Quarterly Commentary

Minimum Disclosure Document as at 31 March 2017

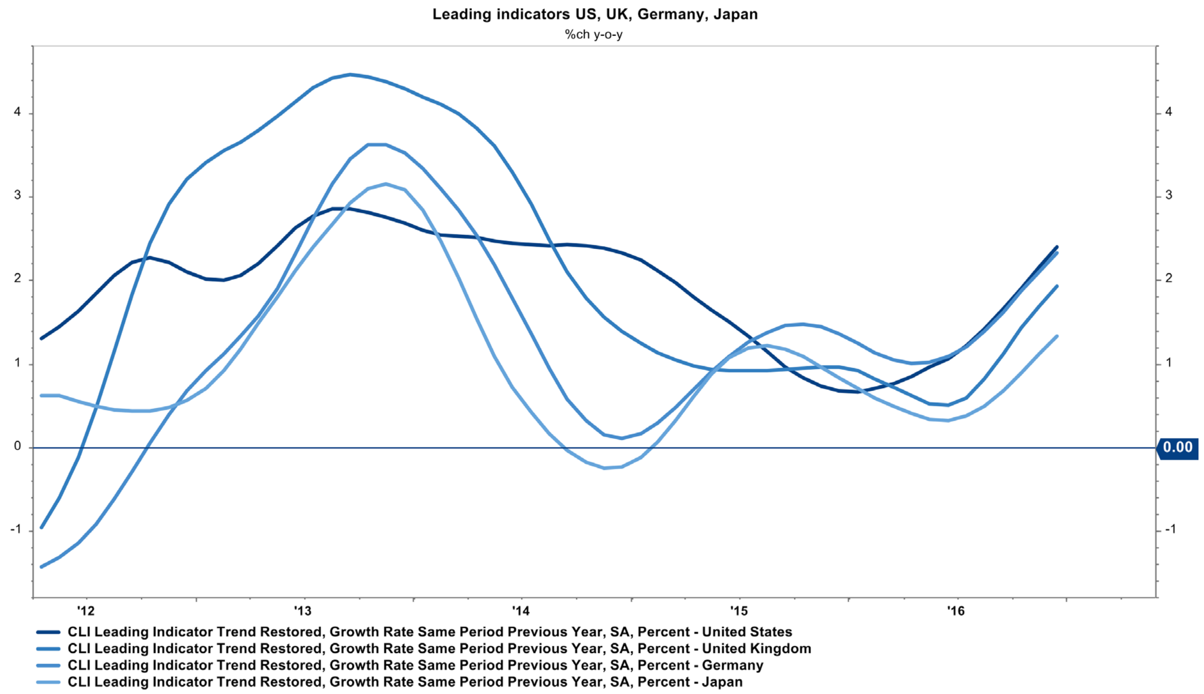
Melville Douglas

Global Equity Fund

When Stars Align

The first quarter of 2017 saw a continuation of the optimism that propelled markets to new highs after the November US elections. Towards the end of March, the initial unbridled exuberance gave way to more selective returns as investors began to digest the political limitations, harsh realities and likely compromises that any attempt by the Trump administration to reflate the US economy must necessarily overcome.

That is not to say the market optimism is entirely unfounded: indeed, many fundamental metrics and leading indicators seem to suggest that there is at last some element of synchronized global growth taking hold. While we are unlikely to see global GDP growth return to the long-term trend level soon, the fact that several large developed economies are all showing signs of improvement concurrently positions equity as an attractive asset class for 2017, in our view.



This is particularly true when keeping in mind that the Federal Reserve raised US interest rates another 25bps in March, and signaled that further rate hikes in 2017 are very much on the cards. Fixed income investors face the unappealing certainty of capital erosion in a rising rate environment. Equities tend to outperform bonds in an upturn, as higher rates are counterbalanced by improving earnings growth as the underlying economy recovers.

This doesn't imply that investors should think 2017 will be smooth sailing: if election results in 2016 taught us anything, it is that the future is inherently unknowable, and unlikely outcomes should be expected. The risk of further political instability in Europe is one such factor, and the German, Italian and French elections will be closely watched for signs of further traction of the protectionist economic mindset that has emerged since the middle of 2016.

The negotiations around Brexit are likely to be antagonistic, and geopolitical volatility in general has increased, with renewed tensions between the US and China a potential source of risk. On the topic of China, the ongoing transition to a services-led economy has the potential to create dislocations in that economy as the government tries to stimulate domestic demand.

We readily acknowledge all these unknowns – any of which could be the cause of a sharp market correction – but would point out that our investment philosophy is focused on investing in businesses with a durable competitive edge that allows them to grow their profits over a long-term horizon. Unless we have reason to believe the durability of the competitive advantage has been eroded, the intrinsic value of such a company will increase over time, and we would use short-term price volatility to build our positions at attractive prices

Finding Structural Growth in Consumer Spending

One interesting conclusion our research has led us to is that consumer spending patterns are changing to prioritize experiences and services over physical goods. In short, people are more likely to spend money on holidays or dining out than on regularly buying the most recent fashion. While the exact cause can be debated at length, the practical outcome is that there is an opportunity to invest in businesses that capture this structural change in consumer behavior. To that end, Priceline was introduced to the fund late in the quarter.

Priceline is one of the market leading online travel agents (OTAs), and has been around for some time. Our investment case is built around the abovementioned increased propensity to spend on experiences over goods. However, we believe there is a second structural shift occurring in this particular industry: more people are using the Internet to research and book trips and holidays, taking business away from traditional travel agents.

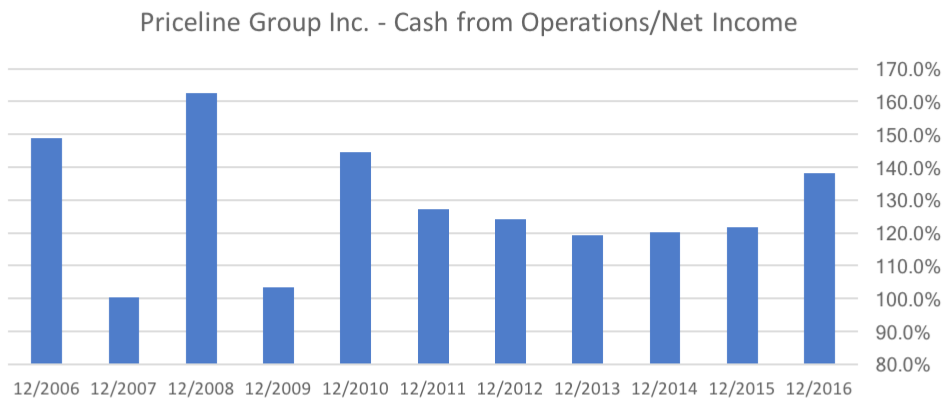
Both these structural changes make Priceline attractive to us. In addition, Priceline also has business model that gives it a sustainable competitive advantage.

Priceline is built around connecting rooms from hotels and other accommodation providers (or 'bookable inventory', as the industry prefers to call it) to potential travelers, who can then directly book their accommodation from Booking.com – Priceline's flagship site for online travel. Many hotels rely on Booking.com for a large component of their reservations, meaning Priceline can collect a healthy premium as a percentage of the overnight room rate, as the friction of switching to a competing online travel portal is too high for their customers.

In this regard, Priceline is very much acting as an agent that relies on the network effect enabled by the internet. One advantage of this business model is that is requires relatively little capital to maintain and grow – signing up new inventory to the booking platform costs far less than building a hotel!

This feature of the business is evident when studying the cash conversion ratio (cash generated from business operations expressed as a percentage of the accounting profit) and return on equity profile. Over the last decade, Priceline has managed to convert an average of 126% of the accounting profit recognized into cash flow; when adjusting for required investment to grow and sustain the business, the free cash flow conversion over the same period was 120%. The return on equity has averaged 35% over the last ten years, while the cash return on invested capital was marginally higher at 37%.

These two metrics indicate to us that Priceline has a superior business model. The business generates surplus cash every year, which the company then reinvests. On average, every dollar reinvested in the business is recovered within roughly 3 years.



Source: Company reports, Melville Douglas research, FactSet

The biggest threat is that of competition, but our view is that having a wide breadth of bookable inventory signed onto their platform gives Priceline an advantage over players who merely provide search results or review services. New entrants such as AirBnB need to be watched closely, but the overall size of the online travel opportunity is large enough to allow for multiple winners at this stage. Priceline has also responded by beginning to include shared accommodation options on its platform.

Finally, since Priceline operates in the travel industry, it is also a play on general economic activity. We think Priceline is well positioned to benefit from both structural change and an improvement in the economic cycle, and we consider ourselves happy long term holders of the stock.

Making Equity Great Again (maybe)

No discussion of recent global equity performance would be complete without addressing the so called 'reflation rally' sparked by the US elections in a bit more detail.

Clearly, the prospect of lower tax rates, less regulation and huge fiscal stimulus can be used to paint an attractive outlook for US equities in general, and industries that stand to benefit from favourable policymaking in particular. Immediately following the election of Donald Trump as president, markets took the view that cyclically sensitive stocks – those found in the financials, industrial, energy and mining stocks – were likely best positioned to benefit from the factors mentioned above.

While our philosophy would not easily see us merely following the momentum in these names, we did tilt our exposure from a defensive bias to be more cyclically sensitive in a way we believe aligns with our investment process.

In late October and early November of 2016, forward-looking US economic data was robust enough to suggest to us that 2017 might well see a normalization of interest rates – something the Fed would likely only do if the underlying economy was strong enough to absorb the change. Based on this view – and the fact that rising interest rates would be enormously beneficial to US financial institutions – the allocation to our US banks holdings was increased. It is important to point out that this decision was driven by belief in fundamental data suggesting an improved outlook – not to benefit from regulatory reform or lower tax rates, which wasn't seen as remotely likely at that point. Clearly, once the result from the election became clear, markets began to price in a much rosier outlook for earnings growth of the US banking sector.

For us to consider investing in banks – animals that are difficult to forecast at the best of times – the non-negotiable requirement that must be satisfied is a high-quality balance sheet. This is a standard we simply will not compromise on for any reason: a robust, well capitalized balance sheet provides a margin of safety to protect against an inevitable cyclical slowdown. All our holdings (JP Morgan, Wells Fargo and US Bancorp) meet this standard, in our view.

By mid-March, these companies had all returned well in excess of 20% each after the US elections, and was pricing in an excessively benign set of outcomes, in our opinion: increased interest rates, lower tax rates and less regulatory cost. We believed markets had become overly enthusiastic about how easy these reforms would be to implement, and we modestly trimmed the positions to reflect our concerns.

As things turned out, this occurred just before the failed push to repeal Obamacare in Congress; as news broke that the Republican caucus had indefinitely delayed voting on the legislation to enact the repeal, markets began second-guessing the likelihood of the Trump agenda being implemented without some big concessions. By and large, US equities lagged for the remainder of March as the positions backing the reflation trade were unwound.

To us, this example illustrates a broader point: getting sucked into short term momentum is mostly a good way to lose money when the news turns against you. Whilst our actions to increase US banks in November 2016 superficially looked like a bet on the drivers of the reflation rally, our process – sticking to quality names that would weather market volatility; buying for fundamental reasons as opposed to a near term trade – allowed us to also take the opposing view when we were convinced the stocks in the portfolio were priced to reflect only the good news.

Nailing your colours to the mast on outcomes that can prove quite binary is always risky, and we don't think it can be done in a fashion that will sustainably deliver returns. As such, while we would be very surprised if there isn't some form of tax and regulatory reform announced in the US later this year, we approach the issue with eyes wide open – our process demands that we look beyond the near-term drivers and find businesses that will survive and thrive for many years to come.

Outlook

As previously mentioned, we believe there are signs of synchronized global growth from major developing economies. Combined with the Fed hiking rates in the US, we think the outlook for equities are reasonably positive for 2017, barring any major adverse geopolitical outcomes. Emerging markets in particular may benefit, as commodity prices have recovered markedly, and valuations are not as expensive relative to developed markets.

However, as there are several major potential risks to markets – mostly of a political nature – we advocate that investors should be selective about committing capital: returns may diverge dramatically, and investors need to be cautious about the price paid. We will stick to our process: finding businesses with a durable competitive edge that are exposed to markets experiencing structural growth.