CREDO

This too shall pass

The Old Testament tale of Joseph offers an important lesson for long term investors – that of cycles. In it, Joseph interpreted Pharoah's dream of seven fat cows consuming seven thin ones, portending seven years of bountiful harvests followed by seven years of famine and successfully advised Pharaoh to stockpile grain in preparation.

"Forecasting" is a dirty word amongst some value investors. As academics have (statistically) proven that (sell-side) analysts are bad on aggregate at estimating earnings – why even try? Following that logic, one could do better by simply owning a portfolio of cheap stocks – chosen solely on the basis of valuation multiples (whilst ignoring the underlying businesses). This top-down, passive strategy has its philosophical roots in numerous econometric studies, which have shown that the value "factor" outperforms over the long term. Inconveniently for them, over the last 15 years, growth has outperformed, placing increasing pressure on their definition of "long term".

Sometimes, it's easier to see things more clearly as an outsider. I am reminded of this by my school friend's late father, who was a maxillofacial surgeon during the week and a "hobby farmer" on weekends – as some joked.

The joke was on them though. The funny thing was, that this "hobby" proved most lucrative, more so than for most full-time farmers. The secret to his success was to be cognisant of the cycle and invest (plant citrus trees and buy land) when prices were depressed and do the opposite when prices were strong. In direct contrast, most professional farmers (over) invest when prices are strong. Firstly, that's when they have extra money. Secondly, "selling the farm" is never a consideration when it's your home - even if it makes sense financially. Citrus prices are volatile, affected not only by seasonal weather patterns but by the (multi-year) capital cycles which literally sow the seeds for future booms and busts. Consider that from planting, a citrus tree can take around five years to produce fruit and over 20 years to reach peak production; hence, investing on the basis of high prices today and at the same time as everyone else (i.e., when land prices are elevated) tends not to be a sensible long-term strategy.

Whilst the ivory tower academics are correct that it's futile to estimate near-term earnings (i.e., for this quarter or this year), the good doctor showed us that it can prove more "fruitful" (pun intended) for patient investors to focus on mid-cycle earnings (a few years out) when estimating achievable returns. Medium-term earnings tend to be beyond the focus of CNBC commentators and sell-side cheerleaders. In so doing, investors might capitalise on the "short termism" exhibited by equity markets. To the extent current earnings (and sentiment) are only temporarily depressed, investors with a horizon measured in years (as opposed to months) might pick-up bargains. I have heard this strategy aptly described as "time arbitrage". The key risk is differentiating that which is temporarily or cyclically out of favour, against that which is permanently impaired or secularly challenged.

Often this is easier said than done. By way of example, we can be confident people will still be consuming citrus in 20 years' time, but will they be driving cars with internal combustion engines? Certainly, our governments seem intent that these go the way of the cart horses and buggy whips. ▶▶

Cycles overshoot to the upside a well as downside. One doesn't need a doctorate from an Ivy League university to know that the negative oil price in April 2020 was unsustainably low. Nor that the Liquefied Natural Gas price is currently unsustainably high due to the shutdown of Russian piped gas supplies to Europe. We know from previous commodity price shocks that high prices today are temporary, result in (short term) demand destruction through substitution, and beget more supply over the medium term. Over the long term, it is not only logical but in fact can be statistically proven that commodity prices "mean revert" around the long-run, marginal cost of production.

One of the wrinkles in the passive approach (of fixating solely on valuation multiples) is that it is completely ignorant of cycles and cyclical shares which can paradoxically screen most expensive (on a P/E basis), when they were in fact cheapest – when the "E" gets (temporarily) depressed more than the "P". By way of example, in April 2020, the S&P 500 energy index's P/E peaked over 5,000 at the same time that the index was plumbing 20-year lows. As a buy signal it was about as useful as a chocolate fireguard. Today the P/E is 9.7 which is (superficially) cheap by historical standards, though the index is near 20-year highs and energy prices and profit margins are unsustainably high - well above the long-run, marginal production costs to which they will mean revert, hence caution is warranted. Similarly, many resource companies, particularly those benefiting from (temporary) war-induced shortages (coal, fertilizer, etc.) today trade on (superficially) low single digit P/E's. Yet if you put many of these on "normalised" earnings, many would in fact be expensive "value traps".

Bottom-up, value investing differs by overlaying fundamental analysis of the company and industry, including inevitable mean reversion over the investment horizon. Our approach takes into account business cycles. We estimate prospective returns over the medium term, decomposing them into three sources. Firstly, earnings per share growth over 3-4 years – beyond the horizon of most market participants. We are not attempting to accurately estimate earnings this quarter, or even this year. Rather, we are taking a longer-term view, capitalising on the market's "recency bias". Indeed, where a company misses earnings expectations, but the stock reacts strongly, it can be seen as a positive signal, indicative that skittish investors have by and large fled the share register. Our recent additions of Auto insurers (Admiral and Progressive), where we believe underwriting margins are temporarily depressed whilst price "hardening" will take time to come through, illustrate this approach. Secondly, we consider the rerating or derating potential implied by the exit valuation multiple in 3-4 years' time. We are not necessarily interested in the multiple today. Lastly, we consider sustainable capital returns (of excess free cash flow) through both dividends (regular and special) and buybacks (to the extent they reduce share count).

2022 has been a tough year for equity investors, with the S&P 500 ending the year down 20% in US dollar terms. However, it was a great year for energy (up +59%) and insurance (up +8%) buoyed by higher interest rates and a hardening market. Meanwhile, spare a thought for those in retail (-35%), and media and entertainment (-44%), which have been impacted by higher interest rates, inflation and taxes stoking a so called "cost-of-living crisis". ▶▶

Why is this stuff important? The world is complex, there are many concurrent, imperfectly correlated cycles, which vary both in amplitude and duration. Like Bruce Brown in search of the perfect wave in Endless Summer (which he ultimately discovered in St Francis Bay), we are constantly on the lookout for opportunities and re-evaluating existing positions. We are cautious about getting suckered by value traps; all the while intensely focused on medium term prospective returns – remaining patient, seeking to capitalise on cyclical mean-reversion and improved sentiment. If one believes that "this too shall pass", then one might find value in the sectors which have temporarily underperformed. There's always a bull market somewhere. ■

Important notice