CREDO WEALTH

Material Decisions

In his most recent memo to investors, Howard Marks (Chairman of Oaktree Capital Management) borrowed from Charlie Munger in recounting the only absolute truth in investing: it's not supposed to be easy, and anyone who finds it easy, is stupid.

Which brings us to Credo's holding of Anglo American plc (AAL) within our Best Ideas Portfolio (BIP). It may appear to some that a decision to sell out of the company should have been an easy one over the last few years: the commodity cycle has been unwinding, the news flow emanating from the company has been tepid, and the momentum of the share price has been negative. At various points in time we did consider our position, but on each occasion we came to the conclusion that the share had simply become too cheap to sell, and that the likely future upside exceeded the possible downside. This was also the summary response that we provided when questioned about it by clients.

In hindsight, we were wrong. The AAL share price has continued to lag, slipping approximately 75% since we first bought it. As an investor, it is tempting to rationalise and continue believing that you can see or that you "know" something the market doesn't, but in the end there is only one arbiter and that is the market itself.

Regardless of where the share is trading today, the real question is how it is likely to perform going forward. Should one "hang in there" if you already have a position? And should one deploy fresh money by investing in the stock at levels which are historically cheaper than they've been in years?

To give some context: our original decision to own AAL was premised on a few factors, first of which was the belief that commodity prices (having slumped significantly from previous highs), were nearing a bottom and would look to recover in the near future. This to a large degree was based on the belief that the Chinese economy was stable, and would enter a period of consolidation, followed by future growth. However, with economic growth in China proving significantly weaker than any strategist had predicted, demand, particularly for base metals (iron ore, copper, coal – all key product lines within AAL), is looking weaker and may drop even further.

There is no question that the super-cycle in commodity stocks had been driven predominantly by demand in China, as well as the resurgence of economic growth in India. As an aside, other emerging markets such as Brazil, Russia, Turkey, and South Africa benefited from the commodity boom and an emerging middle class arose. Other than India, one can see that these economies are now all suffering, adding further pressure to global GDP growth and any nascent recovery of the commodity cycle.

The second reason to hold AAL has been the belief that this was essentially a “self-help” story. The new CEO, Mark Cutifani, was brought in to correct a number of mistakes made by the previous management team. So far, he seems to have done a good job: disposing of the Tarmac business, unprofitable mines in Chile, and coming to a deal with Sibanye on the platinum mines spring to mind. Having said that, the company still faces substantial upheaval in South Africa from the unions, and may therefore have no choice but to continue operating a number of unprofitable mines.

Ultimately, with net debt of some $13.5bn, we believe that the AAL dividend (which in our view has held up the price somewhat) is at risk of being cut completely, and should the commodity cycle not turn (say, in the next 12 months?), we believe that the company will have no choice but to have a rights issue, adding further downward pressure to the price. After an arduous discussion, we have come to the conclusion that any real upside in AAL is likely to be years away, and that a continued holding of the stock (or a new investment at this point in time) therefore has little point. Accordingly, we have decided to exit the position.

Selling out of AAL at a time like this does of course raise the question as to whether we might be selling at (or very close to) the bottom. In truth, we are only likely to know the answer to this question in years to come, but it's also the fear of falling foul of precisely this risk that has played a significant part in stopping us from selling the stock earlier. Accordingly, we have agonised over this question on many occasions and whilst we acknowledge the risk, we also believe that the investment currently tied up in this stock can be better deployed elsewhere.

The decline in AAL's share price since the inception of the BIP (and more in particular, the continued/accelerating weakness over the past number of months) has been the biggest detractor of the absolute as well as the relative performance of the product. Having said that, we may take a small amount of comfort from the fact that the negative impact on portfolio performance of our typical investor has been somewhat less than what is reflected in the published track record of the BIP product. The reason for this is simple: the monthly calculation of BIP performance assumes that the portfolio is rebalanced periodically. In other words, it assumes that as the stock tumbled, we continued to purchase AAL shares to maintain the position. As our investors will know, however, such regular rebalancing is in fact not implemented in client portfolios as it would seldom make sense after considering transaction costs. What this means is that while AAL may well have been the weakest stock in a client's portfolio, it would have become less and less of a value detractor as the share price continued to decline (which, correspondingly, shrunk the position).

In hindsight, we accept that perhaps we never should have invested in AAL; alternatively, we probably should have sold out of the position earlier. Having said that, we are fortunate not only to have invested in a few very strong performers since the inception of BIP, but we have also made a number of good sales over the past few years (Tesco and Volkswagen spring to mind). Unfortunately, an earlier sale of AAL has not been one of them.

Over time, as long as we get more decisions right than we get wrong, we should be able to add significant value to client portfolios in the longer term. The decision to sell AAL has not been an easy one - as set out above. But then, as Charlie Munger and Howard Marks so eloquently put it, it’s not supposed to be easy.

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