CERNO CAPITAL

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The outperformance of high quality equities has been one of the most distinguishing factors of the post global crisis period. "Quality" is loose moniker and there are disparate characteristics that can be construed as quality. More often than not it is associated with higher margin companies with solid balance sheets and well established and well defended business franchises. These types of companies are sometimes called defensive growth stocks.

Investors who closely follow our work on equities will know that we sip from the same font as Michael Porter and his ilk of Harvard. Porter promulgated the Five Forces and attached them to his surname. He wrote his first paper on the subject in 1979 *"How Competitive Forces Shape Strategy"* and morphed that into the 1980 book *"Competitive Strategy"* rounding off his ideas with "*Competitive Advantage"* in 1985.

https://www.amazon.co.uk/s/ref=nb_sb_noss_2?url=search-alias%3Dstripbooks&field-keywords=michael+porter

A stream of other publications followed, as he noodled away on the same basic tune. His contention was that great companies stay great because they build, or happen upon, some advantage which they prosecute and defend mercilessly. He also argued that high market share was a defining characteristic of such companies and lent them the power and wherewithal to shape their industries around them. He deemed that strong companies in growing industries often tended to form oligopolies as small clusters of firms grew to dominate. These companies tended to have higher margins than the trailing competitors and these were unchallenged by authorities provided that they did not consolidate into monopolies.

http://www.investopedia.com/terms/o/oligopoly.asp

In fact, it could be argued that the oligopoly structure defines modern business and politics even; it is the way of the world. The World Economic Forum at Davos is, in effect, an annual gathering of oligopolists and their service providers, leavened by a sprinkling of disruptors: (mainly) young men with their hats on the wrong way round.

When we think about the performance and particularly the <u>out</u>performance of the quality style, we need to tease apart the confluence of two trends: the longer term tendency of quality to do well against the medium term style trend where one group of stocks tend to do better than another on account of the twining of business cycle effects and momentum.

Warren Buffet's career is a hymn to the persistence of returns from quality. Strip his *savoir faire* for communications from his actions and we see that, far from being a value investor, as he is often construed to be, he exhibits the very acme of quality investing.

Quality, though, can do so well that valuations eventually revert downwards in a gravitational manner. The best example of this in modern financial history is the case of the Nifty 50: stocks that powered the US bull market of the 1960s but were at the vanguard of the bear market that defined the following decade.

Brokers spoke of them then as being "one decision stocks". Buy.

Do we have a Nifty 50 phenomenon at work today? Something akin to it, perhaps. The difference is that those stocks were all US corporations selling predominantly within the US but also accessing incremental growth overseas. Today, an updated 50 would be a universe of global companies, still with most domiciled in the US but augmented by plenty of European, Scandinavian, Swiss and Japanese names. (Few UK names, our good businesses of scale have generally been bought).

We study these characteristics in some depth to provide feedstock to the Cerno Global Leaders programme.

Fay Ren, who calibrates the source universes at Cerno Capital points out that her most recent update has collapsed the initial universe screen down from 827 global names to the aforementioned 521.

Some previous members have now failed on earnings stability: sequential growth is broken but the biggest drops have been on account of deteriorating financial strength and this has struck hardest in the US universe.

http://cernocapital.com/less-cream-expensive/

A deeper dig shows that many US companies are gearing progressively higher: either to make defensive, cost-driven acquisitions in their own sectors or to buy back their own shares with more gusto, or both.

The share buyback thing has gotten way outta hand - to become Trumpesque for a moment.

What started as optimisation became enhancement and has descended into straight out financial engineering.

It is becoming easier to spot where America's next crisis is coming from and it'll be inside the wall, Donald.

More generally on valuations, it is worth noting that the prospective price earnings ratio of the median US stock has reached 21x. This represents an all time high, higher even than at the peak of early 2000 when the bull market was concentrated in the Tech-Media-Telecoms troika.

Recognition of this has prompted reallocation flows into Europe and the Emerging Markets within the equity class and indeed both those regions have outperformed the US this year. Those who have surmised that it would also herald better times for Japan have been disappointed. Even including the QTD performance of +7.9%, the main Japan index is down -12.1% YTD.

Certainly the softness of the dollar, largely the product of the Federal Reserve's delay, demur, defer policy with respect to interest rates, has provided a generous window for the countertrend recovery in EM currencies, bonds and equities but we find it hard to be constructive from here. From a top-down basis, credit cycles have progressed a long way, pushed along by the same forces that have extended the cycles in the West, namely low interest rates and sizeable augmentation of the world's free liquidity position. On a bottom-up basis, there is no evidence of any incremental growth in Return on Equity. The China part of this, as ever, requires its own set of explanations and here the data points to a near-term softening of the deflationary picture and it is logical to understand this effect as being driven by the progressive relaxation of the monetary regime there.

Rounding off our own thoughts about allocations, we note that the valuation of companies that pass both qualitative and quantitative tests to form part of the Cerno Global Leaders approved list is no higher than that of the average stock in America. Both are priced at 21x. Nonetheless, we are feeding in new investment very slowly and do our buying on bad days when markets are in a spin.

We are doubtful that the fashionable chat on fiscal stimuli will deliver anything close to what is hoped for. For example, government spending plans have become so much part of the Japanese policy landscape and the actual delivery is so baleful that disappointment is more or less enshrined. Furthermore, one can also be fairly sceptical of the ability of politicians of nations who run fairly large budget deficits already - the UK springs to mind - to be able to unshackle themselves from conventional thinking. In the UK context, Mr Hammond's autumn statement will either provide enticing wisps of new thinking or sullen reminders of the old. In any case, things would have to presumably be a lot worse in employment and asset cycle terms for truly radical action to beckon.

That all said, we are instigating new lines of enquiry within the portfolio, especially in areas where sentiment is deficient and where we can achieve better thematic diversity. Recent work has focused on European banks and global construction firms and we will cover these in forthcoming notes.

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