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TAYLOR YOUNG
Investment Management

A View from the Bridge

# Wrapping our service

**Many of you will be familiar with the three sub-funds of the Taylor Young Investment Fund, an OEIC structure which we launched, for the benefit of our existing clients, in July 2001. The Growth Fund celebrated its fifth birthday last year and the Growth & Income and the Equity Income Funds celebrate their fifth birthdays next month. All three funds have been enormously successful and we are delighted to have, last month, added two further sub-funds. The Opportunistic Fund is a best ideas fund which has the FTSE All-Share Index as its benchmark and the International Equity (£ Bias) Fund is benchmarked two-thirds against the FTSE All-Share Index and one-third against the FTSE World ex UK Index. At least 60% of the International Equity Fund will be in the UK, the balance overseas with a bias towards Europe and the US.**

**Whilst many think of "funds" as appropriate for small clients, we at Taylor Young believe that our funds are appropriate for nearly all of our clients. The funds are, in effect, a more tax-efficient wrapper around a similar portfolio of company holdings to that which a client may have held individually and there are also significant administrative advantages. The funds follow the thematic approach which is at the heart of our investment process.**

**"Analysts…they are very bright or stupid" – our first article looks at what prompted a senior industrialist to make such a remark. If one has to be careful with the message analysts are trying to convey, our second article suggests why one also has to be equally careful with the message statistics set out to deliver. Finally, and perhaps less controversially, we look in a little more in depth at one of our key investment themes – luxury goods.**

**If there was ever any doubt to which "Bridge" this publication might be referring, we trust the doubt has gone and the Bridge and design meet with your approval!**

**Philip Todd** Director, Private Clients and Charities
**Peter Thomson** Chief Executive Officer

## Equity analysts in the spotlight

One of the long-running investment themes at Taylor Young has been that equity markets tend to be well supported by a continuing high level of merger and acquisition activity. Over the past few weeks, this activity – or a perception that activity is imminent – has reached altogether new levels. Rumours of takeover have swirled round a wide variety of the stocks in the FTSE 100 Index, including Rio Tinto, Home Retail, Hammerson, Pearson and Prudential.

In the case of Alliance Boots, after a sharp bid battle, an offer has materialised which has been accepted by the Boots Board. This offer was pitched at £11.39 a share, considerably above the level at which Alliance Boots shares have been trading over the past year. In fact, since June 2006, before the bid interest materialised, the trading range was between £7.50 and £8.50. During this period, only a small minority of City analysts had been recommending

the purchase of shares in Alliance Boots, whilst a significant number had actually been recommending their sale.

It is reasonable, therefore, to pose the question as to why, with one or two praiseworthy exceptions, the vast majority of UK retail analysts failed to spot the additional value in such a well established and well known company as Alliance Boots, whilst a private equity company was apparently prepared to pay at least three pounds more than the prevailing price for most of the previous year. Indeed, the Chairman of Boots, Sir Nigel Rudd, launched a trenchant attack on the analytical profession in an interview in the Financial Times last month; "When I did the Alliance Boots deal, everyone hated it. The greatest pleasure out of all of this has been the analysts. I actually love that. They are stupid most of them; they are very bright or stupid. They write all this stuff but they don't sit back and say healthcare is a growing business, people are getting older, they need more medicine."

The fact that in early March, before rumours of a private equity offer appeared in the market, only four analysts out of a universe of 21 were recommending a purchase of Alliance Boots, while half were recommending a sale. This is very reminiscent of the aphorism of John Maynard Keynes that in many walks of life it is better for reputation to fail conventionally then to succeed unconventionally. To redress the balance a little on behalf of the analytical community, it must be appreciated that it is often hard to plough a lonely furrow against the consensus views of one's peer group. The rewards of being proved right are often not enough to compensate for the downside of being proved wrong. A succession of unsuccessful recommendations against a prevailing consensus view may well mean that an analyst has to seek his fortune elsewhere.

Nevertheless, this issue does highlight a potential problem for fund managers such as ourselves. Although we conduct our own analysis and evaluate for ourselves the merits of each individual stock in which we invest, it is only reasonable to attach some credibility to the views of analysts whom we have known for a long time and whose judgement we respect. It is particularly important to focus one's attention on a relatively small group of analysts within each particular sector in order to screen out the so-called "random noise", which is a pervasive feature of developed capital markets. An analyst's view of an individual stock will reflect his or her judgement and may also reflect his or her opinion as to whether the market has correctly evaluated the stock's current share price. What is difficult to forecast is the extent to which a trade competitor or private equity house may see additional value in a stock. Acquisitions, and more particularly hostile takeovers, are by no means a one way bet. On one hand the huge success that Philip Green has made from his acquisition of Arcadia is a clear example that capital markets fail to perceive fully the benefits that a change of management can bring. On the other hand, two high-profile corporate acquisitions in the past – the acquisition by Ferranti of International Signal and the acquisition of Crocker Bank by Midland Bank – were notorious in their respective outcomes. Ferranti was forced into bankruptcy in 1993 after fraud was discovered in its target acquisition, whilst continuous heavy losses from the acquisition of Crocker Bank weakened Midland Bank substantially throughout the 1980s and eventually led to its acquisition by HSBC in 1992. The transformation of GEC into Marconi through a series of unhappy acquisitions is a corporate disaster still vivid in the memory.

With the current high interest in acquisition activity, analysts can also overlay their fundamental view of companies by using screening techniques to identify which kind of companies may be most likely to succumb to acquisition attention. Companies with little gearing on their balance sheets, with an abundance of freehold properties or those with the potential to boost margins through extensive cost cutting have attractions to predators at the current time. Whilst it is clearly wrong to recommend a stock on the basis of its attraction as a takeover target alone, analysts nowadays need to reflect a little more on the market environment in which we are living and perhaps to perform some more "what if" analysis on the universe of stocks which they cover. Over time, investors would tend to reward more far-seeing analysts, who are prepared to think more laterally rather than those who automatically seek the comforting warmth of the consensus view. At Taylor Young, we are very appreciative of the efforts that analysts put in to learn and write more about the companies they follow – the judgement as to whether to invest or not remains nevertheless the responsibility of the fund manager.

# Only if it makes a difference

What makes an interesting statistic? Many of the eye-catching figures we read are just that – attention-grabbing. Most of us like facts and figures that stand out (whilst others are rather better at retaining the details!), and a sample from the 2007 edition of The Economist World in Figures provides stimulating and interesting information: 'India's population is set to grow by 500 million in the next 50 years; Russia's is set to fall by over 30 million'; 'Life expectancy in Japan is over 82 years, in Swaziland it is under 30 years'; 'The Euro area now accounts for 17% of the world's total exports,

about 40% more than the United States'; 'The United States consumes 20.5m barrels of oil a day, roughly twice the daily output of Saudi Arabia.'

But then, as the old saying goes, there are lies, damned lies, and statistics. Examples of the use of statistics to shore up a weak case, or to impress or intimidate, can be drawn from the excellent (non-mathematical book) Statistics Without Tears by Derek Rowntree. One tells of the British politician who claimed that '50% more teachers consider that education standards had fallen rather than risen over the previous five years' – this assertion being worrying but rather opaque: 50% more than what? In fact it was based on a survey in which 36% of the teachers believed that standards of pupil achievement had fallen, while 24% believed they had risen. However, the politician failed to mention that 32% believed they had remained the same, and 8% didn't know. Had he wished to publicise a rosier view of British education, he might, with equal validity, have pointed out that 64% of teachers did not believe that standards had fallen!

There are many techniques employed in gathering and analysing data and in presenting the results, and as many hazards, potential conflicts and obstacles for the statisticians and their audience. Biased samples can be employed to produce almost any result you may wish. So can properly random ones, if they are small enough and you try enough of them! Then there are the different types of averages – most commonly the mean, median or mode – which can result in very different messages. The mean is calculated by taking the sum of a set of values and then dividing by the total number of values, whilst the median is the middle-ranking value of a set of values laid out in numerical order and the mode is the most frequently occurring value within a set of values.

In addition, the graphical or pictorial representation of data can lead to distortions in perception and comprehension. The technique of chopping off the bottom of a vertical graph to accentuate a change in the values is all too common, when the percentage change might be minimal. Further, one can get horribly bogged down in the detail, when it might be better to remember the old saying, 'A difference is a difference only if it makes a difference'.

One of the great worries in the global financial arena at the moment is the quality of the data entering the statistical chain. Some of the data made available by some countries is, at best, of dubious quality, and any analysis of it must itself therefore be tarnished. We are perhaps fortunate that in the UK the Office of National Statistics does provide good-quality analysis with a high level of transparency. The latest release of the consumer prices index (CPI) data showed that in the year to April 2007, the CPI rose by 2.8%, down from 3.1% in March. In the year to April, the all-items retail price index (RPI) rose by 4.5%, down from 4.8% in March. Over the same period, the RPI excluding mortgage interest payments (RPIX) rose by 3.6%, down from 3.9% in March. The CPI is the main UK measure of inflation for macroeconomic purposes and forms the basis for the inflation target that the Bank of England's Monetary Policy Committee is required to achieve. The CPI and RPI are compiled using the same underlying price data, based on a 'large and representative' selection of around 650 goods and services whose prices are monitored in about 150 randomly selected areas in the UK. But while it's difficult to fault the mathematics behind the methodology, it is important to remember that the UK population is highly diverse, with individual shopping and spending habits likely to vary considerably from the statisticians' artificially created basket of goods. The result is that we will all experience quite different 'personal' inflation rates, many of which will be quite some distance from the statistical average.

So, even when the source is good, statistics should still be treated with healthy scepticism. Rest assured that we at Taylor Young focus on statistics that really are showing that the world is changing. We try not to 'drive the car through the statistical rear view mirror'; instead, we look for the enablers, the resources and the opportunities that make change feasible and viable.

# The global luxury market

A powerful theme that we have been scrutinising for some years and have looked to participate in as and when appropriate, is the long-term growth in the global luxury market – designer accessories, expensive cars, watches and the like.

The drivers of the luxury sector can be divided into two sections. The first is a set of rational drivers, including the sustained growth of global GDP, the strong levels of world tourism (which in turn leads to a high proportion of luxury transactions) and the somewhat astonishing yet unrelenting growth in the wealthy section of international society that are the prime participants in the luxury goods market. The second is a set of emotional drivers, including 'aspirational buying' and the search for comfort, indulgence or opulence.

Different civilizations have always sought to develop ornate and luxurious things. In delivering modern-day luxury, businesses tend to focus on craftsmanship, service, performance, longing, exclusivity and the so-called 'dream'. Shares in some luxury brands have been

increasing at a strong pace and there seems to be little doubt that the increased wealth evident in major economies is what is fuelling this growth. China and India are perhaps providing the principal engine of growth in this respect, with the oil-producing nations, Russia and Brazil also contributing heavily to the rapidly expanding middle and upper-middle classes and the rising number of entrepreneurs who enjoy an escalating amount of disposable income or discretionary spending power.

Demographic and social change forms the bedrock of the thematic analysis of the luxury sector and there have been a number of recent first-rate research reports highlighting the changes that are unfolding at a rapid but arguably sustainable rate. The dynamics of sub-sectors of the luxury market are quite remarkable, with small volumes of sales often accounting for substantial value. An example is in the watch market, where it is estimated that 1–2% of the market by unit volume (this being between 5–10 million units of a total volume of perhaps 520 million units) represents 30–40% by value (this being between £3.5–4.5 billion of a total value of perhaps £11 billion). This highlights the importance of the luxury market to a sector such as this and also the opportunities available in less mature segments of a market.

There are obvious attractions to the investor in targeting luxury sectors, with good and prudent diversification available at both the sector level and also at the geographic level. Whilst the UK has little quoted exposure to the luxury goods sector, there is a bias in western markets towards Continental Europe and, in particular, the manufacturers and distributors such as LVMH, Swatch, Porsche and Richemont, which are considered to display strong fundamentals and striking business models. In a wider context, the retailers, service providers and house builders who are catering to the top end are also considered attractive. Tiffany (the jewellery house from the US) is a good example of a business responding to demographic changes in a positive and pro-active manner through a major strategic initiative addressing the developing markets of the Far East and Emerging Europe.

The majority of stocks in this area of the market are not cheap but they have generally displayed powerful growth patterns and the prominent intertwining themes present various potentially attractive propositions for certain investment mandates.

Please send your views and comments on any of the articles above to Nick Rundle at:
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