

On the Failure...



On the failure of Alexander Fordyce's bank, June 1771

"There has not since the year of the South Sea been, I believe, such extensive distress or so frightful an alarm. It can however be little more than a panick terrour from which when they recover, many will wonder why they were frightened."

Samuel Johnson, letter to John Taylor

There have been plenty of "panick terrors" since 1771 of course, up to and including our very own of Summer/Autumn 2007. Fordyce's investment bank was brought down by his imprudent speculation in East India Company stock – a reminder that some economies have been "emerging" for centuries. Of the collapse, the then thinking man's journal, the Gentleman's Magazine reported - "An universal bankruptcy was expected, the stoppage of almost every banker's house was looked for." Today's bear squeeze on the British banks is not unprecedented.

Panick terrors are terrifying and it takes men of commonsense - and Samuel Johnson is perhaps the most commonsensical Englishman who ever lived - to hold a steady nerve. We have no keener insights about the solvency of British banks or their future dividend paying capacity than anybody else, but we are sure it is important to stay cool. ABN-AMRO changed hands very recently at 2.9x price to book (P/B) in a contested auction. That is an important strategic marker. Actual book values may be difficult to determine today, but the justification for paying a multiple of book for a well-entrenched banking franchise is confirmed.

The reasons banks can command a premium to book are, first, that they remain necessary to the workings of a modern economy and, next, they are difficult to build up from scratch, as is demonstrated by the willingness of up to ten

institutions to win control of a franchise as impaired as Northern Rock. If HBOS did not exist it would be necessary to invent it. Professor of Money and Banking at Loughborough, David Llewellyn explains what is so valuable about diversified banks, especially those with a major retail franchise, in his research paper - "The New Economics of Banking". Banks, he argues, are essentially in the information business. A customer may not wish to make personal or business information public, but is willing to share it with his banker on an exclusive basis. "In this way the bank gains a monopoly advantage over its competitors". "A bank's overwhelming advantage is the information it has on its customer base". This privileged access to information has permitted the leading UK banks to earn returns to equity way above their cost of capital, over long periods.

Today, RBS trades on 1x P/B, HBOS on 1.4x, Barclays 1.6x and Lloyds 2.4x. Being realistic about the immediate outlook, but ignoring the prophets of doom, we think by far the most likely outcome for the banking sector will be, yes, bad debts will go up, profitability will decline and dividend growth slow or in some cases stop. But – that's it.

If such a non-catastrophic outcome were combined with declining domestic interest rates and a consolidating deal or two, then we're sure that bank shares are a buy today and that "when they recover, many will wonder why they were frightened". In 1989, before the last significant credit-driven contraction in the UK/Global economy, Barclays share price, in current form, was 42p, Lloyds 36p and RBS 27p – giving gains of many times over. Investing in bank shares, over the course of economic and stock market cycles has proven highly rewarding. We do not think there has been a fundamental change for the worse in the "over-the-cycle" economics of British banks and they will be rewarding again.

By the way, for those interested (and, certainly, it matters for our strategies), we note that the annual cost of HBOS and RBS' preference dividends amount to c£50m and £12.6m respectively, compared to current ordinary dividends of £1.5bn and £2.6bn. In other words, their preference dividends have cover of 30x and 200x each. If HBOS and RBS are going bust, they're going bust, but in any other circumstances these preference shares are safe and, we think, very cheap.

They're so cheap, because one result from current market turmoil and economic dislocation will be to put high, safe income at a premium for investors. But we need to arrive at that conclusion after an understanding of what may happen next and I propose to address that with the guidance of another commonsensical fellow – Bill Miller, manager of the Legg Mason Value Fund. His “streak” is broken, the 14 consecutive years of outperforming the S&P 500 were not followed by a fifteenth and he is struggling again in 2007. Never mind, the most recent Value Fund report is a model of good sense and thoughtful prediction.

Miller analyses the root of current woes as the unsustainable shift in US consumption, from 66% of GDP in the 1990's to over 70% today, fueled by low interest rates and equity withdrawal from the housing market. That 70% is a record “and the most likely direction from here is not up”. He notes that the US has been the marginal consumer to the world, as demonstrated by the scale of the current account deficit and that, from here, it will no longer be. The implications are legion. Most important, legions of economists are about to get what they have been wishing for and will find out if they like it: the US current account deficit is already narrowing and the pace will quicken. Miller warns – “It comes with a price. When our current account deficit is expanding, we are providing liquidity to the rest of the world, by buying their goods with our Dollars. When it is contracting, we are withdrawing liquidity”.

In his opinion, what happens when the US withdraws its liquidity is twofold. First, the Dollar begins a recovery from being, in his

words – “deeply undervalued against the Euro and the Pound”. Next on his agenda is deflation. “It was only in 2002 that the world was worried about deflation. The forces that gave rise to those fears – high debt, excess global labour, falling real prices for technology and a global savings glut – have not disappeared”. Today it still feels as though the appearance of deflation would be a surprise to equity market participants. However, the performance of Anglo-Saxon government bond markets since the subprime crisis erupted shows pretty good confirmation that the fixed interest guys recognise the deflationary risks – the US long bond is up 13% since June and the UK Irredeemable gilts up 10%. Meanwhile, the copper price, perhaps most sensitive of all to future economic activity, has fallen 20% since early November, as the evidence of slowdown mounts. It is not as if US and UK CPI inflation is high to begin with, at 2.4% and 2.0% respectively – prices could easily go negative, if what happens next is recession. Remember, prices are still falling in Japan, 18 years after the bursting of a property bubble led to the credit contraction that hobbled its banking sector.

Miller then turns his attention to recent sector performance within the S&P and highlights the by now well recognized, but spectacular underperformance of “value” stocks – “the best quintile of stocks based on traditional valuation factors, such as price/earnings, price/book, price/sales and dividend yield has underperformed the market by 1000 basis points this year”. We know the same is true in the UK, where income-seeking equity strategies (including our own), not a bad proxy for “value”, have had a rough six months. “Value” investing traditionally means investing in inherently low growth or cyclical businesses, which benefit when economic growth is more robust than expected (although this is not our approach). The underperformance of say, the housebuilders of late suggest that investors are beginning to discount the opposite.

Here is Miller's conclusion about sector preferences – “If credit is becoming harder to come by, if spreads are widening, if growth is slowing, then it seems to me the leadership is about to change...I think the new leadership will

be US, large-cap, Dollar-based and grow to encompass what no one wants to own today, especially financials and consumer. I also think so-called growth stocks will continue to do fine. When growth becomes scarcer and the discount rate becomes lower, growth becomes more valuable.”

We report these comments at length, because they accord with our own thinking and portfolio disposition. For us big-cap, Dollar-earning growth stocks are cheap and most likely to provide positive surprises – given for how long domestic, mid/small-cap value trounced them. The pendulum swing will be long and “value” could underperform for many quarters. We still like Cadbury, Diageo, Pearson, Reed, Reuters, Sage, Schroders and Unilever – as a collection of major global businesses, with decent growth outlooks. At home, we think there are bargains to be found in the B2C Media sector, with Daily Mail very undervalued and ITV getting interesting. In the Financials, once the “terror” has subsided, it will be the savings franchises that will deliver growth, as the British public eschews debt and looks to rebuild equity, via an upturn in the savings ratio.

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