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Investors should not write off 'bond proxies'

They have been derided as overvalued, but the doubters have been wrong so far, says **Terry Smith**

ADVICE & COMMENT

Terry Smith

The Fundsmith Equity Fund that I run seeks to generate superior returns for investors with a simple three-step strategy: Buy shares in good companies; don't overpay; do nothing.

The three steps are not placed in that order accidentally. The strategy begins with the decision about whether or not the shares are in a company of sufficient quality for us to want to own it. In our view, that is more important than the valuation.

But don't take my word for it. Here's what Charlie Munger, vice-chairman of Berkshire Hathaway and Warren Buffett's business partner, said on the subject in a *speech entitled A Lesson on Elementary, Worldly Wisdom as it Relates to Investment Management and Business:* "Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earnings. If the business earns 6 per cent on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6 per cent return — even if you originally buy it at a huge discount. Conversely, if a business earns 18 per cent on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with one hell of a result."

Mr Munger was not guessing or putting forward a theory. He was stating a fact. If you are a long-term investor, the return on capital which a company can generate and its ability to reinvest at a superior rate of return is more likely to determine how well its shares do — and not the valuation at which you buy or sell it. Or, as his partner Warren Buffett once said more pithily, "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

However, most people are incapable of behaving as longterm investors either for behavioural reasons and/or because they have the "benefit" of advisers who see their *raison d'être* and fees as driven by activity.

The arithmetic is inexorable — high rates of return on capital can compensate for seemingly high valuations, whereas low-return companies are not worthwhile for the long-term investor almost irrespective of how lowly the shares are rated. The strategy of most investors who choose to invest in persistently low-return companies is usually some combination of buying them ahead of a perceived cyclical upturn in results or events, and/or waiting for the valuation and therefore the share price to improve.

The problem — other than the fact that very few investors seem able to perform this successfully — is that even if you get it right, you then have to sell the shares and find a new investment that fits these criteria. Such shares should never be allowed to become long-term holds otherwise the share price returns will start to gravitate to the low return on capital the underlying business produces.

In a corporate version of the axiom "you are what you eat", a number of acquisitive conglomerates have managed to demonstrate the drawbacks of an approach based primarily on valuation rather than quality by acquiring businesses in basic foodstuffs, building products and engineering. They managed to produce short-term gains by improving their profitability, albeit some of this was a manifestation of the magic of acquisition accounting rather than anything more fundamental. But thereafter, the acquired businesses started to produce returns and growth rates which began to drag the acquirers' performance down to their level.

Hence the demise of BTR and Tomkins. Just about the only UK-based serial acquirer which has managed to buck the trend is Melrose, which makes a point of selling businesses once the short-term gains have been realised, much in the same way a portfolio manager would have to.

But notwithstanding the sound advice from two demonstrably great investors, I have much more frequently been asked whether a share is cheap or expensive rather than whether a company is good enough to want to own it. This has reached a crescendo in recent times with the strong investment performance of so-called bond proxies: shares in companies which have such reliable returns that investors have allegedly flocked to invest in them.

The suggestion is that while these bond proxies have performed well as investors have desperately reached for yield in an era of low, zero or even negative interest rates, their valuations have now become too extreme to make the strategy viable.

Needless to say, this suggestion usually seems to emanate from investors who have completely missed out on the performance of these shares and who have been singing this siren song for a considerable time.

Following their advice to date would have been disastrous. I can trace back warnings about the perceived overvaluation of so-called bond proxies for over three years, a period of time over which the total return on this strategy has been approximately 100 per cent. However, just because a theory has been consistently wrong for some time does not mean that it might not ultimately be proved correct — like the proverbial stopped clock which is right twice a day.

So I have decided to explore this subject a bit further. In my next column, to be published next week, I will turn to the Nifty Fifty, the 50 NYSE-listed companies that were viewed in the 1960s and 1970s as solid buy-and-hold growth stocks.

The rise of the of the so-called bond proxies is often compared to the era of the Nifty Fifty, so it might be wise to look back at those events and see what we can learn from them.

Terry Smith is chief executive of Fundsmith LLP