Surprises In 2011

'Tis that season of year – a flood of New Year predictions from strategists and talking heads, as traditional as Christmas cracker mottoes and about as memorable.

But this year I'm more relieved than ever I don't have Byron Wien's job, because, as 2012 kicks off, I'm most certainly not gazing, seer-like into the future. On the contrary, I'm firmly looking back. I'm still trying to get my head round the actual surprises thrown up by the capital markets last year. Forget the putative surprises of 2012, I'm still digesting the surprises of 2011. So, even though yesterday's news may be irrelevant, already fully captured in security prices, what follows is a review of some of the events that surprised me through to the close of 2011 (events we judge still have material implications for our portfolios).

Liquid Gold beat Metallic Gold

By December 30th gold had retraced 18% of its all-time peak price, of $1,900, set in September, leaving the asset up a still creditable 10% in 2011, at $1,560. Meanwhile, Diageo enjoyed a storming close to the year, ending up 19%, at its own all-time high. Diageo's stocks of maturing whisky are truly a kind of "liquid gold", in that they offer a similar protection against long-term monetary inflation as gold itself. To be fair, what Diageo's brands can't do – as gold arguably can – is protect you against political dislocation, abolition of property rights and outright anarchy. And the fact that gold sold off through Q4 2011 is actually a comforting indication that investors are less convinced about such cataclysmic outcomes to the world's current malaise. On the other hand, what Diageo's brands can do for their owners – in addition to protecting the purchasing power of capital – is to offer access to real, inflation-plus growth in cash flows (as more people on a more populous planet enjoy their tipples). Diageo's brands can also fund a 3% current dividend stream. A bar of gold can do neither of those good things. I'm no bear of gold – I would never have dared predict or act on a bullion bull market, so it's none of my business to call its termination – but safe dividends, generated by quality operating assets look awfully competitive against it, if you inhabit the "world will probably muddle through camp".

1959 Gilt Yields

It wasn't only Diageo that outpaced gold in 2011. We own some of the UK's 2.5% Consolidated Loan Stock in the Lindsell Train Investment Trust (this holding a longstanding hedge against deflation for a multi-asset strategy). That irredeemable gilt took out not only gold, but Diageo too, closing the year at a recent high, up a startling 25% in capital terms, to a price of 68p. This is the highest price, I believe, since the year I was born, which I sincerely regret having to admit is 1959. At 68p, the gilt's running annual yield to infinity or the bankruptcy of the British state, whichever comes first, is 3.7% gross.

This extraordinarily low yield, at least in the context of my lifetime, matters for Lindsell Train, because we tend to value Sterling equity cash flows against it. For instance, and sticking with Diageo, our starting proposition for valuing that company and those very few others of its calibre, is that it ought to be more valuable than an irredeemable gilt. Now, with a yield of 3.7%, that gilt is effectively trading on a P/E of 27x (100/3.7=27x). And if one values Diageo's consensus 2012 earnings of 80p at a multiple of 27, you get to a warranted price of £21.60 (versus £14 today).

The point is not that we expect Diageo to trade at £21 any time soon (although in the unlikely event Diageo was ever bid for, we would look for its ultimate takeout to be proximate to this price – you can only sell Guinness and Johnnie Walker once). Indeed, one interpretation of that the super-low gilt yield is that it is signaling all is not right with the world and that, perhaps, Diageo's 80p of earnings is vulnerable to a sustained deflation or bout of global protectionism. No, the point is that when the discount rate has fallen as low as it has, particularly in the Anglo-Saxon economies, then there is scope for extreme valuations. Sub-4% bond yields suggest that investors believe returns on mainstream asset classes will be low. The corollary is that high returns or high secular growth rates on exceptional investments could become extraordinarily highly valued. Bond yields this low could engender "bubble" valuations. The emergence of a global cohort of exceptional companies valued at exceptional valuations seems quite plausible.

It Was a Busy Year for Investment Banks

It is always bemusing that the professionals who purport to advise clients to buy at the bottom and sell at the top are, apparently, condemned to disregard their own advice and expand during the boom years, then retrench in the pits of despair. However, the fact is that 2011 turned out to be a better year for Investment Bank activity than might have been deduced from the gruesome news currently emanating from the sector; certainly a better year for volumes than 2010. Bloomberg's global IPO ticker closed on December 30th on 2424 new issues worldwide, up 13% on last year. At £12.6bn the value of new floats in London alone was up 27%. Meanwhile deals, the life-blood of the IB industry and a prime indicator of the animal spirits of the corporate sector, were up again in 2011. Bloomberg monitored 27,723 corporate transactions around the world, with an aggregate value of $2.23 trillion – these counts up 5% and 4% respectively over 2010 totals and way ahead of the still traumatized 2009 (though, admittedly, still 45% by value below the previous peak of 2007 and it looks like too many bank cost bases are predicated on a quick return to those levels).

We watch deal volumes for what they tell us about corporate confidence and to identify where we are, early or late, in bull or bear market. For equity investors the stock market cycle matters a lot more than the economic cycle – stock markets often go up during recessions. The fact that deals were up in 2011 and that, for instance, the FT All-Share was only down 3%, despite everything the bears could throw at it, suggests that the stock market cycle is still pointing upwards. Or so we hope.

By the way, from the perspective of the economic historian of the future, we're sure that the most significant deals of 2011 will be seen to be those involving stock markets themselves, albeit the Singapore/Australian and London/Toronto mergers failed and Germany/New York is hanging on the edge. It's all about globalization. Increasingly global corporations require increasingly global liquidity pools to finance their expansion and consolidation strategies. National stock markets are gradually becoming irrelevant, just as the Birmingham and Manchester stock exchanges became parochial and irrelevant in the UK during the C20th. Governments and regulators may not welcome or even permit the creation of pan-regional exchanges, but if they stand in the way, someone, somewhere is going to build a global exchange from scratch and disintermediate the incumbents anyway – depend upon it.

There's Information in Those 27,723 Deals

Any deal struck between corporations, which are typically run by rational, strategically minded people, carries much more information about equity values than any number of broker notes or ticker marks by hedge fund day traders. And two late 2011 UK transactions really took us aback and may have meaningful implications for related holdings.

First, Heineken's purchase of a collection of over 900 freehold, but tenanted pubs from RBS. This is a substantial parcel of assets, commanding a £420 million tag and when combined with the existing estate, which arrived with the purchase of Scottish & Newcastle, establishes Heineken as one of the biggest pub owners in the UK. As the company itself remarked, it's a statement of confidence in the "Great British Pub", a species whose days some regard as numbered. What's more, at 9.4x EBITDA, or £460,000 per outlet – the valuation makes the stock market ratings of the similar collections of pubs LT owns for clients - Fullers, Greene King, Marstons and Youngs – look cheap.

Pubs provide their punters with an affordable treat. Just as few folk give up smoking because of a recession, so we can now see - in the business performance of the regional brewers we are invested in and in Heineken's willingness to bulk itself up in the sector – that few stop frequenting well-invested, good value pubs either. Three of our four brewers increased their dividends in 2011, while Marstons meaningfully improved dividend cover. Compared to the performance of High Street retailers this is nigh-on miraculous for consumer-facing businesses. And the potential for future returns both for us and for Heineken can be best encapsulated, perhaps, in the dividend histories of the LT quartet. Bloomberg's dividend records only go back 24 years, to 1988. Since then, Fullers has increased its dividend 8.1x (over 8-fold), Greene King 7.2x, Marstons 4.0x and Youngs 4.9x. More of the same please.

Next, we were startled at the price London Stock Exchange was prepared to put on the 50% of FTSE International, the index business, it doesn't already own. That price was £450 million, or 22.5x 2010 EBITDA – albeit that EBITDA has grown at a CAGR of 22% since 2006 and accelerating to 30% in the current year. We are investors in LSE, in part for reasons alluded to above – it is a jewel in the crown of any emergent global exchange. And so we wonder

whether an implied £900 million is too high a ticket for this asset. The Exchange is clearly desperate to diversify and bulk up – so making itself less digestible. But let's cut LSE management some slack and assume, for the moment, this is a good deal - that FTSE International really is worth £900m. If so, the current market capitalization of the whole group, at £2.1bn, is scarcely double the value of just this, now, wholly owned subsidiary, one that is likely to make up only c15% of total revenues. In other words, any new investor in LSE is getting the London and Italian exchanges and sundry other highly profitable assets for far less than was apparent before this deal. Our consolation prize, if it turns out LSE has overpaid, is that the vendor was Pearson, an even larger LT holding, cashing up its balance sheet at a time of multiple attractive investment opportunities in its core education business.

America the Beautiful

Deutsche Börse isn't the only German company that aspires to own a US business. At the close of the year SAP announced its own US acquisition, a deal to buy "cloud computing" concern SuccessFactors Inc. SAP laid down $3.2bn cash, or 11.0x SF's historic revenues – so no snip. Here's what Bill McDermott, co-CEO SAP, has to say about his purchase – "The cloud is the core of SAP's future growth…The acquisition will help us address the top priority for CEOs globally – managing people and talent".

What if McDermott is right? What if "cloud" is the future, progenitor of a new wave of innovation and global productivity gains? What are we going to do about that as London or Frankfurt or Singapore-based portfolio investors? I'll tell you. We're going to have to do exactly what SAP has just done. We're going to have to invest in the US technology sector ourselves, because there's nowhere else to access substantive companies with credible secular tech growth prospects.

Why else would Warren Buffett have broken the habit of a lifetime in Q4 2011 to buy a stake in a technology company - IBM (and probably the biggest surprise in this entire note)?

The S&P 500 closed 2011 unchanged – the best performing major equity market. How come? The US economy seems to be ahead of the rest into recovery. In part because it is home to the most dynamic growth companies in the world. Amazon sold 5 million Kindle Fires in 2011, faster than the iPad. Apple is hinting at a 40% price cut for its next tablet device – accelerating their proliferation. New apps, new app-creators, new industries will result.

I don't pretend to know anything about it, but you can throw into the above mix the prediction that "fracking" will turn the US into a net energy exporter in a few short years.

And when you add all that up - although, we never, ever make macro or asset allocation calls – when you add it all up, it all points to soaring US Equities and Dollar.

That would be a surprise for 2012.

Lindsell Train Limited
Cayzer House

30 Buckingham Gate
London SW1E 6NN
ENGLAND

Tel. 020 7802 4700
Fax. 020 7802 4700
www.LindsellTrain.com
Info@lindselltrain.com

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