CERNO CAPITAL

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In the famous outlaw film of 1969, *Butch Cassidy and the Sundance Kid*, two anti-heroes of quite distinct personalities combine forces. The early scenes of the film are filled with tales of derring-do, laddish behaviour, drunkenness and opportunistic heists. By virtue of their charm - and the contrasting blockheadedness of the authorities - the pair have the audience entirely on their sides. As the film progresses, in response to their success in holding up his trains, E.H. Harriman of the Pacific Union Railroad begins to pursue them down in a more determined fashion, employing a mythic tracker to do so. One begins to sense a certain fatality in each attempted evasion. In the end, they are cornered by the Bolivian army in a barn and make a futile effort to shoot their way out. The film closes with a frozen frame and a volley of gunshots.

The determined but ultimately futile efforts of Mr Tsipras and Mr Varoufakis are brought to mind. Some distinctions need to be made immediately: our Greek anti-heroes are entirely sincere individuals, with no trace of criminality. This should be made clear.

However, if we allow for this imaginative construction to persevere, anti-heroes they plainly are. They have been conjured out of the despair of the Greek people, they preach an alternative agenda and run enormous risks. The arcs of these two stories are synchronised: from the early euphoria to the drawn out end. The E.H. Harriman character is played by Wolfgang Schäuble.

As none of the European agencies wish to bear the blame of precipitating the end game, it will come a little later. If insolvency becomes an inalienable fact, Greece will have little option but to erect capital controls. This action will be the probable trigger for Greece’s exit from the euro.

The interregnum, to borrow a word, between now and those eventualities occurring will provide some breathing space for equity markets to behave constructively. As well they might given oil has retreated from US$100/bbl. to US$60/bbl.

And to those that say this dividend from lower energy costs will not be spent I say: phooey. History says it will be.

Here we have an ally in Terry Smith of Fundsmith who makes the point that in every case where the oil price has halved, the global economy has boomed and every time the oil price has doubled, the economy has struggled. Oil and its by-products are a pervasive cost, for consumers and industries alike. A recent trip to central Florida, land of the big truck, suggests we are on track here as the trucks just got bigger.

The other manifestation of note has been the cooling, perhaps temporary, of the strength of the US dollar: travel mate of the ardent deflationist. The tempering of the dollar's rise has allowed other themes to prosper.

Notable amongst these is the shift in favour of cyclical shares in developed markets and the geographic shift toward Europe. Global investors have begun to curb US exposure.

Given the institutional stampede out of Europe in the second half of 2014, European equities have stood to benefit from reallocation flows from the US on any flag in its bull market. The euro itself offers some value. There are some early signs of economic revival within the region.

Will they prove a wonderful investment? Probably not.

For European equities cannot be said to represent outstanding value. In the past few years, the good companies with well installed franchises never became materially cheaper than their global peers. It never happened. For optimism toward Europe to become full throated, it requires the earnings *cyclum interupptus* to resume. The possibility of this happening cannot be denied. And so, if not wonderful, they are a plausible investment for the pragmatic investor who likes mean reversion to do the heavy lifting.

Cause or effect, we seem now to be locked into a psychology where further dollar strength will reactivate deflationary narratives but dollar weakness or a range bound dollar allows other stories to propagate.

The article that follows was written by Fergus Shaw and addresses valuation risks in global healthcare stocks.

James Spence.

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The Healthcare Sector – Time for a Check Up

Through the first 8 years of the noughties, global healthcare stocks were notable underperformers. There was an aversion to "paying up for growth", considerable concerns about the patent expiry cliff and government spending cuts. As a consequence, valuations became progressively more attractive. The long term outlook for the sector was and remains attractive given ageing populations with expectations of remaining active well into old age and the money to achieve this.

This underperformance ended after the Global Financial Crisis and Healthcare stocks have been a great place to invest in the past five years with the MSCI World Healthcare Index delivering an annualised total return in excess of 17% in USD. Over the same period, MSCI World Index returned 12% per annum. Healthcare stocks have performed almost as well as the Tech heavy NASDAQ index. Therein lays one of the clues to the sector's appeal. The Healthcare Sector now represents 13% of the MSCI World Index – the same weight as Technology.

The sector is not homogenous. Over half of the sector sits in the Pharmaceutical bucket. Many of these companies benefit from prodigious cash flows which can fund dividends and share buybacks that attract bond market refugees. More recently, these businesses have undertaken or attempted corporate restructuring which has attracted another group of investors – those that are drawn to "events".

Elsewhere in the sector, we enter the world of Biotechnology, Medical Devices and Life Science Tools; favoured hunting grounds for the committed growth investor, who must sift what are often binary business outcomes to lure the investor who likes a good story. The pace of technological change has accelerated in recent years with some commentators arguing that we are on the cusp of a technological revolution which will have profound implications for all industries and possibly the capital market system itself. This is the type of environment in which forecasts for revenues and profits can become wildly optimistic.

While price tells us that the sector has become popular, and has given the early adopters the means to fund their ceramic joints, zimmers and implants, we must look to valuation to provide some guidance around future prospects. A simple assessment of multiples reveals that the broad sector offers a dividend yield of 1.7% and a ROE of 16%, for which we must pay 4 times book or 24 times earnings. Expectations may not be as stretched as the '98 – '00 period, but on this basis, Healthcare is the most expensive of the global sectors.

If you discount the income stream of these stocks, you find that, on a forward looking basis, which is what all investors should be concerned with, Healthcare will be an unhealthy place to be. Time for a check up.

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