On Secular Trends – a Value Investor's Perspective

‘Investors have a propensity to overpay for the 'new' while ignoring the 'old'... growth is so avidly sought after that it lures investors into overpriced stocks in fast-changing and competitive industries, where the few big winners cannot compensate for the myriad of losers.’

Jeremy Siegel

‘The line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money. After a heady experience of that kind, normally sensible people drift into behavior akin to that of Cinderella at the ball. They know that overstaying the festivities – that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future – will eventually bring on pumpkins and mice. But they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There’s a problem, though: They are dancing in a room in which the clocks have no hands.’

Warren Buffett

‘Don’t mistake a 'cyclical trend' as an 'infinite direction.'”

Lance Roberts

'Secular – occurring only once in the course of an age or century; taking place over an extremely or indefinitely long period of time'

Encarta® World English Dictionary

Most value investors, including ourselves, are microfundamentalists with a bottom-up investment approach. We analyse the economic fundamentals of individual companies on a case-by-case basis in a quest to identify those with share prices trading substantially lower than their intrinsic value. This differs from a top-down, macro approach which forecasts broad economic trends and then uses these forecasts to decide which instruments to invest in, drilling down ultimately to the individual investments themselves. We've explained many times why we have more confidence in a bottom-up approach, but principally this is because we have greater conviction in our ability to determine the correct values for businesses than in our ability – or anyone else's – to accurately forecast macroeconomic variables. In any event, academic research1 indicates that there isn't much evidence to suggest a strong correlation between macro variables such as strong economic growth and higher equity returns.

However, secular trends sometimes cause permanent, seismic shifts in the investment landscape, fundamentally altering the course and fortunes of whole industries and even economies. Value investors typically accept that mean reversion is a powerful force in investing – that is, the tendency of a series that has deviated from its long-term mean to have a higher probability of reverting closer to the mean rather than further away going forward. Forecasting, by contrast, more often than not results in an extrapolation of the current trajectory. So with this in mind, how do we, as value investors, with a strong predilection for mean reversion over forecasting, incorporate secular trends, which have a permanent or sustained impact, into our thinking and research?

1. Dimson, Marsh and Staunton : 2014
Just because it lasts for a while doesn’t necessarily mean it’s a secular trend

We should probably start by clarifying what we mean by the term ‘secular trend’. Most importantly, a secular trend involves a shift or change, and has a degree of permanence about it. Examples include demographic shifts such as the ageing population in Asia which has altered the entire economy’s saving and spending habits; technological innovation which brings about sustainable change in the way we do things; and increased regulation in industries such as tobacco which have a permanent impact on the companies’ abilities to generate returns. Secular trends need to be differentiated from a trend which has merely endured for some time and may well be part of a cycle.

Often a cycle which has been particularly lengthy or extreme in its upturn or downturn is mistaken for a secular change while it’s still under way. In our minds, a current example of this is the latest commodity cycle, which was labelled a secular trend in favour of commodities in the lead up to 2008 while China was voraciously consuming all the commodities the world had to offer. More latterly, it seems to be considered a secular trend against commodities with as much fervour as the first pronouncement. Public opinion seems to be that resource companies are doomed to never produce economic returns ever again. However, while the recent downturn in commodities has certainly lasted longer than most expected – and like most cycles has its own specific dynamics – it seems perfectly plausible to us that what we’re experiencing is merely the pendulum effect of a cycle having been so overstretched at its peak. What goes up, must come down after all and as it turns out, with quite a thump given the excesses of the boom phase.

We believe time will reveal that the fall in commodity prices is not a secular change per se, but the result of a sector going through the down phase adjustment of a normal capital cycle. This offers immense value to those able to look ‘through the cycle’ rather than simply extrapolating its low points in perpetuity.

Investors are better at valuing physical-intensive businesses than intangibles-intensive businesses

Over the last two decades in particular, the global landscape has been marked by spectacular growth in ‘New Economy’ firms founded on innovation and intellectual capital. You’d think therefore that the emergence of these businesses would’ve provided investors with a rich landscape of opportunities to capitalise on. However, academic research\(^2\) has shown that funds tilted towards intangibles-intensive firms (such as tech and internet stocks) earn substantially lower abnormal returns on average than funds tilted towards physical assets-intensive firms (such as mining stocks). The primary reason put forward for this is that investors are more susceptible to misvaluing businesses that are forging paths into new unchartered territory. The study showed that fund managers’ tendency to extrapolate trends was far more pronounced when focusing on intangibles-intensive firms, and that they often overpay for the long-term benefits of research and development. However the existence of historical experience and data allows less room for error when valuing physical assets-intensive firms. Fund managers were shown to exhibit greater skill in valuing physical-intensive firms over intangibles-intensive firms. This resonates very much with the environment in which we find ourselves currently – with many tech-oriented companies continuing to capture the imaginations of market participants while mining stocks are shunned as the pariahs of the investment universe. While it’s possible that expensive stocks will still deliver a good outcome from a high starting point, it’s not probable and furthermore, the margin for error in valuing these types of businesses is wide. We’re comfortable that our well-evidenced approach, supported by plenty of data and our own long-term experience of similar cycles in the past, indicates that our efforts are well-placed in the under-priced physical-intensive assets we’re invested in today.

A secular trend in favour of a business does not always mean the business is a good investment

The common assumption is that if you can identify a secular trend that’s positive for an industry, then investing in companies within that industry will surely yield good results. However, this confuses the prospects for the underlying fundamental businesses with the prospects for an investor buying the business’s shares. Unfortunately, unless you happened to identify the trend before anyone else did, the positive news of the trend’s impact on the business is likely to already be

embedded in the share price, and then some. As billionaire financier James Goldsmith so famously put it ‘If you can see a bandwagon, it’s too late.’ Technologically-oriented industries are littered with examples of such situations – with the bust following the IT bubble in the late 90s being a spectacular example. Did technology change the way we work and play? Yes, without doubt. But buying even the best businesses such as Microsoft and Intel at price-to-earnings ratios of over 70 and 100 respectively was never going to end well for investors. That doesn’t mean the businesses didn’t do well themselves.

Interestingly, the secular trend towards tablets and mobile devices saw investors conversely losing interest in companies like Microsoft and Intel just a few years ago – labelling them ‘old school’ and ‘ex-growth’. RECM identified this as an opportunity and invested in both companies at attractive prices with excellent results for investors. This demonstrates the importance of focusing not on the story but on the moral, which is: ‘Buy at a good price’. If you pay too high a price, you’re stacking the odds against making a good investment return, particularly if the market has become so enamoured with the potential impact of a secular trend that expectations have drifted into the realms of implausibility.

A secular trend against a business doesn’t always mean the business is a bad investment

The opposite assumption is that a secular trend that’s negative for an industry implies inevitably poor investment returns. But this too can be easily challenged. The article ‘Smoke ‘em and Dope ‘em’ (REVIEW Volume 17, July 2011) suggested that if you were offered the opportunity to invest in tobacco businesses around 2000 you’d have probably said a firm ‘no thank you’. These businesses were considered at the time to be a dying industry with products medically proven to kill users, facing increased regulation, higher duties and looming lawsuits. However, as a result of these secular headwinds, the largest tobacco companies in the world were priced for bankruptcy – with most trading at low single digit price-to-earnings ratios and with double digit dividend yields. The macro story for tobacco companies was dire, but focusing on the micro details for each company would’ve potentially led an investor to a different conclusion about whether to invest or not. On the micro side, companies responded to the headwinds through consolidation, cost cutting and share buy-backs, thereby increasing profit margins and returns on capital. As a result, the low prices of 2000 turned out to be a spectacular buying opportunity for investors rather than a death knell for the businesses themselves.

Chart 1: British American Tobacco vs MSCI World Index – Total Return (US$)

Source: Thomson Reuters DataStream
As Chart 1 shows, if you’d invested in British American Tobacco in 2000, you would have multiplied your initial investment by more than 20 times. In annual return terms, this equates to 22.7% per annum for 15 years, compared to the MSCI World Index which delivered a paltry 3.9% per annum. Again, investment outcomes aren't driven by macro themes, but by the price paid at the outset. Paying a low price, due to overly-pessimistic expectations, stacks the odds in favour of a good outcome from that point onwards.

**How does RECM factor secular trends into its thinking?**

When screening for attractive opportunities, our filters often pick up under-priced assets that share common traits. If they’re supported by a secular trend in addition to being priced attractively this serves to give us further confidence in our thesis and acts as a valuable underpin to our valuations. An example of this was our investments in the aluminium industry in 2014. As discussed in ‘Navigating a Treacherous Industry: Allocating Capital to Aluminium’ (REVIEW Volume 28, October 2014), global aluminium consumption has grown steadily over many decades thanks to technological breakthroughs. These resulted in the ability to produce the metal at a lower cost, with the metal’s favourable characteristics seeing it taking increasing market share from other metals. Examples include replacing steel in beverage cans, automotive and construction applications, and copper in electrical and heat exchange products. This fundamental shift is expected to continue. Fuel efficiency concerns also make the weight savings associated with the growing use of aluminium in motor vehicles increasingly valuable. Given this solid long-term demand picture, the aluminium price should ultimately rise to a level that incentivises the industry to keep producing the metal. Our investments in this industry – Norsk Hydro and Alumina – delivered excellent returns last year with both stocks up more than 30% in US dollar terms, leading us to reduce the positions substantially.

**RECM investors benefited from the secular shifts in the South African medical aid landscape**

RECM investors have benefited from another secular trend on the local front – namely the shift in the medical aid landscape towards incentivising individuals to take responsibility for their own health. The business that drove this change – Discovery – was one of the largest positions in our funds up until late 2014 and delivered spectacular returns since inception of the investment idea. A common misconception is that value investors don’t invest in growing businesses as we’re not able to put a value on future growth. Our investment in businesses like Discovery and Capitec certainly demonstrate that this isn’t the case. It’s fair to say that growth is the most uncertain and difficult to determine source of value – compared to the value of the underlying asset base and current earnings power – and thus widens the margin for error in the intrinsic value calculation. As such we prefer to ascribe value to growth where businesses, such as Discovery, have readily identifiable barriers to entry and thus sustainable competitive advantages to protect the value of the future growth.

**A word on trends in global energy**

The dramatic fall in the oil price last year has stimulated much debate with regards to shifts in energy production and consumption globally and the impact thereof. Given RECM’s exposure to both natural gas and oil producers such as Ultra Petroleum, Inpex, BP and Gazprom, it’s worth commenting on how we value our investments within this context.

Ultimately, our valuations don’t rest on forecasts of oil or natural gas prices. Market participants are notoriously wrong when forecasting future commodity prices. Dan Doyle, president of Reliance Well Services, a hydraulic fracturing company based in Pennsylvania sums up the sell-side’s track record as follows: ‘Their forecasting always seems to be done through a rear view mirror and their calls for peaks and troughs are always overdone. Back in July 2014 when WTI (crude oil) was peaking, they were calling for more ... as oil inventories were beginning to wash up over our ankles. And then when we are forming a bottom in January and retesting it in March, they were calling for a deeper bottom. And then there was 2008. Remember the calls for $150 and $200 oil from Goldman and Morgan Stanley? That was right before we went to $40 and then some.’

We prefer to look at the marginal cost of producing a commodity and from that infer an ‘equilibrium price’ at which most producers are incentivised to produce it. Should the price fall below this, supply

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3. www.oilprice.com/Energy/Oil-Prices/Top-12-Media-Myths-On-Oil-Prices
should fall and this should ultimately lead to a rebalance with the price normalising over time – assuming demand is fairly stable. However, should there be an abundance of a particular commodity such as oil due to a shift towards other energy sources and a resultant drop in demand, the price of that commodity should fall to the point that it’s uneconomical for businesses on the higher end of the cost curve to produce it profitably. This again should lead to a drop in production such that the abundance should disappear over time. To protect our investors in this scenario, and given a sustained low energy price, we prefer lower cost producers – with Ultra Petroleum being a good example of this.

Again, our firm belief is that the clue to whether an investment is priced attractively lies in the analysis at the ‘micro’ individual business level rather than through macro analysis which drills down to individual investment selection.

**A high price doesn't mean a good outcome isn't possible – but it's not probable**

There are always businesses that defy the odds and deliver superior investment returns even when bought at high valuations, due to exponential growth paths fuelled by innovation or secular changes. However, the road to investment ruin is littered with many more examples of businesses seen at the time to be charting new territory that ultimately proved themselves unworthy of the excessive prices paid in anticipation of outsized returns in future. Repeatability and consistency are important characteristics of a good investment process – for this, investors would be wise to invest with an eye on what is probable, rather than what is possible. Ultimately, the trend is your friend, but only if the price upfront makes sense.

Linda Eedes