

Eyes On The Prize

Just what is going on? Although equity markets scraped and banged into positive territory in the first quarter of 2023, it was a painful, gritty experience. Inflation is proving stubborn and interest rates are still on an upward trajectory. Any sense of relief that central banks may be considering a long-awaited pivot evaporated in the wake of the latest banking crisis. Not much to cheer about then. Not yet, anyway.

And why is it always the banks? No fewer than three US banks went the way of Lehman Brothers during the quarter. The highest profile of these, Silicon Valley Bank, was undone by having to realise losses from its government bond portfolio (oh, the irony) to meet spiralling depositor withdrawals. To this unhappy trio was added Credit Suisse whose obituary will refer to a long illness punctuated by astonishing acts of self-harm. It is not known what UBS did to upset the Swiss regulators, but being forced into an unwanted partnership with one of their once greatest rivals must sting, to say nothing of the management time such an arrangement is now going to absorb.

But are things really as bad as they look? After years of near-zero interest rates, an adjustment to a new era of 4%+ base rates and bond yields was inevitably going to be painful. The banks are not out of the woods yet, but unlike the European integrated banking model, the US has over 4,200 federally insured banks and financial institutions. A failure rate of less than 0.1% hardly constitutes a crisis. Unwelcome though any bank failure may be, Silicon Valley Bank is not HSBC.

There are other reasons why comparison with the 2007/2008 global financial crisis is flawed. Banks today are better capitalised and more tightly regulated; the mortgage market is stable (albeit house prices are falling as fixed and floating borrowing costs rise). Also, regulators and other policy-makers have demonstrated their ability to move quickly if needs be (sign-off for the Credit Suisse deal was completed in a weekend, thereby preventing possible Monday morning contagion). This time, at least, derivatives do not appear to have made matters worse. Other financial horrors may lurk in the shadows, but it would take a serious spike in interest rates to unleash them. We are not expecting that.

So far, the Federal Reserve Bank has handled the recent seismic shifts in financial markets adeptly. The recent quarter-point rise in the all-important Fed Funds rate (to 4.75%) acknowledged the threat to market confidence posed by the banks, whilst keeping an eye on their own prize (lower inflation). This is not as easy as it sounds. Inflation in the US is still running at 6%, well above the 2% target. Yet inflation expectations remain very low, currently at around 2.2% on a 5-year view. This so-called five-year, five-year breakeven rate has been steadily falling since peaking at 3.6% a year ago. Even if inflation isn't conquered yet, the direction of travel is the right one. This is reflected in bond markets where the yield curve is also predicting a fall in rates as well as anaemic GDP growth. Countries may drift into recession; at least the UK and parts of Europe. It certainly feels that way on the street.



Don't be distracted.

With so much uncertainty around, it is no surprise that equity markets are struggling to decipher unusually mixed messages. One hangover from the pandemic has been the low unemployment rate, caused not by mass layoffs but by a shrinking workforce. Input costs (heating and fuel) have been falling alongside energy prices after a warm European winter. Supply-chain bottlenecks have unwound as China has emerged from self-imposed purdah. On the other hand, output costs have been rising as workforces have demanded higher wages to compensate for rising prices and the scarcity of skilled labour. Equilibrium will eventually be reached, but once again, it has left equity markets in no-man's land.

Waiting for the cycle to turn is frustrating from a capital growth perspective. Income-wise, however, investors have considerably more choice than for many years. Although it already feels like a lifetime ago, interest rates were zero (or close to it) as recently as the end of 2021 and bond yields were not that far behind. Now, money-market funds are churning out a decent yield (4% in sterling terms, 5% in US dollars) complemented by similar yields from investment grade corporate bonds. Nor have recent events affected the ability of our equity portfolios to produce steadily rising dividend payouts.

For those investors relying on an income stream, this is good news. For those who can reinvest their dividend income, the compounding effect over time should not be underestimated. Investing when markets are low is counter-intuitive, coming as it does at a time when economic news is invariably grim. The list of suitable businesses which qualify for inclusion in our portfolios at times like these is, however, short (because the bar is set very high). Dividend payouts from companies whose share prices are supported by earnings growth, operating in relevant industries, producing things that people need or want (RIP: Kodak, HMV, and BlackBerry amongst others) with a modest amount of debt and an experienced management team, is what we are after. For these companies, falling share prices provide an opportunity, not a threat. That is where we are today.

Russell Collister

CHIEF INVESTMENT OFFICER - APRIL 2023

A Less Crowded House

'...Now I'm towing my car, there's a hole in the roof, my possessions are causing me suspicion'
(*Crowded House*, 1986).

In mid-March, our family's 'WhatsApp' page lit up with an article shared by my youngest son about HSBC's purchase of Silicon Valley Bank's UK unit for £1, to which the eldest responded glibly, 'bargain'. By Wednesday, I added to this slightly fatuous conversation with a little white lie: 'HSBC is now buying Credit Suisse for £1.50 and a tube of smarties'. Perhaps indicating just how ridiculous was the Swiss bank's plight, the eldest then responded 'are they actually?' Well indeed, one might wonder. Over the past decade, shareholders in Credit Suisse had already lost over 90% of their investment and it seemed to us that every time a banking scandal was unearthed, a bad deal brokered or a troubled investment was teetering on the edge of destruction, somewhere behind it would be this beleaguered bank. This occurred so often, it was re-named 'Debit Suisse' by the Twitterati. Sparing HSBC the trouble, the beleaguered bank was eventually rescued by its Swiss peer, UBS, for a mere CHF3bn. Incapable of focusing on more than one event per day, it should not have been surprising that the market and its associated media finally took notice and was spooked.

At the same time, a plethora of smaller US banks, no longer in the catchment of regulatory stress-tests thanks to some nifty deregulation by the Trump administration, also went to the wall. Previously a motto employed by Facebook's Mark Zuckerberg, it's now the Federal Reserve which has 'moved fast and broken things'. In one way, higher interest rates and financing costs were always going to be a regime change for those companies which had, until this point, been the beneficiaries of 'free money'. While depositors are cheering having something to look at on their interest statement for the first time in over a decade, those businesses which survived on fumes will continue to fail, as they really should do, while monetary policy attempts to normalise. Undoubtedly, the pace at which the Federal Reserve and other central banks have raised interest rates has worsened the impact. Having been behind the curve, this was further steepened by Russia's invasion of Ukraine in 2022, taking large swathes of energy and agricultural commodities out of the equation and leading to the kind of inflation central banks could do little to control.

In another way, a 'savings and loan' style string of small bank failures in the US should raise eyebrows with regulators. Silicon Valley Bank is the US' 16th largest bank and while its clients, largely venture capital start-ups, were systematically more segregated than the counterparties associated with either Bear Stearns or Lehman Brothers in 2008, a bank of similar market capitalisation in Europe or the UK would have been stress tested (and found wanting). Lessons must therefore be learned and it is dispiriting that tighter regulation was 'undone' in advance of these events. The CEO of BlackRock, Larry Fink, is absolutely right to suggest that this new regime of tighter monetary policy and persistent inflation could cause a 'slow rolling crisis', which will ultimately knock out some of the market's more leveraged, less well-capitalised players. Ultimately, however, this is a good thing for what some business academics have coined 'The Halma Model'. This is a type of company (named after the practice by Halma PLC) which has the benefit of strong free cash flows from diverse revenues, using these cash flows, rather than debt, to make small, synergistic acquisitions over time, thereby further boosting cash flows and diversity of revenues...and so on, ad infinitum (if management continues with the model). **Halma PLC** is accompanied by many other names in our stock universe in this practice, including **Diploma PLC**, **Spirax-Sarco Engineering PLC**



Dry powder for the next bank rescue...?

and **Bunzl**, to name but a few. All these companies have in common is the fact that they have used this model to successfully grow their annual dividends, usually at inflation-beating rates, over several decades.

During our own communications with these companies over the years, one common complaint from management was the lack of good quality deals available at the right price and, indeed, Bunzl was penalised a few years ago for not making enough small acquisitions as part of its non-organic growth target. It simply did not wish to overpay for assets and would not be bullied by a short-termist market view. With cheap money not fuelling debt-driven acquisitions by private equity or other parties, these companies should no longer be 'crowded out' for value-accretive deals at the right price. This is a facet of a higher interest rate environment that we should celebrate for the opportunity it presents to this type of business model. Perhaps in anticipation of this, Diploma has recently increased its deal-making firepower to the tune of £235m via a share placing, any dilution likely to be countered by ongoing acquisitions (including Tennessee Industrial Electronics, which it has just picked up for £76m).

As long-term veterans of the commercial real estate sector, we are also survivors of the GFC and are naturally allergic to buying real estate investment trusts (REITs) which have high loan-to-value ratios (LTVs), understanding that, as interest rates and financing costs rise, property becomes less attractive and falling net asset values can 'blow out' LTVs quite quickly. For this reason, we have focused on REITs with low initial leverage ratios and on the kind of property investments which have a structural, or cycle-agnostic supply/demand imbalance. One such sub-sector of the REIT market is in UK warehousing, logistics and 'last mile' property, where limited planning and land availability combined with a geography which lends itself to further growth in e-commerce should help to protect property values to some extent, even in a tightening interest rate cycle. While this has not helped sentiment at share price level for the REIT sector, some of its better-managed components, both in the UK (such as **Tritax BigBox REIT**) and in the US (e.g. **Rexford Industrial Realty Inc.** and **Prologis Inc.**), should also now benefit from competing in a slightly less crowded space, achieving higher net initial yields on property purchases (aside from perhaps picking up cheap assets in leveraged investors' fire sales). Watching poorly-managed, over-leveraged market participants failing is uncomfortable and will create short-term volatility but having greater elbow room to commit to deals will also help those participants where, despite the temptation of free money for so long, cash flow has always remained king.

Mary Tait
INVESTMENT DIRECTOR



The Communication Gap

Several years ago, I dedicated a portion of my Sunday afternoons to help coach rugby to 11-year-olds. Whilst I only fulfilled the role for a season, my brief stint as a youth coach allowed me to further appreciate the efforts of all the volunteers and sports teachers from whom I had learned over the years. Rugby was often one of the many sports they taught, and their ability to communicate the techniques needed with equal success, across the board, is something I found impressive, particularly when looking back at my own experience at coaching one sport for one short season.

I was left with similar thoughts more recently, when I had the opportunity to engage with a class of A-Level students about savings and investments. It wouldn't come as a great revelation that maintaining the undivided attention of 17-year-olds is no easy feat, but it's important to differentiate between when they're not paying attention and when your delivery of the subject matter is making it difficult to keep up. The latter perspective is probably the safest assumption to make in most cases because, even if untrue, it invites you to take ownership of the one element under your control: your ability to communicate.

This isn't unique to any one industry and is something which can be expanded widely across all settings, whether personal or professional. Whilst it may be tempting to label a frustrated or confused audience as 'difficult', this is not conducive to you both arriving at the same destination. It has become increasingly clear to me that the hardest part of learning about any industry is not necessarily the knowing of things; rather, the biggest challenge often lies in bridging the communication gap, where all parties can walk away feeling that no more questions lie unresolved. If the answers were obvious, then your services would no longer be sought after.

There's more to it than simply giving prospective clients what they ask for, or telling people what they want to hear. A few short years ago, a friend of mine asked an architect to draw up plans so that he could work on his attic during his down time in the evenings. He specified that the project needed to be achievable without having to remove the roof, which would incur a far greater expense. The architect delivered on this request in due course, only for my friend to conclude that what he'd asked for was unworkable and stupid (his words). He just wished that the architect had told him as much at the outset.

In our industry, the consideration of risk versus capacity is particularly important. What an individual wants may stand in stark contrast to what their financial situation allows. In a bull market, it's common for individuals to identify themselves as having a high-risk appetite. But if they panic-sell when the market turns, it suggests that the opposite is true. In this scenario, it seems more likely that a 'high-risk appetite' could simply have been FOMO* in disguise and it would have been better for everyone involved had we come to this conclusion before finding out the hard way.

Until recently, we spent a chunk of our time justifying why we weren't involved in the spiciest areas of the market which had continued to drive market returns. We contested that valuations in these segments of the market could not be sustained or climb



much further. Yet, continue climbing they did, seemingly unabated. One is eventually tempted to wander into such areas, particularly when avoiding them for too long could potentially lead to underperformance, which would be brought your attention at each quarterly reporting period. As such, we reiterate that investment should always be for the long term, even if quarterly reporting can sometimes make that easy to forget. Companies are also punished by the market for marginal shortfalls in quarterly results and such reactions hardly incentivise long-sighted management vision. That said, avoiding the riskier end of the market was easier to justify because, when the potential reward is not commensurate with the level of risk involved, it's simply not worth it. The wide availability of free money was the ultimate enabler of short-sighted behaviour, as prospective returns only needed to be modest to justify investment. As interest rates rose and deposits starting paying a decent level of interest, this tailwind swiftly unwound and as expected, it was these most highly-valued areas of the market which were hardest hit.

Now, we are in an environment where inflation continues to surprise on the upside, and news surrounding SVB and Credit Suisse has triggered uncomfortable flashbacks to the Global Financial Crisis. Unsurprisingly perhaps, looking at the market through a shorter-duration lens also shortens one's perspective. When unsure of how to proceed, it's important to step back and to remember what you are trying to achieve. If your long-term objective is relatively unaffected by recent events, then the answer is to stay the course. Just as avoiding the more 'exciting' prospects during the recent bull market was the right decision, now is not the time to head for the exits. Using high quality investments to achieve one's goals, an upward trend in longer-term market returns should remain relatively untainted by short-term volatility. This might seem like textbook logic but it is our duty as investment managers to consistently communicate this message to our clients and to navigate their portfolios through the interim.

Michael Craine
SENIOR INVESTMENT MANAGER

* *Fear Of Missing Out (again).*



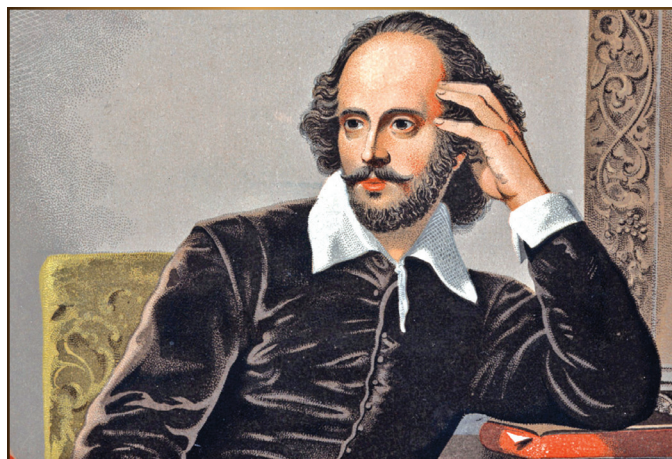
Et Tu, Credit Suisse?

Keeping one eye on the Cheltenham racing on the 15th March and the other on an evolving banking crisis, as screens turned red, it became glaringly obvious that, at least in a ten-horse race, someone wins, unlike market participants on that day. My English Literature teacher, who had a great ability to make a lesson exciting for a group of 'C' stream male delinquents, educated us on Julius Caesar and the Ides of March, but I don't recall any mention of 'et tu, Credit Suisse?'

Over the past thirty years, I have hoarded newspaper cuttings covering all sorts of market and economic events. The house is cluttered with books on similar topics, some going back to the 1930s and then there are the newspapers. Most wives would have found grounds for divorce over my newspaper habit, but my saving grace is that my father-in-law was just as bad, and heaven forbid anyone who tried to read his Daily Telegraph before the crossword was complete. When markets find a new theme, everything comes out, as history is sought as a guide to the future, but does it work?

It helps to put matters into context. It's never a first: similar themes, different names and outcomes but always with a twist. We live each moment of market chaos in front of our screens and on social media and that can be a draining experience. We can obtain instant valuations and study the impact whilst being mindful of every news topic as it unfolds, some of which turn out to be fabrications. My career started when the pace was much slower. It was a multiday task to evaluate an event on a portfolio. Indeed, to find out the price of a share it was necessary to make a call on the Stock Exchange's dedicated STX phone line and speak to a 'Jobber' and heaven forbid if you forgot to call him 'Sir'.

Valuations were prepared by hand using the Financial Times for the previous day's closing prices and would then be passed on to a typing pool, returned the next day. Out came the Tipp-Ex and line by line, everything was checked before being despatched in the post with a covering letter, never forgetting to take a copy as a reference point for next time. Some of it was even guesswork, as some clients held certificates at home while others used our nominee service and this meant heading down to the fireproof safe and reconciling all their certificates. There was no such thing as a quarter-end, benchmarks or even management fees, as the business was commission-based and not just a few basis points. It was 1.65% on the first £7,500 of consideration and 1.25% on the next £8,000. A transaction worth several hundred thousand pounds was a cause for celebration at a country stockbroker but to win such a trade often meant spending hours working out the potential capital gains tax liability. Much has changed, except for the fact that investors still stampede and investment managers still try to stand in front of them, offering sound advice and then typically buying a few cheap stocks which almost always become the best buys a few years hence. That's not to say that there are times when serious action is required, as the macro picture changes.



Shakespeare fretting about herd mentality...

Whatever the spark, capital markets can turn almost anything into a firestorm, and this works in both directions. Psychology, herd instinct; humans are like sheep. While perhaps avoiding a sheep's lifelong ambition to die in the most inconvenient place at the most inconvenient time, humans have a great ability to buy at the top and sell at the bottom. As in the crypto craze, when prices were either heading to infinity or into a good old irrational panic, we have seen 'the fear of missing out' many times over and it's not easy to resist our natural instincts and act irrationally. These traits have been capitalised upon by algorithms to the point where computers know humans better than we know ourselves. There is also a never-ending array of securities which allow positions to be taken out to cover almost any outcome or hunch, even if it's betting against a market commentator's opinion. At times, one wonders if there are any investors left, or has everyone become a speculator or gambler, seeking one-armed bandit, instant returns in a world in which both news firewalls and patience no longer exist.

Investor behaviour remains a murky area for economic research, but algorithms appear to be cracking the code in this respect. The recent past dominates our thoughts, but an understanding of historical reactions might provide us with a better outcome. People observe the behaviour of their peers. For example, a working lunch might often start with guests ordering a soft drink unless one diner orders alcohol and the rest then change their minds. What we wear, what we do during our leisure time, the car we drive; it's not that easy being different when social media influences our lives. In an age of immediate information flows, competitive, accessible markets and with the accumulated knowledge of the past, investors should not be overreacting and markets should not be overshooting, but most humans just can't help being humans and won't bury that herd instinct. This means that there will always be handsome rewards for the opportunist, those who think differently or who are, perhaps, just a little bit eccentric.

Paul Crocker

INVESTMENT DIRECTOR

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The investment team at FIM Capital Limited hopes that you have enjoyed reading our articles this quarter. If you are not currently receiving our Investment Briefing on a regular basis but would like to do so in future, or you wish to inform us of a change in your contact details, please contact Viv Hounslea at vhounslea@fim.co.im. Equally, please contact us if you no longer wish to receive our Briefing and we will remove you from our mailing list.

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