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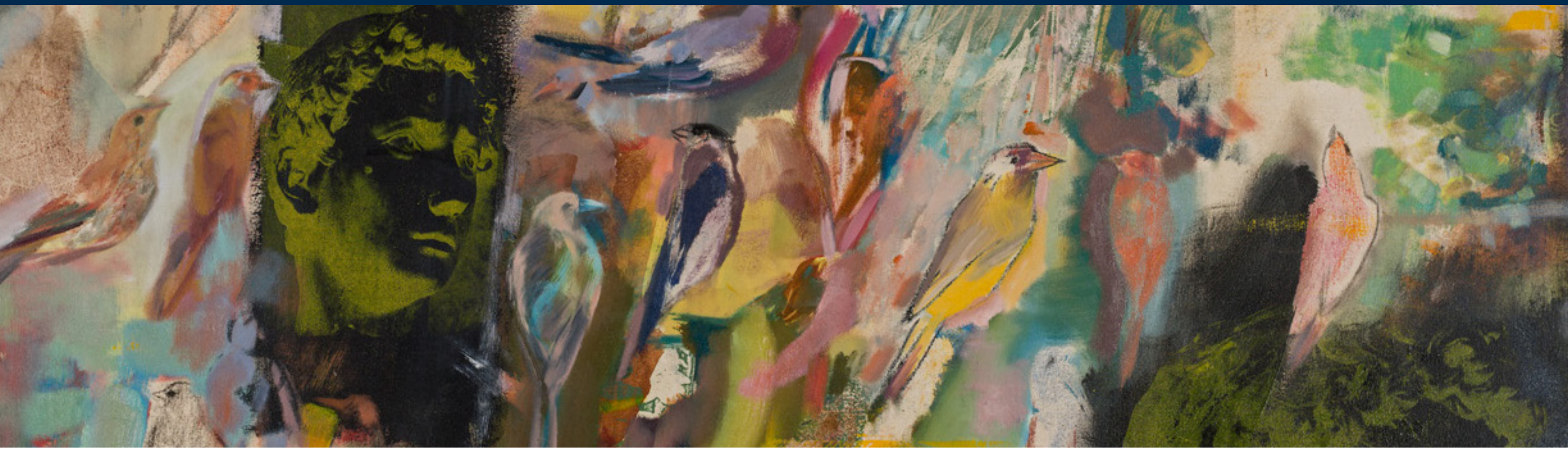

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LOOKING BACK TO LOOK FORWARD

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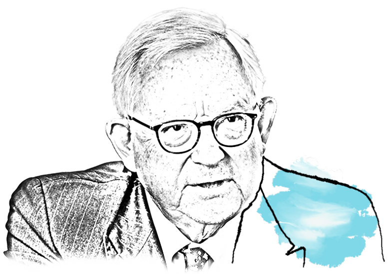
According to Alex Hammond-Chambers, the longer back you look, the further forward you can see. And Hammond-Chambers can look back further than most. Now a Non-Executive Director of Walter Scott, he has worked in the investment industry for 55 years. In these uncertain times, he believes the past holds useful lessons for today's investors.



ALEX HAMMOND-CHAMBERS
Non-Executive Director

I was a portfolio manager in the 1960s and 1970s, and they were difficult times. In 1965, the UK government introduced rigid price, wage and dividend controls. In 1971, President Nixon took the US off the gold standard and also introduced price and wage controls. We had double-digit inflation, double-digit interest rates and stock market indices made very little progress. Markets were very volatile with long downtrends amid other uptrends, but in the event, they went nowhere. In 1966, for instance, the Dow Jones Industrial Average went through 1,000 for the first time. It rose through 1,000 for the last time in 1982.

Those decades taught me some useful lessons. First, it is entirely possible to make money in tough times, with appropriate stock selection. Second, politics determine economic outcomes, not the other way around. And third, if things go wrong enough for long enough, something will happen to make them bounce back.

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In 1979, the bounceback arrived with the election of Margaret Thatcher in the UK and in 1980 Ronald Reagan in the US. That was when the culture of free enterprise displaced that of nationalised industries, capitalism became acceptable and politics began to have less influence on market behaviour.

That positive environment persisted for many years. But in 2008, the financial crisis erupted. It was followed by easy monetary policies from which the better off became even better off, calling capitalism into question and prompting a sea change in the political landscape. Today, the central ground has been tarnished, people are being driven to the left and the right and so, for the first time since the 1970s, portfolio managers need to think about politics and its influence on markets and to build their investment strategies accordingly.

It is not clear to me that the industry fully realises this. Many investors have never seen a bear market; fewer still have seen two – and even if they have, those two new millennium ones didn't last very long, at least in part because the political backdrop was so benign and subsequent monetary policy so easy. It is tempting, too, to think that lessons from the past are irrelevant because today's investment environment is so different from that of the 1960s and 1970s. I think that is a big mistake. Today's conditions are always different from yesterday's; they were in the 1960s and 1970s, just as they are today. But valuable lessons can always be gleaned from the past.

Today, portfolio management competition is far more intense than it was, there are huge pressures to deliver short-term performance, regulators play a far larger role in how portfolios are managed, and information is far more widely available (even if much of it is anodyne), so it is harder to produce penetrative and competitive investment research, let alone competitive portfolio returns.

I would say that the investment culture has changed, too. There used to be an unconflicted focus on making money for clients. Today, many investment managers, seeking to build their own businesses, are driven to pursue competitive or relative returns, or alpha. So it has become all about outperforming the benchmark, rather than achieving long-term absolute returns. I think that focus can be very disadvantageous for their clients.

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In 1974, for example, I was managing a particular fund and within a single year, the net asset value of my portfolio sank by 68%. The market fell by 75%, so I outperformed, but did I do a good job? Of course not. Fortunately, I made it all back eventually, but for me, that period underlines the wisdom of an old saying from Salomon Brothers: You can starve to death on a diet of relative performance.

It is also important to steer clear of style drift, which strong market trends – either up or down – can entice. In December 1999, the FTSE 100 index hit 7,000, driven by the overexuberant performance of tech stocks, including that of Vodafone, whose market capitalisation not only accounted for over 10% of the index, but was also greater than the combined value of the Taiwanese, South Korean, Philippine, Malaysian and Singaporean markets. Common sense alone suggested that was wrong. Yet those fund managers who refused to be seduced by the trends of the time were heavily criticised. Some even lost their jobs. They were proved right within a couple of years, but it was very hard for them to stick to their guns.

That is particularly true if your investment horizon is just one to two years. In such a short period,

TEN INVESTMENT ADAGES

1. The first duty of an investor is the preservation of capital and only thereafter should the enhancement thereof be pursued.
2. Real investors make investments to achieve “hard returns” – money that can be spent one day.
3. The single most important consideration in making a long-term equity investment in a company is the calibre of its management.
4. Cheap shares do not protect investors from poor corporate management.
5. Investment prospects look best at the top and worst at the bottom, encouraging short-term buying high and selling low.
6. Run your winners and cut your losers (quickly).
7. Volatility is not a long-term investor’s risk.
8. The construction and management of any portfolio should make use of all portfolio management disciplines.
9. Indices are not templates for portfolio construction.
10. Benchmarks are comparative yardsticks, not goals and the two should not be confused.

performance will be driven by the market movements rather than by company fundamentals, which is what value investing is all about. But if you invest in a company for ten years, the returns will be dominated by sales, profits and dividend growth. That is what growth investing is all about.

Growth investing can be likened to owning a racehorse and reaping the rewards from its performance over several years. Value investing is akin to betting on it for one race – taking into account the odds and the horse’s recent form.

Both styles of investing have their place – and good portfolio managers can make significant sums of money pursuing either avenue – but for long-term asset owners, such as pension funds, growth investing is clearly more aligned to the needs of their investors. And, when you look at growth investing, the decision-making chain is much the same today as half a century ago.

“The quality – and particularly the integrity – of management is barely mentioned today, but I believe it is far more important to a company’s long-term success than any other single aspect of its business.”

First of all, are revenues growing? Does the company operate in an interesting marketplace and is it managing to deliver a better product or service than its peers? Secondly, is management effective in earning a high net margin? There is a very clear correlation between high net margins and quality management, and, even if the business model earns a good margin, good management will make it better. Growing revenues and a high net margin will deliver potentially sustainable net profits in years to come. And then, of course, there is valuation: if the stock is expensive at the start, you may need to wait rather longer for it to deliver good returns. The Nirvana of stock selection is a good long-term growth stock that is undervalued.

There is another element too: the quality – and particularly the integrity – of management. This is barely mentioned today, but I believe it is far more important to a company’s long-term success than any other single aspect of its business.

I would also say that ten years of bull markets mean that many managers have forgotten the importance of capital preservation – in part because bull markets preserve as well as enhance capital. Naturally, you want to invest in companies that will make your clients money, but you also need to look for companies that will not suffer unduly during tough times.

In this regard, dividends can be hugely helpful. A soundly financed dividend earned from sustainable profit growth is at once a wonderfully defensive

investment and a great returner. And we should not forget that a company's profits belong to the shareholders to be either reinvested or paid out in dividends. Of course, reinvestment is vital to drive growth, but dividends mean that shareholders earn bankable returns today, as well as potentially tomorrow.

Looking back, one of the advantages of being 76 years old is that I have experienced a variety of economic, political and market environments. From that vantage point, I have two principal concerns right now: changing politics and market valuations, which may seem fine in today's market environment but not necessarily so in a different future one.

That is not to say people should stop investing. There are plenty of opportunities out there – lots of companies – new and old doing very good things – always remembering that ultimately, markets do not create wealth, companies do. But you have to be mindful of what works in certain environments and may not in others. Back in the 1960s and 1970s, we quickly learned which companies would survive in certain political climates and which would not. Those lessons may need to be learned again over the coming years.

Looking ahead, the extraordinary pace of change and people's inventiveness make for an extraordinary future, with all the opportunities that it can bring. But there are also plenty of challenges ahead in the nearer future, which is when good portfolio management comes into its own.

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