The Merchants Trust

LOOKING BACK IN TIME IN ORDER TO INVEST FOR THE FUTURE

The Big Short', Michael Lewis's book about the build-up of the United States housing bubble a decade ago, explains in detail what happened in the US mortgage backed securities market ahead of and during the 2008 financial crisis. Lewis talks about the personalities of the few people who really understood what was going on, and were brave enough to successfully bet against the market, and make a lot of money in the process.

As with many investment bubbles, this one may now seem obvious in hindsight, but it was very hard to take advantage of the over-valuation of these mortgage backed securities. Time and again, the key protagonists in the book were under enormous pressure from their backers to exit their positions, which were unconventional, uncomfortable and, for a long period, loss-making.

Adhering to a proven strategy

Hindsight and an understanding of history can inform investment decisions. But anticipating future needs and trends – what might life look like in 'X' years' time? – can be just as valuable. Uncertainty over future trends can create opportunity for those ready to grasp it. That's certainly a factor when it comes to investing. We can't truly predict stock market conditions and how these may impact the economy but, as investment managers, we can adhere to a proven strategy and policy of investing in what we believe in.

This is a strategy that we follow rigorously at The Merchants Trust; we are aiming to build a portfolio of individual stocks that have strong franchises, valuable assets that are priced at a level where we believe they can deliver a high level of income and good total returns for shareholders. This means that we are primarily investing on a 'bottom-up basis' rather than identifying opportunities through sector allocation.

The recent political and investing landscape has been challenging and the UK economy has grown more slowly in 2017 than it did in 2016. The backfiring of the decision to call a general election and the stuttering progress of UK negotiations to leave the European Union have been two of the factors at play. Looking forward, there remain further risks from high levels of consumer debt and the impact of inflation on real earnings, as well as uncertainty in the corporate sector caused by Brexit. However, interest rates, although poised to nudge upwards, remain very low by historic standards. Add to this the weak pound (which helps exporters), historically high employment levels and the fact that the UK stock market is not purely exposed to the UK economy and one can begin to understand why markets have been trading near to all time high levels. After all, the majority of sales and profits in UK listed stocks comes from overseas operations, spread across many industries and different geographic markets.

> "We continue to see opportunities to buy sound businesses trading on reasonable valuations."

There is an old adage that stock markets climb a wall of worry and perhaps we have seen that this year. Markets can shake off political concerns but market peaks also create their own uncertainties: are stocks overvalued? Is a crash, or at least a correction, likely? However, we continue to see opportunities to buy sound businesses trading on reasonable valuations, with attractive dividend yields. We are finding these both within domestic companies and amongst the more internationally diversified. Although an element of caution is understandable, there are several companies in sectors like retail, leisure and financials, that seem undervalued under most realistic longer term scenarios, in our view.

Coming back to interest rates we think the changing outlook for rates could be a game changer. The US is now raising rates and, here in the UK, the Bank of England base rate has nudged up by 0.25% recently. There's no expectation of rapid, sharp increases, but it is nevertheless significant after an enduring period of such low rates. The last few years have seen stable "growth" stocks outperform as they have been seen as bond proxies. However, many of the consumer staples-type companies now look expensive, in our view. With higher inflation and perhaps higher growth, 'value' shares – i.e. shares that appear to have low valuations relative to current profits, cash flows and dividend yields – may take up the running. We have already seen mining shares recover somewhat, while oil majors have also performed a bit better. We are also starting to see interest rate-sensitive stocks like banks, benefit from rising rate expectations.

New borrowing at much lower interest rates

Another game changer, specifically for Merchants, may be the recent announcement that the Trust plans to refinance a loan taken out in 1987 (when the Bank of England base rate stood at 8.375%) and replace it with new borrowing at much lower interest rates. Loans of this nature enable Investment Trusts like Merchants to enhance their investment returns by borrowing money to buy more assets (known as 'gearing'). No one could have predicted the trajectory of interest rates over the 30 years since 1987 but the prospect of cheaper borrowing could signal very good news for Merchants investors as it will cut the Trust's interest costs and potentially give it more investment options, such as the flexibility to grow the dividend faster. Merchants is already proud of its history of increasing dividends year-on-year, having reached the impressive milestone of 35 consecutive years earlier in 2017.

Who knew, 30 years ago, that markets would be nudging peaks and that interest rates would be where they are now? With the benefit of hindsight, we can appreciate and fathom the market trends that we have witnessed, but looking ahead we think it's vital to continue doing what we've always done at The Merchants Trust: identifying solid businesses with good prospects for growth and attractive dividends. ■

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Simon Gergel is CIO of UK Equities at Allianz Global Investors and is portfolio manager of The Merchants Trust PLC. Merchants has for many years focused on a simple proposition to deliver a high and rising income together with capital growth for its shareholders. Although past performance is no guide to the future, Merchants has paid a rising dividend to shareholders for 35 consecutive years.