Melville Douglas Select Fund Ltd Global Equity Class

Minimum Disclosure Document as at 30 September 2016

Quarterly Commentary

The Central Bank on the Edge of Forever

As we enter the last quarter of 2016, it's difficult to believe that only three months ago, the immediate outcome of the Brexit vote and the implications for global growth was being hotly debated. After the extreme volatility that dominated the first half of 2016 – and in particular the wild market gyrations seen in January (following concerns on Chinese growth) and immediately following the UK referendum –investors would have been forgiven for believing that the latter part of the year would simply be more of the same.

It comes as somewhat of a surprise, therefore, to close the book on what can only be described as a reasonably benign three months.Equity markets have performed well, in aggregate: UK economic indicators post-Brexit have mostly been better than feared, China's economic growth trajectory seems to have stabilised, and the US consumer has continued driving their economy without any significant slowdown in spending. Given the strong recovery in base metal and energy prices, the outlook for emerging markets has also improved.

Against this backdrop of better-than-expected data, markets closely watched the Federal Reserve in September. Whilst an interest rate hike was not widely expected going into the meeting, the decision to again delay an increase in rates – despite improved data – does place the Fed in a tricky position. Commentary from the September meeting seems to suggest that forward guidance will improve, and a hike should be expected before the year is out, but given how often this "will-they-or-won't-they" discussion has come around, it is increasingly looking like market volatility is dictating Fed policy. Given that markets in 2016 have several major events with unknown outcomes ahead (the US presidential elections in November being one), there has to be a risk that any unexpected outcome – or deterioration of the global growth outlook - further delays a normalization of US policy rates into 2017.

At the same time, there seems to be a growing realization that the efficacy of the accommodative monetary policy adopted by central banks around the world has largely run its course. At the most recent ECB meeting, Mario Draghi indicated no discussion on additional quantitative easing took place. Whilst it is too early to call it a foregone conclusion, some sort of globally coordinated fiscal action – most likely in the form on infrastructure investment – is now being mooted as the next step to spur growth.

Globally, central banks are now caught between a rock and a hard place: forever on the cusp of wanting to normalize rates – if only to have some scope to cut when the next downturn inevitably hits – but unable to do so for a host of political, social and economic reasons. In a very real sense, there is a risk that any aggressive tightening policy triggers the exact downturn authorities wish to avoid.

This set of unprecedented policy settings has been supportive of equity prices, even as concerns about the nearly eight-year long US economic expansion mount. Such share price distortions may continue to be in place for some time to come, but as prudent long term investors, we are becoming increasingly selective about deploying cash, and keep capital preservation very much at the front of our thinking.

Investing in the cloud

Our bottom up driven research process leads us to invest in companies with secular growth drivers, as opposed to economies. Thus, despite the litany of macro-economic concerns that grab headlines, we think companies with a high component of annuity revenue, growing addressable markets, reasonable pricing power, credible avenues to expand margins and the ability to grow either grow free cash flow – or invest at rates of return that exceed their marginal cost of capital – remain compelling. One industry with such secular growth prospects resides within enterprise facing IT, where the transition to the cloud from the traditional computing model (on-premise software running on company-owned hardware) continues to gather momentum.

For a host of reasons, the transition to the cloud makes a lot of sense for corporates wanting to rationalize their IT costs. In the past, hardware upgrade cycles meant large amounts of capital expenditure, while software was generally licensed from the developers for a set period of time. Built into these economics was some level of support revenue as well. Regardless, this all meant a lot of upfront costs incurred for businesses: all the capital expenditure and most of the licensing revenue was front-end loaded.

The step-change in broadband speeds and availability has enabled a new model for delivering IT to large enterprises. The phrase cloud computing has become something of a blanket term, but serves as an accurate description of this new model of delivering IT services. Cloud computing essentially modularises the entire IT offering: hardware (or infrastructure), platforms (or middleware) and software (or applications) can all now exist in someone else's data centre and delivered as a service over the internet for a monthly fee per user.

In particular, the rise of infrastructure-as-a-service is enabling a huge increase in efficient allocation of computing power. In the past, companies would have to invest in hardware capacity as they started bumping up against the limits of what their current infrastructure could deliver. This investment was costly, and inherently implied there was some amount of excess capacity introduced into the IT environment, as new hardware was rarely used to full capacity off the bat.

With the advent of infrastructure-as-a-service, corporate clients can now scale up (and down) the amount of computing power and storage allocated to them in someone else' data centre. It's a win for businesses looking to cut capital expenditure, since the hardware investment is done by the infrastructure provider (such as Amazon Web Services, Microsoft Azure or Google Compute Engine). However, these infrastructure businesses can also enjoy the benefit of the economics: the cost of hardware will continue to compress, while the increased workloads run on their hardware means there is less 'idle capacity' inside the data centre.

This same concept is being applied to the platform and software layers of the IT, and in many cases by the same players. Initially, investors viewed this transition sceptically: for the likes of a Microsoft or SAP, it would appear that their revenue line is decreasing (due to the loss of the revenue that was recognized upfront under the previous IT model) whilst margins also compress. However, as the transition matures and fewer clients have to 'roll-off' the legacy model, revenues tend to become a lot more stable (due to the annuity characteristic of the monthly service charge) and margins recover rapidly as utilization of the data centre improves.

Over the last few years, several large IT players have credibly navigated this transition. In general, as soon as these legacy vendors could demonstrate they would be relevant in the cloud landscape, investors were much more comfortable in paying a higher multiple for the earnings. In the fund, Microsoft has been our primary exposure to this trend, and has performed extremely well. Part of the reason for introducing Amazon into the fund earlier this year was for the extremely attractive growth path we could see for Amazon Web Services (AWS), which we have discussed before. AWS and Microsoft Azure are the number one and two players by market share, respectively, and we think that as this transition of corporate IT workloads to the cloud plays out, both will continue to benefit.

For a variety of technical reasons, Oracle elected to completely re-architect their offering to be 'native' to the cloud landscape, where other vendors have run their offerings as a hybrid model for the last several years. Whilst Oracle has undoubtedly lost market share to the likes of AWS and Microsoft Azure, they have finally announced their cohesive cloud offering, and we believe those who have remained on the Oracle platform up to this point are now unlikely to transition to a competitor. Given that Oracle has not yet been rewarded with a higher multiple, but exhibits much of the same characteristics of a Microsoft, SAP or Adobe at the start of their cloud transition, we felt the risk/reward profile was attractively skewed in Oracle's favour, and have thus elected to introduce it into the fund (while modestly trimming Microsoft, given the strong performance it has exhibited.)

We believe our fundamental driven research process will continue to identify opportunities such as the one described above, and we continue to look for niches where the underlying economics are the beneficiary of a secular change that is unlikely to be much impacted by macro-economic developments. Given the veritable sea of troubles that markets are currently beset by, it's worth keeping in mind that corporate earnings in the US have actually declined this year, even after adjusting for the impact of the energy sector. Current market prices seem to be anticipating that earnings growth will pick up into 2017, but history over the last several years has proven to be a harsh teacher: expected earnings at the start of a calendar year was always substantially higher than the actual earnings growth ended up materializing.

Keeping this in mind – alongside the risk of further disruptive political or social developments – we think the current state of affairs can be described as somewhat fragile: not a lot of unexpected bad news is required to substantially impact market prices. As we are long term investors, we stick to what we believe in: finding businesses that can grow profits via a combination of revenue growth or margin expansion, supported by sound secular growth drivers and a robust balance sheet.