Independent Investor

NEWS, ANALYSIS AND INSIGHTS FOR SERIOUS INVESTORS

INTERVIEW SERIES: Sandy Nairn (Edinburgh Partners)

It's time to hunker down

Sandy Nairn

Sandy Nairn is the CEO of Edinburgh Partners, a boutique fund management firm that has built up its assets under management from nothing when it started in 2003 to more than £3 billion today. In this interview the former Research Director for Sir John Templeton explains why he thinks world equity markets are heading for a fall.

How do you read the markets now?

The traditional feature that appears towards the end of a stock market cycle is that all the forecasts are pointing upwards in a straight line. At the peak of the cycle, estimates of sales growth and profit margins are way too high. That is how you end up with the big shocks and the big disappointments. When the first set of bad results come in, it is treated as being an isolated event. Then there emerges a stream of profit warnings which point to more systematic weakness which can no longer be ignored. It is not unusual in this second stage for the weakness to be recognised, but ring fenced by investors as being peculiar to a particular sector or country. This is simply part of the attempt to retain a general over-optimism which is being belied by events. Thus one can end up in the paradoxical situation where the stocks most exposed to the centre of the economic upset can end up being cheaper than those that are more distant. This is just part and parcel of how a traditional cycle works. As always the key remains to focus on long-term valuations and step aside from the emotional rollercoaster which accompanies it.

If that is the traditional cycle, is there anything that is different this time round?

The short answer is that there is nothing different this time round. When you have politicians, or indeed central bankers, trying to extend economic cycles, or pretending that the cycle has been abolished, that is when you lay the groundwork for the biggest bubbles. Typically the sequence of events begins with a problem – or at least the perception of a problem. Depending upon which historical example one selects, it could be anything from a currency to a range of different asset markets. The key is that it is expected to have a negative impact on a politically sensitive element of the economy. In order to protect that group from the side effects of the problem, the cost of money is reduced, i.e. interest rates are then cut. It was the US-Japanese trade balance which created the perceived problem of the Yen that gave rise to the Plaza Accord in the 1980s and eventually caused Japanese interest rates to turn negative in real terms. The reduction in the cost of money prompted the asset bubble in Japan and the 10 year hangover that followed it.

Similarly the currency crisis of 1997-98 was a direct result of the economic problems which accumulated from the pegging of exchange rates by many Asian countries to promote growth. Despite engendering rampant domestic inflation, interest rates were held at inappropriate levels to maintain the currency pegs. When it all suddenly gave way, the reaction had a cataclysmic impact on inflated asset markets. The reaction of global authorities to the perceived threat to financial stability was to drop interest rates and loosen monetary controls again. The resulting liquidity surge pumped up the TMT bubble. When that particular bubble burst, the reaction was "Now we have to watch out for deflation." This was not a totally ludicrous reaction, since deflation was a possible outcome, but it produced two years of real interest rates that were close to zero or even negative and coincided with the early stages of economic recovery – a time when you would expect them to be drifting gradually higher. Markets have consequently come to look on the monetary authorities as the cavalry that will always ride to the rescue when threats emerge.

That gives the wrong signals to investors?

When abundant liquidity and low borrowing costs coincide, investors typically react the same way. Risk is dropped from the investment lexicon. The easiest example would be in bond markets. The long-term history of default rates is a reference to the likely balance of risk over the economic cycle. Default tends to be low when economic conditions are good and high when conditions worsen. During a period of rising economic growth, there is always the danger of myopia, during which the short-term focus ignores the reality of longer term dangers. When this occurs the natural conclusion is that to increase returns all one has to do is increase leverage. Debt is good! In all bubbles, you consistently see the same symptoms show up. The most obvious example is the property market; it is almost as if it can't restrain itself. In both the Japanese example and the Asian example, you had very low yields in the property market. This is also true today globally, whether it be residential, commercial or industrial property. Whilst spreads are now beginning to widen, and yields are starting to rise, they are still at levels at which it would make little sense to invest in property on a risk/reward basis.

You can also see the myopia about risk if you look at the spread of Triple-A bonds versus junk bonds, or emerging market debt versus developed market debt. The spreads are the narrowest they've almost ever been. The widening we've seen since the summer is still quite small, and yet interest rates have only really gone back to a normal historical range at the short end of the yield curve. Unless you genuinely believe you have the ability to rewrite economic history and abolish the cycle, there is no real economic reason for them to be cut any further. Indeed it is low real interest rates that have brought us to where we are.

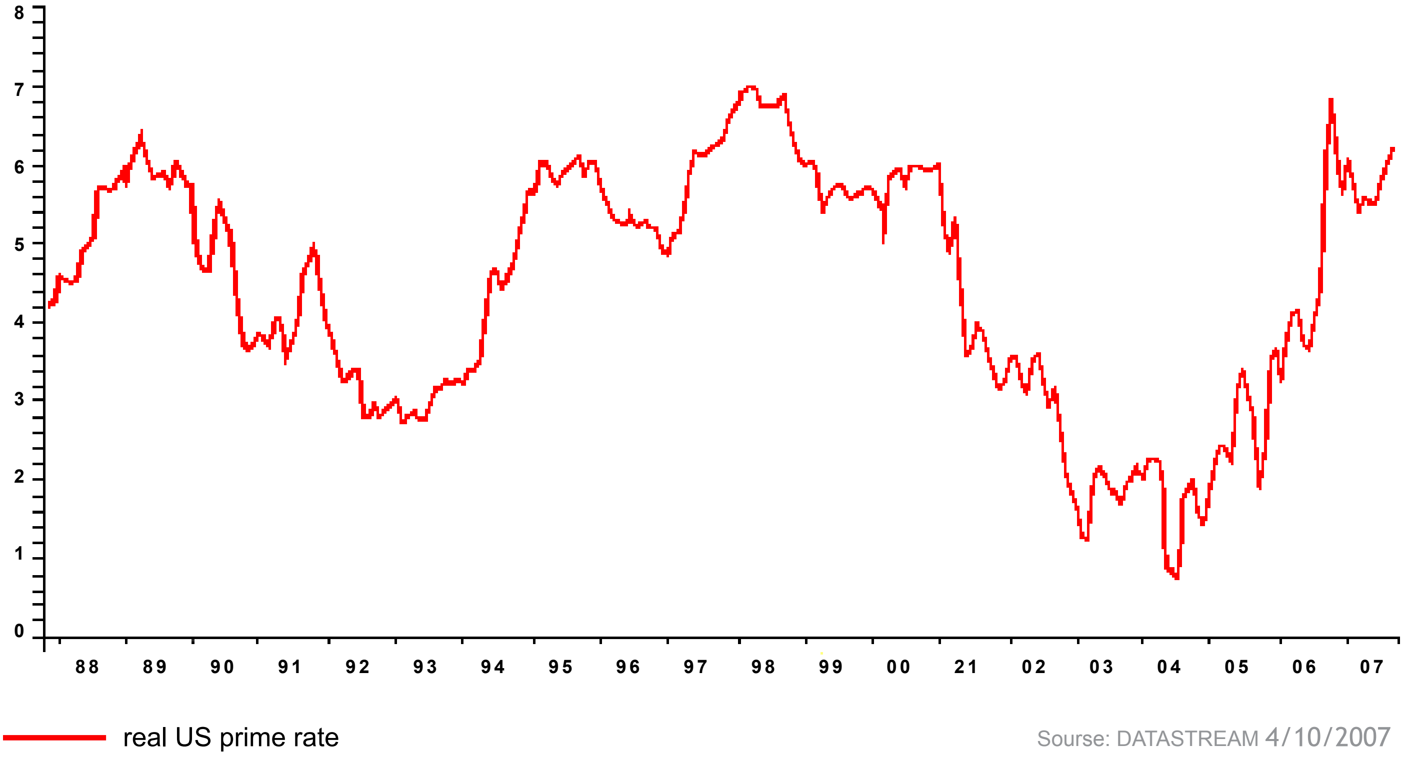
What else happens in this kind of market?

The other thing that happens during sustained periods of low interest rates is that market practitioners get to work creating new esoteric vehicles. Investors who ignore risk-reward and suspend their disbelief are an open invitation which will not be declined. The explosion in private equity, hedge funds and off balance sheet funding vehicles in banks, are all manifestations of this particular cycle. In all but a few honourable exceptions returns have been driven by leverage rather than by some new discovered skill set. The key is that leverage works in both directions for investors. Unwinding illiquid debt-laden vehicles is a slow and painful process. This is the inevitable hangover which follows such a party.

What does that mean for the equity markets?

Hitherto the equity market to a large extent has been acting as a proxy for the activities in other asset markets. The stocks that have risen the most in the bull market have either been asset backed plays, such as hotels, or potential private equity targets, such as many of the mid-cap stocks. The story is that hotel chains don't need physical buildings any more, and

Real Cost of Money



- ***The real (after inflation) cost of money, as measured by the difference between the prime rate and inflation, is rising again after falling to abnormally low levels in the period 2002-2005.***

supermarkets don't need their real estate. But there's a reason why balance sheets are structured the way they are, and that is precisely to insulate you against a downturn in the cycle. If you are a Sainsbury's, or a hotel chain, and your balance sheet has been stripped bare, then when the cycle turns nasty, you can get into real trouble. You can't sustain your margins; your cash flow deteriorates, and so on. Clearly the centre of the storm as it stands at the moment is the financial sector from where these new vehicles emerged or were funded. There is no question but that credit will be restricted until the excesses have been unwound. Some participants have the ability to access funds which will see them through the crisis. Others do not. It would be complacent to think that it is only the financial sector and those obviously directly affected who will feel the impact. Excess liquidity and credit have fuelled the global economy. Restrictive liquidity and credit will have the opposite effect. The stock market is deluding itself if it thinks that corporate earnings will not now have a meaningful setback.
If I am right therefore about the equity market being a proxy, now that the cycle is turning the market looks vulnerable. The argument that's being used to sustain valuations is the emerging market story. This largely revolves around China, and it basically says "as long as China keeps growing at 10% a year, then we're okay". Two things worry me about this argument. The first is that the orders of magnitude just don't work. The US economy is five times the size of China. To expect the latter to be able to bail out the former is simply asking too much. It is a mathematical nonsense.

And how sustainable is the Chinese story going to be? Chinese growth is being powered by exports. The trade balance in China has gone from under 2% of Chinese GDP to more than 6% and is heading towards 8%. But most of those exports go to the Western economies, including the US. The US trade account deficit has turned and the dollar is now highly competitive. The terms of trade will inevitably squeeze the historic beneficiaries of US consumers debt funded consumption. Again the orders of magnitude are important. The US visible trade balance is almost one third the size of Chinese GDP, or to use another example from the so-called BRIC's, it is roughly the same size as the total GDP of India.

If you look at what market participants are forecasting for China, what seems to be embedded in expectations is that GDP growth will continue to compound at 10% per year while inflation stays below 4%. Yet average earnings in China are rising at 15% or more. Something has to give here. If the US is not going to import inflation, then either Chinese companies have to take a cut in their sales and margins, or their productivity has to keep growing at 10% compound a year, which I struggle to believe. In the long run to believe in China having non-inflationary 10% compounding GDP growth is folly. It's just not the way that economies work. You always get bottlenecks, and particularly in an economy such as China, you'll also get political stresses. Indeed, there is the potential for political tensions all across Asia, driven by the income disparity that is being created.

You are saying that the emerging market story is not very robust?

The story is robust in the sense that growth is likely to significantly exceed that of the developed economies for the foreseeable future. Remember though that the story about the significance of the Internet was also robust. Confusing exciting stories with investment opportunities can be very dangerous. The root is simply that equity market valuations are not compelling, even if you believe in the Asian story. Hong Kong is largely a property-based stock market. The valuations don't look terrible at the moment, but that's only because they have had a huge lift in asset values. It's hard to see those continuing, other than in the short run. In other words, I would say that we know how the Chinese/emerging market story is going to end. The only question is how much more can it inflate between now and then? The Beijing Olympics seems to be the totem which everyone is holding on to. The argument runs that the Chinese authorities will not allow anything bad to happen before the 2008 Olympics. I would argue that for long-term investors, it is not the most solid of foundations.

Emerging markets have already gone up by almost a third in very short order. I think therefore that we're potentially in line for a re-run of the last bubble. There could be a nasty reversal coming. That is consistent with the fact that when we look at the developed markets, we are struggling to find any stocks that are now obviously cheap. There are very few stocks like that around. There's every sign, in my view, that we are close to the beginning of a new bear market.

That is based on your valuation methodology, looking at five-year forward earnings multiples?

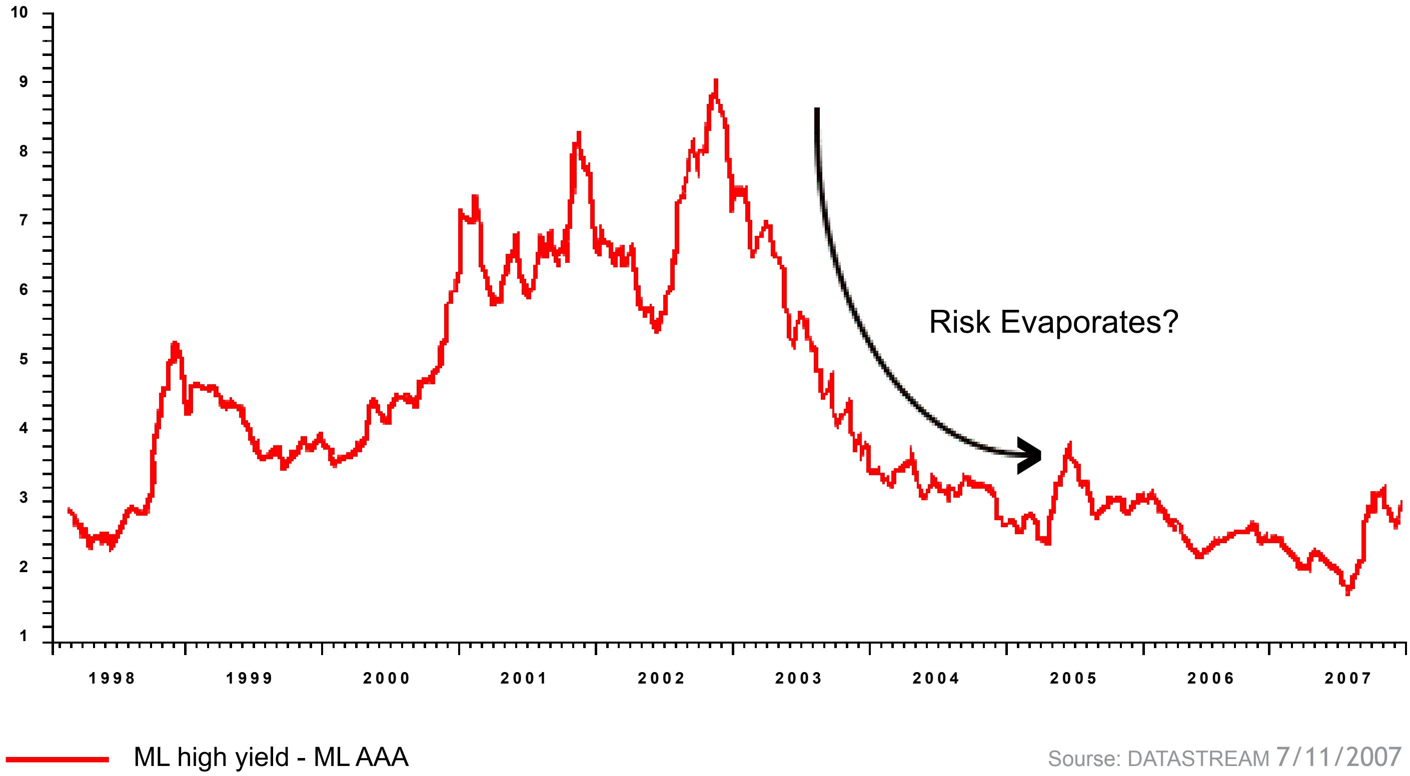
Yes. The only way to avoid that conclusion is to say we aren't going to have an economic downturn. But US GDP growth is already down to under 2%, without the consumer yet having retrenched! There's no way, in my opinion, that we're going to avoid a downturn in the cycle. I don't see much hope in the decoupling argument. It is premised on the view that the Asian consumer will step in to pick up the economic slack. It is not what is currently happening and it is just not the way the governments of Asia work. They are very much wedded to the mindset of export-led growth, with periodic bouts of infrastructure expenditure. It has never been about domestic consumption. They view themselves as catching up with the West as political and economic powers. I find it very difficult to see them moving away from this view of the world in the coming years.

So we are either going to have a normal bear market now or a much bigger bear market later?

Yes. I think it is a case of "pay now, or pay later". A traditional bear market of at least 20% would be the right thing to happen now. That would get us back on a reasonably even keel. But the more it goes on rising from here, the more dangerous it becomes. It is interesting that the bond markets have detached themselves from the equity markets and are taking a different view of what is going to happen. What they're saying seems to me to be perfectly rational. It is the equity market that is floating on a cloud of false expectation.

My hope is that it won't inflate any further, but it could. What often happens to global equity managers is that the further into a bull market you go, the more their portfolios start to look like emerging market portfolios. In the chase for growth risk gets forgotten. It's the same story as default rates in the bond market. Default rates aren't important until the defaults begin! The fact that default rates are inversely correlated to the economic cycle is only common sense. Companies typically default when conditions worsen. The short-term absence of default doesn't mean that the future default risk has diminished. Actually, the logical

Risk: Corporate Bond Markets View



- ***While the spread between the yields of high quality and high yield bonds, a traditional measure of investors' risk aversion, has risen from its historic lows, spreads have still to return to even the lower end of their normal historical range.***

implication is that it has risen. In fact, if I hear one more busted hedge fund manager talking about a once-in-a-thousand year event, I'm going to lose my sanity! What they're talking about are not one in a thousand year events. It's just bad modelling. A bad model is one based on a partial view of the world which does not take into account how events unfold. The phrase itself shows the lack of thought that has been applied. The time tested phrase 'there are no free lunches' would be a much more accurate description than the 'thousand year events' or 'perfect storms' that we are hearing about.

How do value investors like you get through this kind of market?

Sometimes with difficulty! I've been through this cycle a number of times, and it never gets any easier. There's always just a little bit of doubt in your mind whether you may have missed something or slipped into dogma to justify your position. Whilst it unfolds all that you can do is continually question your assumptions and retest your analytical work. If this does not change your conclusions then there is nothing else to do but get ready to go through it all again, waiting for normality to reassert itself. It is not that you necessarily lose your clients' any money – if the bull market goes into overdrive, our portfolios will go up - it is just you don't make them enough money. Other managers, the ones who don't care about value or risk, or believe they can hold expensive stocks and judge when the top is coming before selling them, will be zooming ahead for a while. Then one day it all comes back to earth, but that day is always further out than you hoped. We're starting to wonder when and where the test of nerve is going to crystallise itself. It is definitely going to happen sometime, but how soon nobody knows for certain.

Is the credit crisis of this summer a symptom or a problem in itself?

It is both. It is a real problem because it will drain liquidity out of the economy and the markets. It's hard to see any chief executive of a major bank going into a board meeting next year saying "We must lend more to hedge funds. We must create more structured vehicles". The natural reaction is to batten down the hatches, hoard liquidity and rein in your lending practices. That inevitably will subdue economic growth. It is definitely going to happen. In fact it's happening already. Refinancing will get more difficult. Companies that have been gearing up their balance sheets to keep the equity market happy will suddenly have to de-leverage them to keep their banks happy.

Do you have any other macro concerns?

Inflation has not gone away. There are growing indications that some central banks are not as concerned about inflation as they were. Once you remove the downward pressure that emerging markets have put on Western inflation – in other words, once the price of electronic consumer products stops dropping by 25% a year - you're going to find that inflation doesn't look quite as low any more. Average wage growth in developed economies is robust. Food price deflation has ended and been replaced by inflation. Metals price inflation is there. It has been an article of faith for several years that central banks will keep inflation down, and see that as their first and foremost objective. There is a real danger that this slips. There are already some signs that their fingers are being prised off the target. Inflation does not have to happen, but for the first time in a long time there are worrying signs that political backing for a robust central banking approach is slackening. The sister to worries about inflation is the potential for restrictive trade practices to emerge. Again, one can see the early signs of these pressures rising.

How does the strength of commodity prices fit into your overall view of the world?

I'd distinguish between hard and soft commodities. The prices of hard commodities reflect a general belief in the decoupling argument, which I don't subscribe to, so I'm not bullish in the long term on hard commodity prices. Food has been on a downward trend for 10 to 15 years. While I'm not an expert on food, it's clearly doing a bit of catch-up after experiencing constant lower prices for some considerable time, and an incredibly inefficient allocation of resources, driven by the misdirection of subsidies. We're certainly not going to be buoyed by constantly falling food prices any more. The only question is how much they rise. Unfortunately for the equity investors, since the majority of food production is in private hands it is not an easy story to play. We have some holdings, but not a great deal.

As for the oil price, I don't see any reason for oil prices to rise. In fact they should probably fall, but there are some perfectly respectable arguments on the bullish side. The non-OPEC swing producers of yesteryear no longer have much influence. For example, the North Sea doesn't provide incremental supplies in any meaningful size any more. The new player on the block is Russia, and it's happy with higher prices, so OPEC has got a lot more control over prices than it's had for some considerable time.

Oil prices could be higher for longer than I would have expected. There's no shortage of potential political risks around the oil price either! Anyone who has a conclusive view on oil is a fool, because there is too much you just can't know. There's a range of likely outcomes, and the highest probability outcome is less than a 50% shot. You can't predict the outcome in Iraq,

TOP TEN HOLDINGS

EP Global Opportunities Trust

As at 31 October 2007

Company Name	% Mkt Cap
Vodafone Group	4.8
E ON	3.8
KPN	3.6
Dell INC	3.2
Telefonica	3.1
OAO GAZPROM ADS (XSQ)	2.8
Teliasonera (HEL)	2.8
General Electric	2.7
Royal Bank of Scotland	2.6
Belgacom	2.6
Cash	11.6

The EP Global Opportunites Trust is a global investment trust, one of several funds managed by Edinburgh Partners.

you can't predict Iran, and you can't predict Venezuela or Nigeria.

How are you adjusting your portfolios in the light of your market expectations?

This is the toughest part. It's easy to be bullish at the beginning of a cycle and say things are going up. It's much tougher at the end of a cycle to say that what you have to do is husband your resources now, so as to be able to buy when the panic sets in later. Recognising what seemed to be unfolding, combined with the rise in bank share prices, we halved our investment in banks. We have gradually built up our holdings of both telecoms and pharmaceutical companies, reflecting their security of earnings and cash-flow strength. Since some technology stocks were out of favour and failing to reflect their growth potential, we built up some holdings 18 months ago. All of these changes have benefited our portfolios.

Given our view of the risk unfolding and the sharp rise in valuations, we have been substantially reducing our emerging markets investments, though their share prices have continued to appreciate in line with the sharp general rise in emerging markets. We do not think this is justified. Time will tell if we are correct in this view. Finally, as the turmoil in the US housing market has unfolded, we have started to see some value beginning to appear there, despite the ugly near-term outlook. We have established some small positions in anticipation of the recovery which will eventually appear.

Sometimes, though rarely, cash or cash equivalents are better value than equities. It is hard to imagine a situation where you could find no companies at all to invest in. Hence it is unlikely you will ever want to go 100% into cash. One must always retain some humility about your understanding of the world. You can never know anything with that degree of certainty, and there are always some stocks that are selling around fair value and opportunity cost is a risk which always has to be considered.

Are bank shares fairly priced then?

Banks generally are probably cheap. The difficult part is that it is very difficult to identify which individual bank is cheap. One can make judgements about the traditional activities of a bank and potential levels of loan loss reserves etc. What we do not know about is how much of historic growth has been funded by off balance sheet activities and what residual risk sits with the banks for them. There are some general principles which are fairly obvious. Banks with high gearing and little access to a deposit base are most at risk. The central banks clearly cannot allow the banking system to implode so there is no question that liquidity will be provided. The issue is the extent to which the cost of this funding is borne by equity shareholders through write offs and losses.

You still have a significant weighting in bank shares, do you not?

We still have 13-14% of the funds in banks, but it was nearly 30% at its peak, so we've reduced our holdings a lot. We started doing that the second quarter of 2006, as the share prices were going up, and we were getting more concerned about the risk-reward ratio of many of our holdings. We still own a few UK banks. They're among the cheapest on a global scale, but the specific risk in the stock is very difficult. You can't tell much from their financial statements. The banks won't tell you their exposures, and even if they could, they may not know the full story. So there is a fair deal of hope involved. However I would expect at some point in the next two years to have a pretty heavy position in banks again, as the credit story unfolds and the write-offs are taken.

What about your big position in technology stocks – have you maintained that?

Yes, and it has worked out well. The likes of Intel, Dell, et al had gone out of favour, despite their strong cash generation. Dell had particular issues with its major competitors, but it has shaken them off one by one, and the share price has responded strongly. It is the same thing with Tom Tom, which has more than doubled this year. Nokia has also gone up very strongly, because Motorola, its principal competitor, has an aging product range and it's been able to grab market share. Nokia's growth in emerging markets growth has been strong. They've done well, but they're not cheap any more. I think we have had the big move on the technology stocks. The telcos are still okay – nothing startlingly attractive there, but they remain reasonably priced utilities. In general we are hard pushed to find any segments of the market that are obviously cheap, other than the banks and potentially some of the housebuilders.

What do your portfolios look like now?

We have effectively around 10% in energy;

Conclusions

- Equity markets are priced for continued strong growth and not for an economic slowdown. In particular, emerging markets are priced as if they are immune from external influences despite the importance of exports to their recent growth. Continued rises in higher risk equities are a temptation which should be resisted.

Sandy Nairn speaking at the Independent Investor Conference 2006

photography by Mazz Image / PaloAltoMedia.com

- The loose credit-induced party is over and lending standards are going to be ever more exacting. This will last for an extended period irrespective of whether central banks reduce official interest rates in response to weakening economic growth.

- It is important that portfolios continue to broadly focus on risk reduction and capital preservation. Opportunities will present themselves when sentiment turns and one needs the capital to take advantage of them.

20% in the telcos; 15% plus in technology; 10-15% in banks; 5% in other financials; and 10% in pharmaceuticals. We would love to own more in consumer stables given their relatively stable earnings profile, but they're starting at multiples of over 20 times, so they're not cheap and therefore the protection you get from them is not great. The rest of the portfolios fall into a number of sectors, but they're a fairly disparate group. In our institutional accounts, we are able to hold up to 5-10% in cash, and we are currently around 6-7%. In the investment trusts, it's in the same range, but rising.

When stocks in the portfolio trigger one of our sell criteria, unless there's a very good risk/reward stock to replace it with, we'll let the cash or cash equivalents build up - and take the flak, which I fear is going to come. Of course there will be smart people who will make some money out of the final stages of the market. There is a huge difference between, as the term goes 'having a punt', for example by putting a chunk in the Hong Kong market and hoping to get out in time. This is gambling, not investing. We have been hired as long term value managers and that is how we are going to act. Short-term capital preservation is an important component of long-term capital growth. History is very clear on this it is the only sure way to make superior risk-adjusted returns in the long run. Losing your discipline can be very costly. The immediate potential loss of discipline lies in being seduced into buying expensive stocks. The future loss of discipline will come as sentiment turns negative and share prices fall. Then the requirement will be to buy the cheap stocks when everyone around you is mired in gloom.

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