NICK TRAIN, Joint Founder and Fund Manager, Lindsell Train

The king of buy and hold

If you thought that value investing is buying below book or buying a low P/E stock or going contrarian, you have much to learn from Nick Train. Nick doesn't look for any of the these when hunting for stocks. He doesn't even try to spot the next multi-bagger. And yet, when he finds companies he likes, he keeps them for years. An avid fan of Buffett, Nick tells Mohammed Ekramul Haque and every value investor how to invest for value. Read on.

ON EQUITIES, MARKETS AND MARKET VALUATIONS

John Templeton once said, "History shows that time, not timing, is the key to investment success. Therefore, the best time to buy stocks is when you have money" – a philosophy you share. What would you do in a 1999 or 2007-like scenario? Continue to invest? Yet another view says, "Wait till there is 'blood in the streets'." How do you reconcile these two?

I have never suffered from any delusion that I am an unusually smart or far-sighted investor. A keen sense of my many investing limitations means I have had to keep my approach simple. I am mostly concerned with avoiding obviously bad or 'losing' investment behaviour such as over-trading or backing low-quality companies and I'm willing to stick with basic investment principles that seem to me likely to work over time, even accepting there will be periods when they don't.

Your first question is a good example. For a while, as an inexperienced investment professional, I tried to judge whether equity markets were cheap or expensive. I even allowed myself to express pessimistic views about market prospects in public and, worse, to act on them. Now looking back over the thirty or more years of my career, it seems to me every one of those negative calls I made on markets was just plain wrong. They've gone up a lot over time and in hindsight there was always something to be enthused about. And likely there always will be.

Eventually, I acknowledged, for me, the futility of such guesswork about market levels and concluded that it makes good commercial, investment and – perhaps most importantly – emotional sense to be permanently bullish. This, I believe, is good, 'winning' investment behaviour. Being bullish brings a competitive advantage over the many market participants who are either negative because that is their habitual outlook on life (an outlook that tends to overstate temporary problems and to underestimate human problem-solving ingenuity) or who back themselves to trade in

and out of equity markets on the basis of their hunches about market levels; or both. Of all the losing investment approaches out there, that of being a pessimistic trader must be the most certain to lead to disappointing returns. So I practise the exact opposite – I'm an optimistic buy-and-holder. In this way I put history on my side, given the long-term propensity of stock markets to go up over time, Anglo-Saxon ones at least. In addition, I feel a lot better about myself – being optimistic keeps you young!

Admittedly, this determined bullishness means that periodically I am 'long and wrong' about stock markets, including 1999 and 2007. This is no fun at the time, but holding cash when markets are recovering is even less so.

Nick Train's Career

2000
Co-founded Lindsell Train

1998–2000
Head of Global Equities, M&G Investment Management

1981–1998
Director, GT Management and CIO, Pan Europe (latest position held).

Total investment experience
30 years

What according to you, indicates that the market is expensive or cheap? Are dividend yields a good indicator?

In my opinion, nothing reliably indicates markets as cheap or expensive. For this reason, as outlined above, I believe it is a better bet to assume that equity markets are always cheap. The long-term returns from stocks suggest that this is not as deluded a proposition as it might appear to be.

The fact is stock markets are driven by technology innovation and the associated rise and fall of industries brought about by that innovation. As a result, the constituents and industry weights of markets are always changing, so trying to judge the value they offer in relationship to a different historical period is pointless.

It is wrong to think that stock markets exist in order to make investors wealthy. This is a possible but by no means certain outcome. No, markets have evolved as the most efficient means so far to test and finance new ideas about how to satisfy human needs and wants. Investors fret about the cyclical wobbles of economies and periodic spikes and dips in equity prices but these are irrelevant to this central function of stock markets and to their long-term trajectory. For instance, people worry today about a turn in global interest rates. I understand this is an issue if you invest in government bonds. But what equity investors should really be worrying about is whether Moore's Law still holds (whether computer power will continue to double every two years, as it has for the past fifty). This is far more relevant to the outlook for stocks than the vacillations of interest rates. Take a look at a long-term chart of the S&P 500. Every bull market you see, the remorseless accumulation of long-term value is associated with the emergence of new industries, new companies or the productivity gains brought by new technology. The ups and downs of interest rates? Not so much.

I'm sure that if you're optimistic about technology and innovation, then you should be optimistic about equity markets. In that sense, markets are always cheap.

> **Of all the losing investment approaches out there, that of being a pessimistic trader must be the most certain to lead to disappointing returns**

When market yields are below gilt yields, do you still buy equities or wait it out?

Gilt yields and stock-market average dividend yields are irrelevant if you have identified a good equity idea. Good ideas are rare, in my experience, so buy.

Equities, you mentioned in one of your insights, perform well in recession years. How do they do that if earnings are down?

The 'duration' of the stock market can be thought of as its dividend yield divided into 100. So, a 3 per cent market yield gives a duration of 33 years. One or two years of recession-depressed earnings are of little importance when investors, whether they know it or not, are looking out over this sort of time horizon.

You have quoted Deirdre McCloskey, "a more reasonable diagnosis... is that booms and busts

arise from uncorrectable optimism and pessimism about novelties." Do you see any novelties that can become a boom-bust scenario ahead?

I certainly hope so. Booms and busts are integral to markets and without them they can't do their job, namely, finance new ideas. We pejoratively describe booms as manias, suggesting that individual investors have become irrational – carried away by greed. This may be so, but at the societal level these manias are, in fact, quite rational and beneficial. We wouldn't have Facebook and Google without the mania of 1997–2000. And many treatments for previously intractable medical conditions will emerge from the current biotechnology boom.

ON COMPANIES

You ascribe a lot of significance to dividend-paying companies. What of companies that skip dividends to invest in growth?

Yes, dividends are interesting, particularly long-term dividend histories of industries and companies, but maybe not for the reasons you might think. Here's why.

Technology change is the big driver of both wealth creation and destruction. How does an equity investor respond to its challenge? Some look to participate in cutting-edge technology itself and this is probably the most rewarding approach, particularly if you have a superior understanding of the technology and the competitive advantages of the companies you choose. I do not have this expertise. Instead I've chosen another response: that of identifying companies whose value-added is unaffected by technology change, or, even better, companies whose value-added can be enhanced by applying technology to its existing franchise. For example, Burberry is a company whose brand and heritage have made its products desirable for well over 100 years. And Burberry is now demonstrating how the deployment of digital marketing techniques can make its brand and heritage even more aspirational. Technology can't disintermediate Burberry's products as it might, say, a telephone company. But the company can use technology to reach more customers and understand them better.

This means that longevity, tradition and predictability are important investment criteria for me. If a business has not just survived but thrived over previous periods of technology change, then there is a possibility, never a certainty, that it will continue to do so. For this reason, I am interested in the long-term dividend histories of companies. If a company has proven capable of paying growing real dividends over long periods, it is a signifier that here is a business model or set of assets that has retained relevance and offered protection against past disruptive technology change and the effects of monetary inflation. Of course, the past is no certain guide to the future. But I prefer to start from identifying existing great, durable franchises and asking what could hurt them, rather than trying to predict the next generation. If at all possible, I avoid companies that appear to be certainly vulnerable to technology change, however 'cheap' they may appear. That seems to me to be the most difficult approach of all.

"Nothing reliably indicates markets as cheap or expensive. I believe it is a better bet to assume that equity markets are always cheap.

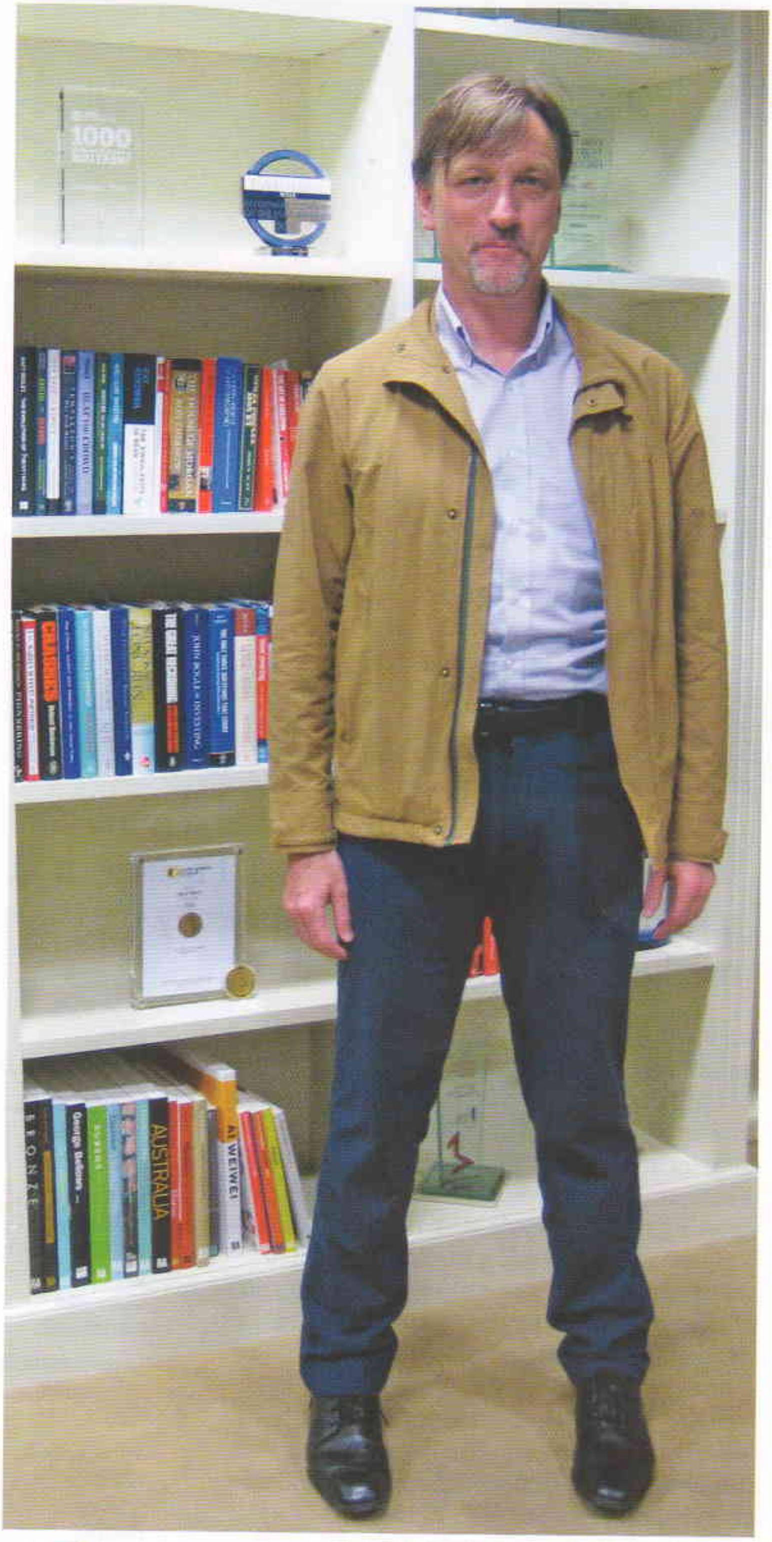
Investment principles followed

Investors undervalue durable, cash generative business franchises.

Concentration can reduce risk.

Transaction costs are a 'tax' on returns.

Dividends matter even more than you think.



Longevity, tradition and predictability are important investment criteria for me

You hold companies for many years. When, in your view, does a company start losing the plot and is on the sure path of decline? Are there any indicators?
I don't like it when a theoretically cash-generative business model stops generating free cash. Also if debt builds up for no good reason, alarm bells ring. A long time ago I made a bad mistake investing in the music industry. I failed to understand how technology was unravelling the record labels' superior economics based on copyright. The problems soon showed up in falling free cash flow and rising debt. I should've reacted quicker.

Generally though I agree with Buffett that investors are too ready to sell out of investments, that they are too confident that doing something, as opposed to nothing, will make a positive difference. It seems to me that it is more likely that experienced, smart managers of a company with temporary problems will find a solution to those problems than that I will successfully switch out of said challenged company into a better one. That might sound defeatist, but in a competitive capital market, with other investors highly alert to risks and opportunities everywhere, it is hard, particularly after costs, to demonstrate that regularly trading in and out of companies adds value.

Why is mismanagement of retained earnings significant? Are there any indicators that signal such mismanagement?
Sadly not until it's too late.

ON STOCK PICKING

What is a bagger? What are the qualities you look for in a bagger (or in a prospective investment stock) and what not?
A bagger is a stock that goes up multiple times on its purchase price. So far as I know the first investor to use the term and to build an investment approach around looking to capture as many baggers as possible was Fidelity great Peter Lynch. But credit too to Bill Miller, whose dictum "He who has the lowest book cost wins" expresses a similar idea. It seems almost a pointless truism that the best investment you can make is one which rises many times over and that you never have to sell. But my observation is that few people invest in such a way as to give

themselves the best chance of multiplying their capital because they're always, as the cliché runs, pulling up the plant to look at the roots.

In the end, I think there is a psychological factor here. There are those who love to trade – to take cutely timed profits and move on to the next idea. Variety keeps them engaged. Then there are the hoarders. People who painstakingly accumulate holdings in valuable companies over the years, harbouring them during periods of underperformance, buying more on the dips – monitoring the gradual build-up of book value and dividends over time. It takes patience. Both are equally valid. Perhaps the most important learning for every investor is to figure out what psychological type they are.

An old friend of mine – an investment banker actually – likes to point out that the dividend per share he receives today from his longest-standing personal equity holding is higher than the price per share that he paid for the stock – although, admittedly, it was purchased 25 years ago. Isn't that amazing? Only equity can do that for you. But you have to own the right company and you have to be patient. I always tell our clients that we expect to be invested in the companies we commit their capital to for a long time. We're looking to stay invested over the course of several business and stock-market cycles – way, way longer than many professional investors. Of course, this sort of strategic approach is not perfect. We're not nimble – not because we couldn't be, but because we don't choose to be. We'll hold underperforming businesses and shares maybe for too long. But there is a big benefit too in what we do. We're giving ourselves and our clients the best-possible chance to benefit from compounding, which takes time.

"Never invest in any company that makes anything out of metal. And if you find a company whose products taste good, buy the shares.

CF Lindsell Train UK Equity Fund

Performance is for the CF Lindsell Train UK Equity Fund Acc Shares. This fund is a UK-domiciled retail scheme, with an inception date of July 10, 2006. Perfomance is provided net of fees in GBP (management fee 0.65% p.a. and TER 0.77% p.a.). The fund's benchmark, FTSE All-Share, has been provided for comparison purposes.

Source: Morningstar Direct

Both, in your UK Equity Fund and the Global Equity Fund, you have no investments in commodities, industrials, mines, cement, steel and real estate. Why?

Investing is challenging – both intellectually and emotionally. I prefer to avoid investing in industries which I know for sure have gross cyclicality of earnings and/or which rely on borrowings to make their returns. I'm not saying there aren't great opportunities to make money in these sectors. It's just that you always have to remember to sell and I, being a hoarder, prefer to own stuff I hope I never to have to sell.

My two favourite pieces of investment advice help explain these preferences. 'Never invest in any company that makes anything out of metal'. And 'If you find a company whose products taste good, buy the shares'. By and large those two rules have helped me avoid the worst investment errors and pointed me to some of my best ideas.

In some stocks, with high dividend yields, is there not a risk of getting into a value trap, where the stock behaves like an annuity but does not offer much long-term stock price appreciation? How do you identify and do you invest in such stocks?

Just never buy anything for dividend yield alone.

Favourite books

Warren Buffet Way
Hagstrom

One Up on Wall Street
Lynch

Stocks for the Long Run
Siegel

Big Short
Lewis

What Technology Wants
Kelly

Leisure activities

Spend time with family

Reading

Yoga

In a recent interview, you said you have not bought anything new for the last four years. What did you mean, and what did you do during that period? Do you wait for a fat pitch, as Buffett says? How long?
Yes, I've just been through a four-year drought when no new idea seemed sufficiently compelling to supersede existing holdings. I've been lucky enough over that period to enjoy strong flows into my fund and had no problem investing that cash into the current constituents. Doesn't Buffett say somewhere, "Often the best idea for new money is to buy more of what you already own?" I think it's interesting that this four-year period has coincided with a streak of competitive absolute and relative performance from the strategy. Activity is overrated!

ON STOCK VALUATIONS

Exceptional companies with durable competitive advantages are often not cheap. Would you buy a Diageo at 40 or 50 times earnings? What is the maximum you would pay for such companies in terms of earnings multiples?
Actually, I'd argue the opposite. To me it appears that 'exceptional companies with durable competitive advantages' are in fact cheap almost all the time.

The point is such companies are rare. It is plain wrong to expect them to be valued similarly to what is the vast majority of ephemeral, low value-added businesses. I like to think about the conundrum of 20. Many investors presented with a stock on 20 times earnings – Diageo for instance – will say that's expensive, relative to, for example, the long-run average P/E multiple for Anglo-Saxon markets of 15. However, if I offered those same sceptical investors the opportunity to invest in an asset with a guaranteed 5 per cent yield, with likely protection against inflation over the next 25 years, with some real, above-inflation growth thrown in too, they'd fall over themselves to buy. Diageo seems to me to offer such potential, by the way. Yet, of course, the 'high' P/E of 20 and the attractive real yield of 5 per cent are one and the same.

> **Exceptional companies with durable competitive advantages are cheap almost all the time**

So, a rule of thumb for me is that an exceptional business can easily justify a valuation up to 30 times earnings or a real earnings yield of over 3 per cent. After all, inflation-protected government bonds are keenly bought by investing institutions today with starting yields of lower than 1 per cent.

How can investors use the gilt rate to come up with a discounting rate to arrive at the intrinsic value? Can you explain with examples?
I do use the long gilt yield as a discounting rate, but it is important to understand that any resulting measure of value is very imprecise.

To my mind, the real benefit of the exercise is the questions it forces you to answer about the company you are proposing to value. The longest dated government bonds have lives of 30 up to 50 years. If you're going to use these instruments to value an equity, then first you must have a reasonable expectation that the company will have a similarly long life. Otherwise, you are not comparing like with like. Of course, most companies will not survive for 30 years or more. Most companies fail. So just applying this filter – 'will such and such a company likely be around in 30 years?' – savagely reduces the universe of potential investments for me. But every so often you come across a business with a brand or a franchise that has survived and thrived over many decades and where it doesn't seem totally absurd to expect it to continue to do so. Then you can start thinking about its value compared to a long bond. The next question is – 'how likely is it that this durable corporate asset will be able to grow its cash earnings over the next 30 or more years ahead of the rate of inflation, whatever that turns out to be?' Again, this is another unanswerable question; but again history suggests few companies are able to maintain the real value of their products or services over time.

But say, you decide that Diageo's brands, Johnnie Walker, Guinness, Captain Morgan etc., are likely to at least maintain their real pricing power over the next three decades and might even offer some inflation-beating volume growth too, as the world's spirit drinking population grows. If you have made that decision, then you're immediately faced with the critical question at the heart of our investment approach. Why should Diageo, or any other of these rare wonderful corporations, be valued at less than a government bond? We know for sure that the bond will pay its fixed coupon for the next 30–50 years. That's something. But we also know for sure that the government bond will be unable to protect investors against the effects of unanticipated monetary inflation over time because the coupon is fixed.

Meanwhile, we've already agreed that Diageo will not only have survived over the life of the long bond, it will likely, in addition, have grown its earnings ahead of inflation. This means Diageo ought to be worth very much more than a government bond to a long-term investor. But when you look at current valuations, you find that this is not the case. The longest UK gilt has a redemption yield of 2.4 per cent, or a P/E of 41.7 (100/2.4). In contrast Diageo trades at a prospective P/E of 20 (according to Bloomberg) or a yield of 5 per cent (100/20). If Diageo were to be valued just in line with the UK long gilt, it should today be trading at £40, rather than its market price of £18. And there is a clear case to argue that Diageo ought to be worth more than a gilt because of the likely real growth it offers.

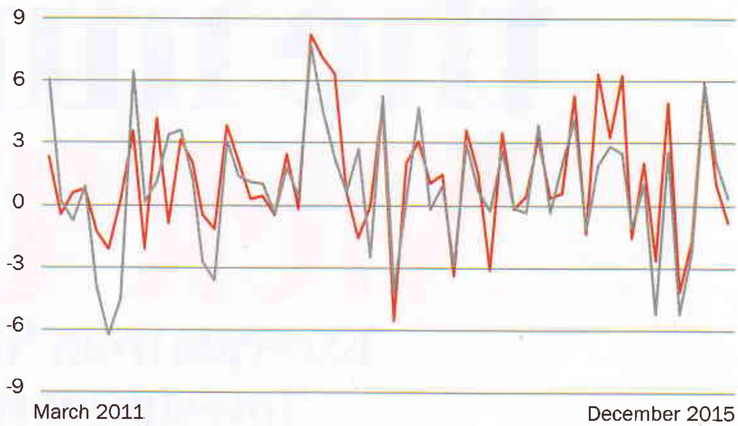
The above is in no sense a formal target price for Diageo. I don't know any certain way of arriving at the 'correct' value of any asset. What I do know though is that I've been asking the right questions about the attraction of any equity asset. And the thing is history supports the proposition that those companies that do succeed in growing real value over long periods of time are not only rare, they are also extraordinarily valuable.

India's bank deposit rate is about 8.5 per cent. Should this be the minimum yield rate to demand from quality stocks? What if the yield rate offered by high-quality stocks is lower than 8.5 per cent?

> **Companies that grow real value over long periods of time are not only rare but also extraordinarily valuable**

Lindsell Train Global Equity Fund

Performance is for the Lindsell Train Global Equity Fund B-Class shares. This fund is Dublin-domiciled, with an inception date of March 16, 2011. Performance is shown net of fees (management fee 0.65% p.a. and TER 0.79% p.a.). The fund's benchmark is the MSCI Developed World and this is shown for comparitive purposes.



Source: Morningstar Direct

Should one wait for markets to cool down or yield rates to go up?

No. Short-term interest rates have no bearing on the long-term value of a real asset like a quality stock. Given long enough, its share price will correlate perfectly with its growth in free cash flow.

How do you value whether a company is undervalued or overvalued: DCF, free cash flows or private market value, or a combination of all?

On my time horizon, the calibre of a company is much more important than its value. You can be wrong about value in the short term, but still have a great investment over time. My worst errors have come from overestimating a company's business model, not overestimating the worth of a fine company.

That said, I pay a lot of attention to M&A activity in the sectors that I invest in. One actual transaction – when serious business people, staking long-term corporate capital, are prepared to buy or sell 100 per cent of the equity of a business – is worth dozens of investment-bank research notes.

ON SELLING

When should a person sell a long-term investment and when not?

Best to never sell.

Favourite sectors

Consumer branded goods

Media (including, computer software)

Pharma (including healthcare)

Retail financial services

COVER STORY

Inside the mind of Nick Train

Excerpts from Nick Train's 'Investment Insights'

Nick Train authors 'Investment Insights', which can be found at LindsellTrain.com/investment-insights.aspx. The following excerpts are just a sample of the wisdom that you can learn from reading the insights. After going through the excerpts below, you can go to the link above and get your hands on more goodies.

Lynch Law

August 2015

Famously Lynch built his investment performance around "baggers" – shares that doubled, trebled, sextupled or better over time. Magellan benefited from over a hundred "10-baggers" during his stewardship. Think about that. Few of us are lucky enough to identify and, crucially, have the fortitude to hang onto, 10, let alone 100, stocks that go up 1000%. It might sound obvious, but you don't get to enjoy those sorts of gains if you sell out early. Yet all the psychological pressure is to take profits on winners and to go fishing where stocks are down and "cheap".

Another investor we admire, Richard Oldfield, wrote a stimulating book with a brilliant title. "Simple but not Easy." And it is true, because Lynch demonstrated it in his own career, that investment can be simple. It can be simple in that the ideas that make the best returns over time do not have to be intellectually abstruse. For instance, one of Lynch's key rules was to watch out for where your household shops and what for. It's important when your wife tells you that M&S has lost the plot in kids' wear. It's important that you respond to the realisation that you buy a Cadbury Crunchie every time you fill the car. These are not complex ideas. "Know what you own." But the practice of investment is not easy. What makes it hard are noise and distraction. Lynch wanted the private investor to understand that his or her ideas can be just as valid as those of the professionals and that for some professionals sitting all day in front of scrolling news and price feeds can distract and detract from the delivery of investment returns.

Common Sense never goes out of fashion.

Men more frequently require to be reminded than taught

January 2014

"Lynch ran his winners, arguing that if a share has done well – at least for reasons that are explicable and not wholly speculative – then there is every reason to expect it to continue to do well (although always remembering that nothing goes up in a straight line). He (and we) dispute the conventional wisdom that says: "It's never wrong to take a profit". It can be very wrong. If by doing so you permanently reduce your interest in a great long-term investment. Share prices of the best companies double, then double again and again over time. Locking into that observed propensity for wonderful businesses to compound wealth for their owners is at the heart of our approach."

"I forgot more than you'll ever know (about them/her)"

Jan 2008

Sir John Templeton's "Investment Maxims" and other words of wisdom are always worthy of consideration. Truly, Sir John "forgot more than we'll ever know about" equity markets. Today we recommend investors dwell on the following:

"To buy when others are despondently selling and to sell when others are greedily buying requires the greatest fortitude and pays the greatest reward."

"The time to buy stocks is when the short-term owners have finished their selling, and the time to sell a stock is when the short-term owners have finished their buying."

"Too many investors focus on "outlook" and "trends". Therefore, more profit is made by focusing on value."

"An investor who has all the answers doesn't even understand the questions."

And my favourite – "History shows that time, not timing, is the key to investment success. Therefore, the best time to buy stocks is when you have money."

Lynch wanted the private investor to understand that his or her ideas can be just as valid as those of the professionals and that for some professionals sitting all day in front of scrolling news and price feeds can distract and detract from the delivery of returns

Size doesn't matter (very much)

July 2014

"In our UK Equity Fund we own:

World's #1 Emerging Market FMCG Company (Unilever)

World's #1 Spirits and Dark Beer Company (Diageo)

World's #1 International Beer Brand (Heineken)

World's #1 Educational Publisher (Pearson)

World's #2 Index Service Provider (LSE, post Russell)

World's #1 Scientific Publisher (Reed Elsevier)

World's #1 Online Newspaper (MailOnline)
World's #1 Trading and Investment Infrastructure Software Provider (Fidessa)
World's #5 Most Valuable Luxury Fashion Brand (Burberry, according to Interbrand survey)
World's #1 Chocolate Company (Mondelez)
World's #1 Business Information Provider (Thomson Reuters)

What we're conveying here can be summarised as "size doesn't matter" – that much. In our opinion our portfolio comprises a collection of exceptional brands and franchises, many so at global level, or if not, strong regional or national champions. What is attractive about them has nothing to do with their market capitalisations. Many of them could be described as small companies, certainly by global standards – but that does not mean that they are not dominant in their own way. So, Pearson is not as big as Apple, in fact it is only 1/36 th of the size. Yet, arguably, Apple needs Pearson more than vice versa in order to achieve their separate ambitions in EdTech...Biggest is not necessarily best."

Pearson is not as big as Apple, in fact it is only 1/36 th of the size. Yet, arguably, Apple needs Pearson more than vice versa in order to achieve their separate ambitions in EdTech.

An old-timer looks back

November 2006

"One of GT Management's founders, Richard Thornton, taught his young fund managers an important lesson. "Great money-making ideas are rare" he'd say, "make sure that when you find one, you make it count". Indeed, here is Richard's 4-point action plan for investment success:

- Identify your great investment idea.
- Buy as much of the idea as you feel comfortable with.
- Buy the same amount again, so you can no longer sleep at night, because of the size of your holding. Finally,
- TELL EVERYONE ELSE ABOUT IT!

This advice can be summarised, in contemporary parlance, as to build "high conviction, highly concentrated" investment portfolios."

Sardines and soap

May 2006

The story goes that sometime in the early years of the Twentieth Century there was a lull on the trading floor of the New York Stock Exchange, a lull that extended from hours into days – and the boys were getting bored and restless. Come an afternoon, for want of any better entertainment, one of the traders pulled out an elderly sardine tin and announced his willingness to sell this unique item for no more than a nickel. In a moment two jobbers from the Railroads pitch had bid and counter-bid for the tin, pushing the price up to a dime. Not to be outdone, the swells who trade Texas oil stocks jump in, doubling the price of the sardines, then doubling it again. The tin passes from professional hand to professional hand, with the ticket sometimes a cent or two higher, sometimes up a quarter. At last the hubbub attracts the attention of the baby of the floor, a wet behind the ears college kid. He spots the unusual label and can't miss the excitement in the open outcry yelling of the traders. The kid, determined to show he can play with the big boys and genuinely intrigued by the apparent rarity of the item, firmly calls out "Ten bucks" and is delighted when the bidding comes to an abrupt end. Hefting out his pocket-knife, he punctures the tin, only to be met with the unmistakeable stink of rotting fish. Bewildered and heavily out of pocket, the new boy turns to one of his elders and betters, who

> **Our portfolio comprises a collection of exceptional brands. What is attractive about them has nothing to do with their market caps.**

It is not dangerous for defensive stocks to be apparently highly valued, compared to the average, mediocre company. They deserve to be.

had taken a half Dollar turn out of the tin an hour previously. "I don't get it" says the kid, "these sardines are long gone." "Son", says the old jobber, "those weren't eating sardines, thems were trading sardines."

We're fond of this apocryphal story, which illustrates one aspect of the workings of capital markets. We all know about the ramped "concept" stock, the speculative issue that almost unaccountably captures the attention of traders and the investing public. This is the kind of stock whose appeal begins and ends with the prospect that it might go up a lot in a short period of time. Sometimes an entire subsector of the market is implicated, or even created, in the excitement. If you play the game and, we must admit, we tend not to play this type of game, then one important thing is to not be the patsy who pays top Dollar. The other consideration is knowing, if and when the music stops, whether you hold trading or eating sardines. There were many months after March 2000 and many rallies, when it was possible to sell out of various Internet "trading" sardines, not at the top, assuredly, but before the things reverted to penny stock status.

A new Nifty Fifty? Bring it on!

December 2012

For reasons that will become apparent, we regularly return to Jeremy Siegel's masterly analysis of the original Nifty Fifty episode in his invaluable book – "Stocks for the Long Run" (2nd Edition, 1998) and I crib what follows from him.

The share prices of the Nifty Fifty – that collection of "one decision" stocks (the recommended decision being "buy and hold forever") and identified by Morgan Guaranty Trust – peaked in December 1972. It was a disparate group, comprising some consumer staples, but also technology companies, retail and industrials. And at the peak the shares commanded expensive valuations, by traditional measures. The average P/E ratio for the group was 42x, with a dividend yield of 1.1%, respectively double and half that of the S&P500 in 1972.

But what really is dynamite (and, reader forgive me, here I arrive at last at the real point of this lengthy piece) is that it is by no means obvious that the Nifty Fifty was materially overvalued, even at its peak. With the benefit of 25 years hindsight, Siegel worked out the return on the Fifty from its peak, compared to the benchmark.

Notwithstanding a nasty lurch down in 1974/5 the group returned 12.7% pa to December 1997, compared to the S&P 500 12.9% pa – effectively a wash. What's more, for a typical real world investor, that is a higher rate US taxpayer, the Nifty Fifty would have actually outperformed the S&P, because of the lower dividend yield on the Fifty (capital gains being taxed more lightly than dividend income).

Sometimes an entire subsector of the market is implicated, or even created, in the excitement. If you play the game and, we must admit, we tend not to play this type of game, then one important thing is to not be the patsy who pays top Dollar.

Let's be clear what Siegel is saying. A collection, however arbitrarily selected, of "great" companies outperformed the broader market over 25 years (for the likely average investor), even from the point of its highest relative valuation and despite the list containing more than several that turned out to be real clunkers. In short, 42x earnings turned out not to be expensive.

Here's how Siegel summarised his findings: "Those stocks that sustain growth rates above the long term average are worth their weight in gold, but few live up to their lofty expectations."

And, even more apposite to this discussion: "Stocks with steady growth records are worth 30, 40 and more times earnings."

In other words and turning to today's debate, it is not so dangerous for defensive stocks to be

> [Cadbury's] assets are of significantly better quality than those of the average UK company and therefore deserve to be valued more highly

apparently highly valued, compared to the average, mediocre company. They deserve to be. What is dangerous, though, is to be complacent about their perceived defensive qualities. Only the most exceptional sustain very long steady growth records.

Hitting the twenty-year sweetie spot

June 2005

"Our starting point is the conviction that the best share to own is the share that you buy today, that at some point in the distant future, let us say twenty years, is worth many, many times what you paid for it.

> Over the last decade Cadbury's EBITDA per share is up 70.0%, while Northern's is down 17.0%. We think anyone who answers "Northern" [is cheaper] knows the price of everything, but the value of nothing".

So, what about Cadbury? Well, we know that it is an unusually profitable company, with operating margins for the last ten years averaging over 15.0% and an average Return on Equity for the same period of over 24.0%. We also know that Cadbury's assets, which generate these attractive returns, have exhibited extraordinary durability. Dr Pepper was first formulated in 1885, before Coke and 120 years later, its volumes and cash flows are still growing. The Dairy Milk "megabrand", as Cadbury calls it, was introduced exactly 100 years ago and is today sold in 33 countries worldwide, with annual retail value of $1.0 billion. Bassett's Jelly Babies came to parturition in 1918 and now over 1 billion are consumed every year. Creme Eggs are of more recent provenance, 1971, but over 300 million are laid every year at Bournville (a dubious statistic - our office secretary must eat over 100 million a year on her own). Hall's cough drops were invented in the 1930's and now account for 50.0% of international cough drop sales. This makes the Hall's brand not only the leader of the world medicated confectionary market, with a share of 22.0%, but also the top global sugar confectionary brand, with a 2.0% share – goodness knows how many packs of Halls nestle in the bottom of grandmothers' handbags, alongside the Trebor Extra Strong Mints (established in 1935, owned by Cadbury and the UK's number one sweet brand by size). Back in the 1970's, Dominic Cadbury, then chairman of the family business, made a proud boast – "Schweppes will still be being mixed with gin long after North Sea oil runs out". Of course, here in 2005, those reserves are indeed depleting, encouraging investors to fund speculative surveys for oil as far away as the Aegean Sea. When, periodically, such appraisal wells prove to be dry, those same investors will doubtless console themselves with several stiff Schweppes and Gordons (let's include a Diageo brand in this pantheon of "predictables") – proving Dominic Cadbury's earlier prediction.

The longevity of Cadbury's brands and their proven capacity to generate cash mean that these assets are of very significantly better quality than those of the average UK company and therefore deserve to be valued more highly than the average. It is, in particular, frankly absurd for institutional investors to dismiss Cadbury shares on the grounds they are overvalued compared to the UK Food Manufacturing sector. This is now a sorry group of companies, mainly comprising low margin raw material processors and the manufacturers of "own-label" goods for the supermarkets, in whose pockets they firmly sit.

Northern Foods sells on a prospective P/E of 12.0x, a discount to the market average. Cadbury sells for a prospective 16.0x, a premium to the All-Share and over 30.0% more "expensive" than Northern Foods. But over the last decade Cadbury's EBITDA per share is up 70.0%, while Northern's is down 17.0% - which is going to be "cheap" or "expensive" over the next ten years? We think anyone who answers "Northern" - "knows the price of everything, but the value of nothing". WI