Eleon Capital Management Ltd.

- MARKET OUTLOOK -

EDITION 1/2024

NET ASSESMENT

JANUARY

*T*he Yield to Maturity (YTM) of a bond is the rate that equates the market price of a bond to its future cash flows. For an investor to realize the YTM, it is necessary to reinvest the coupons received at that yield over the remaining duration of the bond's life. Should the prevailing YTM of bonds be lower than what was originally bought, the return achieved by an investor will be lower than when it was initially bought and vice versa. Further, should the investor not reinvest the coupons received, they will almost certainly not realize returns commensurate with the initial YTM. Another issue with bonds is that they have set payment amounts, which implies that should actual inflation be higher over the maturity of the bond than the inflation expectations initially priced in at the time of purchase, the investor, in real terms, will be worse off.

*T*o an extent, equities can also be thought of as bonds (think of coupons as free cash flow to be paid as dividends or through share buybacks) with some exceptions. Specifically, there is no maturity *date*, the value of free cash flows is unknown, and the full or partial payment of the free cash flows through dividends or share buybacks is entirely at the discretion of management. The most crucial difference between equities and bonds, or any other asset class for that matter, is that with equities, management can retain earnings for growth. Assuming these retained earnings can be invested by management at decent returns (i.e., more significant than a company's cost of capital). The company becomes a compounding mechanism, increasing the equity's intrinsic the primary reason that equities over a long-time horizon have better returns than most asset classes, albeit with higher volatility (not risk).

*E*ven though very little value is placed on macroeconomic expectations (although they are almost certainly important), above-average returns can best be achieved at lower risk by identifying those equities that can retain their free cash flows and grow them at reasonable returns above their cost of capital over a long-time horizon. The reason is that most equities valuations are based on the microeconomic phenomenon of reversion to the mean, i.e. a firm's return on invested capital (ROIC) tends towards the mean as competition gradually erodes margins. For those equities where reversion to mean does not apply (there are indeed some but very few), they will generally be mispriced by the market.

*A*t present, the trajectory of inflation and as a result, interest rates are too uncertain. Although inflation has moderated, it is still sticky, and there is no compelling reason why interest rates should fall rather than remain where they are, given that, by historical standards, they are more typical than what they have been over the last 20 years. Given this unpredictability, the prevalent geopolitical tensions could affect trade, prospective markets to access, and labour outsourcing; hence, caution is warranted for companies' margins and growth prospects. A fair balance between bonds and quality equities is rated.

20 January 2024

Strong Roots, Sustainable Growth

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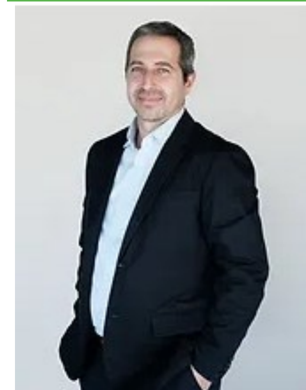

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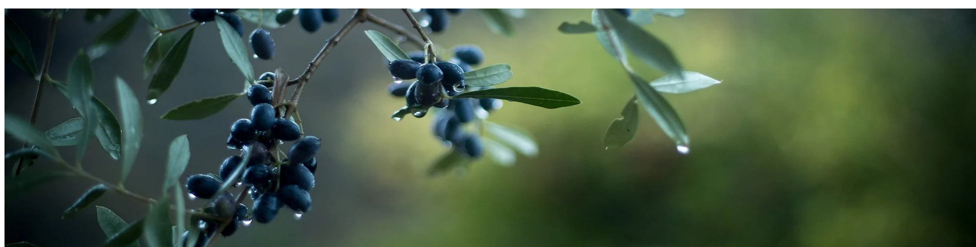

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