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INTERVIEW SERIES: **Dr Sandy Nairn (Edinburgh Partners Ltd)**

The risk today is not buying cheap equities

Dr Sandy Nairn

Dr Nairn is the founder and CEO of the specialist fund management company Edinburgh Partners Ltd. In this interview he discusses the global investment environment and explains why his attitude towards the equity markets has undergone a radical change over the course of the last 12 months.

Last time we spoke your theme was "It Is Time to Hunker Down". You explained why caution was the imperative and cash attractive. Has anything changed?

Caution was the key because of the lack of attention being paid to risk and the consequent misalignment of valuation and future prospects. The 'decoupling' myth which suggested emerging markets were immune from the western economies and could ride to the rescue of the world economy was just the latest variation of the age old mistake of trying to convince oneself that the economic cycle has been abolished.

Superficially plausible but arithmetically impossible, this was just one of a number of indicators that we had reached the silly stage of a bull market. More simply, we found it almost impossible to find cheap stocks. The best we could do was find reasonable value in a relatively limited range of companies. Since then a number of things have changed, and that is why our stance has swung round to being much more positive about equities and much more cautious about Government bonds and cash.

What has prompted this change of view?

The first is that we are a year further on and so we're now actually in the recession. The hope that it would be avoided has evaporated and economic optimism is conspicuously absent. The discussion is not now about whether there might be a recession, but rather about just how bad it will be and whether depression is the future. Reflecting the change in conditions and sentiment, almost all asset prices, including equity prices, have fallen sharply between then and now.

We therefore have an economic environment which is characterised by pessimism and equity markets which have fallen sharply. The question now is whether they have fallen enough to discount the economic future that we face. My view is that on most historic comparisons, and modelling what happened during previous recessionary periods, it is hard to argue that equities are now in general any worse than fair value.

They may not be uniformly screamingly cheap, and it is possible that they may become so in the coming months, but that is a debate about sentiment rather than valuation. You only have to look at what has happened to the yield spreads on corporate bonds (see chart page 3) to see that risk has been repriced with a vengeance.

It is important to be open about the assumptions that stand behind this conclusion. It depends absolutely upon the view that we are not entering a depressionary period reminiscent of the 1930s.

With banks collapsing and credit disappearing, how can you be confident that we are not facing a depression?

If you look at how the current crises came about, and the reaction to it, I find it hard to see how deflation will be the outcome. What we are witnessing at the moment is a combination of two things. Firstly, we are seeing valuations drop. They are adjusting to a more realistic view of the global economy, one in which the economic cycle has not been abolished and hence one where profitability is not on a constant upward trend, as was the implicit assumption before.

Secondly, because of this economic cold shower, credit is contracting and deleveraging has become the name of the game across the financial world. The destruction of capital this entails removes the illusion of wealth creation that was associated with the flood of liquidity which washed round the global financial system from 2000 onwards. Most of the major market collapses in history were the result of some form of financial illusion, or pyramid scheme, being laid bare. This one is no different.

Surely a lot depends on how the authorities now react?

Absolutely. The crash of 1929 and the depression that followed it followed a long line of similar events in which financial distress caused massive economic contraction. Almost all the crashes between 1837 and the Great Depression followed a similar path in precipitating very sharp economic slowdowns. The reasons are straightforward. The lessons of 1929 were that when the financial system carries any risk of imploding, it must be protected; liquidity and support must be provided to ensure that the economy can continue to function and recover; and fixed exchange rates/gold standard, trade protectionism and capital restrictions must be avoided at all costs.

After some dangerously faltering steps in the early stages, it is clear that the authorities worldwide are pursuing a massive course of reflation. I believe it will succeed. Other issues will follow from that, but deflation is not one of them.

Is the reaction to this crisis not simply the recreation of conditions which brought this about in the first place?

The policy response of dropping interest rates and injecting liquidity is certainly the same. The key element is not whether this occurs, but for how long. The mistake before was to leave interest rates too low for too long. Zero or negative real interest rates in combination with 6%+ nominal GDP growth by necessity creates inflation. The most recent inflation has been in asset classes rather than in wage income, but that does not stop it from being inflation.

The problem was made worse because the longer asset inflation went on, the more it became underpinned by leverage. Leveraged overvaluation is a highly toxic mix. What caused it? The simple answer has to be that governments conspired with central bankers to create the conditions in which leverage became inevitable. Back in the 1990s when Alan Greenspan was Federal Reserve Chairman, he used the term irrational exuberance to describe what he saw as overvaluation in equity markets. Eventually, as markets continued to power ahead, he capitulated and became a 'new paradigm' convert.

This was critical because if you were willing to believe in the productivity miracle and hence in the absence of inflation, you could allow yourself a free rein on monetary policy, which he did. The stimulus to leverage was further compounded by a critical change in the US regulatory regime. The Glass-Steagall Act had effectively separated retail and investment banking. These constraints were removed in 1999 with the repeal of the Act. It meant that for the first time retail banks were able to use retail deposits as a source of capital which could be leveraged for trading and other investment banking purposes.

When combined with a Federal Reserve chairman who believed that technology-inspired productivity growth had banished inflation, the inevitable consequence was that interest rates no longer acted as a moderator of growth. It did not help that Greenspan also adopted the view that since the market's judgment was always best, inflation in asset markets could not exist. We know better now, as even he has had the grace to admit.

The firewood and gasoline were now in place. All that was required was a match. It is arguable that the tragedy of 9/11 provided it. There was already concern about growth slowing as a result of the fallout from the earlier collapse of the TMT bubble. When combined with the psychological effect of the terrorist attack, the desire to avoid a recession at all costs meant that interest rates were reduced with support from all sides of the political spectrum.

Overwhelming political will was applied to preventing a recession and promoting growth. The absence of wage inflation allowed the belief to be propagated that the economic cycle had been abolished, or at the very

Risk: Corporate Bond Markets View

The spread between the yields of high and low quality bonds are one measure of investors' risk aversion. Whilst 2007 marked the historic low, 2008/2009 may equally well mark the peak. The change in investor sentiment is demonstrated clearly in the chart. No longer is risk being ignored!

ML high yield - ML AAA

LOW: 1.736 15/06/07 HIGH: 15.139 12/12/08 LAST: 11.878 10/01/09 Sourse: THOMSON DATASTREAM

least severely muted. It encouraged the view that house prices could only ever go up. The result: the latest incarnation of the four most dangerous words in investment: 'this time it's different'.

Inflation is normally the warning sign when growth is artificially prolonged. Why was there no inflation?

The answer is that there was inflation. The difference has been that, because of the strength of global competition and the new supply of labour and products coming onstream from emerging markets, it has not shown up in labour markets, as it had always tended to do in the past. The excess liquidity this time round found its way into asset markets. Domestic property, commercial property, commodities, corporate bonds, equities; one by one the various asset classes began a seemingly unstoppable ascent.

Because wages remained relatively restrained, policy-makers basked in the reflected glory of growth and low inflation. To a man they claimed the credit for having abolished the economic cycle. As growth progressed, supply constraints on certain products combined with speculation to push up prices. Eventually the rising prices of assets began to work its way into the cost of living for residents of the developed world. The party was beginning to end. No longer were living standards rising because of lower cost imports from emerging markets. Food and gasoline costs overtook them and disposable income started falling. The cry now was: watch out for stagflation!

You have not yet mentioned the role of the banks in the development of the crisis.

As all of this was unfolding, the banks started to face a dilemma. Because interest rates were so low and capital was so abundant, it was almost impossible to conduct traditional lending at a profit. Mortgages were extremely price-sensitive and had to be more or less given away. Corporate lending margins were threadbare and sometimes even negative. The only profits that seemed to be available derived from either trading assets as a principal, or from writing insurance in the form of ever more sophisticated derivative instruments. Unlike normal insurance where the person buying the insurance needs to have an interest in the underlying asset, in the financial world there is no such binding limit. The net effect was to magnify many times over the potential costs if anything went wrong.

Both objectives were conducted with vigour, and in the herd-like manner that has so often characterised the behaviour of bank management. Perhaps not surprisingly those who appeared to be most successful also were characterised by an acquisitive tendency. In such circumstances, the greater the leverage the greater the appearance of profits. When balance sheets became stretched, many institutions actively hid the leverage off-balance sheet where neither the regulators nor investors could see it.

This was not in itself a problem unless conditions changed, but remember, policymakers the world over were busy rejoicing about the abolition of the cycle.

And where did this calculation go wrong?

The calculation failed when the mirage of the abolition of the cycle faded. As rises in food and energy prices cut into household budgets, more discretionary items had to be cut back. Employees began to agitate for higher wages to allow consumption to be maintained and the central banks responded by raising interest rates to avoid the onset of wage inflation. Faced with an attack from all sides - slowing growth, rising interest rates and too much debt – the credit bubble eventually imploded. All the equations which had been created to model risk fell apart because they had not included a sufficiently long historic picture to pick up what really happens when a deep recession occurs.

What about the worry that we are going into a downturn that is more serious than anybody has anticipated?

This worry is based on the concern that we face a return to the 1930s. For a time that was a disturbingly plausible outcome. So long as the talk was of moral hazard, there was a danger that the entire financial system would implode. The US authorities were the first to realize the gravity of the situation and whilst history may criticise the techniques that have been used, I think the outcome is that the sanctity of the banking system has been preserved.

As I have mentioned, the 1930s was not a unique event. It was merely the latest in a series of financial meltdowns which morphed into disastrous declines in the real economy. The lessons learned from that experience have underpinned recent actions and are the reason why we have not had a repeat since that time. The problem then was that liquidity was withdrawn from the banking system rather than pumped in.

There was no co-ordinated central banking system, and on top of that, you had the Smoot-Hawley trade legislation, which brought in a whole series of trade barriers and tariffs that decimated the global economy. Whilst there remain many who hark back to the supposed golden days of the gold standard, there is no question that it too was a contributory factor to the economic declines which followed. We don't have these things now.

A lot surely still depends on how politicians react – and in particular on how Barrack Obama chooses to build on his mandate as the new US President?

There are all sorts of reasons why as an individual you may welcome Mr Obama's election as President. I am convinced that it is helpful for policy to be conducted in a more participative and less doctrinaire manner, but the optimism that he can change the world is misplaced. The impact on the global economy of his election will be limited. Why? Because there's a limit to what you can do when the economic imperative is to an extended period of increased saving. It means that economic growth is bound to slow, whatever the US President chooses to do. The critical issue for him will be maintaining the integrity of the global trading system and not falling into the trap of trade barriers, capital movement restrictions, tariffs and attempting to regulate or dictate one's way out. That would be extremely dangerous.

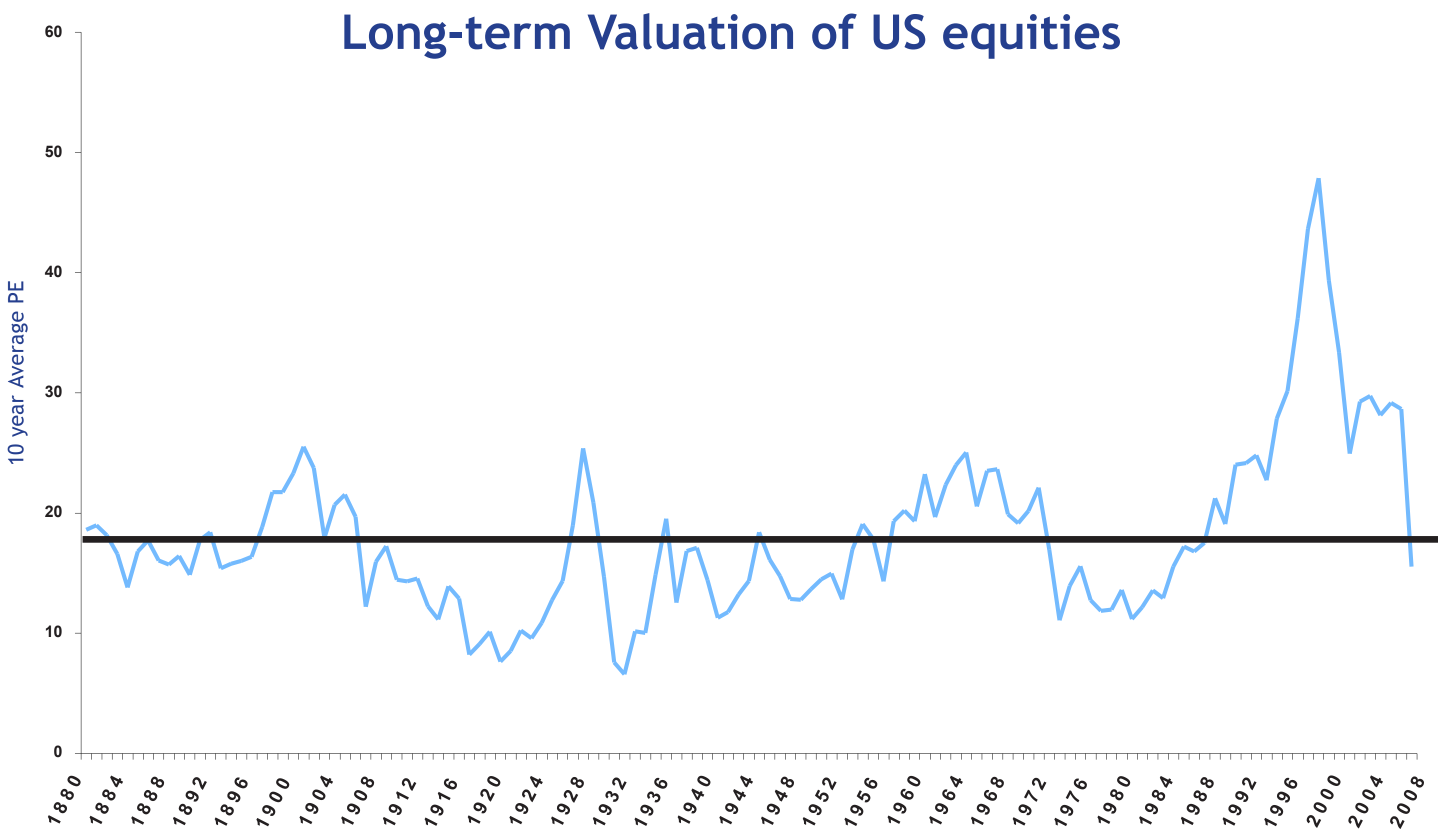
Does that mean that any increase in regulation is necessarily a bad thing?

Absolutely not. Increased regulation always follows economic catastrophe. The most successful regulation, from then introduction of limited liability companies in the 1800s onwards, has been based on improving the requirement for transparency. The least effective has been prescriptive policy measures imposed by Government to try and direct the course of the economy. It is the absence of transparency which helps to create most of the problems. Regulation can correct this. It should ensure the economic consequences of actions are clear, not seek to dictate which economic actions should be taken. It should also at all times protect the integrity of the banking system since this is the lifeblood of the economy. Almost certainly we will see the principles of Glass-Steagall returning, no doubt in a different form, but returning nonetheless.

What are the implications for investors of the current uncertainty?

I expect the outcome will be at least two years of seriously sub-trend economic growth, with a particularly virulent impact on white collar service employment. I don't think this view is any longer different from the consensus. Indeed I think one of the things that is happening at the moment is that markets are becoming fixated with that two year period, and whether or not it turns out to be an over or under estimate of what we eventually experience.

If you do not believe that the risk of deflation has been averted, or if you believe that a depression is nigh, then clearly you want to hold the safest bonds you can find and nothing else. If you believe that the fork in the road leads in a different direction, then these are the last assets you would wish to own. It seems to me that Government bonds are currently attractive only if you believe in some form of prolonged deflation.



The above graph shows the valuation of the S&P based on the average of 10 year trailing earnings, a valuation metric employed by Benjamin Graham to try and smooth out short-term distortions such as cyclical peaks in earnings. On this measure US equities look to be at worst fairly valued

Sourse: DATASTREAM

All this focus on doom and gloom is meanwhile also creating opportunities for investors with a medium/long-term horizon. Excessively short time horizons are the fundamental and repeating imperfection in modern financial markets. Some describe it in terms of 'fear and greed', but the root cause is that we tend to extrapolate whatever we are experiencing now into the future. For example, 12-18 months ago economic conditions looked relatively benign but it was really difficult to find stocks that were cheap on a meaningful long-term view. It only made sense if you adopted the view that the cycle had been abolished.

Since few such bargains were available, all you could do was seek to identify stocks that were reasonable value but low risk. Everything is ultimately a risk/reward issue, and if you chase alleged cheapness at the tail end of a bull market, typically what you end up doing is simply pushing up the risk profile of the portfolio at just the wrong time. Emerging markets was the obvious example of this. The risk profile looked way, way too high, with the principal justification being all the nonsense about decoupling.

This has now reversed. Economic conditions are far from benign and deteriorating, but it is difficult to find stocks that are expensive on a long-term view, unless you still feel that the cycle has been abolished! For example, we are finding companies in emerging markets whose share prices are down 80%. Their risk profile has improved substantially simply because the valuation is down so much. In recent weeks and months we have purchased share ranging from China Mobile to Baidu to Samsung Electronics. All of them at prices which we feel more than discount the near-term risks.

Today everyone is understandably focussing on short-term risk, and on what will happen during 2009 during the recessionary period. Few are focussing on the longer-term. Risk is still important, but if solvency is solid and long-term returns are potentially high, then the opportunities need to be grasped, and grasped now. This is where I think we are now.

Risk in your terms is defined as deviation from absolute valuations rather than deviation from the market or volatility?

Yes. The problem with discussing risk is it means so many different things to different people. For many people, risk is defined in terms of its relationship to a particular index. This has always seemed odd to me – the bigger the company, by definition the larger its size in the index. Hence you have to believe that the larger a company is, the lower its risk. This is not an obvious conclusion.

My primary definition relates to the risk of losing money in the long-run. The secondary definition is the risk of not making enough money (i.e. the opportunity cost). For example, cash and Government bonds are likely to return your capital, but they can simultaneously be awful investments if opportunities elsewhere are much better. Equally, a company share can be low risk in the sense that earnings are relatively secure and predictable, but still be a high risk investment if the valuation of the company's shares is too high. In that case the risk of losing money is commensurately high.

If a security has the right valuation over the long term, you know you'll make money from it. Your principal risk is that your estimate of the valuation turns out to be wrong. The difficulties of forecasting derive from many things, the business a company is in, where it operates, what it does and so on. You need to differentiate between cyclical and non-cyclical stocks, factor in management questions, political risk, industry trends and all a host of other related issues. Out of all this you obtain a range of probable valuations and, it follows, a range of potential returns.

TOP TEN HOLDINGS

EP Global Opportunities Trust

REGION	SECTOR	COMPANY NAME	%
Europe	Healthcare	SANOFI	4.3
Americas	Technology	CISCO SYSTEMS	3.9
Europe	Telecommunications	BELGACOM	3.8
UK	Telecommunications	VODAFONE GROUP	3.7
Europe	Telecommunications	KPN	3.3
Europe	Oil & Gas	ENI	3.3
Europe	Food & Beverage	UNILEVER CERTS.	3.3
Europe	Healthcare	NOVARTIS R	3.2
UK	Healthcare	GLAXOSMITHKLINE	3.1
Europe	Technology	NOKIA	3.1
Europe	Utilities	E ON	2.9
Americas	Healthcare	PFIZER	2.8
Asia/Pacific (ex Japan)	Telecommunications	SK TELECOM	2.6

Holdings as at 20 January 2009. EP Global Opportunites Trust is a global investment trust, one of several funds managed by Edinburgh Partners.

And that is where the opportunities are now, in your view?

Yes. There comes a point when share prices fall enough that you have a sufficient margin of error to be very confident about long-term returns. In other words, even in the worst plausible case you are unlikely to lose money. Right now, there are an increasing number of companies that, in this terminology, I view as relatively low risk. It doesn't mean that their share prices may not fall in the short run – no-one can predict those movements with confidence – but in the long run, you can have a high degree of confidence about the earnings profile and hence the valuation. Cisco would be a prime example of such a company. The long-term earnings profile is one of reasonable growth, the balance sheet is rock solid and the company is well managed. Recent months have added the final, and most important, ingredient of a low share price.

In the long-run, by which I mean five year periods, rather than an indefinite 'in the long-run we are all dead' time horizon, the evidence is compelling that share price returns mirror valuations. We have studied the relationship between low starting p/es and five year returns across all markets and all time periods, and the correlation is both universal and unambiguous. It is the simple fact that share prices are periodically hit so hard that creates these opportunities. It is also why I now have a much more optimistic view.

When did you start to feel that we'd reached this trigger point?

The biggest trigger for me was in the early autumn of 2008 when the House of Representatives rejected the bailout package the first time round. This caused a very sharp fall in share prices, based on the possibility that governments would stand by and let the financial system implode. A whole range of companies we'd been looking at, which we had earlier rejected as still being too expensive, suddenly went to being cheap enough for us to buy. It all happened in about 24 hours!

Since then, share prices have periodically rallied and fallen back. The fact remains however that we now have four times the number of potential investment ideas than we did two to three years ago. Instead of 18 months ago finding small pockets of undervaluation in a large ocean of overvaluation, I would now describe it more as finding pockets of overvaluation in an ocean of fair value or better. In some cases, shares are simply, unequivocally cheap once more.

The counter argument is that since shares had become very overvalued, there remains a risk that the pendulum will now swing the opposite way and everything suddenly becomes a lot cheaper. Markets do have a habit of overshooting on the downside. Could that happen now? The answer to the question is: "yes, it possibly could". But you're never able to tell for sure and there are loads of studies that show the dangers of being in cash when the market turns.

We know that interest rates are going to fall sharply. We've got a prolonged recession coming, and we're not near the middle of it yet. We're going to see deteriorating news. A lot of sensible investors have been warning people "watch what you're doing with cash," because you could get a year's return on cash from equities in three days, and then your cash position begins to look rather unwise. The difference now is that valuations are fair once more, and you need to be ready not only to move to a fully invested position, but watch the composition of your portfolio very closely.

Trying to spot the bottom of the market downturn doesn't work because (a) you may miss it; and (b) even if you do spot it, you may have to move quickly to catch it?

There's no consistently predictive way to know when something peaks or when it troughs. The only predictive capability we have, if you have a long term view, is that when something gets to fair value, you have to start averaging your way in. In our portfolio, which had 20% in healthcare and 20% in telecoms, those proportions have drifted upwards because of their relative performance.

We have started reducing them and putting the money into companies whose earnings growth rates are way ahead of what the pharmaceutical industry, for example, could deliver. The pharmaceutical stocks are still the market's darlings because their earnings are relatively predictable and secure. But you can now buy companies whose earnings are slightly less predictable in the short run, but where the possibility of higher earnings is not even in the price. If I had to summarise, I am pretty sure you have never caught the bus by being late…

In which sort of areas have you been finding these lower risk opportunities?

Technology, primarily in the US, is certainly one. It's beginning to spread to the rest of the world. Capital expenditure related companies are going to have an awful couple of years, because I guess the one thing companies can do is defer capital. We're seeing Japanese robotics and machine tool companies which are world leaders in process technology terms but whose share prices are down 60-70%.

Sure, they were overvalued to begin with, but you can be pretty certain that on a five year view you're going to make good money from them. You have to be careful about the losses which those companies will sustain in the next couple of years if cap ex gets suspended. With one company we invested in, Fanuc, the share price went from 7,000 to 5,000 in the space of a week! That was an opportunity to pick up more shares and there are many more of them appearing.

China is the other major area where we have gone from almost zero exposure to north of 6% in a very short space of time. Having believed the 'decoupling' story to a ridiculous extrapolation of the economic importance of China, we have seen a complete turnaround in sentiment to the extent that some share prices are down 70-80%. That is creating an opportunity for us to invest with what we regard as some of the best risk reward propositions.

What about corporate bonds and preference shares?

I think there is outstanding value in many corporate bonds and preference shares. The yield spreads over Government bonds look way to wide. I think there are some big opportunities for specialists in the area. I also think that it's not quite so easy for generalists, as the best opportunities will be had by those who know the instruments, particularly all the bundled products, inside out. It is slightly ironic, and obviously unfair, but many of the people that got us into this mess could make the most money out of it!

How will the world look as we emerge from all of this?

It is certain that the regulatory regime will tighten. The focus has to be on future protection of the banking system. 'Light touch' will be consigned to history and transparency will be the order of the day. This is not necessarily a negative. After every crash there has been a legislative response, from the original UK Companies Act onwards. History is replete with examples. Many of them were positively helpful to future development. We will need to wait and see how this unfolds.

We have had ten to fifteen years of Western consumers over-consuming whilst Eastern producers built up reserves. This is a transfer of wealth and it is entirely likely that this wealth will be recycled. If history is a guide, assets will be purchased to assist the growth of living standards. China, for example is likely to invest in the 'new' emerging markets as well as to seek to move up the value chain in its domestic production. This means building operations in Asia and Africa. It also means purchasing intellectual property from the West. Expect a growing number of selected acquisitions.

What will be interesting will be how Western governments react. It is entirely possible that national security is used

Conclusions

- Equity markets are at worst fair value and large segments now look appealing. Equities are discounting a prolonged recession. At current valuations companies with strong growth opportunities look the best risk/reward for the long-run and we are increasing our technology and emerging markets exposure.

- Future tax burdens must rise to finance the transfer of private to public sector debt. Expect higher personal and corporate tax rates. As a consequence the sustainable rate of global economic growth will be meaningfully lower than has been recorded in recent times.

Dr Sandy Nairn speaking at the Alpha Society, London, October 2008

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- Risk is now over priced and the best opportunities are further out on the risk curve. 'Safer' investments now have appreciable risk and opportunity cost. The portfolio is gradually evolving its structure and removing companies which have attracted a premium because of the predictability of their 'dullness'. They are being replaced with companies that are trading at a significant discount to their potential earnings stream. This evolution will progress through 2009.

- Liquidity is being poured into the system and at some point will overflow. This will not be for a number of years but because of the liquidity injections depression is unlikely. The more likely path is inflation further out.

to prevent this perfectly natural cycle of events. Equally, it is also possible that capital controls may be employed to seek to prevent the accumulated wealth of Asia being taken out of unproductive government bonds issued by Western governments and put into more productive use.

So while free trade does seem to remain the conventional wisdom, it is not hard to construct a scenario where freedom of capital movement is threatened. This would be a very negative development and it is vital that it is avoided if economic growth is to be maintained. It is probably not an issue for the next couple of years or so, but one can see it emerging thereafter as various governments struggle to finance their debt being currently incurred.

Finally, how would you summarise the world now?

For an investment professional it is slightly schizophrenic. One the one hand there is an economic and corporate environment which has deteriorated sharply and will continue to do so for at least another 12 months. Falling growth, falling profits, dividend cuts and equity issuance will continue to be the order of the day. It is constantly in the news and very depressing. On the other hand, we find ever increasing numbers of companies which look good value, even under these circumstances. From early 2007 the best you could find were companies with low but reasonably secure growth at moderate valuations. Without being rude, dull companies at dull valuations.

Now you can find companies with excellent earnings potential at cheap valuations. This really is exciting. It is hard to be excited when the world is beset by bad news but that is why such valuations exist. It is absolutely imperative that you take advantage of them which requires you to accept that it may be a while before sentiment changes and prices start to move in the right direction. As was said earlier in the interview, you don't miss the bus by being early, although you might get cold and bored. Being late though is definitely the wrong strategy.

INVESTMENT WARNING

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