LINDSELL TRAIN

A New Nifty Fifty? Bring It On!

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I hope Crispin Odey won't object if I begin this discussion with a typically stimulating idea I heard attributed to him recently. I was told that he is short durable defensive stocks and long what he terms "wild west" situations, such as (again reportedly) Sky, BP, Barclays, BAe and others. One reason is, he claims, that many of the current crop of London-based Chief Investment Officers have been recruited from their house bond desks – fixed interest having, after all, enjoyed a bull market for the last decade or more - displacing hapless equity specialists. These bond-fanciers are drawn inevitably, he says, to predictable, low beta, "annuity" stocks – in short, stocks that look as much like bonds as possible - and have encouraged their line managers and clients to pile into the same. The result, Odey's argument runs, is that fund flows have rendered defensive shares expensive, certainly relative to those of lower quality or more volatile companies.

His conclusion would certainly resonate with several of Lindsell Train's clients and counterparties, who have told us recently that they wonder if our strategy has been a beneficiary of the above tendency and may now be vulnerable to setback or underperformance.

Now, that's a big and fraught set of questions. Have defensive stocks become expensive? Does our strategy rely on defensive stocks for its performance? If it turned out that we agreed that such shares were temporarily (rather than grotesquely) overpriced – would we actually do our clients any service by selling down and thereby altering our style? And as befits a big and fraught set of questions, we've a number of observations.

First I'll review the core proposition – that defensive stocks have been driven to unsustainable highs by a wall of institutional money. That "unsustainable" is impossible to define, of course – but let's agree that if it was indeed the case, then such stocks and the sectors that house them would have gone through the roof – gone into an exponential price curve - in 2012.

But at sector level it is not at all obvious that such a mania is upon us. The FTSE All Share had a total return of +5.8% to end October. Admittedly, the Consumer Goods sector, that holds many defensive companies, is up 10.8%. And drilling deeper into the sector, Beverages are up 22% and Household Goods 26% - punchy gains. But Personal Goods and Tobacco are both down in 2012, showing that defensives are not having it all their own way. Meanwhile, Oil & Gas, Health Care (including Pharmaceuticals) and Food Retail – big traditional defensive sectors all – are negative so far this year. Overall, there are 12 UK subsectors up at least 20% in 2012. Of these, only the two noted above are obviously defensive, while other strong performers – Forestry & Paper, +50%, General Retail, +31%, Chemicals, +26%, General Industrials, +24%, Electrical Goods, +24% and Banks, +23% - suggest that something quite different from the "defensive good/cyclical bad" narrative is playing out.

It is important too, in a world of global capital flows, to note that the MSCI World Index to end October is also not signalling a defensive boom. The MSCI is up 12.3%, but the Consumer Staples sector is slightly lagging, at 12.1%. Global Pharma is outperforming, +15%, but Utilities and Energy – defensive sectors – are struggling, both up no more than 3%. Again, the real sector action, globally speaking, is away from the low beta annuity stocks – Consumer Discretionary is +17% and Financials +22%. The best performing global sector is Media, +27%.

Next, what we must conclude from this brief analysis is that, as always and as provokingly as always, equity markets are never as simple as one would like. You might think predicting outperformance for defensives on January 1st 2012 would have seen one right for the rest of the year. But in fact you still had to know which type of defensive. There really is no escape from getting individual stocks right. For instance, how galling would it have been at start 2012 to pile into Glaxo, Tesco and Vodafone? And on December 31st 2011 no one would have argued about the defensive credentials of this trinity. But today you'd be down 14% on average. Somehow their reliable defensiveness has proven unappealing, or even worse, unreliable. The truth is companies formerly regarded as defensive can lose that cachet and the term is, anyway, more fluid than market strategists care to acknowledge. I can't help but note that three of the "wild west" stocks that Crispin Odey reportedly favours - Sky, BP and, maybe, British Aerospace – have all, in the past, been held up as paragons of defensive reliability. Until events

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intervened. Tobacco has wobbled in 2012, as investors wonder will it be as sure a bet when the companies can no longer even demarcate their packs.

Turning to our UK Equity performance, we have three obvious winners that can be tagged “defensive” – Barr, Heineken and Diageo. But there are specific circumstances that explain their perkiness – to wit, they’re all up because they have pulled off transformative deals over the period. We submit simple membership of the defensive club is not enough to justify their returns - as is demonstrated by the contrasting performance of another major LT holding, Unilever, which, to end October, was up a helpful, but scarcely portfolio-busting 7%. Elsewhere and without conducting an exhaustive attribution, I’d note that our UK representative portfolio has benefited from 11 holdings that have gained at least 20% in 2012 to date, out of a total 24. Of these, Diageo and Heineken are both up more than 30% and as chunky positions (18% combined) have made a meaningful contribution to the portfolio’s return. However, the remaining 9 big winners are scarcely conventional defensive names – Daily Mail, Euromoney, Greene King, Hargreaves Lansdown (up 78%!), London Stock Exchange, Marstons, Rathbone, Reed and Schroders (nearly 38% of the whole).

In sum, to this stage of the discussion, I rather reject both aspects of the proposition being put to us. I don’t accept that it is obvious that 2012 has simply been a year to “Buy Defensive”. And I also dispute the interpretation that says LT has done well this year because of a structural bias to defensive stocks. I prefer to think that we have a structural bias to unique companies, some of which sometimes are designated by other investors as defensives.

What, then, of the current valuation of LT’s successful “defensive” investments? And let me cut to the quick. Our top two holdings – Diageo and Unilever – amount to 20% of portfolio value and both are trading at all-time highs. Diageo is up 33% in 2012, to £18.75 and is likely to earn c£1.00 in the current financial year, putting the stock on over 18x earnings. Unilever has nigh on doubled from its 2009 low and the stock offers a historic dividend yield of 3.6%, no more than in line with the average for the FTSE All Share. Unilever - a company that many investors have believed for many years ought to offer a meaningful yield premium to the average UK share – if for no other reason than its ineffable boringness.

And, continuing to play with a straight bat, let me say that to our minds neither of these shares is overvalued and we are not tempted to sell. Admittedly, we have not added to the Diageo holding for about £1.50 and can quite see why it might underperform for a period, at some stage, but are still steady buyers of Unilever. We have three perspectives on the pair and, by implication, on those other, vanishingly rare, companies in the world with comparable brand equity and global distribution to Diageo and Unilever. But before sharing those three perspectives let me attempt a list of those true comparators – Inbev, Coca-Cola Co, Colgate, Danone (maybe), Heineken, L’Oreal (maybe), LVMH, Mondelez, Nestle, P&G, Pepsico, Pernod and SAB (maybe). Have I missed any obvious candidates? There are 1,625 companies in the MSCI World Equity Index and maybe 13 of them can match Diageo and Unilever on these criteria – less than 1% of the sample. As we say, vanishingly rare - and that scarcity merits a high valuation.

First, we invert Diageo’s prospective P/E of 18x and Unilever’s of 16x and find earnings yields of 5.5% and 6.25% respectively. We then remind ourselves that these earnings are likely to grow ahead of inflation for the foreseeable future. Try as we might, we can’t persuade ourselves that index-linked cash flows of well over 5%pa in 2012 are expensive.

Next, we heard the suggestion during a recent Schroders presentation that the current enthusiasm for defensive shares might develop into a Nifty Fifty phenomenon; although with little inference whether this might be something to welcome or fear. But it is certainly an interesting proposition and worthy of dissection. For reasons that will become apparent, we regularly return to Jeremy Siegel’s masterly analysis of the original Nifty Fifty episode in his invaluable book – “Stocks for the Long Run”(2nd Edition, 1998) and I crib what follows from him.

The share prices of the Nifty Fifty – that collection of “one decision” stocks (the recommended decision being “buy and hold forever”) and identified by Morgan Guaranty Trust – peaked in December 1972. It was a disparate group, comprising some consumer staples, but also technology companies, retail and industrials. And at the peak the shares commanded expensive valuations, by traditional measures. The average P/E ratio for the group was 42x, with a dividend yield of 1.1%, respectively double and half that of the S&P500 in 1972. So we can say, in passing, that Diageo, Heineken and Unilever valuations still have a long way to go if we really are going back to a Nifty Fifty future!

But what really is dynamite (and, reader forgive me, here I arrive at last at the real point of this lengthy piece) is that it is by no means obvious that the Nifty Fifty was materially overvalued, even at its peak. With the benefit of 25 years hindsight, Siegel worked out the return on the Fifty from its peak, compared to the benchmark. Notwithstanding a nasty lurch down in 1974/5 the group returned 12.7%pa to December 1997, compared to the S&P500 12.9%pa – effectively a wash. What's more, for a typical real world investor, that is a higher rate US tax-payer, the Nifty Fifty would have actually outperformed the S&P, because of the lower dividend yield on the Fifty (capital gains being taxed more lightly than dividend income).

Let's be clear what Siegel is saying. A collection, however arbitrarily selected, of "great" companies outperformed the broader market over 25 years (for the likely average investor), even from the point of its highest relative valuation and despite the list containing more than several that turned out to be real clunkers. In short, 42x earnings turned out not to be expensive.

And that is not a theoretic or debateable proposition. What Siegel was able to do, with actual, indisputable historic data, was to calculate what the warranted P/Es of each member of the Nifty Fifty should have been, if investors had been able to correctly estimate the future value creation. Specifically, he worked out what the P/Es should have been to ensure that each of the Fifty's shares did no more than perform exactly in line with the S&P500 over the next 25 years. So, Philip Morris traded on 24x earnings in December 1972. The stock proceeded to deliver just short of 20%pa total returns until 1997. If Philip Morris investors had known that, they would have valued the stock in 1972 not on that apparently lofty 24x, but 78x. Coke sat on 46x earnings in 1972, but with perfect foresight investors should have valued it on 92x. Meanwhile, to illustrate this cuts both ways, tech-favourite Burroughs enjoyed a 46x P/E that "ought" to have been 4x, given the subsequent disappointments suffered by its investors.

Here's how Siegel summarised his findings:

"Those stocks that sustain growth rates above the long term average are worth their weight in gold, but few live up to their lofty expectations."

And, even more apposite to this discussion:

"Stocks with steady growth records are worth 30, 40 and more times earnings."

In other words and turning to today's debate, it is not so dangerous for defensive stocks to be apparently highly valued, compared to the average, mediocre company. They deserve to be. What is dangerous, though, is to be complacent about their perceived defensive qualities. Only the most exceptional sustain very long steady growth records.

A final perspective on our unwillingness to sell Diageo and Unilever. We've written before about Fidelity's Peter Lynch and his potent approach of investing for "baggers". To invest not for pops of just 20% or 40%, but to invest in shares that can "bag" - double, treble, quadruple and more over time. The value of the holding in Diageo for LT's oldest client is up 2.25x against book cost. We're confidently looking forward to it doubling again. Why should it do so – a cynic might ask? Why doesn't the current valuation capture all the future potential already? Because unexpectedly good things tend to happen to good companies. Or, more formally, the predictability of the future cash flows of exceptional companies accords them a strategic flexibility or optionality that enables them to advance their business in a way not available to the average, bank-reliant company and to an extent often unexpected by investors.

If I said to that cynic that over the next two years Diageo will acquire for cash both Jose Cuervo, with which it currently has a distribution agreement and Moet Hennessy, of which it currently owns 34% and that these deals will be accretive to both earnings and brand equity per share would he still be a seller, even on 18x (and both transactions are feasible)?

As Lynch put it so trenchantly in 1994: "Other investors invent arbitrary rules for when to sell."

For us the conclusion is - don't be bounced out of your rare, value-creating shares or, even, out of a Lindsell Train fund for arbitrary reasons.

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