PRICE**VALUE**PARTNERS

Know what you know

"Happiness and freedom begin with a clear understanding of one principle. Some things are within your control. And some things are not."

- Epictetus.

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So one inauspicious date – that of the UK's official departure from the EU on Halloween – has been replaced by another. Absent some highly unusual activity in the House of Lords, the country will learn the identity of its new Prime Minister on Friday 13th of December. Of all the various options available, a Boris Johnson premiership and a majority Conservative government might finally, and perversely, allow a process of national healing after three-and-a-half-years of increasingly intense Brexit psychodrama. If the bogeyman turns out to be Jeremy Corbyn, or some coalition of the dismal, the long national nightmare will in fact have only just begun.

This correspondent got his first taste of the ultimate powerlessness of government, by comparison with the market, over a quarter of a century ago. Just as now, the problem then was Europe.

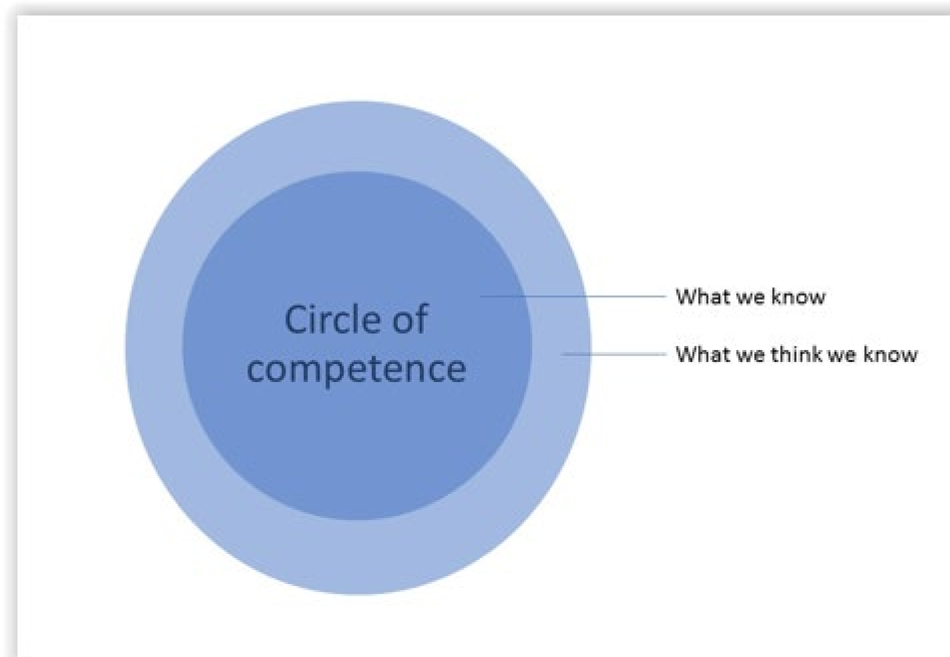
27 years ago, John Major's government was going to ridiculous, Basil Fawlty-ish lengths to keep the pound sterling in the European Exchange Rate Mechanism, but at the wrong rate. The British government, by way of the Bank of England, tried to bend the foreign exchange market to its will. It failed. There are some markets that you don't try and push around, and the foreign exchange market is one of them. The Bank hiked interest rates, twice, but to no avail. The cost of this futile exercise in proving governmental economic incompetence was so great that one magazine suggested that it was as if the UK Chancellor and the UK Treasury had spent the afternoon lobbing schools and hospitals into the North Sea. The architects of the involuntary ethnic cleansing of sterling from the ERM ? They included John Major himself, Michael Heseltine and Kenneth Clarke. You would think that the bruising experience of Black

Wednesday might have warned some high profile political catastrophes off from their costly adventuring in Europe. But there are none so blind as those who will not see. In addition to the economic damage of our European kidnap ordeal, the ERM crisis subsequently opened the door to a Labour administration that would ultimately bankrupt the country. ***Thanks, Europhiles.***

Daniel Boorstin, Librarian of the US Congress, once observed that

> The greatest obstacle to discovery is not ignorance – it is the illusion of knowledge.

Warren Buffett and Charlie Munger have long advised investors to stick within their circle of competence:



In Buffett's words,

> Know your circle of competence, and stick within it. The size of that circle is not very important; knowing its boundaries, however, is vital.

In the realm of equity investing, we try and keep strictly within that circumference of genuine familiarity. Our investible universe does not comprise the entire market of listed stocks; rather, it comprises only those shares of listed businesses that satisfy the following sort of requirements (informed heavily by the 'value' philosophy of Benjamin Graham):

- Price / book ratio of less than 1.5x
- Price / earnings ratio of less than 15x
- Cash-flow from operations yield of more than 10% per annum
- Cash from operations growth over the prior 5 years
- Return on equity of more than 8% on average over the prior 5 years.

To complement these 'hard' characteristics, we then apply some 'softer' (but no less important) ones:

- Management who are exceptional capital allocators (the evidence of which should be visible in their companies' operational and profits history)
- Management with respect for shareholder capital (who don't squander it on the likes of trophy headquarters or annual reports laden with photographs of themselves)
- Management with a history of share buybacks conducted at no great premium to underlying book value.

In recognition of a mixture of geopolitical and economic threats, we then supplement our holdings in 'value' stocks and specialist 'value' funds with some genuine portfolio diversifiers, namely systematic trend-following funds (portfolio insurance against fund manager hubris, including our own) and real assets (notably the monetary metals, gold and silver, ahead of the forthcoming inflationary crisis and the final explosion of an unsustainable global debt bubble). The relative allocations held across these disparate asset classes then become a function of our clients' risk appetite and any requirement for explicit income.

It helps when the markets hand you really special opportunities on a plate. The following analysis is from the Man Institute (hat-tip, *en passant*, to Brian Dennehy):

> Imagine a stock that had consistently achieved margin expansion and earnings-per-share growth, but had got cheaper. For a stock-picker, this scenario is what dreams are made of.
>
> As it turns out, this scenario is reality, but on a regional basis rather than describing a single stock. We looked at three components – margin expansion, multiple expansion and other earnings-per-share growth – to determine total return across four regions over the whole cycle: the US, Japan, Europe ex UK and emerging markets..
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> Our analysis showed the US experienced growth in all the three components of return. Emerging markets have been a mixed bag: margin contraction, but at least the multiple got cheaper. Europe looks particularly unappetizing, with stocks becoming more expensive via multiple expansion, while experiencing a contraction in margins and other EPS growth.
>
> ***The standout contrarian opportunity is Japan, which has seen margin expansion of 2% annualised, and other EPS growth of 0.75%, while multiples have fallen by 2.75%. This is a counter-intuitive and intriguing prospect: In other words, Japan is becoming cheaper despite having got operationally better. If Japan were an equity, it would be an overlooked value stock.***
>
> Indeed, this reinforces our positive stance on Japan and bolsters our case of Japan being a forgotten equity market.

Forgotten, perhaps, but not by us. In equities, Japan remains our single largest country allocation. (Our emphasis above.)

Some things are in our control. The valuation metrics we use to screen for stock opportunities globally are among them. As are the forms of portfolio insurance we use as protection against the unforeseen. Some things are not in our control, and domestic politics happens to be one of them. Just because you are based in the UK does not compel you to invest all of your investment capital there. The forthcoming General Election is, to our way of thinking, too close to call. But whoever wins, we will remain unconstrainedly global, as opposed to purely home country, investors. Know what you know, and – perhaps more importantly – what you don't.

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Tim Price is co-manager of the VT Price Value Portfolio and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets'. You can access a full archive of these weekly investment commentaries here. You can access the archive of our regular 'State of the Markets' podcasts, with Paul Rodriguez of ThinkTrading.com, here.

Price Value Partners manage investment portfolios for private clients. We also manage the VT Price Value Portfolio, an unconstrained global fund investing in Benjamin Graham-style value stocks and specialist managed funds.

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