investment themes

– it's got a good beat and you can dance to it

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Graham Bentley looks at the longer-term themes that could impact the way we invest.

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I don't set trends. I just find out what they are and exploit them.
Dick Clark, TV producer

Dick Clark may not be a household name in the UK, but Americans know him as an icon of popular culture. Particularly during the late 1950s and 60s, but in total for over 30 years, his TV musical variety show *American Bandstand* was US teenagers' main access point to music, dance and, indirectly, fashion. Clark produced and hosted the show for most of its life (he rejoiced in the prefix 'the ever-youthful'), and maintained its currency throughout. A section of the show offered teenagers the chance to review new record releases, spawning the immortal phrase 'It's got a good beat and you can dance to it'. While the programme was seen as a trend-setter, in reality it served as a mirror of the times, from

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>> Rock 'n' Roll to Run DMC. Clark's quote supports that. Investors might take note; elsewhere in this month's informer, articles from our fund group partners discuss shorter-term investment trends and themes; consequently this month I thought I'd follow in the same vein, but looking at the longer-term trends that might influence investment decisions (right or wrong) over the next 10 years.

equities

Much has been made of equity markets' so-called 'lost decade'. The FTSE All-Share index ended 2009 some 14.8% lower than New Year's Day 2000. The S&P 500 in the US is down over 24% over the same period*. However, when dividends are taken into account (ie via total returns), the figures look very different: The All-Share is up nearly 18% while the US is down less than 14%. This illustrates the benefits of dividends. Analysts and fund managers pay great attention to various methods of valuing securities, to determine whether share prices were cheap or expensive, thus hoping to predict the future trend of share prices. In the 1980s and 1990s, for example, rising Price Earnings (P/E) ratios were seen as the principal drivers of equity returns – the lower the ratio, the higher the predicted earnings relative to the share price. Valuation measures consequently tended to look at earnings and book value (value of a company's assets).

The prevailing economic conditions during that period included falling interest rates, from a UK official bank rate of 17% (yes, really) at the end of 1979, to its current 0.5%. There was a concomitant fall in inflation, from 18% to virtually zero/negative. This led to expanding P/E ratios (as company borrowing cost less). Many managers now believe that we have entered a period in which P/E ratios are more likely to remain flat or contract rather than expand, as interest rates and inflation appear more likely to rise rather than fall from recent historical lows. Current low interest rates should reduce equity risk premium. Given the inverse relationship of P/Es to interest rates, in these conditions P/E multiples should cease to be the primary measure by which equities are valued in the future. This will leave only earnings growth and dividends to drive equity returns. These two drivers come from a single source: cash flow. The main measure for analysts in these conditions is Net Free Cash Flow – net operating profit after taxes, minus company's investment (including variation of working capital), is cash flow from operations minus capital expenditure. It is argued that this is a better and more transparent methodology to understand how a business works. Companies that have an ability to generate free cash flow and to allocate it properly among dividends, share repurchases, debt pay downs, internal reinvestment opportunities, and/or acquisitions, will probably look attractive to investors over the next 10 years.

markets

No news here I imagine – emerging markets and commodities seem to be prime candidates for above-average returns over the next decade. In case you've been hiding under the covers for the last couple of years, the story relates to the growth of the middle classes in emerging market countries, and mass urbanisation in China fuelling demand for housing and consumer goods. Both these themes are good for emerging market exporters in South-East Asia, particularly as westerners may be spending less for the foreseeable future. Emerging markets are expected to be bigger contributors to global GDP than developed countries by 2030. Commodities are inextricably linked to this growth. While much has been made of the rise of the gold price – in 2009 UBS

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forecast a 'price cone' of $500 to $2,500 to 2015. This one has done the rounds ever since to the point where gold is almost certain to rise. A self-fulfilling prophecy? Well by all means have a small part of your portfolio in gold – physical gold, eg ETF-based or coins. The gold Britannia is legal tender (one ounce of gold with a face value of £100) and therefore exempt from CGT. However, since physical gold produces no yield, it is by definition speculative and not an investment (I can already hear the screams of protest from the gold bugs). Gold mining shares, on the other hand, can pay dividends out of profits. Let's focus on investment.

Agriculture, while producing commodities, has the hallmarks of investment because plants are self replicating – the dividend is the next crop. According to a recent UN report, food prices could rise by as much as 40% over the next 10 years due to growing demand from emerging markets, and for biofuel production. Political will in western economies is driving this, with vegetable oils and sugar being key commodities. The world demand for meat is climbing faster than for wheat and coarse grain, which themselves are expected to rise by up to 45%. Brazil is by far the world's fastest growing agricultural producer, with output expected to rise by 40%. China, India, Russia and Ukraine should also see significant production rises.**

sectors

Green energy (see biofuels above) and technology will grow in importance. The European Wind Energy Association has estimated that on average the sector will employ an additional 450 people every week for the next 10 years.
Already, firms are creating joint ventures to develop projects that will overhaul household energy, water, transport and waste provision. This implies higher capital expenditure, and may prove to be the basis via which the UK's manufacturing capability reasserts itself. In technology, cloud computing, where information can be provided to devices on demand in the same way that the National Grid provides electricity, will rise dramatically in importance. Portable devices like the iPad will become ubiquitous and the desktop PC (and even the laptop) will probably seem as quaint as a stylophone by 2020. If you don't believe me, ask your kids. In healthcare, there will be many beneficiaries of our increasing life expectancy – pharmaceuticals, and so on. However, these assumptions can throw up some weird possibilities. Duke University estimates that life expectancy is increasing (and has done) at an ever increasing rate. They suggest that currently, every day human life expectancy increases by six hours. They estimate that at some point over the next 20 years, every day we live our life expectancy will increase by 24 hours. Work it out – that means immortality. I wouldn't bet on it...

funds

Finally, baby boomers start retiring this year. The effect of this unique bulge in population that drove the consumption and consequent growth western stock markets have seen over the last 40 years, is beginning to wane. These investors are looking to decumulate, rather than save. They will begin to focus on income generation, and possibly capital protection. As a consequence there will be pressure on pension funds and their advisers to reallocate. Pension funds are among the biggest investors in the west; they directly influence demand for securities and hence prices. In the equity section above I mentioned the focus on dividends and dividend growth. Here is another reason why companies with good cash flow, a relatively generous dividend policy and whose business models imply strong dividend growth prospects will be highly sought after.

In conclusion, despite the negatives surrounding the state of this nation and others, there are reasons to look forward to excess returns being delivered by diversified portfolios over the next decade. Stock markets may not play to the same beat as they have for the past 20 years, but I wager we'll still be able to dance to it.

*Source: Financial Express 1 January 2000 to 31 December 2009.

**OECD, UNFAO.