PRICEVALUEPARTNERS

"A huge structural advantage"

"Sir, As chancellor of the exchequer, George Osborne would extol the virtues of fair pay while decrying those who received something for nothing. Would Mr Osborne explain, please, how he and Blackrock determined that £650,000 a year for a day's work per week constitutes "fair pay" ?

"On the surface it may look as if Mr Osborne is receiving a chunk of money for nothing. No doubt, the pay is based in part on something, namely the contacts and privileged knowledge that Mr Osborne can bring; but they were acquired when he was chancellor paid by the taxpayer. So, should he be free to profit further from them ?"

- Letter to the *Financial Times* from Mr Peter Cave, London W1, 11 March 2017.

Of course Blackrock, as a listed business with assets under management of $5.1 trillion, is free to do what it likes with its money. Vanguard, which in the US at least is run as a not-for-profit business, has to operate with the constraints that come with being one of the lowest-cost fund providers. But that has not prevented Vanguard from attracting over $4 trillion by way of assets itself, and the company is said to have seen more inflows in 2016 than the rest of the asset management industry combined. Compared to these two firms, the newly created 'Staberdeen' (Standard Life and Aberdeen Asset Management), with its £660 billion of assets, looks like a tiddler.

Corporate Elephantiasis is all very well, but it correlates poorly with subsequent investment returns. As Merryn Somerset Webb points out in her latest FT column,

"Look at lists of top-performing funds and you will more often than not find they are dominated by small and medium-sized asset managers. You will also note that the best performance tends to come from the kind of funds that are the hardest to sell: the smaller, newer ones."

Warren Buffett, to his credit, has never made any secret of size being an anchor to performance. As he remarked in an interview with BusinessWeek in June 1999,

"If I was running $1 million today, or $10 million for that matter, I'd be fully invested. Anyone who says that size does not hurt investment performance is selling. The highest rates of return I've ever achieved were in the 1950s. I killed the Dow. You ought to see the numbers. But I was investing peanuts then. It's a huge structural advantage not to have a lot of money. I think I could make you 50% a year on $1 million. No, I know I could. I guarantee that."

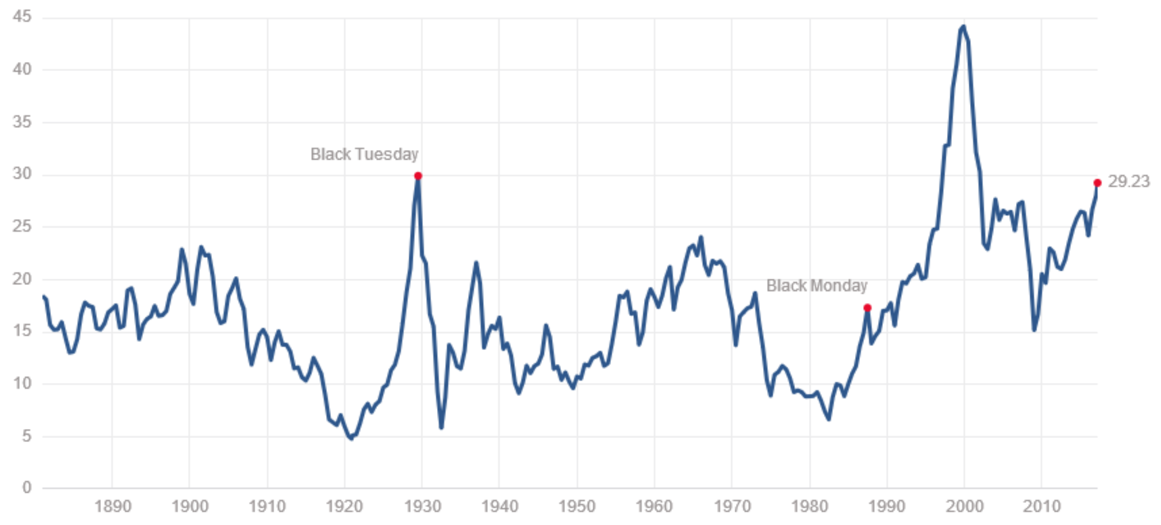
Ben Carlson recently [ran the numbers](#) on Warren Buffett's performance broken down by decade, which makes for interesting reading:

	Berkshire Hathaway	S&P 500	Annual Outperformance
1960s	28.3%	5.0%	23.3%
1970s	22.2%	5.9%	16.3%
1980s	39.1%	17.3%	21.7%
1990s	20.5%	18.0%	2.5%
2000s	5.9%	-1.0%	6.8%
2010s	17.9%	15.3%	2.6%

Note that as Berkshire Hathaway amassed more by way of capital to deploy, its annual outperformance versus the market shrank. Faced with what is likely to be a general trend across the asset gathering industry, shareholders in Staberdeen and Blackrock may not care, but investors in their funds probably should.

The Economist in its latest edition asks whether stock markets have entered bubble territory. Financial bubbles are difficult to define, but one useful description has a bubble as a market that reaches unsustainable levels, and then doubles. One of our favourite tools is Yale Professor Robert Shiller's 10 year cyclically adjusted p/e ratio, or CAPE.

Shiller CAPE ratio for the S&P 500, 1880-2017



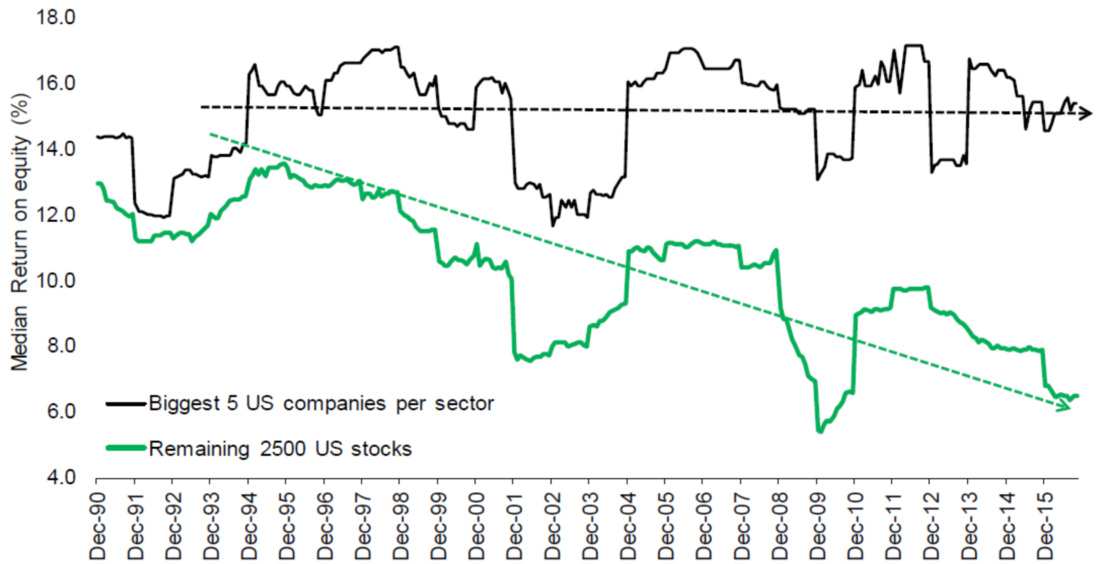
Source: http://www.multpl.com/shiller-pe/

We have no real dog in this fight, or perhaps just a puppy, since we have negligible exposure to the US stock market in either our global value fund or any of our managed accounts (and we don't engage in shorting), but US stocks, on a Shiller CAPE basis, do look expensive. At 29 times historic earnings, US stocks are trading at the same level at which they peaked on

Black Tuesday 1929. The market has only been more expensive once before, during the first dotcom boom. Just as ominously, as SocGen recently pointed out at their annual investment conference, US market breadth seems to have evaporated. As the chart below suggests, while the five biggest companies per sector are still generating decent profits, the same can't be said for the 2,500 stocks that comprise the rest of the market.

US CORPORATE INEQUALITY...

The biggest US companies remain very profitable, the rest are struggling



Source: SG Cross Asset Research/Equity Quant, Factset

We do wonder whether the failure of Warren Buffett's (and 3G's) bid for Unilever on behalf of Kraft Heinz might represent something akin to 'Peak Growth': with mega-cap corporations in many cases struggling to grow their top line, their only practical alternative is to acquire and then address the bottom line instead, through a combination of divestments and job cuts. The same defensive logic may also apply to the Staberdeen "merger". But doing this on a global scale is more difficult in a post-Brexit, post-Trump world. *The Economist* describes the problem as populism being "a menace to companies that thrive on the free movement of goods, labour and capital". We take issue with their slurs against populism, which to *The Economist* would appear to mean any form of democracy with which the editors disagree. But then we're not stamping our feet in childish outrage against the Brexit referendum – a popular vote in which more British people voted for something than ever before in history.

Yet the uncertainties remain. Most developed stock markets seem expensive, and the current rally – surely one of the most unpopular in history – is starting to look long in the tooth, and built on increasingly shaky foundations. With bond yields remaining derisory and a whiff of inflation in the air, equities as an asset class are still a place to be. Deciding which ones to own ultimately comes down to discriminating between cheap and expensive stocks. Sadly, asset management leviathans and index-tracking giants are in no position to conduct this activity. They are both obligated in their different ways to own the entire market, warts and all, either through index replication or index-tracking.

Rather than attempt market timing, we believe the pragmatic solution is simply to focus on bottom-up unconstrained value, acknowledging that such an approach has practical limitations in terms of size and scale. Greg Fisher, of the Halley Asian Prosperity Fund, points out that two large US investment firms

"..are both keen to put $1 billion to work in 'value' Japanese small caps over the next 12 months. Good luck to them with that, as they compete with other foreign investors, the Bank of Japan, the government pension fund, and other local pension funds, all bidding up the same stock."

Stocks globally, meanwhile, continue to climb a wall of worry. But as and when any substantive correction does come, assuming central banks haven't made them illegal by then, those in the Anglo-Saxon markets, having reached the loftiest valuations, will have furthest to fall. This may turn out to be a religious experience for those investors with a new-found faith in market-tracking ETFs – or in fund management colossi with nowhere to hide.

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