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Introducing our New Core Theme: "The Strong Get Stronger"

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The dramatic and unwelcome developments of the Third Quarter have convinced us that we should anticipate an extended period of credit rationing. In the aftermath of the credit crunch, governments will compete with corporates to borrow a diminished store of capital. Consequently we have decided to reinforce our Core Themes by the addition of “The Strong Get Stronger”, and I would like to explain the thinking behind this development.

Prepare for Credit Rationing

We have picked through our universe of thematic larger cap companies, with an eye for gorilla companies which dominate their sectors and combine the dual qualities of autonomy and self-funding. These are the attributes which we expect will trigger re-rating and outperformance when lesser companies find that their existing lines of corporate credit have been drawn down, reached the end of their term, and need to be renegotiated, but on considerably less favorable terms. Remember, although there is still cash on the sidelines, these savings have been hard earned, and we suspect will be deployed cautiously. If the post-crunch environment offers softer global growth, reduced cash flows, re-priced lending and stuttering earnings, then we are confident that the first destination of this liquidity will be companies within our new core theme "The Strong Get Stronger."

The Self-funder Shall Stand Tall

"They say the darkest hour comes right before the dawn" (Bob Dylan), but frustratingly, it is in the nature of market bottoms to have a number of false dawns, until finally, even the most resolute investor has to capitulate. Should we, at that moment, buy the weaker companies, who have only just survived, and will experience the most euphoric relief rallies? Certainly, if we are clever enough to recognize the moment. However, our more pragmatic investment strategy is to accumulate the strongest companies - those best able to take advantage of the trough times, however long they may be, to increase the blue water between themselves and their competitors. Our new Core Theme, "The Strong Get Stronger" is the home for this group.

Because we lack the perfect knowledge of the precise moment when the market will turn, and actually suspect that a protracted bottoming out process is more likely, we are sticking to the rigour of our thematic process and trusting the particular strengths of our Core Themes. From Pricing Power we need superior free cash flow (PP), and we expect our gorillas to have sustainable edge (IP and Excellence) as well as superior control over the value chain (Security of Supply). But particularly, we demand that they have strong support from their bankers or, better still, no need for bankers. The companies screening best for all these attributes form our universe for "The Strong Get Stronger."

The Search for Autonomy

At this moment we rate especially highly any company which we feel has superior control over its own destiny. AD Little, our retained consultant, reminded us in our last quarterly brainstorming session, of the importance that some companies place on a sophisticated

venturing strategy. This is a way to align interests, and control more of the value chain, without the need for formal acquisition or merger. Electrolux's manufacture of the Kenmore range of white goods for Sears would be an example. The strategic advantage is that ventures shrink the market available to competitors who find Sears outlets virtually closed to their brands. So in addition to financial autonomy of self-funding, which will require hard analysis, we shall be looking also for softer examples of autonomy within our companies. Leadership in trade associations, vendor funding deals, big factories in swing states, or scholarship programmes to pick the best post-graduates in a specialist area (say enzymes or proteonomics), can all be indicative of a gorilla company's superior ability to shape its environment.

Joining the Sage who knows his Onions

The Sage of Omaha, Warren Buffet, is already starting to deploy some of the cash in his war-chest, and it is instructive to study his own approach to the risk/reward opportunities. I see three elements. He uses the pricing power that his own prestige has conferred to obtain a tranche of Preferred Stock yielding 10%, plus five-year warrants, to participate in any share rally from current depressed levels, and all conditional on the House passing the TARPs package. He has combined yield, leverage to the rally, a five-year option (very expensive when volatility is so high), and the chance to take his chips off the table if the circumstances change. We would like to emulate this within our portfolio, but lacking Buffet's ability to cut such extraordinary deals, we have instead recently bought Berkshire Hathaway, his investment vehicle, to put into our new Core Theme, and co-invest along with him.

Nifty Gorillas

Without broad earnings momentum to give confidence across a market where the financial sector has undergone such massive structural change, we feel that liquidity flows in the equity market will be drawn toward "The Strong Get Stronger" for their ability to self-fund. This is reminiscent of the 1970s money that gravitated toward the Nifty Fifty confident of their ability to sustain growth. The difference this time is that we do care what multiples we pay to own the strong self-funders. The largest and most robust, their PEs beaten down to single digits, offer the best store of value and promise of future earnings, and can ease their way through the period of capital rationing with disposals and cost reductions. They will be an obvious destination for conservative and consensual liquidity flows. Although it is not glamorous for us to run with the sheep, it consoles us to give this theme the sub-title "Gorillas in the Mist" and we heartily hope they will emerge from the mist thumping their chests.