

## How do you know something is cheap?

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Having been in the investment industry for over 30 years it is still confusing to us that most investment processes attempt to put the valuation of an asset at their core. In simple terms the decision these investors are making is either that an asset is cheap today because of its historic attributes or it is cheap today because of what it may do in the future. In reality neither of these simplistic approaches is right. For example, are you considering the value in nominal or real terms? If it is future prospects that you are buying, how can you be more than 50% certain that other factors will not derail your thesis? What else could you buy to have the prospect of the same return with higher certainty?

The world is a complicated place and history shows that trying to assess the valuation of an asset from day to day is futile. Something that appears expensive today may not be, and something that appears cheap today could remain cheap for many years. The past decade has shown that technology companies that appeared expensive continued to rise in value due to other factors: primarily that interest rates were at zero and it became free to speculate.

At Tacit our approach is different. We have considered the long data sets available to us in the context of the environment in which we are now forced to invest: a dominant US economy, US\$ as the safety currency of choice for most, increasing protectionism, the global population and demographics, the ongoing 100+ conflicts around the world, and highly indebted western governments to name just a few. Our conclusion when considering this long data set, and overlaying the prevailing environment, is that there is no clear connection between asset valuations and any of the factors we have listed. In fact, many of these factors should lead to lower asset prices today but they have not.

We could now spend the next section of this week's Thought explaining why we think this is, and the Tacit view on this analysis. But we have stated many times that we do not forecast, and instead we attempt to stack the odds in the favour of our clients. You will be familiar with our three core principles for choosing companies to invest in: strong balance sheets, the ability to increase cash flow even through periods of inflation, and the compounding effect of reinvesting profits. When asset prices in our universe have gone up, we become more cautious and when they go down, we become more positive. Some companies still appear expensive on conventional valuation measures whilst some appear cheap but their strong balance sheets and increasing cashflows stands them in good stead.

Currently, following a period of broad market falls last year, we find that a wide selection of our preferred investments are trading below their longer-term averages as measured by the price to earnings multiple. A sustainable upward move in equity markets will need confirmation that inflation is under control and that inflation expectations are once more anchored around the 2-3% level which is the policy target of most central banks the West. When this confirmation comes, it will likely be too late to take advantage of the valuation opportunities as prices will move very quickly to reflect this new stage of the investment cycle. In the meantime, the current dividend yields on our strategies are now over 3% which means investors are being paid to be patient.

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