Quarterly Commentary as at 30 June 2018

MelvilleDouglas
A Member of Standard Bank Group

Melville Douglas

Global Equity Fund

Taking care of the pennies

At his Spring Statement the UK Chancellor of the Exchequer announced a review into eliminating penny coins. The potential loss of an iconic monetary unit reflects the rising cost of living and the ongoing digitisation of payments. Shockingly, six out of ten copper coins in the UK are spent only once before being stashed in a jar or simply thrown away. Although many trouser pockets will be saved, the end of coppers may sadly be the death knell for arcade tipping point machines. Many hours of a drizzly British summer's holiday have been happily whiled away at the Golden Sands arcade in Cromer, Norfolk helping feed pennies onto a large pile of coins hanging over a precipice. Eventually, a single additional coin catalysed a satisfying and rewarding penny avalanche.

Similarly, stock market commentators fervently try to identify the final penny or cent that will tip the balance of this long bull market. Would it be a rogue inflation number, a toxic tweet or a misplaced word by a central banker? Rather like the machine at the arcade, identifying this last straw that breaks the camel's back is nigh impossible to predict.

Whilst traders fret about exactly whether the penny will drop today, tomorrow or next year, we remind ourselves to think long term. Indeed, the temptation to check portfolio performance on a daily basis is guaranteed to make you feel glum. Loss aversion is a hard-wired behavioural trait. According to psychological research we feel the disappointment of a loss twice as much as the pleasure of a similar gain. This is a problem given the probability of a stock market loss or gain on any one day is close to 50%. Successful investing is more a result of time.

MSCI All Countries World Index from 1988 to 2018 – frequency of negative total returns

Time Frame	% negative returns	
Daily	46%	Many losses experienced
Monthly	38%	
Quarterly	30%	
Yearly	27%	
3 Years	25%	
5 years	15%	
7 years	0%	No losses experienced
14 years	0%	

Source: Melville Douglas, Bloomberg

As the table shows, if an investor had looked at the market index once a year over the past 30 years he or she would have reduced losses down to one out of four occasions. Even better, a loss would have been experienced only 15% of the time over any rolling five-year period since 1988. Your patience is blessed if you take a biblical "feast and famine" seven-year view, which also happens to be the length of a typical business cycle. If so, you would have never experienced a loss over the past 30 years, despite the bankruptcy of Lehman Brothers, 9/11, the Dot-com bubble, both the Russian and Asian crises, and two Gulf Wars.

What has stood the test of time over the course of history is to pay a reasonable price for growing, cash generative businesses with a sustainable competitive advantage that, through the power of compounding, will build value over time. This fundamental approach is the foundation of our investment philosophy. It is a discipline that enables us to resist the pain of short term losses in order to capture larger long term gains.

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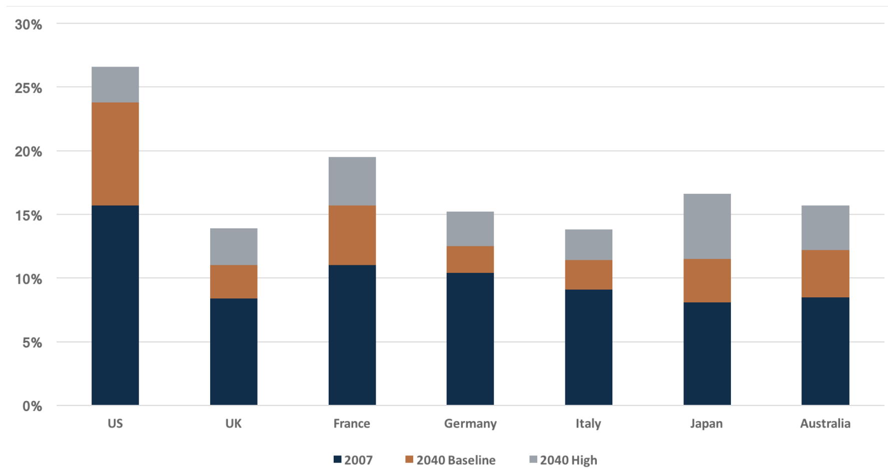
From our Fund Manager's Desk

Our quarterly reports regularly explore the investment rationale of one of the companies we own in the Fund, to articulate what we find compelling. This time round we have chosen UnitedHealth.

The ageing of the world's population is a ticking fiscal time bomb due to explode on younger generations required to support outdated social welfare programmes designed for 10 years of retirement rather than 30 years. A silver (or grey) lining is that this demographic mega-trend is also a huge opportunity for companies operating in the healthcare sector given the expanding cohorts of elderly patients.

The chart shows healthcare spending will consume an ever higher proportion of GDP in future. Surprisingly, the United States is expected to be one of the fastest growers even though it is already the biggest spender and has comparatively better demographics. This is a problem because spending more than a quarter of your GDP on healthcare by 2040 - much of it on those retired from the workforce rather than on productivity boosting investment, such as education and infrastructure - is not conducive to national wealth creation.

Healthcare spending as a percentage of GDP – 2007 and projected level by 2040



Source: McKinsey & Company (2013). Baseline projection based on best fit on past data. High case assumes higher patient expectations and better (i.e. more expensive) treatments

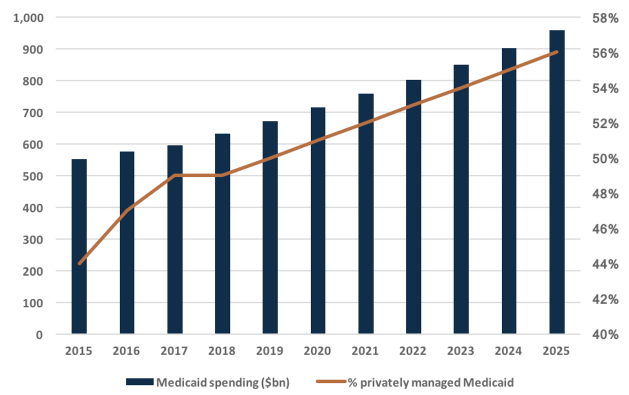
Profligate US spending is a result of a Byzantine healthcare system that is over layered by middle-men, is fragmented and has practitioners incentivised to overspend on treatments and tests. For example, even refilling a prescription is complicated as a US patient requires a doctor deemed suitable by his insurance company, a health maintenance organisation, a list of approved drugs, an approved pharmacy, a pharmacy benefits plan, and up to three levels of government approval.

UnitedHealth Group, a top five position in the Fund, is a part of the solution to the US health sector's inefficiencies and ballooning costs. In a nutshell this health insurance and services giant adds value through scale economics and a holistic approach via its broad offering. It has two business platforms: UnitedHealthcare and Optum. So, what does each do and why are they compelling?

The first, UnitedHealthcare, offers health insurance and benefit plans primarily in the US for employer and government controlled schemes. It has a competitive edge over its peers due to a larger network of doctors and other medical clients. UnitedHealthcare is gaining a larger slice of the pie as the government seeks to control costs by effectively privatising a larger proportion of two inefficiently managed federal-state health insurance programmes, namely Medicare (for people aged 65 years or older) and

Medicaid (for low income earners). The charts show the projected increase in the share of privately managed health insurance of these public schemes. We expect managed Medicaid and Medicare (called Medicare Advantage) to grow +8% and +9% per annum respectively to 2025. Market leader UnitedHealthcare is expected to grow revenues at a similarly vigorous rate.

Medicaid spending and proportion privatised



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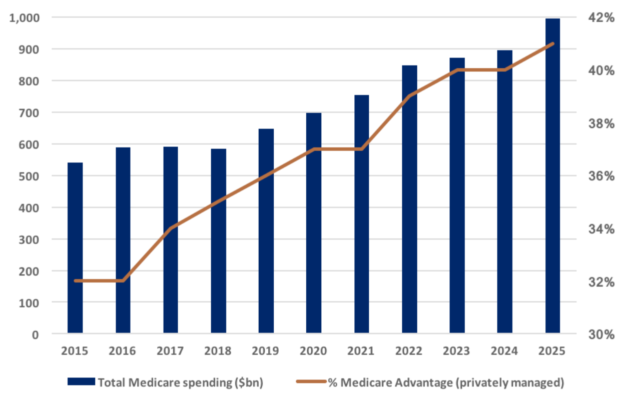

Source: Melville Douglas, Congressional Budget Office, CMS, Bank of America Merrill Lynch forecasts, Statista

The second business division is Optum, which is UnitedHealth's healthcare data analytics, consulting and services arm. It is the ying to UnitedHealthcare's yang. Optum's origins were as an in-house effort to lower medical costs for its Unitedhealthcare offering. It now also offers its services externally across the US healthcare sector, whether it is through lower priced medications from its OptumRx pharmacy benefits manager, the use of hospital data analytics via OptumInsight, or avoiding member hospital visits via preventative medicine and wellness programmes.

As well growing rapidly, Optum is also more profitable than the core health insurance business. US health insurers are mandated by their regulator to spend 80% to 85% on medical costs, and must give excess profits back to members. By contrast Optum only has to ensure it provides good services at a fair price. This means it can and does achieve higher profit margins and growth than the regulated insurance business, enabling it to surpass UnitedHealthcare over time as the group's largest business.

The combination of these two businesses will enable UnitedHealth Group's earnings to grow at a robust low-to-mid teens clip to at least 2025 due to demand for its Optum services, rising expenditure on healthcare amidst an ageing population and the expanding share of privately (more efficiently) managed health care within the Medicare and Medicaid government programmes. In our view it will be a while before this growth stock is put out to pasture.

QT or not QT

Are we at the tipping point for this long-in-the-tooth business cycle? As explained earlier, we see little value in attempting to time a random walk. However, it is still useful to assess the risk of capital loss over a meaningful timeframe, and whether further gains are possible.

The good news is that the fundamental backdrop provides little clue of an imminent downturn, albeit with the caveat that economic data tends to be a rear-view mirror exercise. A recent deceleration, partly due to a chilly Northern Hemisphere late winter, does not detract from job creation, business and consumer confidence and credit availability all lending support.

How about corporate profitability amidst a rising tide of labour, commodity and interest costs? What provides comfort is that top line growth and the associated operational leverage has tended to be the more important factor driving profitability. So long as the business cycle is expanding, margins can be sustained. The chart shows the positive correlation between operating margins and commodity prices. The same is true for wage inflation. In short, there is an overlap between pricing power and growth.

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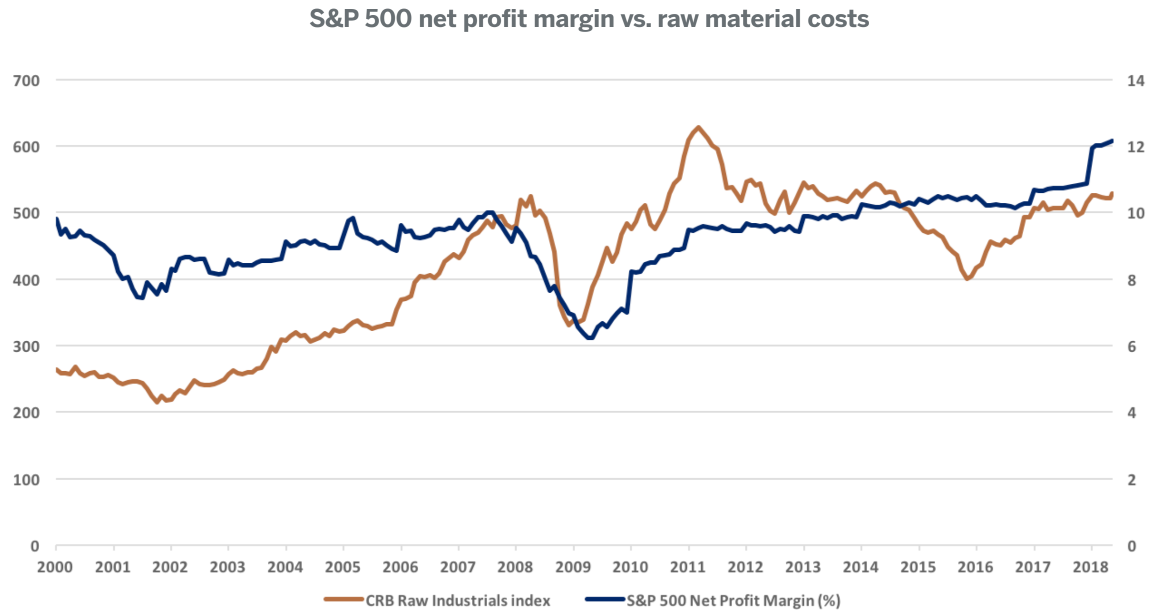

Source: Melville Douglas, Bloomberg

A more imminent concern is quantitative tightening (QT). QT is central banker speak for the reversal of their extreme and uncharted monetary response to the global financial crisis of 2008. Global liquidity will shrink for the first time since the crisis when the European Central Bank stops its asset purchases by year end. Without a valuation agnostic buyer, investors will be forced to reprice risk. QT is already being felt in the currency markets, particularly emerging markets, where higher US rates has driven switching into dollars. In equity markets an early casualty has been steady dividend paying "bond proxy" stocks in favour of virtually risk-free three month LIBOR cash yielding 2.3% and rising. For now, investors are rewarding companies that can deliver healthy earnings growth. As such we have incrementally added to pro-cyclical names, including a Spanish bank and a US car mechanic tool maker, where we find valuations and growth that stack up against a higher interest rate environment.

Over the past two years, economists have transferred their anxieties from deflation to overheating economies. Fortunately, this later stage of the business cycle is not incompatible with higher equity returns so long as earnings growth remains on an upward trajectory and inflation does not spiral out of control, both of which we expect. The catch is that long term returns will be less than what we have been used to given elevated valuations, ageing populations, lower productivity and high levels of sovereign debt. Perhaps we should look after those copper coins after all.