Edinburgh Partners

Are we there yet? July 2008

The last twelve months has been an uncomfortable period for investors in global equity markets and with economic slowdown now clearly in view, markets continue to be volatile. During such periods of volatility many investment decisions can appear difficult to reconcile with the deteriorating fundamentals and sometimes the accompanying share price falls. This can have a negative impact on both the absolute and relative short-term performance of our portfolios.

Understandably, you may be looking for some guidance on where we are now and when we might expect to reach some sort of turning point, hence the title of this note: "Are we there yet?"

We thought it would be helpful if we laid out our views on these topics and described how they are expressed in your portfolio. Above all, we remain confident that robust application of our process combined with patience will deliver the returns you seek. We would be happy to expand on these thoughts; please let your usual client service director know if you would like to discuss our views in more detail.

The debate about whether or not we face an economic slowdown/recession is now dead and buried. There is absolutely no doubt that the economy has already turned ugly and is going to get worse not better. Equally, although many company valuations have not yet reacted and we are still going to see further pain, this is no longer the main debate. Any lingering doubts about whether or not there will be a bear market should now similarly be dispelled. Economic disappointment and further profit warnings are inevitable.

The key question, as always, refers to the profile of future profits growth relative to what is already discounted by the market. In other words, one cannot draw the simple conclusion that those sectors most affected should not be owned. The conclusion has to be tempered by how much of the downturn in prospects their share prices are already discounting. Many phrases are used in this context: 'darkest before the dawn' and 'buy at the point of maximum pessimism' are two of the most frequently heard. Obviously, it is best to buy when the price is lowest and equally obviously, this is likely to happen when sentiment is at its worst. The difficulty is that one only knows this after the event, i.e. long after sentiment has turned and showed sustained improvement. By this time it is too late and share prices will have risen. All that one can tell is that news flow is likely to be highly negative on the best investments and the best time to buy will be when their prices are falling.

The critical point for us to identify, is when sentiment (falling share price) overtakes valuation (lower future profits growth) in the investment race. Sentiment can outpace valuation for some considerable time and we have never been able to identify an indicator which helps us select when sentiment or emotions will turn. It is important to be clear that this is not a deliberately 'contrarian' approach. It is not an attempt simply to do the opposite of what the market is doing. More often than not the market is correct. Our approach is an independent one which can end up with contrarian outcomes. Once we have a view on the value of a business, then we can decide whether the current share price is appropriate or not. The relevant variable then becomes time; the wait for value to be recognised.

Since one can never know with certainty the precise out-turn on future profits for any particular company or sector, all an analyst can do is try to forecast the range of probable outcomes and the broad likelihood of them occurring. Perhaps not surprisingly, often what one finds is that the stocks with the cheapest valuations also have the widest range of outcomes. Risk and return are not independent of each other and the purpose of active investment management is to try to quantify this trade-off for individual stocks and build this up to create a balanced portfolio.

Portfolio positioning

Currently sentiment is most negative on the financial sector and we believe that it has run ahead of prospective valuations to such an extent that the best potential returns in the market, now exist in banks. However, the predictability of future profits is also now as low as it has ever been. The reason for this is not that the economy is deteriorating and loss provisions will rise – as they certainly will. There is plenty of historic evidence about how bad debt experience will evolve, which allows some degree of confidence in forecasting the traditional lines of business of a bank. Rather, the principal difficulty lies in their exposure to a series of financial instruments which they have accumulated in the lax monetary environment of the past five years. Estimating this exposure with any degree of accuracy is an almost impossible task given the lack of transparency which is sometimes compounded by the lack of knowledge of the bank itself. The answer is to put boundaries round the orders of magnitude and then relate this back to the potential damage to shareholders' equity which would be caused by fund raising to fill the gap.

For a number of banks it is our view that, even with substantial further fund raising, valuations are now so low that the long-run profit opportunity and risk reward balance favours portfolios having exposure. Our global portfolios have over 15% exposure to financials. They are the cheapest and the highest risk securities in our portfolios. It may well be that they will fall further and that positive returns will not accrue until we see signs that the economic deterioration is ameliorating; but this can not be known with certainty. What we do know, is that if our central case estimates are correct then their share prices can double or triple over a five year period.

The financial stocks may be at the centre of the storm but the ripples are gradually moving outwards. The squeeze on consumer spending which is emerging from the dual effects of slowing growth and rising energy and food prices is already resulting in retailers reporting lower than expected profits. This will continue and increasingly be seen in industrial companies where margins will be squeezed not only by pricing pressures but also by lower output.

Although some of the industrials' share prices have been hit, they are not in our view yet close to discounting what is going to emerge. In other words, the race between sentiment and fundamentals is still one where sentiment is much better than the deterioration in conditions suggests is appropriate. If this is true for industrials, it is even more so for commodity stocks. There exists a view that emerging markets growth will ensure that even with a global economic slowdown commodity prices will continue to rise. This is possible, but in our view extremely unlikely. The portfolio has limited exposure to these areas.

In contrast, our portfolios do have significant exposure to the telecoms sector, where dividend yields range from 4.5 – 8%. These dividends look secure and whilst profits progression is not exciting, it too is relatively secure. With the protection of high dividends and robust but dull profits, it is reasonable to expect positive returns from these companies. As such we have approximately 20% of our global portfolios in telecoms companies. The pharmaceutical sector, although very different in its operation, has a very similar profits outlook. Profits growth will again be dull but when combined with good dividends, exceptionally strong balance sheets and resistance to the economic cycle; we expect respectable returns from these companies. The negative aspects of patent expiry have been fully discussed and now appear to be discounted in share prices. As a consequence, our global portfolios have close to 20% in pharmaceuticals.

Our global portfolios therefore, have roughly 20% invested in the high risk/reward area of financials and 40% in the more robust and hence counterbalancing areas of telecoms and pharmaceuticals. The two other concentrations of holdings are technology and energy. Our approach to technology has been to initiate holdings in high quality companies when worries over near-term growth hit their share prices. The most obvious example of this in global portfolios was Cisco, where concerns over near-term orders and margins caused the share price to drop sharply. Our intention is to add to these positions whenever we see further share price weakness. Our energy holdings have been in the portfolios for some time and they are now some of the more expensive stocks in the portfolio. Our approach to these companies has been to look at them in two ways. The first starts with a set of oil price and refining margin forecasts from which we create our estimates of long-term profits and hence valuations. The other starts with the current share price and works out what implicit oil prices and refining margins the stocks are discounting. We will reduce positions when we feel that the stocks are discounting an oil price which we believe is unsustainable. The current situation is that oil company valuations are discounting an oil price higher than we think likely, but we are not yet at the point where we could convincingly argue that it is demonstrably unsustainable. Hence we have made only marginal reductions in our holdings. Technology and energy stocks between them account for close to 25% of global portfolios.

Inflation is key

This note started by saying that the debate over recession was dead and buried (or at least should be). The debate which will soon begin is over the duration and depth of the recession. One of the key determinants of this is inflation. Currently we have price rises but not necessarily inflation. Prices have largely risen because of the cost of inputs. Oil, metals and food have all seen very sharp price increases over recent years. The simple explanation for why this has happened is that the supply of all of them is relatively inelastic, and takes time to increase in response to increased demand. Fuelled by low real interest rates, excess consumption by the West and undervalued currencies; emerging market economic growth has been sustained at historically exceptional levels. This has increased the demand for all of these inputs. Normally this would be ameliorated by the consequent rising price. However, most of these items are subject to price controls which suspends the market mechanism. This situation was never sustainable and we are now seeing a combination of rising wages, appreciating currencies and reducing subsidies.

Ultimately, all of these influences will serve to slow the export-led element of growth. Whilst domestic consumption will inevitably rise, it will not compensate for the impact of lower exports in the short-run. The picture therefore is one of emerging markets growth slowing substantially over the next couple of years. The impact on inflation should, on balance, be positive. The reduction in growth in demand for energy and commodities will end the rapid price appreciation, with immediate knock on benefits for inflation numbers in the west. On the negative side, the annual fall in prices of products ranging from consumer electronics, textiles and footwear will grind to a halt.

The net effect for western consumers is that their ability to buy discretionary items, after they have paid for the necessities of life, is sharply diminishing. Effectively, it is payback time for the period of excess consumption. This means that savings must increase and consumption fall, which in turn means subdued economic growth at best. The inflationary question will determine whether this pain is absorbed now or whether it is deferred as the population seeks to sustain an illusory purchasing power. Under normal circumstances one would expect that recession would ensure that wage growth did not become inflationary and hence that price rises were not turned into spirals. The pain therefore would be acute rather than chronic.

The main threat to this lies in those areas of the economy where political control is the principal determinant of wages rather than the market. This is a very real threat since a substantial proportion of those in the public sector are at the lower end of the wage spectrum and hence the most exposed to the lowering of their living conditions. The posturing of the Central Banks can be set in the context of trying to ensure subdued wages growth can be maintained through to the point where the impact of oil and commodity price rises starts to drop out of the published headline inflation numbers.

Should this happen, the next stage will be that markets will move from worrying about stagflation to worrying about deflation/depression. In all likelihood this will mark the low point in valuations. Exactly when this will happen is hard to say but we would expect it to occur at some point in the next twelve months or so. Between now and then we would expect some fantastic opportunities to appear in companies where valuations are currently too high, much as has already begun to happen in the technology sector.

If wage inflation does take hold then assuming that the Central Banks stick to their mandates, we will see higher interest rates and a longer and deeper recession as a consequence. This remains the lower probability outcome but it is not impossible.

In answer therefore to the question: 'Are we there yet?' The answer is no, but we are at least much closer.

Until the mists clear, markets will remain volatile and we will continue to see stocks which we think are cheap go down and stocks that we think are expensive go up. This happens rarely, but it is when the best opportunities occur.

Unfortunately, it can lead to periods of negative absolute and relative performance. We understand that this can be concerning for clients and we must admit that it is also painful for us.

We have been through this experience many times in the past and whilst it never gets any easier, we are clear that only by sticking to our disciplines can we navigate our way back through to the performance we expect to deliver.

Dr Sandy Nairn
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