively stable, market shares are relatively stable, and profitability is okay. The companies are not so dependent on public sector works anymore.

Why is nobody else buying these Japanese stocks?

Some people are beginning to talk about Japan again, but what is interesting is that when we started to buy the positions, it was striking how thin the liquidity was. In other words, people may be talking about Japan again, but they are not doing anything about it. Broker coverage of Japanese equities is both of variable quality and patchy in terms of coverage. On an asset basis, they are very cheap. What that is saying is that nobody believes they will ever make any money. We don't think that's the case.



Japan's Topix index (blue line) has underperformed the S&P 500 significantly since the 2009 lows.

What other thoughts on China?

For the past couple of years we have been in a world where protection of the banking system and fiscal stimulus has been the order of the day. What type of country is best placed to achieve that outcome? The obvious answer is a country that has a fiscal and trade surplus, strong reserves and a control economy. So it is no surprise that China has been receiving the plaudits.

The interesting question for me however is not whether the fiscal stimulus has sustained growth, but rather whether the fiscal stimulus is going to create new productive potential or not. A centrally controlled economy is not necessarily the best model if you want to shift to a more consumption- led economy. Clearly the rate of Chinese growth and development has been impressive, but you can also argue that today's valuations in China are factoring in an implied rate of growth which requires a seamless transition from an economic model in which China is highly skilled to one that is substantially more problematic.

How strong is the recovery in the United States going to be?

Clearly the US is in the same position as most developed economies. According to the IMF, its structural fiscal deficit at over 9% of GDP is the highest of any of the major economies. This must fall and there will be an impact on growth. On the other hand, the economy is resilient, the country is a net importer of labour and it retains intellectual leadership in almost all of the most important growth industries.

We still have about 30% of the portfolio there, and it's in a mixture of companies. We still have some financial and some industrial exposure. We even bought a housebuilder, reflecting just how affordable house prices have become and the level of negative sentiment that was still around.

We expect to retain substantial holdings in the US, but as with other developed economies, unless valuations fall meaningfully from here, it is unlikely we will have much exposure to those sectors of the economy which are exposed to falls in Government expenditure and direct consumer purchases.

One thing to watch out for in the short-run is a continued flow of good economic news reflecting the impact of both fiscal and monetary stimulus on the economy and periodic rebuilding of inventories.

Are you finding stock opportunities in Europe, despite the political issues?

We are still finding European stocks worth buying. Europe is very much a region of contrasts. The largest economies are not in bad shape, even though both Italy and Spain do need fiscal retrenchment. It is in the periphery that the issues reside and it is important to keep in context the relative sizes of each.

Europe as a whole did not over-consume, so the current consumer retrenchment need not go on indefinitely. Balance sheets do not need to be rebuilt to the same extent as in the Anglo Saxon economies. Neither France nor Germany had the same house price explosion as anybody else. The issue is that the gross lack of competitiveness of Greece and Portugal has been masked by deficit funding and the illusion provided by a single currency.

The current hyperbole over the Euro misses one important point. The aggregate fiscal and trade position of the EU is better than that of the United States. While the US may have a more flexible economy, it has to operate within tighter fiscal and monetary constraints. If the Euro no longer included Greece, would it be a stronger currency than the US dollar?

How big a risk is the likely increase in regulation of the financial system?

The big question for the global economy is that the operation of free markets has become a political concern. If it spills over to trade and capital controls, it will be bad news. If you are going to shove a big monkey wrench into world trade, it could be dangerous. I think the key question is: what does the political backlash over what went wrong in the credit crisis focus on? If it becomes protectionism for either trading goods or capital flows, then we go to a not very nice place.

If it focuses on regulation of the financial sector, that will be fine, provided there is some recognition of what has worked in the past. Historically greater regulation and changes in company law in response to crises has often been helpful in supporting future development. The starting position cannot be that regulation is bad. It is what kind of regulation comes in which matters.

New legislation which worked well in the past, such as the Companies Acts in the nineteenth century, was most successful when it dealt with increasing transparency. The Companies Acts did that for company accounts. They also created limited liability companies and this was the bedrock on which the industrial revolution transformed the world. It seems clear to me that we're going to return to some form of Glass-Steagall. Disintermediation and proprietary trading will not be allowed to bring down a retail bank.

How can that be done most effectively?

It is too complex to achieve this through legislation, so it will have to be done through a mixture of carrot and stick. Inevitably a framework will evolve which makes it unattractive for a retail bank to be involved in these activities. The massive growth in disintermediation will also start to move back in the opposite direction. If a bank is originating mortgages, it will have to hold on to more of them than before and that means also holding more capital.

Do you think banking reform can or will happen easily?

No, first we have to remove the emotion. Second, we need to focus on transparency as the critical objective. So long as transparency is the key objective, increased regulation is likely to be more positive than negative. We need to avoid two major distasteful situations: where individuals take profits and their employer the losses; and where individuals and institutions make profits which turn out subsequently to be illusory. The focus should not be on bonuses, but on illusory profits. If you can eliminate the bogus profits, then you won't get the big bonuses flowing from them either. Profit illusion is the big issue.

Action is also required on derivatives, Warren Buffett's "weapons of mass financial destruction". There are a whole series of instruments in derivatives which are effectively insurance policies, but it is the only insurance policy in the world where you don't have to have an insurable interest. In future the person who writes the insurance will have to retain at least a partial interest in the outcome.

Many of the biggest problems in banking arose from banks prostituting their credit rating by saying "I'll insure this, and then I'll reinsure it with somebody who could never pay if it went wrong". In future I am sure you will only be able to issue if you've got proper solvency requirements in place. It will take time. This is complicated stuff.

So how do you sum up the outlook for investors now?

I'm not massively depressed about the outlook. But nor am I massively excited either. I don't think we've woken up, in the West, to the fact that we are poorer than we were. That penny hasn't dropped. We've mortgaged our future to somebody else who now holds the mortgage. If we want to rebuild our wealth based economy, we have to save, which also means that we must consume less.

On the other hand the world has been in worse situations before and comfortably survived. It is critical that investment expectations are reduced to match the new environment. Returns from equities are likely to be lower and volatility greater than in the past, but the long-term outcome for equities remains a positive one, both absolutely and relative to other asset classes. In other words: get rich slowly!

ABOUT INDEPENDENT INVESTOR

Independent Investor was set up to publish analysis and commentary on asset allocation, having particular regard to the ideas and insights of leading professional investors I have come to know and admire over 30 years of following the financial markets. The website, www.independent-investor.com, is updated regularly with notes and features as they are written. It also includes the Editor's columns in the *Financial Times* and *Spectator* and an archive of previously published material.

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