I Wished a Client…

I wished a client in the wealth management industry happy holidays and a happy New Year last week. "Yes", he replied sardonically, "I can't tell you how much I'm looking forward to January 1st… 2011".

And in my experience it is remarkable that after a 20% plus year for the All Share so few of us, apparently, feel like breaking out the Bolly and so many view 2010 with suspicious apprehension.

Perhaps it's "survivors' guilt". In interviews Enoch Powell used to antagonize his wife by publically regretting his survival of WW2. He felt that he should have died with his comrades – not a ringing endorsement of his later conjugal bliss, Mrs. Powell complained. Do survivors of the Great 2008 Crisis secretly worry they've been let off too lightly and that the bullet with their name on it is just round the New Year?

Chatting with the same client I unearthed another instance of this, it might be considered, churlishness about what, by any standards, has been a decent year for our industry. I pointed out the, to me, startling statistics about fund flows in the UK savings industry. Through to the end of October 2009, £21.3bn has found its way into OEICS; this sum already 21% higher than the total for the whole of the previous record year – the TMT -obsessed 2000. A banner year, then.

My own interest in all this asset gathering relates primarily to Hargreaves Lansdown (an important holding for LT), which, it is estimated, speaks for 10% of those record fund flows across its still rapidly growing client base. However, I thought it courteous to hope my client had enjoyed his fair share of these prodigious riches. His response: a hollow laugh and shake of the head.

And to the extent he works for an equity-oriented house, this missing out is understandable. Money has been flooding out of deposit accounts, with their piffling returns, into bonds and gilts - anything that pays a discernible and reasonably safe income. Corporate Bond funds were the best sellers in the UK for each of the 10 months through to August 2009. The Great British Public wants yield, not equity risk.

Similar data for the US provides one plank in the market outlook of Legg Mason's Bill Miller – he the perennial optimist and equity bull. Look, he says, through to October '09, \$21.4bn has been redeemed out of US equity funds. Meanwhile, \$312bn flooded into bond funds. Of the top ten best selling US fund products in 2009, nine are bond funds and the other an equity index fund. Thin times indeed for stock pickers.

Miller cautions that bond investors are fighting the old war and that the asset class cannot be expected to oblige with the same returns as those of the last campaign. During the Noughties US Treasury bonds delivered a return of 85%, compared to the negative 14% from the S&P 500. The story is the same in the UK. Over the ten years to September 09, gilts have offered up 6%pa, with UK equities also-runners at 2.5%pa. Miller's advice is to go against the unreflecting herd – sell expensive bonds and buy stocks.

And it is certainly sobering to read this week of another financial record broken in 2009 – more junk bonds have been snapped up by income-hungry investors than ever before, issuance of \$144bn, just beating out 2006. This despite "high yield" defaults running at 12.7%. In reaction, all one can say for sure - and we write as bloodied holders of Lloyds Bank preference shares, bought for high yield and "security" – is that this apparently "safe" income is illusory, if times are going to get really tough again. Meanwhile sound common stock can negotiate a crisis and recession remarkably well. Diageo's shares, for instance, average at a price level of close to £10 over the last two, turbulent, years – little more than 5% away from current levels. In hindsight holding Diageo has proven a lot less stressful than many junk bonds and the company may maintain its real value into the future rather better than a sub-5% yielding gilt.

Sticking with Miller for a paragraph longer, I must share and embellish, rather lavishly, on his (already borrowed) framework of the six stages of denial that afflict economists and cash-long investors during the recovery phase of any economic/market cycle.

1. This time it is a Depression, the Big One. Fiscal and monetary stimulation won't work; the authorities are pushing on a piece of string.

2. These early signs of recovery are only involuntary inventory build. They'll soon be overwhelmed by a crushing Double Dip. (Perhaps consensus today.)

3. OK, things are a mite better than we feared at this stage. But there's no pricing power out there. Profits won't join in. It'll be a Profitless Recovery. Equities are way ahead of themselves.

4. Anyway, companies won't hire after the trauma of the last cycle. It'll be a Jobless Recovery.

Consumers will never spend.

5. It'll never last.

6. GET ME IN!!!

If you wait for the economists to acknowledge the recovery, the markets will have already moved on to worrying about when interest rates will have to go up.

All the preceding is preamble for our own prognostication for 2010. Last month Buffett reiterated the tried and tested truth that – "a terrible market or a terrible economy is your friend". The question for us all today, on the cusp of the New Year, is whether the Market or the Economy remain sufficiently "terrible" to take serious advantage of.

Well, we're not sellers of UK equities and, for us there are three compelling reasons to stay bullish on sound common stocks and to look forward to 2010.

First the yield curve does remain most extraordinarily helpful, particularly so for the financial sectors, which still account for 20% of the FT All Share. Anecdotally, banks are coining in pre-provision profits – playing the curve's steep gradient. Meanwhile, strong-franchise asset gatherers, like Hargreaves, are benefiting from once-in-a-generation shifts in savings behaviour. Forecasts for 2011 FUM for Schroders (another LT holding) could be far too cautious, we guess.

Next, we must never forget that the worse the news for the Chancellor – plummeting tax take, failed gilt auctions etc – the better for the stock market; this because of its tendency to confirm Sterling's status as toast. This matters because the stock market and the UK economy are not an identity. Only 35% of quoted UK company's revenues derive from the domestic economy (and, let's face it, the share prices of domestic earners have already been obliterated). Another 43% of revenues arise from other developed world economies and a by no means trivial 22% from Emerging Markets. Nearly 50% of UK earnings and dividends are reported and paid in US Dollars. Marginal bad news for the UK economy, relative to the rest of the world, is therefore, quite possibly marginally good news for UK corporate earnings. World class, globally-oriented US companies have had a great share price run through this phase of pronounced Dollar weakness. Now it's the turn of Pearson and Unilever – to talk our own book (and soap).

Finally, we hope that Kraft/Cadbury is just the beginning. Cadbury's price rose 38% on the morning of the approach. This move is eerily consistent with the 37% premium to undisturbed share price that US corporations have paid in all M&A activity in 2009, according to Bloomberg. That 37% average premium for control is the highest paid since 2001, suggesting that companies regard the stock market as a source of bargains, even if individual savers are still nervous. It is true that M&A is well down on the peak year for deals, 2006, but undeniable that activity is picking up. Buffett himself still feels sufficiently engaged to pay a 22% premium for Burlington Northern, as recently as November. We hope deals will be a major theme in western markets in 2010 and beyond (as it painfully has never been for Japan, since its bear market began).

Where should UK investors look for takeover candidates? We are struck by the number of deals being done in the Technology and Media sectors – with Cisco, Dell, HP, IBM, Oracle and Xerox all active and now Comcast acquiring NBC, all in 2009. There are a number of London-listed comparators, of course and we would not be surprised to see, say, Sage or Reed Elsevier involved – one way or another.

Talking of offending your life-partner, I wonder how Mrs Scott, the explorer's wife, must have felt reading this extract from his last letter to her, written from his final camp.

"How much better this has been than lounging about in too great comfort at home."

Again, one misses the tactful, consoling tone. Next year is going to be an adventure, setting out into uncharted territory. Let's hope we don't come second and that we do get home.

Happy New Year.

Lindsell Train Limited
2 Queen Anne's Gate Bldgs
Dartmouth Street
London SW1H 9BP

Tel. 020 7227 8200
Fax. 020 7227 8299
www.LindsellTrain.com
Info@lindselltrain.com

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