# Focusing on real value

## Quarterly Letter

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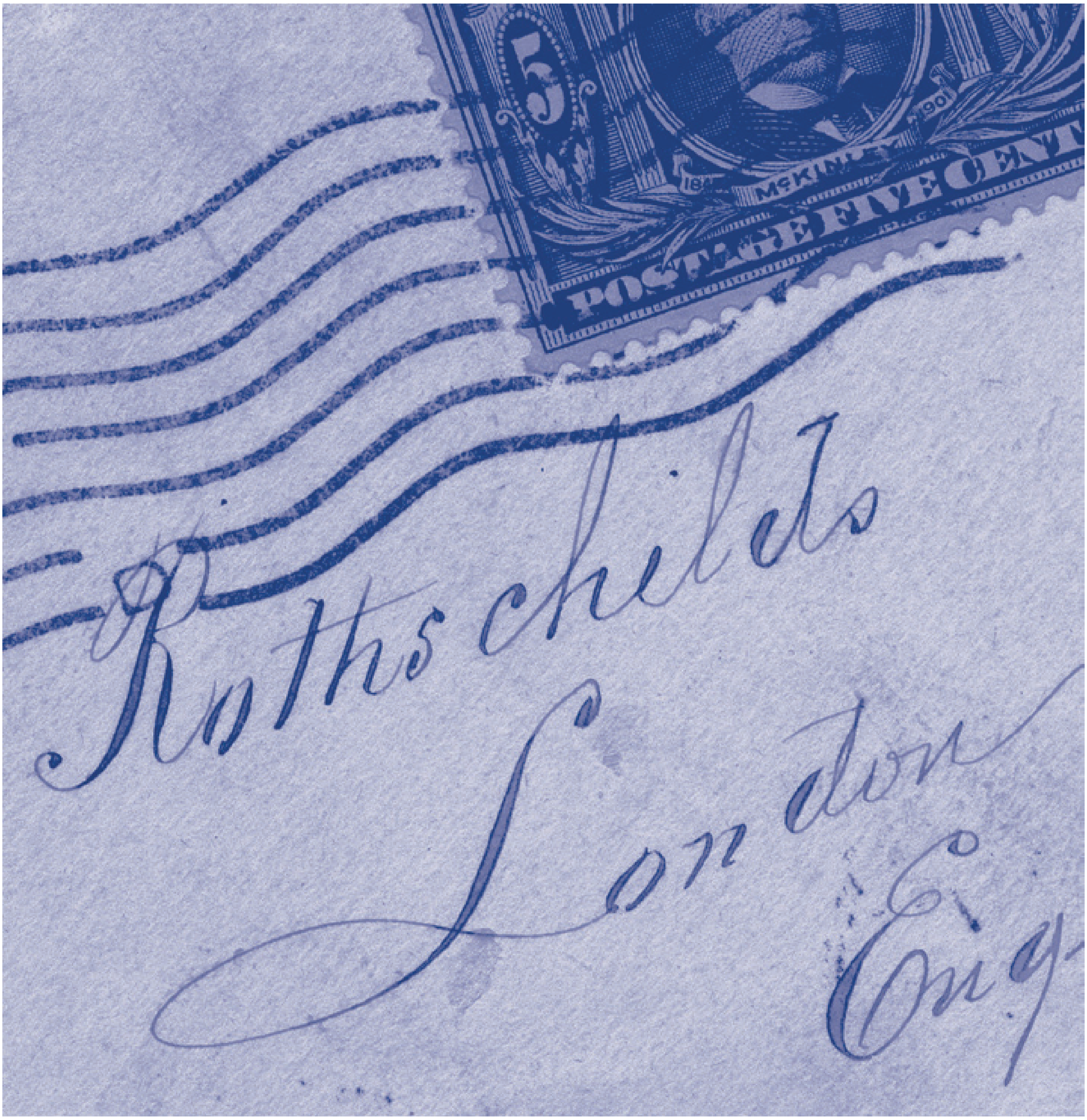

Cover image:
Envelope from a Presidential 'Thank you' sent to Nathaniel 1st Lord Rothschild (1840–1915), Senior Partner N M Rothschild & Sons, from President Theodore Roosevelt (1858–1919) in 1904. Courtesy of The Rothschild Archive

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# Foreword

In today's complex and sometimes frenetic world, we often try and create a sense of order by putting our ideas and experiences into separate mental boxes. In our heads, we compartmentalise our lives into different categories, often unconsciously.

*Financial Times* journalist Gillian Tett called this tendency "the silo effect". In an enlightening book of that name, she explored how mind-forged silos help us cope with complexity but can also lead to blind spots that mean we miss opportunities.

This silo effect can influence how some think about investments. We often focus on share prices and whether they have gone "up" or "down", and forget that behind this share price there is a business with customers, employees, assets and liabilities - a business that is hopefully generating a growing earnings stream some of which may be returned to us through dividend payments.

In the shorter term there are many factors that can influence the share price but, over the long term, it is the underlying business performance that counts. In this letter, we have tried to explain how we break down these silos to think more like business owners and the advantages that we believe this brings.

I hope you find this *Quarterly Letter* enjoyable and illuminating and thanks, as always, for your continued support.

**Helen Watson**
CEO, UK Wealth Management

# Focusing on real value

## "Investment is most intelligent when it is most businesslike"
## Benjamin Graham, *The Intelligent Investor*

Imagine you are standing in the middle of a field. You're a farmer taking a moment to survey your land. The wheat surrounding you is swaying gently in the breeze, skylarks are singing overhead, the sun is beating down on your fast-growing crops. You are pleased with what you see. Your farm is productive and all feels good with the world.

But then your peace is shattered - all thanks to a neighbour who won't shut up. Every day, this man with a farm bordering your property yells out a price at which he will either buy your farm or sell you his. The prices he shouts out swing widely depending on his mood, even over short periods of time.

Sometimes his thoughts turn negative and the price he proffers for his farm seems ridiculously low. You're tempted to snap it up, even though you're not certain it is a good idea. At other times he is infected by irrational exuberance and the sum he offers for your farm is extremely high. You consider selling, even if that isn't part of your plan. All in all, his behaviour leaves you feeling mightily confused. His yelling affects your own thinking, putting you at danger of doing something you may later live to regret.

Sounds absurd, doesn't it? But there is an analogy between this fictional parable of a harassed farmer and the investment markets in the real world. It is one that we can thank Warren Buffett for, who outlined the idea in Berkshire Hathaway's annual letters to shareholders.*

Like our farmer, stock market investors are subject to a barrage of shouting, in their case with share prices. As with our farmer, this "noise" can encourage irrational behaviour, fuelling speculation and the impulse to buy and sell on the basis of price movements alone.

Even worse, rather than changing just once a day, stock market prices update second-by-second. This makes unending share price oscillation very difficult to ignore. Thinking back to our field in the country, it makes the stock market noisier than a neighbouring parliament of agitated rooks.

One of the most influential investors of the 20th Century, Benjamin Graham, characterised this jabbering source of stock market noise as "Mr Market"**. Like our farmer's persistent neighbour, Mr Market is a strange fellow prone to mood swings. One minute he will be calmly and rationally evaluating what a business is worth. The next he lets his enthusiasm or his fears run away with him, and the price he proposes seems silly.

While Mr Market is sometimes rational, he can't be relied on to value companies sensibly. Yet, many investors do rely on him, almost exclusively. They fixate on quoted market prices, and the news around them, without questioning whether they are a true reflection of what companies are worth.

And that is a mistake. As investors spend their days fretting about interest rates, Brexit, President Trump and the myriad other factors that affect sentiment and market pricing, they make blunders and miss out on opportunities.

### Real value vs market pricing

At the heart of our investment process is a fundamentally different way of thinking about value. Our approach focuses on intrinsic, or as we prefer to call it, the 'real value' of companies. We believe this is a much better indicator of what a business is worth than the blunt tool of market quoted prices.

The distinction between market prices and real values is a crucial one to grasp. The market price is the current price at which a company, or a share of a company, can be bought or sold. The real value is an estimate of the true value of a business based on its underlying operating performance and future earnings power.

For those of you who own - or have owned - a private business, thinking about real value will be second nature. It is almost certainly how you value - or valued - your own enterprise, scrutinising its current value and future potential without reference to a market price.

To explain this further it is useful to refer back to our opening analogy. In real life, farmers aren't assailed by constant price chatter. They don't have a share price - or vocal neighbour - to tell them how much their farm is worth on a daily basis.

*For example: http://www.berkshirehathaway.com/letters/2013ltr.pdf

** Benjamin Graham, *The Intelligent Investor*, 1949.

A farm does have a market value; it is what investors or buyers would be willing to pay to buy all or a portion of a farm. But farmers only know the market value when they come to sell, which is usually a rare occurrence. However, even without reference to a market value, farmers and other private business owners tend to have a pretty good idea of what their enterprise is worth. So, if they are not relying on market prices to value their business, what are they using?

In the broadest terms, the real value is based on the stream of earnings a business is likely to deliver, not just this year but in many years to come. As a result, the real values of most companies tend to be relatively steady compared with market prices. Earnings and earnings growth fluctuate, but not usually to the same extent as market prices, which can move dramatically with sentiment over short time periods.

**When market prices are freely available, as they are for stock market listed companies, the tyranny of the markets can be difficult to escape.**

### Overcoming adversity

As we said, real value won't be an alien concept to entrepreneurs. However, you might not have thought to apply it to your other investments. When market prices are freely available, as they are for stock market listed companies, the tyranny of the markets can be difficult to escape.

To counter this tendency, we have for some time been considering how we would operate if we didn't have share prices to refer to at all. Rather than a portfolio of listed securities with corresponding market prices, we imagine a holding company owning stakes in unlisted companies. This thought experiment has helped us to think analytically about how best to assess real value, its application in our investment process and the competitive advantages it can impart.

Because real values tend to be much more stable than quoted market prices, when you use real value to guide decision making, you are less likely to panic when sentiment turns sour. In fact, you are more likely to act like a farmer than a typical stock market investor.

A farmer's lot is rarely easy. A freak hailstorm just before harvest, flooding after heavy rains, animal illness, unexpected weather and disease can quickly put a lot of hard work to waste. However, farmers are not prone to panic just because of one year's disappointments.

Farmers expect the unexpected, focusing on the long-term rather than short-term frustrations. If the real value of their farm remains attractive, no one would expect a farmer to sell up and move on if a single year's harvest disappoints. Yet, such behaviour can be witnessed every day on the stock market, as Mr Market's mood swings.

There is much that investors can learn from farmers' patient approach. Investment decisions are often guided by emotion not rational analysis. Market prices can quickly shift for the worse even if nothing has affected what a company can and will earn.

Investors respond to what other investors are doing: if they are selling, I better sell too, goes the thinking. It's called "herding behaviour", another farming metaphor, but one related to gullible sheep not business-savvy farmers.

Indeed, farmers are much more independently minded. Just because the McGregors in the neighbouring village sell their farm for a lower price than you paid, doesn't mean you are going to rush to sell your farm "before it's too late".

### Earnings power

Most farmers understand that the real value of their farm is the value today of many future years of production. Extending this idea to all businesses, we believe it is useful to think of real value as a measure of the earnings power of a company.

When we analyse a company we think about what sort of earnings the business could generate over the next five to ten years and what sort of value we ascribe to these earnings. It is the future financial and operating performance of a business that interests us more than the current market price. This work provides us with an estimate of the 'real value', from which we can derive an estimate of the 'forward returns' we can expect from owning shares in the business. Rather than being at the mercy of Mr Market, we can use him to our advantage. When he is gloomy we will buy, when forward returns are high.

Crucially, a business can have earnings power, and therefore an attractive real value, even when market or economic conditions are poor. If a business is doing smart things during a recession or at the bottom of the earnings cycle - building capacity, buying cheap warehouses, whatever it may be - this should benefit earnings over the longer term. That is something that will again ring true if you have ever run your own business.

Even in a recession, great companies don't become terrible companies overnight. Mr Market might not like what he sees and the share price may fall. But if the real value of a company has not changed, why would we want to sell just because its share price has dropped?

The journey can sometimes be uncomfortable. However, being patient and refusing to panic will, we believe, ultimately deliver superior results for our clients.

### Real value in action

Being able to compare real values to market prices also helps us to invest more insightfully. If we have conviction in a company's real value, price falls can be used to buy more of what we like at a cheaper price.

Emblematic of this was our decision in early 2016 to buy more shares in American Express (Amex). At the time, investors had become nervous about the demise of Amex's once-lucrative partnership with warehouse retailer Costco, under which the two offered a Costco branded card. Over the previous year, as the 16-year relationship came to an end, Amex's share price had fallen from more than $90 to under $55.

We looked on and concluded that Mr Market had overreacted. Even though the company's share price had dropped substantially, we estimated that Amex's real value hadn't been materially affected – forward returns were high.

The decision to exit the Costco contract might have seemed like a crisis, but to us, and Amex's management, it made good business sense. The credit card giant was outbid by Citi for the Costco contract and it didn't want to engage in a bidding war. Amex had decided that upping its offer wasn't a good use of capital and we were inclined to agree.

We were further encouraged by Amex's decision to utilise the capital that it saved to grow its higher-value own branded cards business and invest in its marketing and service offering. We knew that the loss of the Costco contract would cause earnings to fall in the short-term, but we didn't think Amex's long-term earnings power had been adversely affected. We added to our Amex holding at $55. Two years later its share price is over $100; a pleasing outcome.

One of the key benefits of our approach is that it helps remove much of the emotion from investment decision making. None of us needs reminding that the UK's referendum about whether to stay or leave the European Union was emotionally charged. And it should come as no surprise that the high emotion that surrounded the vote leaked into the investment markets.

Ryanair's share price dropped sharply following the June 2016 referendum result. Investors became concerned that its business, principally short-haul flights to European destinations, would be severely disrupted. Once again, though, based on an analysis of the company's real value, we thought the market had overreacted.

We made the quite reasonable assumption that people would still want to fly to Europe on holiday with a low-cost airline. We also concluded that Ryanair retained the fundamental advantages that had enabled it to offer cheaper prices than its competitors.

**If we have conviction in a company's real value, price falls can be used to buy more of what we like at a cheaper price.**

Indeed, little had changed in its long-term investment case. We bought more shares at €12, believing that the low-cost airline's real value wasn't being recognised. A year later, as the market woke up to our way of thinking, Ryanair's share price was back above €18.

This example helps to highlight an important point underlying our investment process. At times mood-prone market prices won't reflect the real value of a company. But over the longer term, short-term sentiment is trumped, as even Mr Market comes to accept that it is real value that counts. "In the short run, the market is a voting machine but in the long run, it is a weighing machine," as Benjamin Graham eloquently put it.

### Don Bradman's ducks

We believe it is better to be on the side that can deliver attractive average returns over the longer term, even when, at times, the market disagrees with our stance. It is one of the reasons why we have always promoted the notion of a diversified portfolio.

To explain why, it is instructive to reflect on the career of Australian cricketing legend Sir Donald Bradman. A cricketing marvel in the first half of the 20th Century, Sir Donald is famous for his batting average of 99.94. For those of you who aren't fans of cricket, a player's batting average represents how many runs, on average, a batsman scores before getting out.

Sir Donald's batting average is the highest that has ever been recorded. Even so, he wasn't always on form. Out of 80 innings Sir Donald made "seven ducks". A duck is when you get out without scoring a run. Nobody's perfect, Sir Donald made mistakes.

Yet, despite these slips, Sir Donald is still recognised as the greatest batsman that ever lived. That's because a batting average is measured over a player's entire cricketing career. It is Sir Donald's average performance over the 20 years he played Test cricket that has secured his place in history.

It is possible to think about the advantages of a diversified portfolio in a similar way. Like Sir Donald, investors are not always going to get everything right. Cases like Amex and Ryanair are the equivalent of a good innings, but we make mistakes - companies can sometimes be cheap for good reason. An investment might remain cheap or get even cheaper. Our estimated forward returns may be wrong.

Just as for Sir Donald, it is our batting average we are focused on. We know we will make mistakes, but anticipate that our successes will leave us with an acceptable average. We don't need to emulate Sir Donald's world beating achievements to generate very good returns for you, our clients.

**That means that when the unexpected does happen, like Amex's loss of the Costco contract, we can react quckly and with confidence.**

That said, the fewer ducks you have the better, and to improve our batting average our in-house research team gets to know companies inside out. It is an intensive process. Our initial research into a potential new investment can take anywhere between three to six months. Our rigorous approach to research means we are able to assess a business's earning power and real worth with conviction.

Once we have made the decision to invest, our analysts might spend three or four weeks every year monitoring each of our portfolio holdings. This means that when the unexpected does happen, like Amex's loss of the Costco contract, we can react quickly and with confidence.

This was demonstrated again in 2015 when we added to our shares in farming equipment maker John Deere. The farming cycle, particularly in the US, was going through a downward phase. As sentiment soured, the company's shares dropped back to around $80. To us, the real value of the company was broadly unchanged – the quality of the business and the company's entrenched competitive advantages hadn't disappeared. We felt the low share price offered high forward returns and bought more.

Underlying our decision was a technique that in investment circles is called "scuttlebutt". Derived from the ship's bucket around which sailors would gather to share the latest gossip at sea, scuttlebutt is a process that helps you assess a company's strengths and weaknesses by gathering opinions from those who are in one way or another concerned with the company. It is about gathering firsthand information from all possible sources.

In John Deere's case we had been talking to dealers, farmers and competitors for many years, giving us an invaluable insight into its earnings potential. Scuttlebutt helped us to spot an opportunity to invest which we might otherwise have missed. In this case we were again proved right, as three years later the shares have nearly doubled to more than $150.

### Keeping investing honest

Our intensive research process enables us to write a "road map" for every business we invest in. This map includes how we expect the business to perform, what we expect its margins to be and what we expect its management to do - and not do. The map gives us the key metrics to enable us to monitor a company on an ongoing basis.

Each road map keeps us honest as investors. It ensures we focus on what really counts in the long run, and that is real value. It helps us rise above the market noise. When market prices do shift sharply we can rationally and calmly analyse whether there is an opportunity to be seized. It also helps us spot when a business departs from our investment rationale.

An investment process focused on real values gives us, we believe, the best chance of ultimately delivering superior long-term returns. It puts us in a position to take advantage of market prices rather than let prices take advantage of us.

## Notes

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