Tomorrow's Value lecture by Gervais Williams

Why a bird in the hand is really worth two in the bush

Thank you Tony, and thank you CIMA for the invitation to speak this evening.

What a wonderful venue this is. I understand it's often used by politicians when they want to outline their opinions regarding the financial sector. Journalists and politicians are fond of accusing the City of becoming short term.

But that doesn't seem right to me. How come blue-sky stocks get funded? After years and years of losses, Imagination Technologies is now into decent profit. And it's turned out to be so valuable, that both Apple and Intel competed to buy a stake! That doesn't sound very short term.

We don't always get it right of course. Some may remember Eurotunnel, and all those dot com stocks?…
I do!!

But there is something big that does worry me. There's a disconnect between the City and the everyday economy. Fund managers are changing their minds more and more frequently. The length of time each investment is held has become progressively shorter.

In the late 60's it was 7 years, now it's less than 7 months!

The City is there to support, not distort our economy. I've wanted to get to the bottom of this. Why have fund managers attitudes and behaviour changed so much over last few decades?

Looking back at the past often gives a better understanding of where we are going. Writing a book could help me. Because when writing a book the author has to double check, and triple check the facts.

Plus setting out the conclusions logically in text form reveals the gaps.

The title of today's debate is 'Why a bird in the hand really is worth two in the bush'.

Credit booms are about birds in the bushes. During credit booms investors become more enthused about potential upsides.

With decent capital gains all round, waiting around for 'bird in the hand' dividends can look far too dull for some.

But normally credit booms don't last that long. Traditionally a boom is quickly followed by a bust. Over-enthused investors get to remember the value of a bird in the hand. The birds in the bush don't have much value at times of a bust.

But something different has happened in the last 25 years. We've had a credit boom that has gone on and on.

It's been on a worldwide basis. It's been a real giant of a credit boom.

We've seen asset prices rise very substantially. Property, share prices, bonds, housing…

Those who bought a UK home in 1985 have on average made 5x their money.

But those that bought a house with a 90% mortgage have made 50x their deposit.

With capital gains of this magnitude nearly everyone's become interested in the upside…and taking on extra debt to get even more upside.

Those who refuse to take part have looked old-fashioned. Lord Weinstock was continuously criticised for keeping net cash in GEC.

It hasn't paid to be too prudent during the credit boom.

And because the credit boom has gone on for so long, a wider range of assets have joined the trend. This credit boom has refreshed parts others cannot reach!

So we've also seen huge rises in commodities like fine art, vintage wine, internet domains…

There has been a relentless focus on speculating for capital gain. Given the credit boom has been so large, and lasted for so long, these trends have been persisted for decades. For 25 years the invisible hand has regularly favoured the speculative over the prudent.

Speculators demonstrate their success by taking their capital gains, by booking their profits. Speculation is a transactional strategy. Speculators transact more frequently.

The giant credit boom has dazzled us with birds in bushes! We keep spotting new ideas to make a capital gain. For me this explains why investors are holding their shares for progressively shorter periods.

Well before the financial sector globalised, the food sector moved to become international in scale; these changes first started in the late 1950s.

New fertilizers meant that we could grow crops more efficiently.

New chemicals improved the taste and preserved food for longer.

With greater food surpluses, new forms of transportation and technology created a vast new industry.

Worldwide supply chains emerged to move products over long distances.

The food sector moved away from raw ingredients to oven-ready food products.

As a child I remember being impressed with Instant Whip. It was just a powder, but when mixed with milk it produced a near-instant Butterscotch flavoured pudding. I remember my parents making it, and putting it in the fridge to 'cook'.

Over the last 25 years our industry has also globalised. The financial world has followed the same path. The end product looks fine. Success may not be measured in absolute terms any longer, but at least it is relative to an Index.

During the long credit boom we've become adept at speculating. But in doing so, we've had to narrow the investment universe. Only the most liquid stocks can be considered; ideally only those in the big indices.

The position has reached an extreme. Some portfolios have over half their funds invested in just 10 megacap stocks! The bottom line for our clients is that the credit boom has injected more and more volatility into our funds.

These strategies may appear to work when the markets are flying, but the downside risks are becoming more obvious.

I would argue that there is too much convergence in client portfolios. There's too much of a monoculture in the way the industry manages funds; that there is too much concentration on a few stocks; that stock specific risk is way too high as we enter more challenging economic conditions.

In the focus on indices, we've even outsourced the main ingredients in client portfolios. Issuers have started gaming the system against us. Essar Energy successfully grabbed a FTSE100 slot. And then clients collectively got stuffed when it promptly fell 70%.

At the end of the 1960s, people noticed something very strange about the rats in their food warehouses. When the rats broke in, they nibbled the cereal boxes, rather than the cereal.

Ultimately President Nixon called for a review of the US food and nutrition standards. They found that the cornflake manufacturers had formulated their cereals for extended shelf life. They then coated them in sugar because they contained little or no nutrition.

It turned out that the rats were smarter than humans. They knew that food was about nutrition, not just calories. Somehow the food sector had forgotten its principle purpose.

I worry the financial sector has the same problem. We measure our success in calories, through speculating on the next move in the market. Is it risk on or risk off?

Yet I would argue that client portfolios lack nutritional value. That they lack the resilience to deliver in changable market conditions. Somehow the financial sector has forgotten its main purpose. And because customers are left vulnerable, we leave ourselves as an industry vulnerable.

Instant Whip didn't turn out to be so good. It relied on a number of unfamiliar additives. Initially they may have symbolised convenience and modernity, but gradually everyone recognised that they were problematic.

Over time, customers voted with their feet. They don't make Instant Whip any longer.

With the end of the credit boom, I worry that Fast Finance is also dangerously out-of-step with the wider community. The truth is that the financial sector is poorly positioned for the post-credit boom challenges.

And just like the food sector before us, savers are about to express their opinions on the ingredients of their portfolios more forcefully.

There has been unease about what has been happening in the financial sector over the last decade or two.

But now the critics are feeling more confident.

We've seen it with the Occupy protests.

Initially just an idea; but almost instantaneously it's been adopted by multiple cities all around the world.

Bonuses as an entitlement have reinforced our disconnection.
Plus there will be a reaction to the credit boom excesses.

I expect debt to become very unfashionable.

And for simplicity to be favoured over complexity.

If Slow Food is anything to go by, the values and beliefs of our financial customers will change radically.

A 25 year credit bubble is ending. We've had big bubbles before. When they burst, the change in attitude can be extreme.

The South Sea Bubble caused an enormous financial contraction, and a lot of pain. They banned publicly traded stock in England for decades.

There's an urgent need to anticipate this change in mood. If we delay, then the critics will feel emboldened.

My main question is how can we deliver value for our clients in a post-credit boom world? The investment markets are already becoming a more hostile environment.

Looking back to what happened last time usually helps.

Ben Graham was a fund manager that lived through the previous major credit boom; the one that ended in 1929.

In the 1930s, he went on to publish books that are still regarded as the guiding principles of investment management today; resilient methods for delivering even in a post-credit boom world.

His name is still on the lips of many I most admire.

Interestingly Graham made a very clear distinction between two types of market participant; the speculator and the investor.

He believed that speculators were principally interested in share price movement. They select stocks in the hope they will make a capital gain from a move up in the stock market. That sounds familiar, doesn't it?

According to Graham, investors are different. Investors select individual holdings on the basis that they are intrinsically cheap. Companies, or asset classes, with plenty of tangible assets. Mundane businesses that can ride out economic storms for many years.

He maintained that a true investor thinks like the owner of a business. With that perspective in mind, stock owners are not concerned with erratic fluctuations in stock prices.

Graham outlined his strategies on the basis of his conviction. At the time no one could measure if his theories were truly successful.

Today we have the advantage that we can back-test with computers. London Business School has put together the longest series of stock market data in the world. It goes all the way back to 1900. And they've teased out the main drivers of investment return.

The LBS history reveals some unambiguous results. Value investing was successful in Graham's day. Despite troubled economic conditions, his methods built real resilience for client portfolios.

Perhaps more surprisingly, the data suggests it remains successful even in modern times.

Not every year; there are times when it retraces some of its premium returns. But over time it continues to succeed.

The LBS data is interesting in other ways too. It also reveals the importance of dividends in generating decent returns. Remember the birds in the hand!

Premium returns are made by backing companies or indeed stock markets with above average yields, and reinvesting them each year. Returns really escalate when dividend payouts increase over time. It's called compounding dividends.

Just as Graham had implied. Ordinary businesses, those that generate tangible cash each year, really deliver more than growth stocks of the future. Most of the time these don't live up to best expectations.

The best returns are made on stocks with mundane growth prospects. They're unexciting so their share prices are depressed. They sit around on higher dividend yields. Just like Graham suggested many have intrinsic value.

The fast growers have exciting prospects, but by bidding up their share prices, fund managers often drive down their market yields too far.

The fast growers rarely catch up the head start given to the big yielders. Speculators have a sort of collective blind spot. Just like Graham's day, they tend to overpay for growth stocks.

It seems that for speculators - a bird in the bush is worth two in the hand!

So by moving away from speculative purchases for capital gain we can add resilience to our client's portfolios.

Refocusing on those companies that pay good and growing dividends delivers more consistent returns. Because there's less buying and selling, greater effort goes into finding good stocks; stocks that deliver premium performance over many years.

There are interesting spin-offs too.

High income portfolios tend to be less volatile. At times of market weakness, they hold up better. And at times of market euphoria they tend to rally more modestly. But this all adds up to a smoother ride for the saver.

The implications are wide-ranging. If you're anticipating holding the stock for a quite some time, then everything about the individual stock starts to matter more. Remember the comment about acting as an owner.

Benchmark indices become less relevant for those looking to trade their holdings less often. The focus is on getting the right stocks for a duration, rather than buying and selling on the index changes.

After all, indices can spend decades delivering very little return indeed. NASDAQ is still only two thirds of its 2000 level. The FTSE100 has gone nowhere for the last 12 years.

In 1996 Japanese bond yields first fell below 2%. The Nikki 225 has fallen to half the level it was then!

We have no idea if the UK stock market will follow suit. But UK gilts did briefly fall below 2% late last year.

It all underlines my point. There are good reasons to look beyond index stocks. They have no monopoly on investment nutrition.

Most conventional portfolios currently fish in a small universe of the major stocks. Their universe is largely defined by the limited contents of an index. Room for change I feel.

Post-globalisation food trends are interesting too. Food consumers have rebalanced their purchases to include more small and local suppliers. Farm shops, Veg box deliveries, Farmers Markets…

But small and micro caps have been disappointing performers on the stock market. During the credit boom they've not part of the globalisation story. They've lost out badly. Not only in terms of access to capital, but also in loans too. So why would investors buy into these fiddly investments?

Smaller businesses have the advantage that they can double more easily than larger companies. That explains why prior to the credit boom they outperformed impressively.

The LBS back history of stock market data is highly convincing. In fact, the smaller the business, the better. And this effect is evident across many different national markets.

All this suggests active managers will go back to old-fashioned bottom-up stock selection. Selecting the best companies, not those in just those in the index. And some of the smaller ones along with the bigger ones too.

In smaller businesses the investor has greater opportunity to act as a part-owner. I like to think that Graham would have approved.

Shaftesbury plc have always allocated their capital like an owner.

At Shaftesbury, the managers only buy properties that are within walking distance of the company's office in central London.

They want to keep an eye on it themselves. Every day they like to walk their estate, so they can address issues as soon as they become apparent.

For me, it is not unrelated to the fact that Shaftesbury has been one of the very best performing property companies over the last 25 years.

It's common sense. Acting as a part-owner makes a real difference.

Of course there are other perspectives on these questions. I have no monopoly on wisdom. At MAM we know how much we can learn from others.

So today, in conjunction with Tomorrows Company, MAM is setting up a new financial forum. A major program for leading industry figures to set out their opinions on how best we can deliver value to our clients beyond the credit boom. We propose to call this program Tomorrows Finance.

Tomorrows Finance is about the financial agenda beyond the credit boom. Tomorrows Finance is about re-linking the purposes of investment with the wider population.

After all the real purpose of the financial sector is to efficiently allocate capital. Particularly, allocating capital to those who can put it to best use. Writing cheques for businesses to invest successfully.

Graham argued that the careful allocation of capital on a stock-by-stock basis delivers real value to the wider public. That allocating on a bottom-up basis ensures the best businesses get access to investment capital. That real investors play a highly constructive role in society.

That may sound a nice to have. But my view is that the credit boom has left us vulnerable to justified criticism. And despite the FTSE100 hovering near 6000, there's plenty of room for disappointment up ahead.

During the credit boom we have become too interested in the birds in the bushes. It's time to rebalance our efforts on Birds in the hand.

We need to deliver value in a way that makes our clients feel really good about their savings. In future the City needs a more direct link with our domestic economy. We need a stronger sense of common purpose that unifies fund managers and the wider community.

<ENDS>

There are a couple of details I haven't been able to fit into the speech without disrupting its flow. They might make a good question from the audience.

1. The investment consultants are fond of reminding us that all the value add for a client comes from macro asset allocation rather than bottom up stock-selection. This appears to suggest that the savers/clients should avoid active strategies altogether and just buy passive products. (I disagree with this of course.)

2. What is the difference between a growth and value investments. I suspect most will know but it might be a new concept to some of the audience.