ROSSIE HOUSE
INVESTMENT MANAGEMENT

February 2021

2020 was a year all of us will remember for the rest of our lives. If a sage had told us that economies in the west would collapse by 30%, that many companies would be forced to stop trading and that government debt would explode, most of us would have thought stock markets would fall significantly. In fact, most of our clients' portfolios made gains last year. In the first article we give our usual review of what happened and our thoughts on the outlook.

Income has been a casualty of this difficult trading environment, especially in the UK. Many of you depend on the income from your portfolios. We know this has affected some of you but perhaps less than might have been expected. Our preference for investment trusts has provided some protection. The second article goes into this in more depth.

Our penchant for investment trusts is because we note they often perform better over long periods. Our broker contacts frequently tell us that some investment trusts are too small as bigger wealth managers can't put them on their so called "buy lists". For Rossie House this can provide opportunities; for example wider discounts and flexibility for the manager to buy fast-growing smaller companies. One such trust we have been accumulating is the Artemis Alpha Trust. One of its managers, Kartik Kumar, has very kindly agreed to write an article on it for you.

Rossie House portfolios have consistently held a weighting in non-equity (or at least not predominantly equity) assets. We describe them as "defensive" assets in the expectation that should equity markets fall they would protect client portfolios to some extent. A quarter of a century ago the old fashioned certainty of fixed interest bonds used to form the bedrock of such assets. More recently we have tried to convey to clients that nothing is "safe" anymore as interest rates have fallen to such low levels. They now threaten to go negative – something no one thought conceivable in years gone by. This is explored in more detail.

Many of us start the New Year with good intentions and even some resolutions. In some cases these go by the wayside quite quickly! Our next article looks at the value of "Checklists". Whilst we try not to be too prescriptive about anything in investment – there are many different ways to invest – we have found some talented fund managers use checklists when investing. Rossie House use checklists for analysing funds. In the current year our aim is to use them more.

Recent performance has been relatively polarised. Some managers investing with growth philosophies have trounced value managers. We look into this phenomena in greater depth to explain why this may be so.

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In our final article we look a bit at speculative activity. It is high at present. Those of you who have university aged children may have noticed the world of crypto currencies has become very topical – rather like Pokemon cards were to school children in the not too distant past! When central banks print money at an increasing rate and MMT (Modern Monetary Theory – see Periodical 6) seems fashionable it is not entirely surprising that investors are looking for stores of value. We provide some simplistic thoughts in our final article.

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MARKET OUTLOOK

'Why, sometimes I've believed as many as six impossible things before breakfast'. We can't but wonder if the Queen of Hearts had in mind the notion that most world stock markets would finish the year well above their 2019 closing values during an ongoing pandemic for one of these. Nonethless, the roll-out of vaccination programmes and lavish government support, combined with ultra-low interest rates and monetary measures from central banks have achieved this.

In his 1936 book 'Journey Without Maps' Graham Greene recounts his travels into the unmapped interior of Liberia. At times the strange conditions we have found ourselves in during the pandemic have resembled such a journey – historical precedent is of limited value in navigating uncharted territory. What we do know is that things have changed – as anyone who sits at home discussing their business or family matters on a Zoom call whilst listening out for the delivery of the online shopping order can attest. For now, we have ceased doing some things in person, such as going to conferences or parties or the cinema, in favour of either something else altogether or an online or home-based version of the same thing. The hope is that many activities will resume and offices and restaurants will re-populate and things will go back to normal…but the lingering sense is that some changes will be permanent. The oft-noted point is that the pandemic has accelerated certain trends already underway and embedded them. The slow adopters of technology (this writer being among them) have started to use it more.

We now have a landmark which offers navigational hope. Good news about vaccines has sharpened up markets, especially laggardly ones like the UK.

The pandemic has dominated investment markets during the year just as stridently as it has restricted our home lives and work patterns. Governments across the world have turned on their firehoses, in a metaphorical sense, spending money to support economies. The sums concerned are quite astonishing, with government fiscal commitments estimated to already amount to 12% of global GDP by the IMF in September 2020. The problem of course is that the situation is akin to the Pogues' song lyric which runs - 'lend me ten pounds, I'll buy you a drink'. The measures have certainly boosted markets, with the US up some 60% from its lows (the UK has been rather disappointing in managing only 30%, in large part because of BREXIT and its haphazard pandemic management). Government debt levels are rising and rising across the world. The UK's own public borrowings have exceeded £2 trillion for the first time.

How do we square the current, rather grim, situation with current stock market levels? Equities are at a higher level than at the start of 2020, before the pandemic. The exception, already discussed, is the UK. The US has led world equity markets because it is home to the cream of technology companies and internet business models – think Amazon, Alphabet (Google's corporate name) and Microsoft. Such shares now account for over a third of the value of the US S&P 500 index by market value. These businesses have seen their revenues expand and grow and rivals with less 'online' presence (would most people rather shop at Amazon or a local shopping centre at the moment?) have fallen by the wayside. Digital business models have powered ahead with rising valuations for such companies reflecting the scarcity of growth on offer. The effect of near zero interest rates has also helped drive money into riskier assets.

A wander down any provincial high street often shows the other side of this so called 'progress'. Empty shops sit like decaying teeth among peers which are in many cases also struggling (and closed, in the main, at present). These failed businesses may have been the victims of changing consumer habits some years ago, but the pandemic has reinforced and accelerated such trends. Sad as it is, we expect to see

more businesses fail. These may be damaged by structural trends, like internet shopping, or by perhaps shorter term problems such as a decline in tourism.

What does this mean for your portfolio? It means the old certainties have gone – building an old fashioned portfolio which balances equities with bonds will not work to produce adequate returns and protect capital when a ten-year UK government bond yields 0.5% each year to its maturity. This and our fear that inflation is a major ultimate risk – we may see deflation initially – of current conditions given high levels of government spending financed by debt. One should also not ignore the position on inflation targeting by the US Federal Reserve. Put simply, 2% is no longer a ceiling inflation target and they anticipate allowing ‘catch up’ when it is undershot. This is likely to set the tone for other central bankers. Hence our preference for inflation-linked government debt and funds which hold this in combination with resilient equities and other alternative assets such as gold. Positioning such as this may provide some bulwark against any inflationary storm.

The largest part of your portfolio is invested in equity funds managed by investors we believe to have talent, patience and a repeatable methodology for generating investment returns. The conditions we have outlined require investment in companies which offer growth – be that through businesses with technology driven operating models that can weather and even grow during the pandemic or companies with a steady level of market demand. We also need to invest in businesses which will be able to capture improvements in growth when conditions become less restricted. We need managers who can make uncomfortable decisions, kicking away from damaged old business models which, when they collapse, may suck shareholders down into the depths of the investment ocean like the crew of the Pequod in Moby Dick.

We also need managers who can recognise cheap valuations in businesses that will survive the coming decades. Even if these are not the newest or most exciting organisations, if they are well run and inexpensively priced, these too can make good investments. We have recently seen the market’s endorsement of unloved, cheap companies with substantial moves in shares which are judged either to be ‘value’ or ‘growth at a reasonable price’ in investment argot.

The vaccine offers not a full map, but at least a visible landmark to guide us in a behavioural and economic sense. The control of the virus is in prospect, but not yet achieved. Assuming it is, we expect growth to return and with it further investment opportunity. We do however need to accept that the process of bribing us with our own money, which governments have adopted to support economic activity, will have a cost. The *quid pro quo* will be a mixture of higher taxes, probably inflation and hopefully not too many madcap policy experiments such as negative interest rates. In short, the old maps are unlikely to work, but we believe that investment has always been about exploring new territory and we are confident that the managers of the funds in your portfolio have the attributes to find their way in this new landscape.

INCOME

COVID has been brutal as regards investment income, with one financial services company[1] estimating UK dividends were down 39% last year. Barclays, Lloyds and Royal Dutch Shell have been among the once reliable market stalwarts that have cut or stopped altogether their payments. To make matters worse you can barely get a yield on government bonds (the UK 10-year government bond yields 0.5% to redemption at the time of writing). In order to achieve an attractive running income from bonds, you need to considerably relax your standards for the government or corporate you chose to lend to. The risk of Covid-related fiscal and monetary stimulus measures eventually generating proper inflation (2% plus) only makes things look worse. Dividends are starting to be reinstated, so it is not all gloom, but the fact is that some companies may use the cuts as a permanent re-set and this is particularly true in the UK where dividend levels have been rather high in relation to the cash profits available to pay them.

There is a problem here for investment trusts. They have always been an important income vehicle for the UK with a long and distinguished history. However, in an income scarce world trusts have evolved their structures and focussed on new asset classes. The process has been going on for over a decade, as very low interest rates have become a permanent feature. New types of trust range from conventional equity trusts investing outside the UK with an income strategy (such as Schroder Oriental Income Fund) to alternative asset class funds such as infrastructure funds which are designed to produce a high income (The Renewables Infrastructure Fund being one example). Some of the alternative asset classes promoted have been increasingly esoteric, with yields often enhanced with cheap gearing – something which always adds risk – and we have tended to avoid investing in these.

Trusts have also dealt with a low income environment by starting to convert capital to income on behalf of investors. Investment trusts do have a few things going for them over the typical unit trust in this kind of environment. The first is that trusts are able to accumulate income reserves from which they can pay dividends (they can hold back 15% of the income they receive every year if that's what their directors decide). This means they can smooth payments over time: if the dividends they get in one year fall, they dip into reserves and keep the pay-out to their investors constant or rising as in the case of the AIC's dividend heroes[2]. Unit trusts and OEICs can't do this, they have to pay out all the income they get in each year. If it falls, it falls. In the high dividend paying UK Equity Income investment trust sector, the average number was 1.2 years of reserves at the most recent pre-Covid era year end (source JPM Cazenove). Investment trusts are able to pay out capital, if their articles of association permit this or are amended to do so.

However these reserves are an accounting entry and do not - sadly - represent an actual pile of cash. In paying them out the company is effectively drawing, in an accounting sense, on past success in accumulating income to support a current dividend payment. The key point here for investors is that trusts have something many other investment vehicles do not have – structural flexibility. It is often right for boards and managers to use reserves over short time periods if they anticipate conditions may improve. Total return investing has a number of investment advantages.

Although taking income via a total return approach goes against the notion that one should never spend capital, there may be a good reason for doing so: the need for income does not fall simply because the income available falls. The essential question then is this: if you need to draw a relatively high level of income in percentage terms in comparison to market income levels, are you better achieving this through investing in higher yielding stocks or taking the return from a mix of dividend and capital returns (better known as total return)? The vital question is – do companies which pay above average dividends tend to produce a different level of total return to the average?

If we perform a simplistic analysis and compare the 15-year total return of the FTSE 350 Index (which comprises the 350 largest UK companies by market capitalisation) with that of the FTSE 350 Higher Yield Index (the companies in the FTSE 350 paying above average yields), the returns over the last 15 years provide some supporting evidence for the notion that an excessive focus on high yield can damage total return. (The figures are 115% for the index versus 65% for the high yielders). In our view the market values the ability to grow dividends more highly than it does a high absolute level of income. High income is often associated with businesses with limited growth prospects and this has tended to be reflected in dull share price performance. High income equities (and the trusts and funds which hold them) may have periods of strong share price performance, but long term compounding of business value and the ability to generate cash / pay growing dividends will tend to be a better formula for generating returns. We view a total return approach to investing as the best way to ensure you maximise the size of the available cake, regardless of whether it will be consumed via withdrawals or stored in the larder.

[1] Link Financial Group

[2] AIC Dividend Heroes – investment companies that have consistently increased their dividends for 20 or more years in a row.

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ARTEMIS ALPHA TRUST

Dear Rossie House Investors,

Artemis took on Alpha in 2003 when the trust had £10m in assets. The Trust has delivered a near 8-fold increase in net assets per share since inception, with John Dodd as the fund manager over this period and still co-manager today. From late 2018, we switched from a UK small-cap focused strategy to a concentrated long-term value strategy that I (Kartik Kumar) now lead. The last Rossie House periodical to focus on a trust covered the history of Herald Investment Trust, which has a successful 26 year-record. As the strategy we are employing is only formally 2.5 years old, I am focusing on the future and not the past.

First, I will give you an insight into our investment process and what makes us different and then I will explain why I am excited about our portfolio's potential.

Approach

If you were to ask me to characterise our investment strategy, I would say that we are long-term value investors. You might be puzzled if you looked at our top-10 as you would see Barclays, the bank, alongside Delivery Hero, a loss-making German technology business, which we have held since its IPO in 2017.

In recent years, "value investors" have come to be regarded as dinosaurs of the investment community. Great in one era, but due for extinction. In our view, this understates the inherent malleability of the concept, which is just a framework that focuses on valuing a company independently of the market price, and encourages you to invest based on the attractiveness of market prices relative to your judgement of value.

How you interpret and apply that framework requires subjective judgement and depends on what you think drives value in a business. In our view, the alchemy of investing comes from the impact on value of compound interest over long periods of time. In the business world, the driver of compound interest is achieving a persistently high return on capital. Much is written on this subject; but my favourite book that encapsulates what we are looking to achieve is Chris Mayer's *100 Baggers*.

In practice, we think the range of businesses that can achieve high returns is more broad than some observers suggest. For example, airlines are deeply unpopular today, but both Ryanair and easyJet have historically generated high returns. If you don't believe me; and if this wasn't the case, how would Stelios be a billionaire and still own 30% of easyJet?

So, the first thing we think that makes us different is that we are open-minded value investors who search for high return businesses in some places that are not so obvious today. We agree with Warren Buffett, but buying a wonderful business at a great price must be better than buying a wonderful business at a fair price.

Secondly, we seek to invest in businesses where a "competitive moat" is observable. This means that we can watch and understand how the business is maintaining its advantage over competition. Quite often this involves primary research. For example, for our food delivery investments, we track restaurant coverage, prices and user interfaces. For Sports Direct, I was sitting behind Linda Ashley when Mike presented at the Parliamentary Select Commons Committee. If you looked at my Google Maps, you might find it strange to see every Domino's pizza shop and crematoria labelled, but geospatial analysis has been pertinent to our investments in Domino's and the funeral business, Dignity. If we can observe when a company's moat may be shrinking or growing, we think we can invest with greater confidence and potentially lower the probability of making misjudgements.

Thirdly, I regard Artemis Alpha as "owner-operated". Artemis current and ex-employees own approximately 20% of the vehicle. I have invested a significant proportion of my own savings in the trust. I regard this as important for the same reasons I value management having a stake in the company they run – it provides freedom for long-term focus and a true alignment of incentives. I believe we run the vehicle as if we were the last clients invested. So, for example, "run your winners" is a theory I heavily subscribe to. In practice, this means tolerating outsized positions for periods of time to maximise long-term returns. In our current structure, I believe we have freedom to pursue these aims without pressures that others might face. On top of this culture, we still benefit from all the wider scale and resource of Artemis.

Portfolio

We are firmly of the view that technology-driven disruption remains the single biggest risk and opportunity for businesses. A significant proportion of our portfolio has been invested in areas that stand to benefit from digitalisation. In our overseas allocation, this includes holdings in **Nintendo**, **Prosus**, **Facebook** and **Alibaba**. We have tended to make purchases when these companies have stumbled. We had an opportunity to invest in Facebook in 2018 due to the Cambridge Analytica scandal, and Alibaba in late 2020 when "Jack went missing".

However, our single biggest sector position is in online food delivery where we are invested in **Just Eat Takeaway** and **Delivery Hero**. We think online food delivery for restaurants is like e-commerce retailers, but at a much earlier stage of the consumer adoption cycle and with significant scope for innovation to expand the market. For anyone sceptical of this assertion, consider that Meituan, the dominant food delivery platform in China, was only founded in 2010 and currently has a market value of $280bn, which is nearly double the size of the FTSE 100's largest company.

We also have investments across a range of companies where we consider digitalisation to be a likely tailwind when it isn't priced as such. For example, banks, where we think the scope for digitalisation to reduce costs is significant. Santander's Ana Botin has talked about a target cost-to-income ratio for their bank of 25-35% compared to 49% at Lloyd's and 63% at Barclays in normal times. With developments in AI, straight-through-processing and video-conferencing, we think the future of banking will be digital, and with that could come a transformational reduction in costs.

One of our largest investments is in **Frasers Group** (formerly Sports Direct). Unlike many retailers, Frasers is looking to the future with a core set of competitive advantages – valuable owned brands and a scaled low-cost logistics network in sports and luxury retail. The valuation opportunity seems to have arisen because of Brexit and perceptions about Mike Ashley. We have watched the business closely since 2015. In our view, Ashley is misunderstood and not given credit for a business strategy that is uniquely long-term, innovative and opportunistic. For these reasons, Ashley has opportunities to succeed when many past competitors are no longer in business.

The portfolio has a range of investments that are somewhat idiosyncratic. **IWG** (formerly Regus) stands to benefit from a shift to flexible working and a shift to a capital-light franchising model, which could unlock capital and growth potential. **EssilorLuxottica** is the largest and only integrated manufacturer of optical lenses and frames globally. The business has clear demographic tailwinds and could deliver higher operating margins, as the 2018 merger is completed. **Dignity** is uniquely positioned in the funeral industry as an owner of funeral directors and crematoria. Like EssilorLuxottica, the industry is attractive as it is predictable, acyclical and growing. We see enormous potential for the company to pursue a strategy for growth that fully leverages its market position and network.

Drawdowns in equity markets cause pain in the short-term but can be useful for the long-term opportunities they create. We view 2020's drawdown in this way and believe the actions we took leave us well placed to emerge with a more valuable portfolio than we had before. Whilst the Trust made good progress in 2020 with a 10% increase in NAV, we do not think this reflects the significant potential we see across a variety of our holdings. The impact of capacity rationalisation, continued digitalisation and prospects of a robust economic recovery after the pandemic, all serve to make us confidently optimistic about the portfolio's prospects.

Kartik Kumar
January 2021

NEGATIVE INTEREST RATES

The Deputy Governor of the Bank of England (BoE) and CEO of the Prudential Regulation Authority, Sam Woods, has written to banks asking about their "operational readiness" for a zero or negative interest rate policy (NIRP). Although they call this communication "structured engagement" and say it is not indicative that the Monetary Policy Committee (MPC) will employ a zero or negative rate, it clearly indicates they are considering it. One member of the MPC, Dr Gertjan Vlieghe, is apparently in favour of this policy.

Why and how might it work? For some time the UK economy has been growing relatively slowly. That is despite interest rates at 0.1%, significant quantitative easing and a large government deficit. Some criticise the commercial banks for sluggish lending causing the real economy to be starved of investment. There has always been an assumption, at least in textbooks, that interest rates could not go negative. Perhaps, if they were, this might cause money to flow into the economy. The BoE would charge commercial banks who have deposits with them a penalty. This would force, or at least encourage them, to look at ways of lending more money instead.

However, since the 2008/09 recession there has been a tightening of "macro prudential regulation". Basel III banking requirements insist on a "liquidity coverage ratio" so that banks can fund their assets if, for example, the inter-bank market closed. Liquidity coverage is provided largely by cash reserves at the central bank. Regulation combined with NIRP would therefore force banks to hold cash at the central bank and also be charged for it.

Furthermore, Basel III also requires banks to retain higher levels of capital for more risky loans. Most commercial banks now have far more capital than they did before the financial crash in 2008/09 for this reason. This discourages more lending and also does little to attract more capital into the industry. One only needs to look at the valuation of banks on the London stock market to see they are often worth less than their net asset value.

Although bank capital requirements have been relaxed during the Covid-19 pandemic there has been little effect on bank lending in recent months. As many loans are for periods of several years a temporary capital easement during the pandemic has been relatively ineffective.

What about other countries or regions that have tried it? Sweden was the first central bank to introduce a negative interest rate in 2009. Since then both Japan and the EU have also introduced similar policies. Although the effect on inflation has been relatively modest in Sweden there has been a significant effect on the exchange rate, the housing market and a rapid increase in household debt. Indeed, in 2016 credit controls were introduced to dampen speculation. In Europe, inflation remains well under control but bank lending has also recently slackened following the big rises caused by distressed companies drawing down credit lines. Japan has followed a similar path for a long period though there are some tentative signs that bank lending is increasing a little. Some borrowers in European countries have benefited from "reverse charging" mortgages. It is hard to see significant signs of improved economic activity in countries with NIRPs.

Our conclusion at Rossie House is that NIRP would cause our clients some damage (you may be charged to hold cash), would distort economic incentives, be contradictory for bank regulation and would be ineffective in promoting higher growth.

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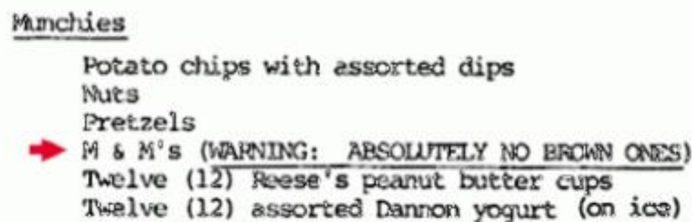
CHECKLISTS AND BROWN M&Ms

In the early eighties, Van Halen was one of the most successful rock bands of its time, fronted by Diamond Dave, David Lee Ross. As Ross explained in his autobiography – *Crazy from the Heat* – "Van Halen was the first band to take huge production into tertiary, third level markets." Their convoy of nine 18-wheeler trucks packed with the latest sound and lighting equipment would roll in to aging American venues. Months earlier, promoters for the venues would be sent the "Rider", a performance contract that laid out line by line what was needed by the band – a checklist. The rider read like a version of the "Chinese yellow pages" according to Ross, making sure all went smoothly on the night. Buried in clause 126, page 40 was the no brown M&M's clause:


Munchies

Potato chips with assorted dips
Nuts
Pretzels
M & M's (WARNING: ABSOLUTELY NO BROWN ONES)
Twelve (12) Reese's peanut butter cups
Twelve (12) assorted Dannon yogurt (on ice)

[excerpt from Van Halen Rider]

Not that surprising you might say, those egotistical rockers were signalling to everyone who was in charge. In fact, it was an ingenious safety check. Ross tells in his memoirs – "When I would walk backstage, if I saw a brown M&M in that bowl, well, we'd line-check the entire production." Inevitably they would find a technical glitch or, as was the case in Colorado, the entire show was forfeited as the local promoter had failed to read the weight requirements for the arena floor. If Van Halen use checklists perhaps we can all learn something!

Our world is getting ever more complex. As knowledge and understanding of just about everything accelerates, the human brain has struggled to keep pace. Take for example the medical profession which Atul Gawande discusses in his eye-opening book, *The Checklist Manifesto*[1]. The World Health Organisation (WHO) in its classification of diseases recognises over 13,000 ways the body can fail. For each of these there are certain actions doctors can take to help, some of them mind-bogglingly intricate – think cranieoctomy.

To cope with this complexity, the medical profession has chosen to specialise, creating distinct fields of practice which, in the modern era of medicine have fractured into areas of super-specialism. And yet, of the many deaths from surgery each year, it is thought that at least half are avoidable. Where experts fail, the answer it would seem, is to turn to the humble checklist. The WHO developed a surgical checklist during 2008 that was piloted in eight hospitals around the world. The results showed that following its introduction, major complication after surgery fell by 36% and deaths by a whopping 47%. These results are hard to ignore.[2] What it shows is that even the brightest and best make errors, miss things or fail to spot subtleties, and it is here where a simple checklist can be crucial.

Closer to home, we have noticed some of our fund managers making use of checklists – the investment world is of course full of complexity and nuance. Take Findlay Park, whose investment philosophy is implemented by assessing stocks against a checklist of 29 questions. Similarly, Baillie Gifford, and the managers of the Scottish Mortgage Investment Trust have a series of questions they ask companies to build a framework for analysis. This is not just coincidental in our view but a measured form of risk management taken by these venerable investment firms.

Checklists are no fun, they are boring to follow and if we are honest, poke at our egos. Think about it, if we have years of experience, have trained and studied rigorously in our field, surely this accumulated knowledge and understanding is sufficient? Depressingly, the answer is an unequivocal, no. Our brains (we) are all too fallible. There is a responsibility on those facing complexity, and arguable in many other circumstances, to recognise the power and simplicity of the checklist. If Van Halen can make them work, there is hope for us all – "go ahead and jump"[3] – try them.

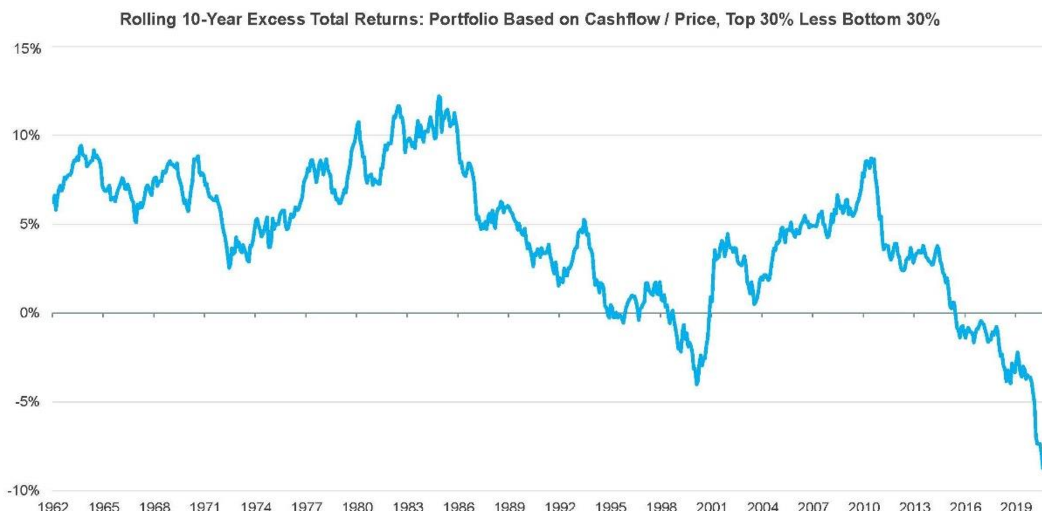
[1] Atul Gawande's book *The Checklist Manifesto* was used extensively to support this piece.

[2] It may reassure you to learn that Lord Darzi (Health minister 2007 to 2009) launched a campaign to implement the checklist nationwide in the UK, shortly after the WHO research pilot.

[3] Lyrics taken from Van Halen's most successful single – Jump.

GROWTH PHILOSOPHIES

There is considerable long term evidence that value investment strategies have outperformed equity market index returns. However, during the last decade a value-based investment philosophy has proved disappointing.



Past performance is not a guide to the future. The price of investments and the income from them may fall as well as rise and investors may not get back the full amount invested

In contrast, growth strategies have been highly successful. Those who have held high weightings in technology stocks and the US equity market (which has a large representation of technology shares) have been star performers. The question is why has this happened and will these trends continue?

It is perhaps easier to answer the first question. Since 2008 interest rates have continually been reduced to their current historic low as economic growth and inflation have been lacklustre. As discussed elsewhere in this Periodical, in some cases rates are actually negative. One way of valuing a company's shares is to discount all future cash flows. Discounting profits a long way ahead with a very low interest rate makes companies much more valuable.

It is also the case that in a slow growth world, companies that have been able to demonstrate fast growth have, quite understandably, been rewarded with higher valuations.

It is usually harder for a big company to maintain high growth rates. This has been less true for some technology stocks which have been assisted by network effects – where the use of something improves with more users. Consider companies such as Facebook or Twitter. The more users they have the more choice and variety of content is available, making it a more valuable and enjoyable experience. Growth rates in such businesses have been higher and persisted for longer than might have been expected.

In the past, most companies that grew quickly required capital to do so. This in turn, led companies to seek a stock market listing in order to access such funding - more recently, this dynamic has not always rung true. Many technology companies have been able to grow with much less need for significant sums of capital, enabling some to stay private until they are considerably more mature and valuable.

Google, for example, can simply add more servers to allow their algorithms to be distributed to more users. Furthermore, geographic expansion is a doddle as long as your customers have internet access and a friendly government. Expensive factories, multiple branch offices and working capital are less needed.

For all these reasons growth companies, especially in the technology sector, have been wonderful performers. Earnings growth has been substantial, there has been no dilution by capital raisings and the ratings for those stocks have risen. It has been a powerful cocktail for outperformance – ask shareholders of Scottish Mortgage Trust or Herald Investment Trust.

In contrast, so-called value investors have had a rotten time, especially in the UK equity market. Why is this and why has the UK stock market been one of the hardest hit? Some of this has undoubtedly been due to Brexit concerns and some because it has relatively high weightings in sectors that have been out of favour.

Buying depressed "value" shares with an expectation of recovery has often seen hopes dashed. The well tested historical norm of "reversion to the mean" seems to have gone out of the window as the price paid for shares has become relatively unimportant. Die-hard value investors have been wiped out. Witness Neil Woodford, poster boy of value investing, having to close his business (albeit partly due to the illiquidity mismatch between the stocks he held and his fund structure) last year.

Much of this can be explained by disruption from new technologies causing many businesses to be cannibalised (think Debenhams) or simply to become obsolete. One only needs to look at any high street to realise this. Especially during the pandemic, it has become ever more obvious that Amazon and its online peers are making retailers' lives very difficult. But it is not just the high street. Practically all industries are affected; car dealers (Auto Trader), offices (IWG), cinemas (Netflix) and media (Twitter, Facebook) to name a few, the list is endless.

Herd behaviour and the fashion for passive investing – mimicking an index – may also explain some of these trends. As these fast growing companies have grown bigger and their growth rates have been sustained for longer than might have been expected, index funds have been forced to buy ever larger amounts of them. For example, the top five companies in the US now account for 22% of the S&P 500 Index; a higher concentration than at the time of the 2000 TMT bubble. This creates a momentum in itself dragging other investors in to keep up with low cost alternatives.

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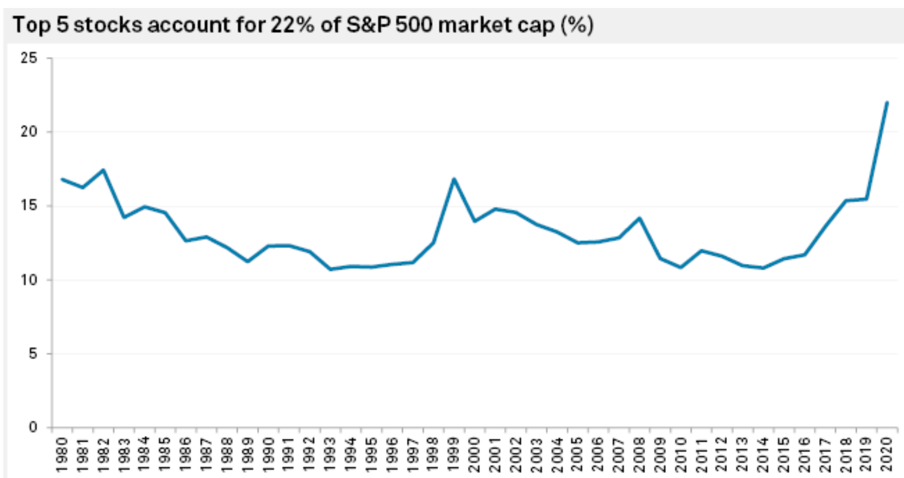

The price you pay for an investment has historically been important. This is not to forget that buying a bad business is almost always a bad idea. As Warren Buffet is famous for saying "When a manager with a reputation for brilliance tackles a business with a reputation for bad economics, the reputation of the business remains intact." Older investors will, however, remember the so called "Nifty Fifty" stocks in the US. An example of these and their performance in the early 70's (see table below) show what can happen when overpaying. Valuations can run ahead of themselves on occasion and we think we are nearing that point. However, there can be no doubt that identifying successful growth companies is still a hugely successful strategy. Even better, buying an out of favour stock on a low valuation that then becomes a growth stock – this provides the very best returns.

Name	1972 Peak P/E Valuation	Returns from 1973 to 1974 Market Trough	Returns from 1973 to 1977
Polaroid	90.7	-79%	-70%
McDonald's	85.7	-49%	-29%
Walt Disney	81.6	-65%	-56%
Baxter Travenol	78.5	-45%	-32%
Automatic Data Processing	76.2	-68%	-23%
Intl Flavors & Fragrances	75.8	-33%	-43%
Avon Products	65.4	-80%	-56%
Rite Aid	64.7	-93%	-61%
Avery International	64.2	-20%	-55%
Hewlett-Packard	63.1	-18%	-9%
Emery Air Freight	62.1	-33%	-28%
Johnson & Johnson	61.9	-29%	-38%
Digital Equipment	60.0	-45%	-91%
Kresge (now Kmart)	54.3	-42%	-32%
Wal-Mart Stores	52.3	-45%	8%
AMP	51.8	-24%	-23%
Black & Decker	50.5	-59%	-9%
Schering-Plough	50.4	-22%	-50%
American Hospital Supply	50.0	-43%	-46%
Burroughs	48.8	-25%	-34%
Xerox	48.8	-44%	-62%
Eastman Kodak	48.2	-42%	-53%
Coca-Cola	47.6	-48%	-37%
Texas Instruments	46.3	-10%	1%
Eli Lilly	46.0	-15%	-44%
Merck	45.9	-29%	-30%

Name	1972 Peak P/E Valuation	Returns from 1973 to 1974 Market Trough	Returns from 1973 to 1977
Corning Glass	42.9	-53%	-32%
Upjohn	41.1	7%	-35%
Chesebrough Ponds	41.0	-39%	-16%
Minnesota Mining (3M)	40.8	-25%	-29%
American Express	39.0	-55%	-26%
American Home Products	38.9	-16%	-21%
Schlitz Brewing	38.7	-42%	-72%
IBM	37.4	-42%	-11%
J.C. Penny	34.1	-47%	-54%
Squibb	33.9	-59%	-46%
Procter & Gamble	32.0	-22%	-13%
Anheuser-Busch	31.9	-43%	-49%
Sears Roebuck	30.8	-46%	-38%
Heublein	30.1	-49%	-47%
PepsiCo	29.3	-49%	4%
Pfizer	29.0	-39%	-28%
Bristol-Myers	27.6	-36%	15%
General Electric	26.1	-43%	-9%
Revlon	26.1	-33%	41%
Phillip Morris	25.9	-24%	10%
Gillette	25.9	-61%	-46%
Louisiana Land & Exploration	25.6	-48%	-24%
First National City	22.4	-28%	-20%
ITT	16.3	-63%	-19%
Nifty Average	46.8	-41%	-31%
S&P 500	19.2	-37%	1%

Whilst Rossie House clients have participated in the trend for growth investing, we hope in most cases sufficiently, there is no doubt that the level of outperformance is causing us to look carefully at some of the more successful funds.

Our long held strategy has been to hold a portfolio of funds, offering a blend of investment styles, managed by the most talented managers we can find. We will never bet the ranch on any one strategy. At the same time we usually look to trim holdings when they rise much above 10% of a portfolio.

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SPECULATION! CRYPTO CURRENCIES

Equity markets have recovered swiftly from the lows in March last year. This follows on from a generally buoyant period since 2008/09 – the last big recession and stock market fall – and some signs of speculation are now becoming apparent.

To start with, the IPO (initial public offering) market is hot. For example, last month Affirm Holdings doubled on its first day of trading in the US. This is not untypical. Many recent stock market listings have been loss making. Multiple SPACS (special purpose acquisition companies) have been launched where investors fund vehicles to acquire companies in the future. Capital is trusted to managers before even knowing what it may be invested in.

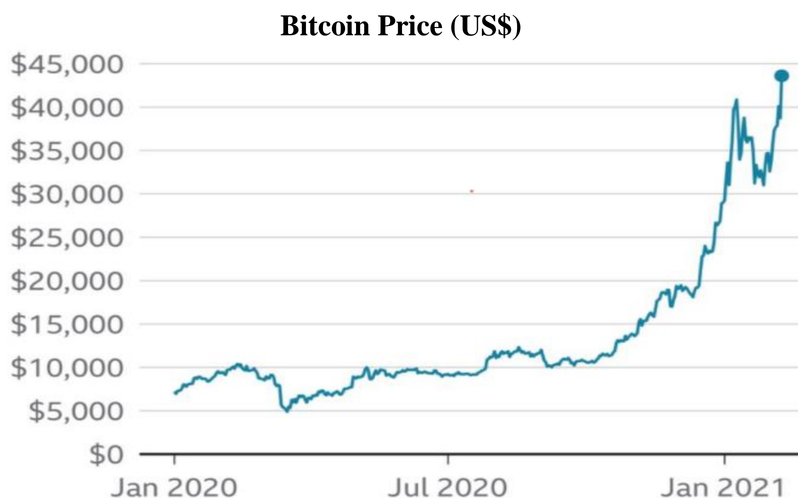
The markets for housing, art, vintage cars, wine and other assets are all strong. In many cases assets are purchased without even being seen – perhaps a reaction to being locked-down and the vast quantities of money that have been printed to prop up economies. However, there is one asset class that is causing particular concern for those in authority.

Regulatory authorities, including the FCA here in the UK as well as Madame Lagarde of the European Central Bank, have been warning about crypto currencies in recent days. University graduates are all over them, some having paid for their tuition fees and now holding house deposit sums after investing their (usually parentally funded) allowances into crypto currency some time ago. Why, they ask, are the so called professional fund management community so slow in buying them? Indeed so! Returns have been fabulous.

An intelligent and thoughtful client recently asked for Rossie House's views on crypto currencies, especially Bitcoin. We wrote about blockchain, the underlying technology that supports them, in Periodical 3. It is a subject we know a little about but we confess we are not experts. They are a relatively new asset and, we should acknowledge, becoming of significance. Several years ago a highly respected investment veteran in Scotland told an acquaintance he had invested a large sum into crypto currencies. Just weeks ago, Ruffer Investment Company (widely held by our clients) announced a much publicised investment – a 2.5% position in Bitcoin.

So why don't we invest? Well, our starting position is that Rossie House will not typically invest in anything that we do not properly understand. We also like to know the people behind what we invest in. We hope that clients find that reassuring; we feel it is fundamental. Bitcoin is a relatively new and untested asset. It has only been around for 12 years and has barely been through an economic cycle. The founder, a person (or group of people) going by the name Satoshi Nakamoto, has never surfaced in public.

Further, they are highly volatile. Bitcoin reached around $20,000 back in 2017 only to fall to $3,000 a year later. At the time of writing it is now trading at $43,600 as it is reported that Tesla has bought $1.5bn worth.



We quite see the, in theory, scarce asset quality of Bitcoin. For sure there is a theoretical need for "stores of value" at a time when QE has been prolific. But we do not yet fully understand and believe in the supply constraints of crypto currencies. If Bitcoin's technology were hacked what might that do to its value – would supply not become compromised? Also, the number of crypo currencies is increasing; Ethereum, Ripple, Cardano & Litecoin to name a few. Scarcity value may be declining?

Another basic rule for us is to know that the custody of any asset is as safe as possible. Holding crypto coins is notoriously difficult. There are many articles circulating about those unfortunate individuals who have forgotten or lost their access codes to a Bitcoin fortune. One, Stefan Thomas, has two attempts left to guess his password to access his £180m fortune!

Bitcoin is certainly becoming more mainstream. Paypal recently allowed Bitcoin to be bought, sold and held through their service and Tesla now appears willing to accept Bitcoin to purchase their cars. But we also know that much of the use and transactions in Bitcoin are for illicit purposes. The dark web is, apparently, a major user of Bitcoins; something that all reputable countries would rather not be the case. There is also its environmental impact. It is estimated that Bitcoin 'miners', who use huge quantities of computing power to run highly complex calculations to win new coins, consume the equivalent of Chile's annual energy consumption - 78 Terawatt hours.

We think there is much more to know about all this and we do not discount Rossie House clients holding crypto currencies directly in future. In the meantime we prefer the tangible security of gold, an asset that has been around for millennia and which has a well understood history of holding its value over long periods and through many different and difficult environments.

Rossie House Investment Management LLP is authorised and regulated by the Financial Conduct Authority and as such is required to state that:

(i) the value of investments and income derived from investments can fall as well as increase and the investor may not get back the amount invested,

(ii) past performance is no guide to the future, and

(iii) the levels and bases of, and reliefs from, taxation can change.

As the issuer, Rossie House Investment Management LLP has approved the contents of this publication.

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