Melville Douglas

Global Equity Fund

Tacking into the Wind

Since the dawn of maritime transport, ships' captains have had to contend with the challenge of making progress from point A to B without the elements necessarily playing along. The speed and success of any voyage during the Age of Sail was dependent on whether the winds were favourable. While no ship can proceed directly upwind, ingenuity won the day. Via a manoeuvre known as 'tacking' – the act of sailing into the wind and setting the sails at an angle – a ship could move in the desired direction by effectively harnessing the headwinds.

Navigating investment markets over the course of 2017 – in particular this most recent quarter – bear some resemblance to this sailing technique. There has been no shortage of risk factors dominating headlines: geopolitical tension in the Korean Peninsula, challengers to the established political and economic *status quo* in many developed nations, and natural disasters with tremendous human cost in various parts of the world, just to name a few. We see this uncertainty and volatility as part and parcel of the investment landscape we face today, but like the captains of old, we appreciate that progress can be made by the rigorous application of a disciplined and tested process.

When one looks beyond the headlines, it would be difficult to imagine a more benign scenario for equity investors. In most developed markets, real GDP growth figures for the second quarter were strong (and were even revised upwards, in some cases). Inflation remains fairly benign, with a low likelihood of any near-term spike. Manufacturing data as well as corporate and consumer confidence are all in positive territory, reflecting a world where businesses are looking to invest and consumers feel somewhat more comfortable in spending. Combined with the accommodative monetary policies still in place in most economies, the backdrop is still supportive of corporate earnings growth, in our opinion.

Admittedly, one risk to financial markets is the punch bowl of cheap and easy money being taken away. The latest rate setting committee meeting minutes indicated that the Fed was likely to hike rates in the US again in December 2017, with three more increases envisioned for 2018. More importantly, the Fed intends to begin shrinking its massive balance sheet from October 2017 onwards, at a rate of $10bn a month, ramping to $50bn a month in 15 months' time. To give some sense of perspective, it would still take nearly seven and a half years to fully run down the entire debt created under the various quantitative easing programmes in the US at this rate.

Our view remains that central banks are ultimately fearful of having changes in financial markets translate into a negative impact in the real economy; as such, they would likely err on the side of caution when withdrawing liquidity. While the risk of central bank policy error is likely to remain elevated for quite some time, we think equity investors are likely to be rewarded for the risk taken by enjoying the benefits of improving global economic growth.

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Unilever of Growth

Valuations have adjusted to account for this optimistic outlook, and as such we believe adequate diversification and considered stock selection remains paramount. We do not construct portfolios based on macro-economic drivers, preferring to use fundamental criteria to find businesses that can provide an adequate return for the risk assumed by investors.

One business where we believe we can deliver a superior risk-adjusted return is Unilever. This global consumer goods giant sells its products in nearly 190 countries around the world, and is well known to investors.

Given the rapid pace at which consumer preferences are changing, even the global staples businesses have had to face the reality of adapting or risk getting left behind. Under CEO Paul Polman, Unilever has been one of the few multinational consumer staples businesses to proactively change direction over time, moving the business away from historically being a developed market food business towards being an emerging markets home and personal care product provider. By changing the category and geographical focus, Unilever will ultimately be positioned in some of the most attractive growth areas in the staples universe. While this strategic shift has been a few years in the making, a series of events over the past year has accelerated the pace of change and highlighted the growing importance of needing to better understand your consumer and what drives their purchase decisions.

The company has undertaken a series of small acquisitions (12 since the start of 2015) that gives them exposure not only to faster growing categories (such as prestige skin care, cosmetics and environmentally friendly home care products) but also to faster growing sales channels (such as online or direct to consumer).

To illustrate the point, Unilever acquired the personal care group Carver Korea last month. Carver manufactures creams, face masks, lotions and other skin care products. The acquisition will enable Unilever to participate in the $13bn South Korean beauty market (where per capita spending on beauty products has nearly doubled over the last decade), as well as those of neighbouring China and Japan.

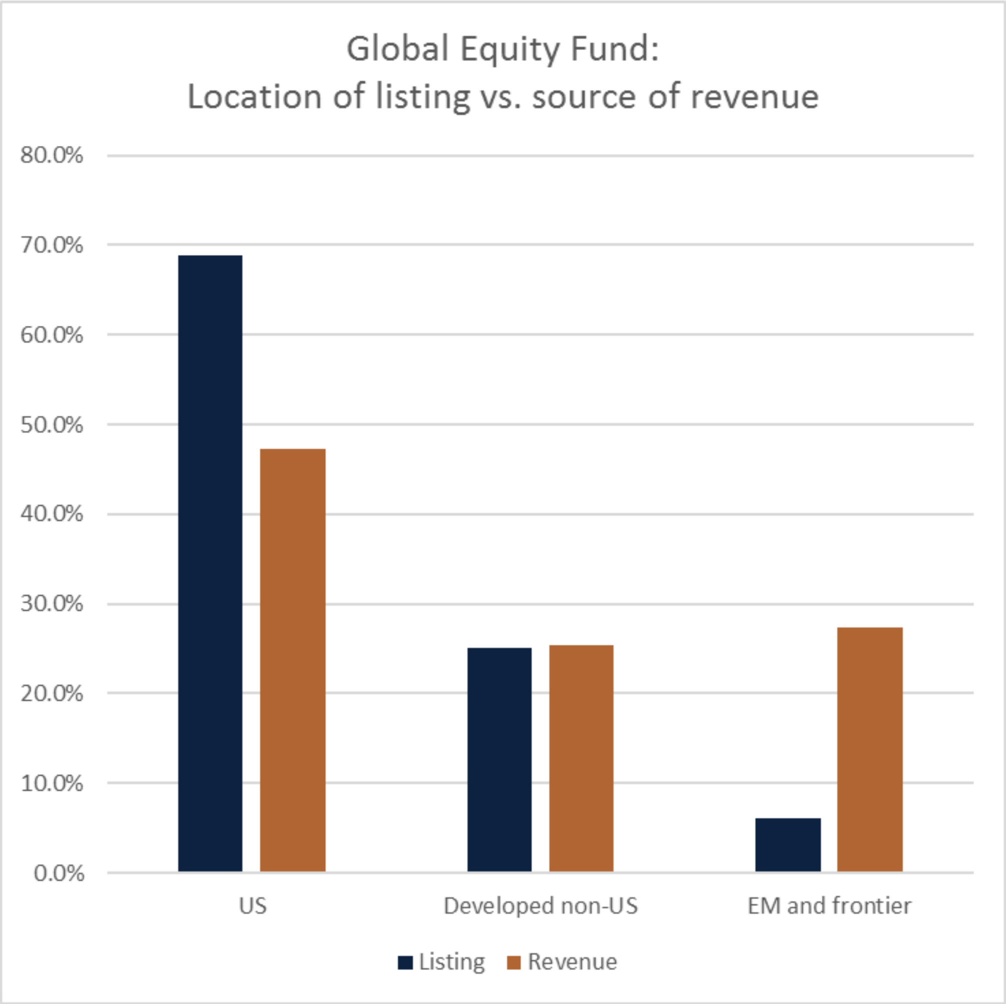
In addition to driving an improvement in revenue growth, new sales channels allow for better and closer understanding of the consumers. This enables Unilever to build consumer loyalty in a way the existing channels have not been able to deliver.

Thus, while the company had taken steps to navigate the changing landscape and rationalize some costs, it was the unexpected takeover bid from Kraft-Heinz in February 2017 that reminded management of the multitude of levers – contrary to the name of the firm – they could pull to further drive revenue and profit growth. Following from a strategic review post the failed takeover bid, the company announced a range of plans to drive earnings growth for the next several years: plans to cut costs without damaging its competitive ability, further rationalizing the business by looking to dispose of the slower growing food spreads division, and increasing capital returns to shareholders in the form of a share repurchase programme.

It is also instructive in terms of our thinking towards regional allocation in the fund. While Unilever has its primary listing in the UK, we find it difficult to see this as a developed market business, given that more than 60% of all the revenue generated by the company is derived from emerging markets. To us, the location of the listing matters a lot less than where the revenues and profits are generated. Thus, at first glance, it might appear that the fund is skewed heavily towards the US, but when reviewing the underlying revenue exposures of the firms we own, the exposures towards other developed markets and emerging markets is far more pronounced than the location of the listing would suggest.

As can be seen in the chart below, our preference for multinationals gives the fund a reasonable balance of underlying revenue exposures. While we acknowledge that currency moves can have an outsized impact on returns, we also believe that owning equities run by quality management teams will allow these businesses to adjust pricing and costs to offset the currency impacts.

Chart 1



Source: *MSCI, FactSet, company disclosures, Melville Douglas estimates*

Another benefit of the way our research process functions is that it allows for cross-sector idea generation. Based on our research, there is a clear change in the spending behaviours of consumers: both from the perspective of *what* they are electing to spend their disposable income on, but also from the perspective of *where*.

In that light, it has been of interest to us to note that businesses such as Unilever are also positioning themselves to appeal to these changing consumers trends with acquisitions of brands such as Dollar Shave Club. Dollar Shave Club has its origins online, having been founded as a subscription service for razors, blades and related products in 2011. The company exclusively engaged in building an audience online, using channels such as YouTube to build a story as to why its product is compelling (as opposed to purely selling on price).

Quarterly Commentary as at 30 September 2017

In line with Unilever's stated strategic goal of moving into the beauty and personal grooming categories, this acquisition also puts the business on a more competitive footing with Gillette (owned by Procter & Gamble). It also speaks to the type of brands younger consumers are preferring: ones with a narrative aspect, combined with a much more convenient channel and sales model (online subscription).

A Steady Hand on the Tiller

We believe that, absent a major geopolitical shock, the fundamentals now at play in many economies are robust enough to drive corporate profit growth for the medium term. Central bank policy error remains a concern, but a manageable one, in our opinion.

When looking at the structure of the portfolio today, we believe we are well positioned to capture the generally improved economic growth, with a focus on specific areas that have secular tailwinds as well. Our investment process and philosophy will always favour businesses that can grow earnings under their own power. Over the last several months, this bias has supported our returns. However, short term investors may choose to pursue optically cheaper stocks when a true risk-on rally takes hold.

We do not think busying ourselves to capture every market mood-swing is an endeavour we are likely to succeed at, and therefore choose to stick with our stated goal: generating superior risk adjusted returns over the long term by finding companies that can reliably compound their earnings.