2021 Q3 Lyndon Fund Commentary

The third quarter of 2021 was a largely flat and relatively uneventful one for global equity markets, with most major developed markets consolidating the significant gains made in the first half of the year. The fund was a little better than this, gaining +4% during the quarter (performance figures cited are for VT Lyndon Fund B Acc units).

Unlike Q1, when lowly-rated "value" and economically sensitive stocks were in the ascendant on the back of the vaccine "reopening trade" and Q2, when fears over the Delta variant saw this pattern reversed, Q3 was not marked by any especially large differentials in performance between highly valued growth stocks and more lowly rated value stocks. The manifest madness in the US equity market took a small breather, with the US tech bellwether index at the eye of the storm, the Nasdaq, being perfectly flat (well, down -0.4%) for the quarter.

After several years of historically awful underperformance, which was then only worsened considerably by the advent of Covid, value did enjoy a couple of very good quarters around the turn of this year. The respite has thus far proven to be short-lived, with the last two quarters not seeing value's relative recovery built upon. Indeed, much of value's hard-won gains have been wiped out by the Delta variant's emergence (and heightened fears of potentially even more virulent variants to come). So, once again, existential questions have been raised about the validity of the value approach by some. Those with short memories and a poor grasp of history, primarily.

Perhaps the first thing to observe in response to yet further value investing obituaries is that the recent relative reversal in performance between growth and value does not necessarily presage a further long period in which growth investing is in the ascendancy. Far from it. Analysis from the much-cited (especially by us) US investment firm, GMO, show that during extended periods in which value very significantly outperforms growth (it does happen), such as 2000-02 (when value outperformed growth by an astonishing 114% in the US), there were within those periods some months when growth enjoyed amongst its best relative performance on record. Sharp reversals in relative performance are therefore a commonly observed occurrence during value runs.

At the risk (OK, certainty) of sounding like an especially boring stuck record, the other key observation is that value stocks look really, really cheap. This is so because the underperformance of value over recent years has had nothing to do with poor fundamental performance by the companies involved and everything to do with the amount that investors are willing to pay for stocks with these characteristics. The result is that value stocks continue to trade at close to their biggest ever discount to growth stocks, with our friends at GMO recently saying that: "Our conclusion remains that this is the most compelling opportunity we have seen for asset allocation alpha since the 1999-2000 internet bubble."

But what if something profound has changed to utterly up-end the investment landscape, such that the old rules and correlations no longer apply? This cannot be dismissed, only a fool would do so, but the strong balance of probabilities lies on the other side. The case for a profound change needs to be made and made persuasively, and we are aware of no such case. Extraordinary claims require extraordinary evidence, after all.

We are not in the habit of making macroeconomic forecasts, but it has long seemed at least likely that a renascence of inflation could play a role in re-setting the investment landscape. It is increasingly clear that the supposedly transient inflationary pressures caused by temporary supply chain bottlenecks are not going to be as transient as all that. In the US the inflation rate currently sits at 5.4%, not far off a 30-year high, which is strangely and discordantly at odds with the sky-high valuations afforded to US growth stocks.

The UK is experiencing a similar bout of inflation, albeit the last reading was just 3.1% on the CPI measure that the government prefers these days. However, UK inflation is up at 4.9% using the old benchmark RPI measure and the UK bond market is absolutely not pricing this in as a transitory phenomenon. The returns on offer to investors in the UK bond market remain dismal, with conventional 10-year gilts (government bonds) offering just a little over 1% p.a. over their lifetime, with this derisory nominal return likely to equate to a significantly negative real return after taking inflation into account.

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In fact we can readily infer just how negative a real return the market is expecting by comparing the yield offered by conventional gilts with those available on index-linked gilts of a similar duration. Currently, 10-year index-linkers are yielding approximately *minus* -3% per year, which means that the gilt market is discounting RPI inflation of 4% p.a. over the next decade (and beyond in fact). The gilt market's implicit inflation forecast is simply the difference between the c. 1% on offer from conventional gilts and the c. -3% available on index-linkers. This difference between the two rates is known as the "breakeven rate", with this being the rate of inflation at which an investor would be indifferent between holding the two securities.

The -3% yield of index-linkers also means that an investor buying and holding this security to maturity would be *guaranteed* to lose the best part of 30% of their money in real terms. It is perhaps, then, not hard to see why equities remain the favoured liquid asset class, with the attractions of other real assets, such as property, also easy to discern given the unpalatable returns available on bonds and cash.

One place where we are already seeing abundant evidence of inflation is natural resources. The oil price rose further during the quarter to $78, so up 50% year-to-date and approaching a five year high. More newsworthy in the UK have been the rather more dramatic moves in the price of natural gas, which started the year at 50p/therm, had risen to 74p by the middle of the year and then spiked to an all-time high of 260p/therm by the end of September (and continued to head higher).

The portfolio holds no positions in Oil & Gas companies, but a fairly direct beneficiary of the shenanigans in the natural resources sector has been the fund's holding in Yellow Cake, a uranium investment company that purchases and stores uranium oxide. It is increasingly clear that nuclear power is likely to need to play a larger role in the global energy mix, not only in the interests of tackling climate change, but also to improve energy security. Being so reliant on a single energy source (and natural gas is typically 40%+ of the UK's energy mix), especially one whose price is so volatile and where Russia is so influential in the market, is surely not the best of ideas. The uranium price moved up from $32 to $43 over the quarter, with Yellow cake up by +20%.

The best performing stock in the portfolio was the business process outsourcer, Capita (+37%), which rallied following weakness in Q2. The group reported half-year results that were merely in-line with expectations, but that was sufficient to send the shares sharply higher, such is the state of gloom around the company. More positively, management guided to full-year revenues being up year-on-year, which may not sound like much, but this would be the first time that the endlessly restructuring group has managed this since 2015.

Another strong performer was Marks & Spencer (+25%), which reported decent results, with strong growth in its Food business and an improving trend in Clothing & Home. We continue to see M&S as being a highly likely recipient of bid interest and the recent strength of the share price does nothing to reduce this likelihood. Experience tells us that corporate acquirers are rarely contrarian opportunists that swoop in when a company is badly down on its luck, bag themselves a bargain, turn the business around and then sell it back to the public markets at a much higher price. Whilst this may be how many believe the process works, in practice it is far more common for the swooping to occur when a corporate recovery is already firmly established and the heavy lifting of the turnaround process has already been done by someone else. After many years of turbulence and multiple turnaround attempts by a variety of management teams, M&S looks to be approaching this position.

A portfolio holding where there has been an abundance of bid interest is William Morrison, which was on the receiving end of several bids in Q2 and then several more in Q3. Early July saw a 254p bid from a Fortress-led group hastily accepted and recommended to shareholders by management, but ultimately it was CD&R that prevailed in an auction in which its 287p per share bid topped its competitor by a whole 1p. In the end the price was regarded as very slightly disappointing by some investors, regardless of the fact that it represented a 61% premium to the undisturbed share price.

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On the other hand, a fund holding where there has been absolutely no recent confirmed bid interest, J Sainsbury, saw some rather peculiar price action during the quarter. Sainsbury's share price briefly spiked up by more than +20% on the back of vague rumours that whichever of the bidders for Morrison lost out on that prize would then turn its attentions to Sainsbury. This is by no means a crazy notion, and we believe that Sainsbury is yet another probable bid target within the portfolio, but after this price movement Sainsbury was up by more than 50% year-to-date on little more than rumours. So not far behind the share price performance of Morrison, the recipient of multiple actual bids. At this point Sainsbury's shares had done plenty of travelling with no guarantee of arriving, so we trimmed our position.

In a very quiet quarter for trading on the fund, the only other notable transaction was the disposal of the holding in Tapestry, Inc. The group, which was formerly known as Coach, styles itself as a "global house of brands", with the Kate Spade and Stuart Weitzman brands having been added to its original Coach business in recent years. However, it is the fortunes of Coach (75% of revenues and more than 90% of profits) that remain very much the driver of the group. Tapestry's share price has had a very good run, with the shares up over +200% over the last 12 months and the risk-reward is now inevitably much less favourable than it was. The group's strategy, with a heavy reliance on sales of Coach products through outlet stores, has always made us a little uneasy, but these concerns were previously salved by the group's rock-bottom valuation. This no longer applies, providing a good opportunity to exit the position at a decent profit.

David Lynch, Fund Advisor, VT Lyndon Fund, November 2021

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