The kindness of strangers – revisited

“For investing to be reliably successful, an accurate estimate of intrinsic value is the indispensable starting point. Without it, any hope for consistent success as an investor is just that; hope.”

These words of wisdom were penned by Howard Marks and are taken from our oft quoted book ‘The Most Important Thing – Uncommon Sense for the Thoughtful Investor’. A couple of very dog-eared copies sit on our desks, testament to the invaluable guidance it has provided to us over the years. One of the key messages, which applies in all walks of life – but especially to the investment community – is the importance of recognising the relationship between value and price, and identifying when one has become disconnected from the other. This brings us to the image below;

Whenever any of us think about buying something, price usually plays a role in our decision making process. Consider buying a T-shirt, we are faced with a wall of choice, either online or in a shop. It is likely few of us would define ourselves as T-shirt ‘experts’ and once we have narrowed our choice by style and colour, we will have to come up with some way to finalise our selection.

We invariably use price in two ways. First, it is an indicator of quality; a very inexpensive T-shirt will be indicative of cheap materials and poor manufacturing. An expensive garment must, surely, be made of superior materials and may well involve some creative design and artisanal elements.

Second, we make a judgment about whether the product is fair value. We generally do not want to overpay for something and like to feel we are getting value for money.

The T-shirt pictured retails for £795 and – according to one fashion magazine - ‘we should all want in on this super cool T….get it before it’s gone, as we predict a sell out’. Whether you consider yourself to be a dedicated follower of fashion, or not, we sense a disconnect here between value and price. The item may well be hand stitched and there is no doubt Gucci is one of the fashion brands of the moment, however, it is only a T-shirt. We would argue this does not represent value for money and would look to spend our hard earned cash on other things. Others will disagree with this view and the fashion magazine may well be right in predicting a sell out.

Our message from this journey into high fashion is price and value are subjective and a matter of opinion. Moreover, whether you are buying clothes or putting capital to work in an investment, the most important consideration is not accounting or economics, but psychology. The key is who likes the investment now and who doesn’t; as price movements will be determined by whether, in the future, it is liked by more or less
people. It is, in essence, a popularity contest and the safest and most potentially profitable approach is to buy something when no one likes it. Over time, at least in theory, its popularity - and thus its price - can only go one way; up.

**The Wisdom of Crowds**

Regular readers will recall this was the title of our quarterly commentary last July, written in the wake of the UK’s EU referendum vote. You will be pleased to learn we do not propose to dwell on the controversies of this topic; instead we have chosen to reflect on the current psychology impacting the value and price of UK assets.

The Office of National Statistics has just issued its latest raft of numbers, which provide a rather downbeat insight into the economy. For example:

- The saving ratio fell to just 1.7% in Q1, 2017, meaning Britons saved a smaller proportion of their incomes than at any time since records began in 1963
- Real household disposable income fell 1.4% and, adjusted for inflation, was down for a third straight quarter. The last time such a sequence of declines occurred was 40 years ago
- The current account deficit widened to £16.9bn, from £12.1bn in the previous quarter
- Net trade knocked 0.8% off GDP, leaving the economy growing at the slowest pace across G7 nations

We are very aware quarter-on-quarter data can be volatile and it is not sensible to place too much weight on one set of numbers. In general, the economic data, up to May, has not made for good reading, but analysis at the sector level reveals a more mixed bag - both good and bad. That said, a deteriorating trend would appear to be emerging, which could worsen further, given domestic political uncertainties and Brexit negotiations.

Against this backdrop, it is very easy to see why investors may be reticent to commit capital to UK plc and, referencing our earlier comments, why it is not winning any popularity contests. However, we recently learned there is a very interested investor with significant buying power, and one seemingly believing a price/value disconnect has tilted very much in their favour; namely China.

**Cumulative Chinese investment per capita**

![Cumulative Chinese investment per capita](source; Toscafund 2017)
The chart clearly illustrates, across Europe, the UK has been a stand-out destination for Chinese investment. Moreover and, no doubt, contrary to expectations – most certainly ours - this flow of inward investment has actually accelerated post 23 June 2016, to the point one-fifth of all Chinese investment (since 2005) has arrived during the last 12 months. The charts and supporting information were sourced from Dr Savvas Savouri, partner and chief economist at Toscafund Asset Management LLP, a London-based hedge fund. A couple of weeks ago, Sav kindly spent some time in our office reviewing his discussion paper “The Wealth of Nations, in China’s hands”, which provides a deep dive into China’s strategy of deploying its wealth across the globe. In this excellent paper, Sav argues China is ‘motivated very much by its self-interest in developing areas that can be of use to its economy in providing offshore centres to house its firms and people.’

**Chinese investment by sector per capita**

![Chart showing Chinese investment by sector per capita](chart.png)

Source: Toscafund 2017

The subsequent chart provides insight into how diverse this investment strategy is in terms of sectors. For example, China has taken a 11% stake in National Grid, supporting a vital part of the UK’s infrastructure and, in the summer of last year, acquired Odeon and UCI Cinemas in a c.£1bn deal. It would seem UK assets have become more attractive to this investor and the price is clearly right, helped by the fall in sterling.

Moreover, this investment is not concentrated in London and the south of England – far from it; these capital flows are being committed to the regions, particularly in the Midlands and the North. Interestingly, Sichuan Guodong Construction Group has partnered with Sheffield City Council to fund the city’s first ever five-star hotel, as well as new office and leisure developments alongside high end and affordable housing.

**Implications for portfolios**

As a team, we like to be contrarian. At a time when a lot of money is flowing into allocations we have long held, namely European and – increasingly – emerging market assets, we wonder whether the UK deserves a second look? As Sav eloquently articulates, Beijing’s commitment to the UK ‘is in no way being made out of altruism or benevolence.’ To say UK plc is benefitting from the kindness of strangers is naïve, but it would appear a long term strategy is in place and – in China’s view – value has emerged
at the right price. It is also a timely reminder for us to revisit our UK expectations and exposures; to determine whether we should reposition or add to this increasingly unloved market.

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