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Capital Management Group

A View from Asia

FOR PROFESSIONAL INVESTORS ONLY

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Compound interest - when the interest rate is applied to the original principal and any accumulated interest.

Alice would be at home in today's investment world. You remember Alice, the one from Lewis Carroll's 'Alice in Wonderland'. There are such wonderful monologues and dialogues in that book. The one that stands out for me is between Alice and the Cheshire Cat.

"Well! I've often seen a cat without a grin,' thought Alice 'but a grin without a cat! It's the most curious thing I ever saw in my life!"

All our lives we have learnt about the holy grail of investing: compounding returns and compound interest. Albert Einstein called compound interest "the greatest mathematical discovery of all time"; some people speculate he said it's the eighth wonder of the world. Compounding is the process of generating earnings on an asset's reinvested earnings. If a business generates high returns on capital, and is able to redeploy those earnings into similar or higher return-earning assets, the value of that business grows exponentially. That is what we try and do in our process: identify and invest in compounders.

For compounding to work, it requires two things: the re-investment of earnings and time. The more time you give your investments, the more you are able to accelerate the income potential of your original investment, which takes the pressure off of you to work harder. But you also need positive interest rates or positive returns on capital.

Now contemplate our current financial world of negative interest rates. How then does compound interest work today? It's almost like a grin without a cat. In Japan, the latest victim of negative rates, savers are buying safes to store physical cash. In some Nordic countries I hear that the governments will impose fees or taxes to prevent tax-payers from pre-paying their taxes. In the past you wanted to reward companies that had a negative working capital cycle, but would creditors now start paying up earlier? Will we have to penalise companies that hold cash? What happens to insurance companies, let alone the banks? We can only compound the phrase: savers be doomed.

I am now more convinced that the incipient deflationary mind-set is becoming engrained in our collective psyche. Asset price action seems to be suggesting this outcome. It is not an easy place to be in when faced with deflation. It is like a slow drip of water on your head; the pressure of each drop is hardly felt, but over time it takes its toll. Very few parts of the world and very few sectors have learned to live with deflation. How could you have given the past 30 years have been defined by credit, misallocation of capital and asset inflation? Luckily, Asia did experience a deflationary crisis once before, in 1997-8. But as I mentioned in my last missive, only a few companies still adhere to those lessons.

I have tried to revisit all of our portfolio holdings through the looking glass of deflation. At the moment, I am relatively confident the businesses I have in the portfolio should be resilient enough. But this deflationary force is not country-specific or regional. It is global and hence vigilance is of the essence. After several years, I am suggesting that owning some cash might be prudent. In the past, I have always maintained that I want to be fully invested. After all, you do pay me to manage equities. But in the current environment I have a strong belief that holding some cash is critical. You might legitimately ask if I am taking a macro-economic view. I have to admit it is partly the case. But it is also backed up with feedback from several meetings we've had recently with companies and observations from results declared by a swathe of companies across the region. Prudence, to my mind, is paramount.

"One day Alice came to a fork in the road and saw a Cheshire cat in a tree. 'Which road do I take?' she asked. 'Where do you want to go?' was his response. 'I don't know,' Alice answered. 'Then,' said the cat, 'it doesn't matter."

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