INVESTING THROUGH THE CAPITAL CYCLE
A MONEY MANAGER'S REPORTS, 2002–15

CAPITAL RETURNS

EDITED WITH AN INTRODUCTION
BY EDWARD CHANCELLOR

CAPITAL RETURNS

Wall Street's Wheel of Fortune
(illustration by David Foldvari)

CAPITAL RETURNS

INVESTING THROUGH THE CAPITAL CYCLE: A MONEY MANAGER'S REPORTS 2002–15

Edited by

EDWARD CHANCELLOR

macmillan education palgrave

First published 2016 by
PALGRAVE

Palgrave in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of 4 Crinan Street, London N1 9XW

Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave is the global imprint of the above companies and is represented throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries

ISBN 978-1-349-55541-3 ISBN 978-1-137-57165-6 (eBook)
DOI 10.1007/978-1-137-57165-6

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

Library of Congress Catalogingin-Publication Data

Capital returns : investing through the capital cycle : a money manager's reports 2002–15 / Edward Chancellor.
pages cm

1. Business cycles. 2. Marathon Asset Management. 3. Speculation. I. Chancellor, Edward, 1962– editor. II. Marathon Asset Management.
HB3711.C353 2015
332.6—dc23 2015025955

CONTENTS

LIST OF CHARTS, ILLUSTRATIONS AND TABLES

CHARTS

ILLUSTRATIONS

TABLES

FOREWORD

Marathon Asset Management LLP[1] will shortly celebrate its 30th birthday. Over three decades, our investment philosophy has evolved, but two simple ideas about how capitalism works have always been paramount.

The first notion is that high returns tend to attract capital, just as low returns repel it. The resulting ebb and flow of capital affects the competitive environment of industries in often predictable ways – what we like to call the capital cycle. Our job has been to analyze the dynamics of this cycle: to see when it is working and when it is broken, and how we can profit from it on behalf of our clients. The second guiding idea is that management skill in allocating capital is vital over the long-term. Picking managers who allocate capital in sensible ways is crucial to successful stock selection. The best managers understand the capital cycle as it operates in their industries and don't lose their heads in the good times.

We found that the kind of opportunities created by capital cycle analysis often have long gestation periods, as the timing of the pay-off was highly uncertain. As a result, we discovered that our approach has worked best when we invested in a relatively large number of stocks, holding onto them for long periods of time. This rather goes against the grain of our industry where the preference has been to hold concentrated portfolios, confirming a fund manager's conviction in his or her ideas, albeit for shorter and shorter periods of time.

While we have sometimes struggled to explain our stance to consultants and other professionals in the financial services arena, it has always proved easier when it came to our clients. The latter – pension funds, state funds, foundations and endowments, predominantly in the United States – are often staffed by individuals with experience of working in non-financial businesses. A common refrain from them when explaining our process is "that's just common sense." Fortunately for us, these ideas about how the capital cycle operates and how management allocates capital are not widely followed by our own competitors in the investment industry. This throws

[1] Trading under the name of Marathon-London in the United States.

up investment opportunities for us around the world. While we have made innumerable errors over the years, our overall record in terms of relative performance has been favourable.

Furthermore, the investment approach has fared well under conditions of extreme stress and market madness. The Asian Crisis of the late 1990s and the technology, media and telecoms (TMT) bubble of the turn of the millennium were documented in our last collection of essays, *Capital Account*.[2] Since 2004, the principal stress test was the long run up to, and calamitous aftermath of, the Global Financial Crisis (GFC). The challenges this posed for fund managers is the main story of this book. We were responsible for numerous howlers – catching "falling knives" from the detritus of both the TMT bubble and the GFC, as well as numerous errors of judgment when it came to picking management teams. Our hall of shame includes the likes of Bear Stearns, Bradford & Bingley, Blockbuster, MBIA, HMV etc., etc. Nevertheless, overall performance has been gratifying, giving us confidence in the robustness of the investment philosophy.

This good fortune is matched by our success in persuading Edward Chancellor to reprise his role as editor of this volume of essays taken from the period 2002–15, as well as to write an insightful introduction. We thank him, along with Marathon's employees, past and present, for their role in building this firm and creating this book.

Neil Ostrer, Founding Member
William Arah, Founding Member
June 2015

[2] Edward Chancellor (ed.), *Capital Account: A Money Manager's Reports on a Turbulent Decade 1993–2003* (2004).

PREFACE

Capital Returns appears just over a decade after the publication of Marathon's previous publication, *Capital Account*, which I also had a hand in editing. This new work is arranged along the same lines as its predecessor. The pieces here have been selected from the firm's *Global Investment Review*, which appears eight times a year and typically contains six essays of around 1,500 words in length. The review, or *GIR* as it is known in-house, is written to inform Marathon clients of the firm's investment approach and to provide real-time insights into developments in the investment world.

The essays collected in the current volume have been chosen because they exemplify Marathon's capital cycle investment philosophy, which Marathon believes to be of some interest to the wider investing public (and perhaps even the odd economist if any can bring himself or herself to read a book devoid of equations and mathematical models). The process of selection inevitably leads to what is known in the investment world as "survivorship bias": those essays which haven't survived the test of time, or have turned out to be plain wrong, have been jettisoned, while the better investment calls have largely avoided the cull. The result is to make Marathon appear more clairvoyant than is actually the case – one could quickly put together a far larger volume of duff pieces! My intention has not been to flatter the authors' prescience, but rather to find interesting examples of capital cycle analysis, as applied by Marathon's analysts over the past decade.

As before, I have been given a free hand in editing and have employed the same technique as formerly. Namely, I have edited the text to make it read more fluently than when it first appeared. Editing a text long after it has been written necessarily involves some hindsight bias. This diminishes to some extent the integrity of *Capital Returns* as original source material. My aim, however, has been to draw out the capital cycle analysis as clearly as possible without changing the meaning of the original piece.

The authors of the essays in this collection are (in alphabetical order): Charles Carter, David Cull, Mike Godfrey, Jeremy Hosking, Nick Longhurst, Jules Mort, Michael Nickson, Neil Ostrer, James Seddon, Nick Sleep, Mike

Taylor, Simon Todd and Qais Zakaria. I have received even more help putting together *Capital Returns* than with the earlier volume. Simon Todd valiantly started out the selection process, which in many ways is the most arduous aspect of the job (there were over 600 essays from which to pick). Quentin Carruthers undertook the initial sub-editing. William MacLeod has assisted with many of the footnotes. Nicola Riley has helped on the administrative side, printing off numerous drafts and sending me countless files. Bridget Hui kindly checked the proofs. As with *Capital Account*, the present volume is largely the product of my friend and former colleague Charles Carter. It has been a pleasure working with him again.

Edward Chancellor
June 2015

INTRODUCTION

This book contains a collection of reports written by investment professionals at Marathon Asset Management. What makes these reports stand out, in my opinion, is an analytical focus on the ebb and flow of capital. Typically, capital is attracted into high-return businesses and leaves when returns fall below the cost of capital. This process is not static, but cyclical – there is constant flux. The inflow of capital leads to new investment, which over time increases capacity in the sector and eventually pushes down returns. Conversely, when returns are low, capital exits and capacity is reduced; over time, then, profitability recovers. From the perspective of the wider economy, this cycle resembles Schumpeter's process of "creative destruction" – as the function of the bust, which follows the boom, is to clear away the misallocation of capital that has occurred during the upswing.

The key to the "capital cycle" approach – the term Marathon uses to describe its investment analysis – is to understand how changes in the amount of capital employed within an industry are likely to impact upon future returns. Or put another way, capital cycle analysis looks at how the competitive position of a company is affected by changes in the industry's supply side. In his book, *Competitive Advantage*, Professor Michael Porter of the Harvard Business School writes that the "essence of formulating competitive strategy is relating a company to its environment."[1] Porter famously described the "five forces" which impact on a firm's competitive advantage: the bargaining power of suppliers and of buyers, the threat of substitution, the degree of rivalry among existing firms and the threat of new entrants. Capital cycle analysis is really about how competitive advantage changes over time, viewed from an investor's perspective.

[1] Michael Porter, *Competitive Strategy* (1980), p. 3. See also *Capital Account*, pp. 6–7.