What Investment

www.whatinvestment.co.uk FOR A WEALTHIER FUTURE Issue 453 December 2020 £4.50

Investors looking to benefit from the timeless power of the compounding of wealth need to get over any fear of equities. Michael Crawford explains

Lessons from Babylon

The Richest Man In Babylon – a book by American George S. Clason – is approaching cult status. Set in the context of the prosperous ancient city, it simply describes how the richest man built his wealth from a combination of spending less than he earned and investing the surplus in income producing assets. The income from those assets was invested in more income producing assets, and so on… In other words, the compounding of wealth.

Move forward 6,000 years to the present and we see a growing appreciation amongst investors that a combination of saving and frugality can lead to financial independence and therefore freedom in later life.

Indeed the 'FIRE' movement (Financial Independence, Retire Early) believes that this can be achieved as early as one's 40s by applying similar principles. But what assets should adherents purchase to achieve this miracle of compounding? Due to the ravages of inflation and quantitative easing, bonds and property do not deliver the returns they used to. We must turn to equities.

Equity aversion

Many are fearful of equities despite their track record of having produced capital growth, income growth, and inflation protection for hundreds of years.

It is well documented that we tend to fear short term losses more than appreciate long term gains. This is exaggerated by the failure of many to understand that an equity conveys long term ownership rights to a business and should be treated as such.

The best companies are able to achieve high returns on capital and growth, but it takes time for this to convert to value. The beauty of the mathematics of long-term compounding is that even modest growth rates can produce spectacular results over decades. This applies as much to the income as the capital.

Interestingly the advocates of FIRE understand they have time on their side.

Contributory factors to equity aversion are the focus on the travails of weaker companies and fraudulent management teams. These are valid concerns. I estimate that at least a third of all company management teams engage in some form of exaggeration of the performance and worth of their businesses. However, equities are issued by companies with many different characteristics and varied management teams; there are over 40,000 quoted equities globally. With so many to choose from, a portfolio can be selected which minimises the negative and accentuates the positive.

> **"At least a third of all company management teams engage in some form of exaggeration of the performance and worth of their businesses"**

Choosing assets

Put simply, there are companies which are long lived, having been around for decades and even centuries, that are well positioned in solid industries, achieve high returns on capital and finance their businesses mainly through equity rather than debt.

In contrast, there are companies that are operating in fast changing industries, poorly positioned in those markets, achieving average or low returns on capital and running high levels of debt.

An example of the good is Procter & Gamble, which can trace its origins back to 1837 and now has globally strong brands such as Tide in laundry detergent, Pampers in infant nappies and Pantene shampoo. The industry has proved stable over time and looks stable now with low economic sensitivity. The company is strongly positioned within the industry and looks likely to stay so.

In contrast, take any airline, say American, which operates in a highly unattractive industry. The company can only truthfully trace its economic history back to 2011 when it last emerged from bankruptcy. It is difficult for any airline to differentiate its product from others therefore they have little pricing power. The market is highly economically sensitive which, combined with the asset intensity and low returns on capital, requires higher and higher debt and eventually will result in bankruptcy again.

These are clearly two very different asset types. Their attributes and defects are simple to understand and verify; however, the general perception is that equity portfolios have comparable risk characteristics which lie at the higher end of the spectrum. Perhaps we should segment stocks into distinct sub-asset classes, one of which could be described as 'long term sustainable' companies. This would reveal to admirers of the enterprising citizens of Babylon, advocates of FIRE, and retirees generally, an attractive income producing asset class to help achieve their aims.

Michael Crawford is founder of Chawton Global Investors, a boutique global equities fund manager. This article is reproduced from the December 2020 edition of What Investment.