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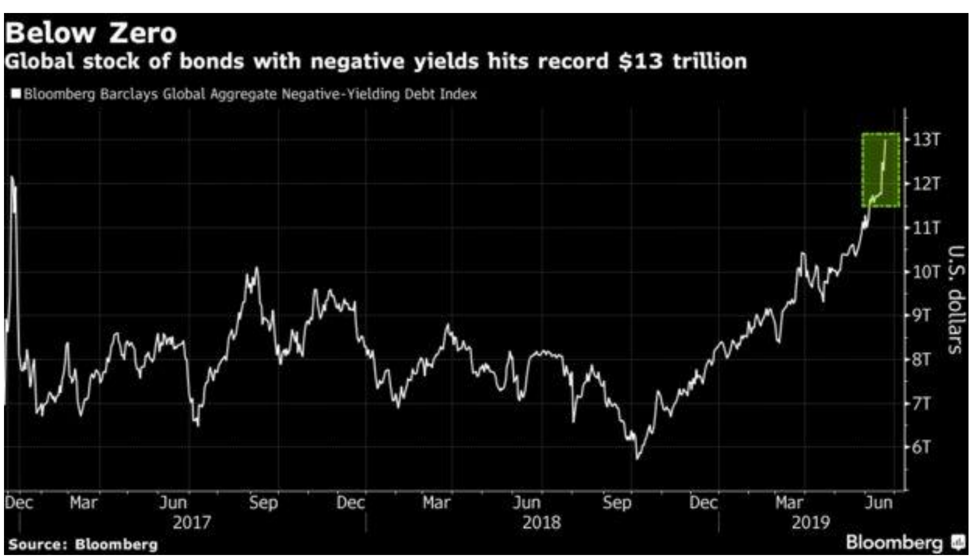
The Friday Filter

12 July 2019

The price of predictability

2018 had a challenging end to the year as investors grappled with rising interest rates in the US. This concern has been taken care of with poor economic data and stock market weakness causing the Federal Reserve to change course abruptly over the past few months. Expectations of interest rate cuts are now expected to start later this month and investors are rejoicing as depicted by the latest cover of Barron's Magazine below.

Key beneficiaries of the change in interest rate outlook have been fast-growing companies whose value accrues in the distant future (mostly technology stocks), as well as businesses with defensive earnings and high dividend payouts that are deemed to be bond-like by enthusiastic investors. While investors are paying a very high price for predictability in the stock market, they are paying even more in the bond market. $ 13 trillion worth of global bonds are now trading at negative yields. Investors are happy to lock in a negative return for the supposed certainty that these investments provide. We live in interesting times.



Crowded quality

Coca Cola is perhaps the ultimate defensive company in the minds of most investors. It is a good example of the type of share that investors are seeking safety in and embracing with great enthusiasm on the back of the coming change in interest rate policy.

Coca cola – past 5 years "growth"

	2013	2018
Revenue	**46,854**	**31,856**
Net income	**8,584**	**6,434**

Source : Coca Cola Annual Reports

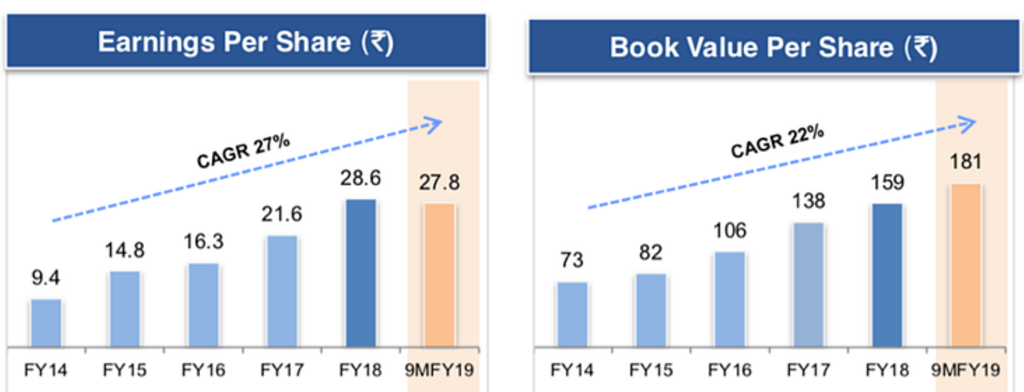
Despite the solid dividends and continued buybacks funded by increased debt levels, we do not think a company that is not growing warrants a 33 PE ratio or 24 EV/EBIT multiple. Coca Cola is a good business, but like most low-growth defensive businesses we do not think it is priced to deliver good returns, regardless of what happens to US interest rates. We have used Coca Cola merely for illustrative purposes, but most well known global defensive companies have the same fundamental characteristics of little or no growth, but very high valuation multiples.

We also seek safety and prefer predictability in the companies we invest in but are just not prepared to pay top dollar for it, especially if the companies are not really growing. We are disciplined value investors, but do have a strong quality bias even though we may not find it in crowded names where the quality is obvious and already priced in.

Hidden quality

Fairfax India Holdings is a company that has not benefited from the change in market sentiment, but where we have been adding to positions in recent weeks. It is too small to be on the radar of most institutional investors and certainly won't screen well for quality investors seeking a high Return on Equity (ROE) such as Coca Cola. Fairfax India Holdings owns a number of very good assets in India, the largest of which are the Bangalore Airport and a financial firm called IIFL that has a very solid track record and has recently split into 3 different listed pieces.

IIFL track record



Source Fairfax India AGM Presentation

While it is still very early days in the investment life of Bangalore Airport, the slide on page 3 from the latest AGM provides a good overview of the opportunity.

(Rs billions - IGAAP/Ind-As)	Twelve months ended Mar 31, 2014	Dec 31, 2017	Dec 31, 2018	Compound Annual Growth
Total assets	35.5	57.0	67.4	
Shareholders' equity	7.8	23.0	30.0	33%
Revenue	6.5	15.0	16.1	21%
Net earnings	0.7	6.9	8.5	71%
Return on equity	8.6%	29.9%	28.4%	27% [1]

- India's 3rd largest and world's 2nd fastest growing airport
- Passenger traffic grew 29% in 2018 to 32 million
- Aero revenue has grown at compound rate of 21% since 2009
  - Dependent on regulated tariffs, which are set for 5 year 'control periods'
- Non-aero revenue has grown at a compound rate of 17% since 2009
- Real estate monetization – 460 acres available for development

In simple terms, our investment thesis on Fairfax India Holdings can be summarised as follows:

- Very good assets
- Very long growth runway
- Very good management/owners who are long-term thinkers
- Trading at a discount to a conservative estimate of a **<u>growing</u>** book value

Investors continue to scramble to pay up for growth and quality companies, most of which are now large parts of the indices and very widely owned, irrespective of valuation. This is challenging for value-conscious investors such as ourselves in the short-term and will inevitably lead to bouts of underperformance and volatility. In the long-term, however, we think the opportunity for patient investors prepared to invest where others aren't looking remains significant, and disciplined value investors should ultimately be well rewarded.

Price may not matter in the short-term, but in the long-term it usually does. Times like these always make me think of a Howard Marks quote which hangs on the wall of our office.

" Investment success doesn't come from *buying good things* but rather from *buying things well*."