MelvilleDouglas
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Melville Douglas

Global Equity Fund

You Can't Always Get What You Want

The first nine months of 2018 has not been quite the bed of roses projected by economic soothsayers at the start of the year. Whilst the US economy continues to cruise on, Europe has shifted down a gear and some emerging markets have even gone into reverse.

The US economy has powered ahead, fuelled by tax cuts and a continued improvement in economic confidence. Unemployment is at multi-year lows, and wage growth – though modest – seems to be improving. Growth in consumer spending and business capital investment are both firmly in positive territory. The latest reading of the US Institute of Supply Management (ISM) Manufacturing index – a measure of corporate confidence in economic conditions – was at a 14-year high at the end of August. In fact, if one were to exclude the peak of the index (61.4, set in May 2004), the current reading of 61.3 is the highest level for more than three decades. Small business confidence is equally high.

Using history as a guide, if August was the peak in the ISM index, the stock market would not peak for another two years on average. As shown in the table below, it would take another two-and-half years until the economy would drop into recession. The notable exceptions were the two oil price shocks in the 1970s, which is very much a long tail risk on our current analysis.

ISM Peak		S&P 500 Peak			Start of Recession	
Date	Level	Date	% Gain	# of Months	Date	# of Months
Jul-50	77.5	Jan-53	49.4%	30	Jul-53	36
May-55	69.5	Aug-56	31.2%	15	Aug-57	27
May-59	68.2	Aug-59	3.1%	3	Apr-60	11
Jan-66	65.8	Nov-68	16.7%	34	Dec-69	47
Jan-73	72.1	Jan-73	N/A	0	Nov-73	10
Jul-78	62.2	Jan-80	14.4%	18	Jan-80	18
Nov-80	58.2	Nov-80	N/A	0	Jul-81	8
Dec-83	69.9	Jun-90	122.8%	78	Jul-90	79
Oct-94	59.4	Mar-00	223.4%	65	Mar-01	77
May-04	61.4	Oct-07	39.7%	41	Dec-07	43
Median	**67.0**		**35.5%**	**24.0**		**31.5**

Source: US Institute of Supply Management, Canaccord Genuity, Bloomberg, Melville Douglas

Wall Street is at a new record high, the US economy is in overdrive and the consumer is starting to spend. Why isn't the rest of the world joining in?

As soon as one looks beyond the US, the divergence in economic growth becomes painfully obvious. A lacklustre Europe has only just started to regain its feet after the initial acceleration in growth was curtailed by an extremely cold winter. Even worse, some of the more fragile emerging markets were exposed by higher US interest rates and a reversal of capital into the US dollar, with some seeing ominous echoes of the Asian and Russian crises of 1997 and 1998.

All of the above is playing out against the backdrop of an increasingly fraught global trading backdrop, with the US imposing tariffs on Chinese imports (with China responding in kind) and looking to aggressively renegotiate other trade deals, such as those with the EU and NAFTA.

We acknowledge the multitude of risks, but do not think that macro-economic prognostication is a reliable method of generating performance for our clients. Instead, we allow the wonder of compound returns to take effect by investing in quality businesses that are well run, exposed to secular growth trends, in a healthy capital position, and possessed of a competitive advantage.

Quarterly Commentary as at 30 September 2018

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From Our Fund Manager's Desk

Our quarterly reports regularly explore the investment rationale of one of the companies we own in the Fund, to articulate what we find compelling. For this report, we have chosen Snap-On Inc.

In scouring the investable universe for ideas, our investment philosophy and process delivers certain outcomes. For example, utilities don't look attractive to us on either qualitative or quantitative measures. Equally, deeply cyclical businesses struggle to make it onto our radar, as the return profile is overly dependent on getting the timing of the purchase decision right. In addition, many deeply cyclical businesses don't generate a return on capital in excess of their cost of capital through a business cycle – an immediate disqualifier for us.

This does not mean cyclically sensitive businesses can't make it into the fund. However, in addition to meeting our normal qualitative and quantitative criteria – we need to do a lot of ground work to truly understand this kind of business and build the requisite amount of conviction before allocating our capital at an acceptable margin of safety. We think Snap-on Inc. is one such business.

Snap-on provides tools, equipment and diagnostic hardware (and software) to the automotive maintenance industry, targeting professional mechanics, service centres and even the auto-manufacturers themselves. From purely being a provider of hand-tools in the 1990s, Snap-on has expanded its offering to address the entire automotive service landscape. Its tools are generally considered as the best and a must-have for a professional mechanic. Snap-on is able to charge three or four times more than an equivalent in a retail store, such as Home Depot, given their quality and life-time warranty. In fact, the CEO had once described their offering to us as the "Gucci of spanners". As a result, their products sell at a sizeable (as much as 50%) premium to the professional offering provided by their closest competitors.

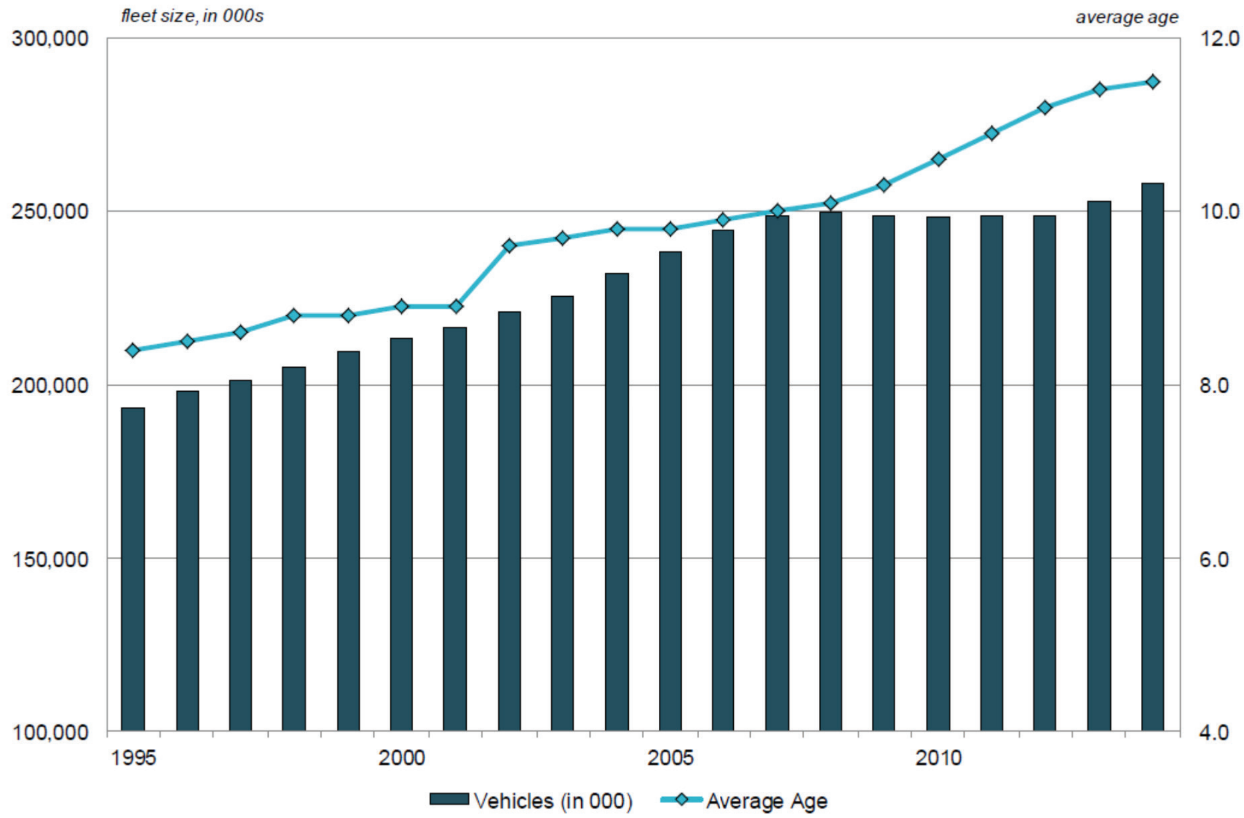
Snap-on primarily does business in the USA, where the automotive mechanic market functions slightly differently to what most might expect. Roughly 80% of mechanics are independents and as such, have to provide their own tools when approaching a garage to practice their trade. The remaining 20% is split roughly 60/40 between car dealerships and commercial machinery mechanics.

Snap-on targets the independent mechanics via a unique distribution model: a fleet of vans operated by Snap-on franchisees. This represents a significant competitive advantage as it would require a lot of time and money to set up such a sales force from scratch. In effect, every Snap-on van on the road is a small, independent business, operated by someone who pays Snap-on a franchisee fee to operate the concession. In addition to the franchise fee, these operators also purchase the tools they sell out of the van from Snap-On – in many cases funding the purchase via Snap-on Credit, the in-house financing option.

Each van-owner then has an assigned route they drive weekly, selling the tools and equipment to the roughly 250 mechanics they service. Driving the route on a weekly basis is seen as an essential part of the sales strategy: not only does it build a sticky relationship between the mechanics and the Snap-on operators, it enables the operator to give real-time feedback to Snap-on to better anticipate demand. In addition, the franchisor uses this visit to collect the weekly payments on the sales they make to mechanics – a business practice successfully employed by Snap-on for several decades now. Mechanics are regular and prompt payers when it comes to their Snap-on tools, as it literally represents their livelihoods.

The growth of the US auto repair market is largely driven by the age of the vehicle fleet, combined with the average age of vehicles. Over the last decade, Americans have chosen to run their cars longer and opted for additional repairs over purchasing a new vehicle. The recent economic strength has seen an uptick in new car sales, which one would naturally assume causes a decline in business for independent mechanics.

US Vehicle Fleet Size and Average Age



Source: Company reports, HIS, US Department of Transport, Census Bureau, Baird Research

The opposite is actually true: the hugely increased technological complexity of newer cars has necessitated more repairs, with specialised equipment required to do it. Snap-on has benefitted from this trend by expanding its offering to offer diagnostic equipment in addition to tools and has expanded its addressable market as a result. Snap-on has the industry's most advanced offering, which leverages the proprietary database of over 1bn repair records to offer mechanics the best possible diagnosis and repair decisions.

This trend towards increased complexity is expected to continue. Combined with the strength of the Snap-on brand, the quality of the product (and an extremely robust warranty programme) and the close relationship between mechanics and the franchisee force, there is an attractive case to be made for secular growth over the next few years. In addition, Snap-on enjoys the benefits of substantially lower working capital requirements than most businesses exposed to the industrial cycle due to the franchise sales model. As such, the company also has best-in-class returns on capital, which can be reinvested into the business.

Outside the US, its sales are less reliant on a franchise force. The tools and diagnostic equipment are largely sold to car dealerships or auto manufacturers directly. Even here, the brand and product quality are enough to keep buyers loyal. One would think that price competition in this space is intense, yet the warranty conditions, speedy delivery and brand perception are all cited as much more relevant in making a purchase decision than having the lowest price.

In our opinion, the combination of continued organic revenue growth (with a supportive secular outlook) and further opportunities for margin expansion equate into strong free cash flow generation for the next several years. Snap-on is a unique business in the Industrials sector, and one that has quite some runway for growth left before it.

Quarterly Commentary as at 30 September 2018

Sometimes, You Get What You Need

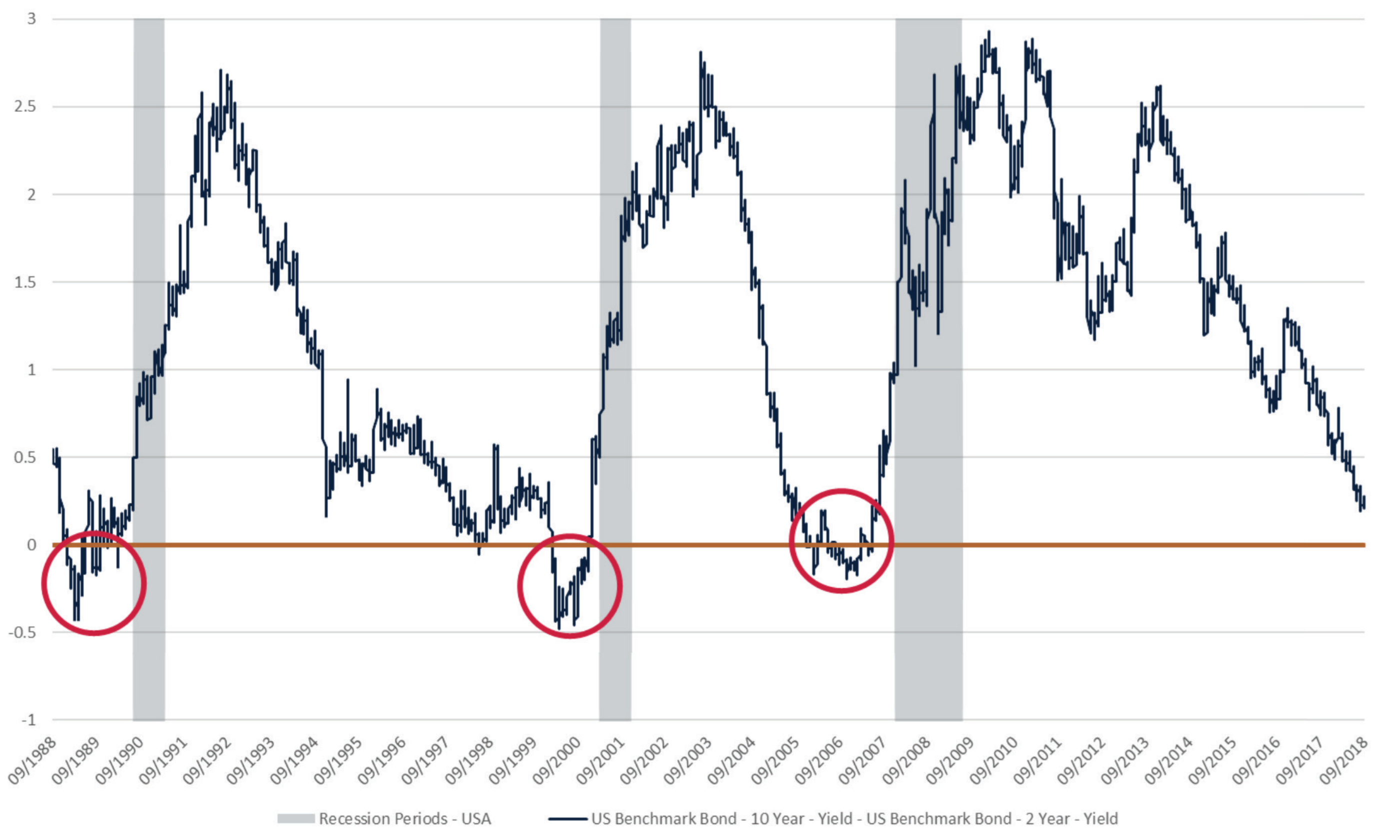
As the Rolling Stones (accompanied by the London Bach Choir) told the world in 1969, you can't always get what you want. Those looking for a repeat of the extremely low-volatility, high-return market conditions of 2017 have been disappointed this year.

The traditional 'pull' effect of a late-cycle US consumer boom has not been as acute in this cycle, meaning economies outside the US are more reliant on internal forces to generate growth. As such, the global synchronization that drove much of the 2017 rally seems to be breaking down, as few economies outside of the US have sufficient momentum to meaningfully push GDP growth above trend for a sustained period of time.

We continue to closely monitor the business cycle for any change in trend. Corporate revenue growth and margins serve as good bottom up indicators of the economic outlook. As we have stated before, any indication of a move from a late-cycle expansion into a more pronounced slowdown would likely see the fund tilt defensively within our universe of companies.

The US Treasury yield curve is a useful indicator to watch as a possible red flag for economic momentum beginning to slow. The yield curve is calculated as the result of subtracting the ten-year and two-year US government bond yields from each other. This measure has gone into negative territory prior to each of the last three recessions. This phenomenon – known as a flattening yield curve – suggests we are well advanced in the current cycle.

US 10-year Treasury yield minus US 2-year Treasury yield



Source: US Department of Treasury, FactSet, Melville Douglas

Quarterly Commentary as at 30 September 2018

US growth (and by implication, global growth) is likely at peak levels for this cycle. Although a recession is not imminent, the lateness of the business cycle and the global rollback of central bank liquidity has led to the fund gradually tilting its positioning more defensively. To this end, we have recently added to select Health Care names - to wit, UnitedHealth and Anthem. These are quality businesses that have attractive growth prospects, but they are less cyclically sensitive, given their exposure to the drive to extract costs from the US medical system.

At the same time, Snap-on is a recent addition, and is arguably more cyclical. We are happy to add to a quality cyclical business if the fundamentals are attractive and there is a sufficient margin of safety in the valuation – as we have said before, the fund is not managed by making big macro-economic calls. It also speaks to another key consideration when it comes to our portfolio construction philosophy – balance matters. We do not believe in building one-way-bet portfolios and prefer to let the fundamentals guide us when selecting stocks.

Despite the year not playing out to script for many macro traders, investors who have focused on the fundamentals of quality businesses have been rewarded this year. As Messrs. Jagger and co. pointed out at the closing of the 1960's, you can't always get what you want, but sometimes, you get what you need.