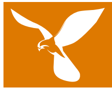

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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro
Capital Management Group

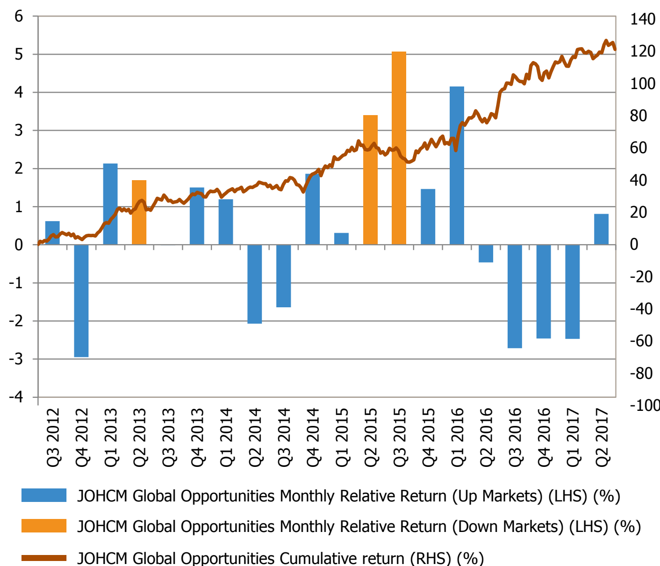
Leyland's Global Look

Ben Leyland, JOHCM Global Opportunities Fund

Five years on: outperformance with lower-than-market volatility

The Fund now has a five-year track record, and we are pleased to report that that we have to date delivered on our two objectives at launch: strong long-term performance (the Fund is ranked in the first quartile of its peer group since launch) and lower-than-average volatility. We have beaten the index in nine of 16 up quarters and in all three down quarters since June 2012, validation of our mantra of "heads we win, tails we don't lose too much".

Outperforming on the up, defending in the down



Source: JOHCM as at 30 June 2017.

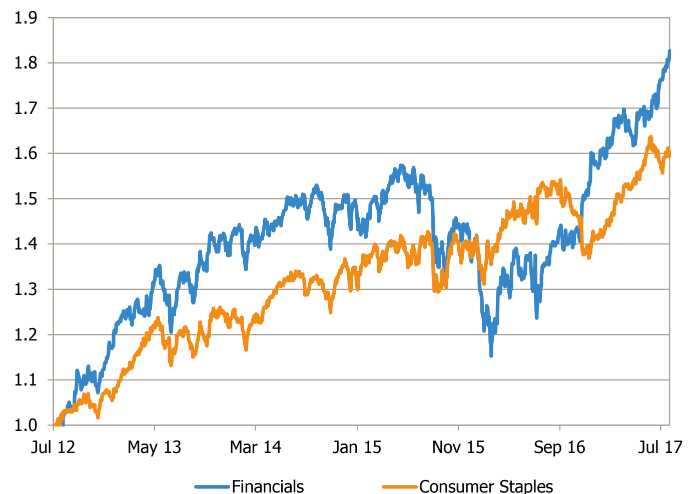
Looking ahead: tread carefully – there's currently nowhere to hide in global equity markets

An anniversary is a good opportunity to review what has happened and reflect on what that might mean for the future. In general, our view is that the next five years will look nothing like the last five years. It is impossible to enjoy the same degree of multiple expansion as we have seen already, and the scope for balance sheet re-gearing is much more limited. In particular, this means that today's opportunities are not the same as five years ago, or indeed two years ago, so the portfolio will continue to evolve and adapt to changing circumstances, treading carefully whilst opportunities are thin on the ground and ready to act decisively when they present themselves. The best ideas today are likely to be found in stocks and sectors which have spent the last few years de-rating and de-gearing, with limited downside if things don't go so well and lots of upside if unexpectedly positive things happen, such as a cyclical recovery in earnings power or management making value accretive investments. In contrast, those many stocks that have re-rated and re-geared are priced for disappointment and therefore to be avoided.

Re-ratings everywhere – not just 'bond proxies'

The most notable feature of the last five years has been the almost universal re-rating of earnings multiples, reflecting rising values in the face of limited actual earnings growth. It is important to note that this re-rating has not been restricted to, or even led by, so-called 'bond proxies'. It is commonplace to argue that the market has been buoyed by bond refugees herding into high-quality dividend-paying stocks in sectors with the most reliable cash flows. This has undoubtedly happened, however it is not really the whole story. When we launched the Fund in mid-2012, US bond yields were at their lows and since then, despite a notable reversal during 2015, we have seen a significant recovery in cyclical expectations accompanied by rising interest rates. It may surprise many that financials have outperformed consumer staples over the last five years, and not just in the US.

Surprised? Financials have actually beaten consumer staples since July 2012



Source: Bloomberg as at 31 July 2017.

At the same time, markets have rekindled their enthusiasm for growth stocks, particularly in the mega-cap US technology sector but with spill-over effects elsewhere. Technology indices are rising beyond their previous high watermarks from the dotcom era, inviting a raft of comparisons between the two periods. In our opinion, these are overly simplistic. The problem for equity investors now is not the distortion of generalist indices by a single, extremely overvalued and consequently oversized, sector, as it was at the end of the last century. The problem is that valuations are elevated across the board, in 'quality' and 'value' segments of the market as well as 'growth'. Unlike in 1999, there is currently no obvious area of the market offering genuine value.

A narrow opportunity set

Where does this leave us? With a narrower than usual opportunity set and a risk/reward balance in the portfolio which is not particularly compelling. As a rule, we look for less than 15% downside and three times the upside potential to get excited about an investment idea. These stocks are now few and far between. The portfolio has a downside closer to the high-teens and only twice as much upside potential. And that is after selling plenty of stocks with even more unattractive

profiles. Far too many stocks have a higher valuation and more debt than they did five years ago.

Reckitt Benckiser is a great example: in 2012, it had £4bn net debt (less than 1x EBITDA) and traded on less than 15x earnings.[1] Now it has £14bn net debt (more than 3x EBITDA) and trades on over 20x earnings. Is Reckitt Benckiser still an excellent company? Yes, almost certainly. Is it possible that its shares can carry on rising? Of course it is. Is the risk/reward balance currently in our favour? Absolutely not. There is limited prospect of a further re-rating and excess cash flows will now be diverted towards repairing the balance sheet rather than making further value accretive investments. Meanwhile the impact of any disappointment will be that much greater because of the starting multiple.

The same can be said for a great many stocks we have previously owned and now sold. The consequence is a cash balance close to our maximum of 20%. This is on hand to deploy into good ideas when they appear. We monitor our watchlist constantly to see where value is emerging, and we are ready to take advantage of volatility when it picks up again.

Remember Buffett's number one rule

The temptation in such a note is to succumb to the salesperson's spin and regale readers with tales of an abundance of investment opportunities in global equity markets. But unfortunately reality gets in the way. We are always reminded of Warren Buffett's top two rules of investing: "number one, never lose money; number two, repeat number one". Valuations across many areas of global stock markets currently afford little room for error. We believe that, over the next five years, investors need to follow strategies which have the avoidance of capital destruction at their heart, while maintaining the flexibility to judiciously back the best investments where the risk/reward balance is clearly positive.

[1]EBITDA: earnings before interest, tax, depreciation and amortisation.

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