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Melville Douglas

Global Equity Fund

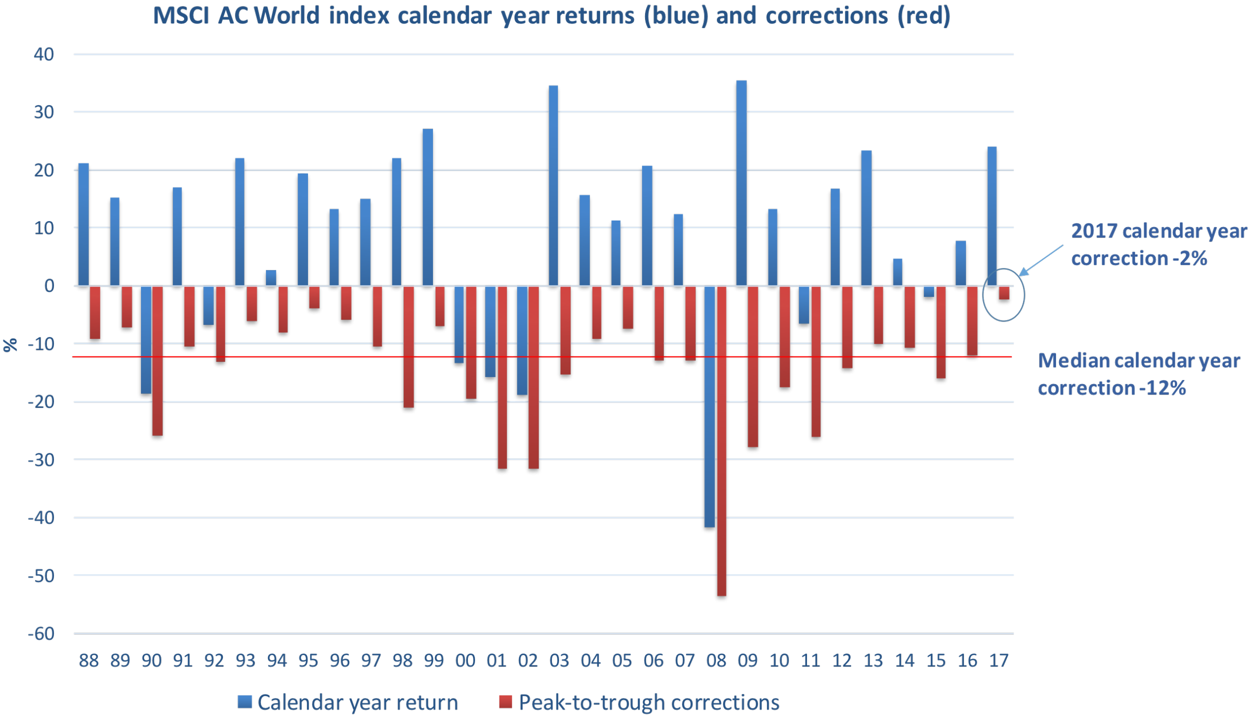
All so quiet

"Just a perfect day, problems all left alone" drawled rock star Lou Reed. One could say the same for 2017, which was the first perfect year for the S&P 500 index since records began in 1928. A perfect year is when there is a positive total return, including dividends, in every month of a calendar year. This remarkable statistical record encapsulates an extraordinarily calm backdrop for equity investing.

The Goldilocks not-too-cold-not-too-hot resynchronization of the world's major economies drove corporate earnings across most geographies and sectors without central banks needing to slam on the monetary policy brakes. The quarter has not been without geopolitical incident, such as the Supreme Leader of North Korea's threats of nuclear Armageddon, but market reaction has been nonchalant.

Near the end of the quarter, President Trump's administration at last saw tangible progress with the passing in Congress of his tax reform bill. The resulting cut in the headline corporate tax rate from 35% to 21% will provide an estimated +8% uplift in 2018 to US corporate profits already spurred by the robust economy.

The final quarter of 2017 also marked the thirtieth anniversary of the 1987 Black Monday crash, which saw the greatest one-day Wall Street decline in history. On that auspicious day the S&P 500 index fell over -20%. The correction was a painful shock, but in hindsight proved to be short-lived.



Source: Melville Douglas, Bloomberg

Quarterly Commentary as at 31 December 2017

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Our work on the history of corrections, defined as -10% or more declines, show that they are more the rule than the exception. As shown in the chart, over the 30 calendar years since 1987 there have been 21 years when there have been peak-to-trough declines (i.e. the red bars) of approximately 10% or more. To put it another way, investors experience corrections in two out of three years on average. This has not prevented a global equity investor, who is prepared to buy and hold, from generating a twentyfold total return over the past 30 years.

Last year equity markets exhibited an extraordinarily low level of volatility. An investor who had bought the intra-year peak and sold at the intra-year trough would have only lost -2%. This ultra-benign investment environment certainly will not last, but corrections should only be feared by short term investors. They are part-and-parcel of equity investing and unavoidable for those with multi-year time horizons.

Indeed, attempting to avoid the psychological discomfort of a short-term correction in paper profits can be very damaging to long term returns. There is 100% chance of a correction at some point. The problem is that it can be just as expensive to be ahead of the curve as it is to have missed the peak. Typically, being three months too early results in missing out on the remaining +7% average return before the market peaks. If you sell three months after the peak, your average loss is -7%. Hence, being too early can be as damaging as being too late. To quote 1980s investment legend Peter Lynch, "far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves". Rather than catching every zig-and-zag in the market we remain focused on the power of compound returns by picking stocks that will stand the test of time.

From our Fund Manager's Desk

Every quarter we 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 Experian Plc.

Far from President Trump's tweets, the fourth quarter also saw Professor Richard Thaler dubbed a Nobel laureate for economics. To the uninitiated, he is widely credited for helping to shift economic thinking away from overly theorising that people in an economy act as rational automatons. In his bestselling book "Nudge", Professor Thaler makes the point that society does not run like a machine but is made up of real people that "have trouble with long division if they don't have a calculator, sometimes forget their spouse's birthday, and have a hangover on New Year's Day."

This blatantly obvious point has escaped much of the financial theorems developed in academia's ivory towers over the past half century. We also share his view of predictable irrationality when observing the emotions of fear and greed behind market gyrations. The fear of missing out on seemingly easy ten-bagger gains apparent in cryptocurrencies is the latest example of market psychology dating back to the South Sea Bubble and Tulipmania.

Behavioural economics has made significant contribution to public-policy in the way people can be nudged, often through their own inertia, into making the right societal decisions. One form of nudging people to make the right choices is the use of automatic opt-in policies, whether it is signing up to your corporate pension policy or registering to donate your bodily organs upon death. For example, organ donation in countries such as Austria where you need to explicitly opt-out is 99%, whereas it is only 12% in neighbouring Germany where it is opt-in.

Companies can also benefit from such libertarian paternalism policies. One example is Experian, in which the fund initiated a position in the quarter.

What is Experian? Experian is the world's largest provider of credit reports. Simply put, its extensive network of credit bureaux collect credit data for free from financial institutions and then sells the data, albeit repackaged and aggregated, back to the same institutions as well as to consumers.

Although a credit report is often a tiny fraction of a lender's total costs, it is a crucial piece of information to assess the risk of default. Hence, the credit report industry does not need to compete on price. The market leaders tend to provide a joint service as banks and lenders usually pull credit data from more than one firm when determining the creditworthiness of consumers. The result is a highly profitable and cash generative credit reporting industry.

So, given the highly attractive dynamics, why doesn't this industry attract more competition? There are three main reasons.

First, there is the difficulty and expense of replicating a database of similar depth and quality. Experian has a powerful network effect, whereby businesses want to use its information, and are happy to supply it with their own, as it has the best data. This has fuelled multi-decade growth of an unrivalled database of millions of records that have been tirelessly matched and enhanced.

Second, there is no incentive for most banks to go to the expense of setting up data distribution to new entrants, unless there is a major pricing issue, which there isn't.

Third and finally, regulators have imposed high barriers to new entrants to ensure consumer protection. For example, the US regulator requires credit bureaux to have the infrastructure and processes in place to deal with any consumer disputes over the accuracy of their credit score within 30 days.

Experian's three largest markets for its data are the US, the UK and Brazil. The first two are expected to grow steadily, boosted by newer segments such as health insurance and mobile phone contracts. Brazil, where Experian is the only significant credit bureau, is a more nascent market and therefore has much faster growth. In Brazil, limited financial data means lenders charge borrowers significantly higher rates of interest as they are unable to determine good or bad credits. Inefficient capital allocation is detrimental for economic growth, and therefore the government is keen to address this issue.

This is where Professor Thaler's nudge theory comes into play. The Brazilian government is in the process of passing legislation for credit data to be opt-out, rather than its constraining opt-in status quo. The availability of better quality credit reports will be positive for society through lower financing charges, and a boon for Experian as the main provider of this data.

Given its credit data niche, Experian brings a somewhat different industry exposure to the fund whilst staying true to our stock selection philosophy. In summary, the business is attractive given its hard-to-replicate database, regulatory and institutional barriers to entry, oligopoly market position, 25% operating profit margin, low capital intensity, and steady mid-single digit revenue growth driven by non-financials and emerging markets.

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Mature on optimism

Elevated equity valuations, particularly on Wall Street, remain a well-documented risk factor. So when do we turn bearish?

Although valuation is a powerful empirical indicator of long term returns (i.e. over five years or more), it has a weak record as a near term timing tool. Hence, our focus is on identifying change in the longer-term trend. We would become much more cautious about equities if the business cycle moved from expansion to slowdown given bear markets are usually associated with global recession and a collapse in corporate profits.

Tried and tested signals of an impending economic slowdown include an inverted yield curve (i.e. when short term interest rates are higher than long term rates) and a sharp increase in credit spreads (i.e. companies are required to pay more to borrow). Although the yield curve has flattened, it is not in the danger zone levels of 2000 and 2006 ahead of their respective recessions. Furthermore, all the evidence from the latest quarterly corporate results and macroeconomic data confirm expansion rather than contraction. As such, the path of least resistance remains to the upside.

A final, more anecdotal measure, is sentiment. The late great global investor John Templeton famously quipped "bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria". Despite the length and magnitude of this nine-year bull market, investor sentiment is not at the euphoric levels that marked previous market peaks. We stay the course for now but will be more apprehensive, and contrarian, as and when market participants become increasingly enrapt in the positive narrative.

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