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Return of the Mega Cap

As regular readers of this piece know, we have a firm technical or behavioural bias when we look at markets. The main objective of this analysis is to identify market trends and invest accordingly. Unfortunately not all trends persist for a long time but some do and if we combine our technical view with fundamental analysis this gives us a greater chance of identifying the sustainable winning trends.

So what trends do we observe now? Over the past few months the most readily observable trend has been the impressive outperformance of large global multinationals. Many of these companies (Nestle, Diageo, Coca Cola, Colgate, etc) broke out of consolidations last year and have been leading markets higher for several months. The reason for this trend seems clear; these companies have bullet proof balance sheets, established brands and growing revenues, thanks in large part to new markets in the developing world.

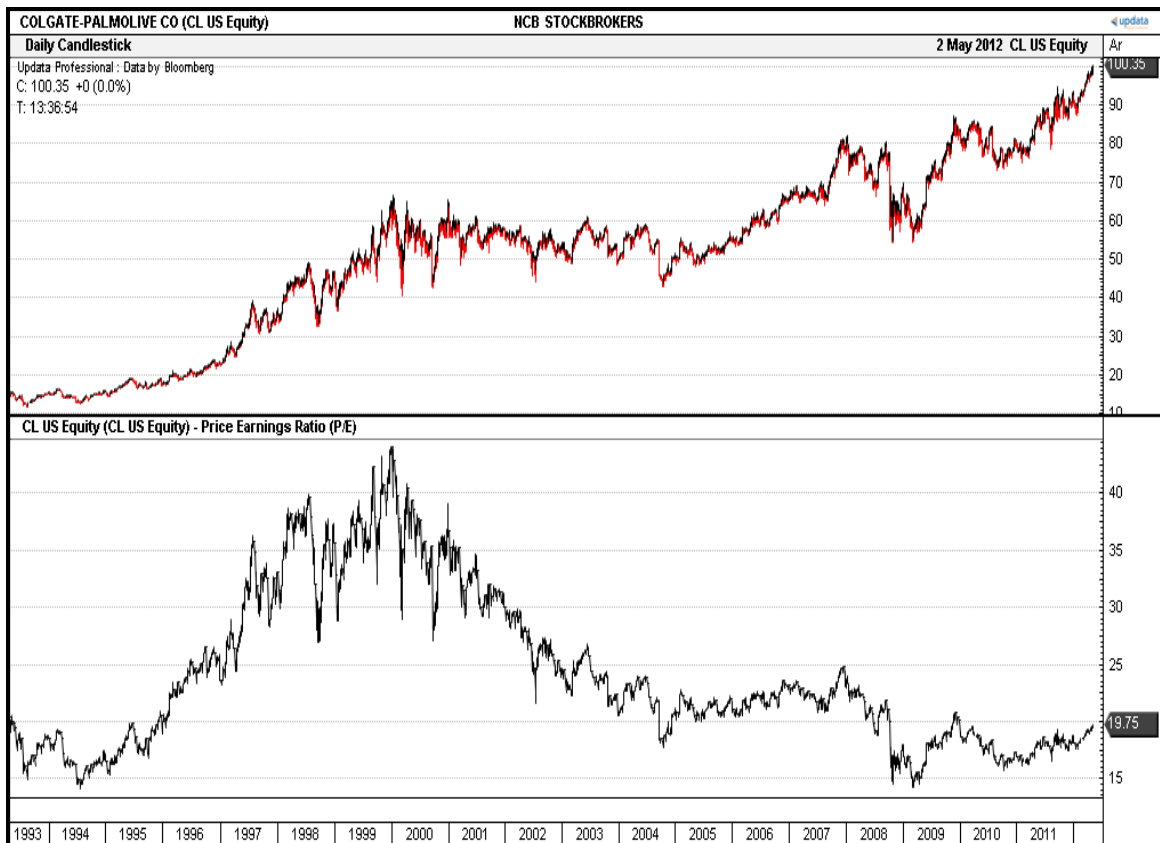
So here we have a combination of very supportive technical price behaviour and a very logical explanation for the recent outperformance. If we further turn to fundamental analysis, we see that most of these companies trade on price/earnings (P/E) multiples in the 15-20 range. This is not super cheap but in most instances this represents a discount to the average multiples these companies have traded on over the past decade. Let's take Colgate for example, the stock has just moved to an all time high and looks expensive on a P/E of 19.75. However, this is below the average P/E of 21.35 for the last 10 years and some way below the highs above 40, reached at the end of the tech boom. Looking at Johnson & Johnson, we see that the stock is currently on a multiple of 13 compared to an average of 17.8 for the past 10 years and again somewhat below its peak around 37 in 1999. We could go on.

There are multiple examples like this in the US and in Europe and while these companies are not at record cheap levels, they are inexpensive relative to their history and they have a powerful combination of balance sheet strength, growing revenue and dividend yields in excess of 'safe haven' government debt. It is quite possible that these companies become expensive but they are not now.

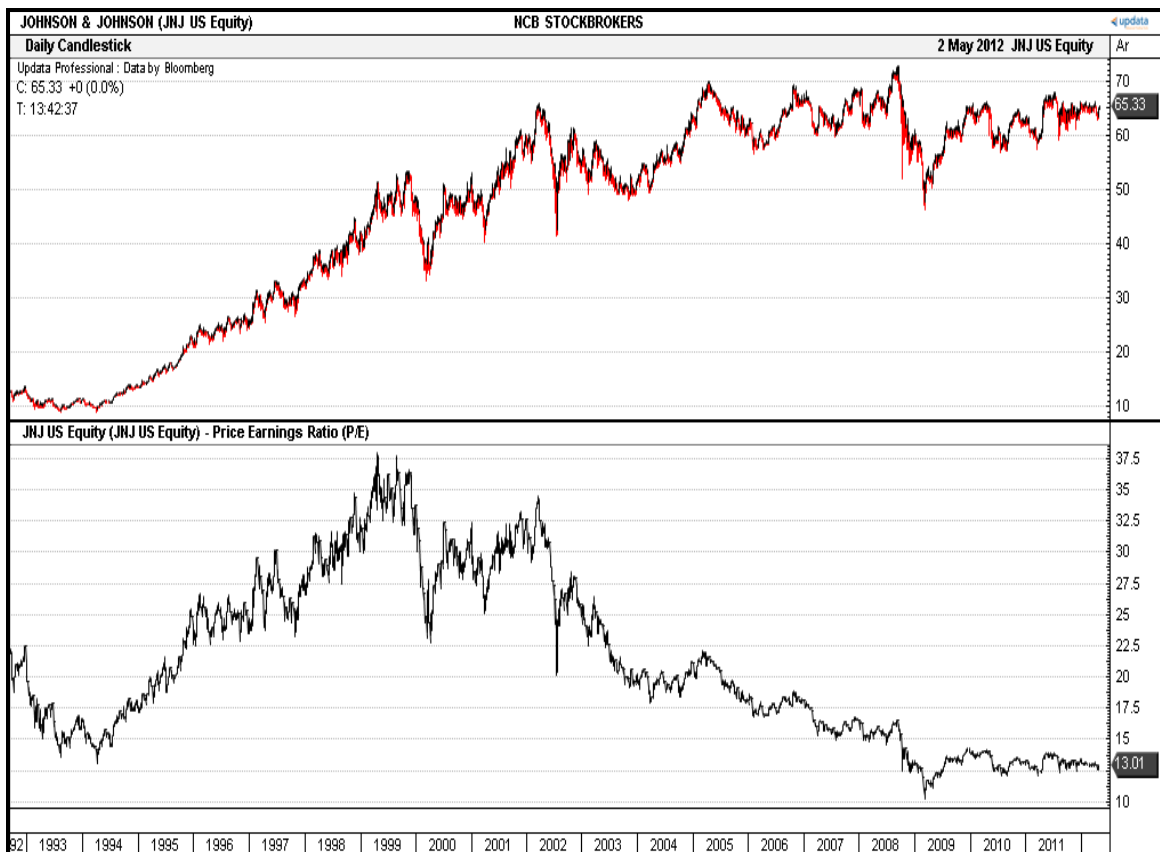
While a number of these multinationals have performed well of late we do not think it is too late to buy them. While buying on dips is always sensible, the current valuation of these stocks tells us that we should be happy to accumulate at current levels. It is instructive to think that if an investor bought Colgate and Johnson & Johnson at the worst time in history, in 1999, when they were very overvalued, they would not have lost money if they held firm. At current valuations, if an investor takes a diversified approach to buying a basket of high quality multinationals there is very little risk of permanent loss of capital in our view.

For more details on the multinationals we like and how we invest in this theme please contact us.

Colgate-Palmolive



Johnson & Johnson



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Footnotes

1. Ratios where share price is an input are calculated using (a) the respective fiscal year average share price for historic years and (b) the current share price for current and future years.