Melville Douglas

Global Equity Fund

Sound and fury

None other than Vladimir Lenin supposedly said that there are decades where nothing happens, and weeks where decades happen. In closing the book on the first quarter of 2018, the statement certainly feels as if it carries the ring of truth. After an extended period of extraordinarily low volatility in equity markets, the quarter delivered two separate corrections that effectively wiped out all the gains made in January (which was, in itself, one of the strongest starts to a calendar year for global markets going back to the 1980's). After getting used to seeing stocks tick up on the back of positive economic momentum and sentiment around the globe, this quarter had no shortage of reasons for markets to get spooked: the possibility of an upside surprise to US inflation driving the Fed to increase interest rates more rapidly, ongoing geopolitical tension threatening to escalate, and the spectre of a possible US/China trade war all put a solid damper on the bullish tone struck in January.

It may therefore help to put matters in some perspective: global markets only ended the quarter down very modestly in absolute terms. Admittedly, the ride from point to point was exceptionally bumpy, but for all the breathless headlines, we are effectively back to levels last seen in mid-December 2017, and it is worth keeping in mind that 2017 was itself a year with extraordinarily strong returns.

If anything, given that markets have effectively remained flat for the period despite an additional quarter of earnings being reported, the elevated valuation multiples have contracted somewhat since December. Sentiment is clearly no longer euphoric, and though the more recent fundamental global growth data is off the late-2017 peak levels it is still pointing to the economic expansion continuing – at least for now.

As we pointed out in our December 2017 quarterly letter, investors should expect a peak-to-trough sell-off of 10% or more in two out of every three years in the market. They are part-and-parcel of equity investing. As such, the anomaly wasn't the correction during this quarter, but rather the extremely benign environment of 2017 – which we believe we can confidently say is now off the table for the foreseeable future.

Our investment philosophy is not to try and time the market, nor to position ourselves for every possible market mood-swing caused by a tweet or headline. We remain focused on finding businesses that can stand the test of time and grow their profits in real terms through strong competitive positions.

Big Tech vs. the Regulators: is the party over?

Normally, we would take you through our thinking on a particular stock and why we own it in the fund. In this letter, we will be taking a slightly different approach. Given the topicality of increased regulatory scrutiny on the global large cap technology names – and our preference for some of these names in the past few years – it seems like an appropriate moment to re-test our own thinking and highlight what we see as potential pitfalls (and opportunities).

Whilst it is generally difficult to get economists to agree on anything, one fact that seems to be reasonably widely accepted these days is that the advent of the internet has created a change in how and where economic value is created. Much like the Industrial Revolution, the introduction of new technologies has profound implications for business, labour, capital and society as a whole, and many of these implications are only becoming apparent now.

Quarterly Commentary as at 31 March 2018

One attractive business model enabled by technology – and by no means a new one – is the network model. Businesses such as Visa and MasterCard – both of which are owned in the fund – have for years grown their profits by ensuring there are enough incentives for consumers to switch from using cash a credit or debit card, thereby increasing the volume of transactions on its network. By taking a small cut of the value of every transaction that flows over the network, Visa and MasterCard generate extraordinarily high returns on capital, which they then reinvest to strengthen their competitive position and improve their service.

Given our preference for investing in businesses with secular tailwinds and an attractive growth outlook, it is no wonder our process has delivered quite a few names that benefit from the network model within the information technology space. The combination of high-speed internet, affordable data pricing and a small computer (that also happens to make phone calls) in everyone's pocket enables people to access services or order goods online at a scale never before achieved.

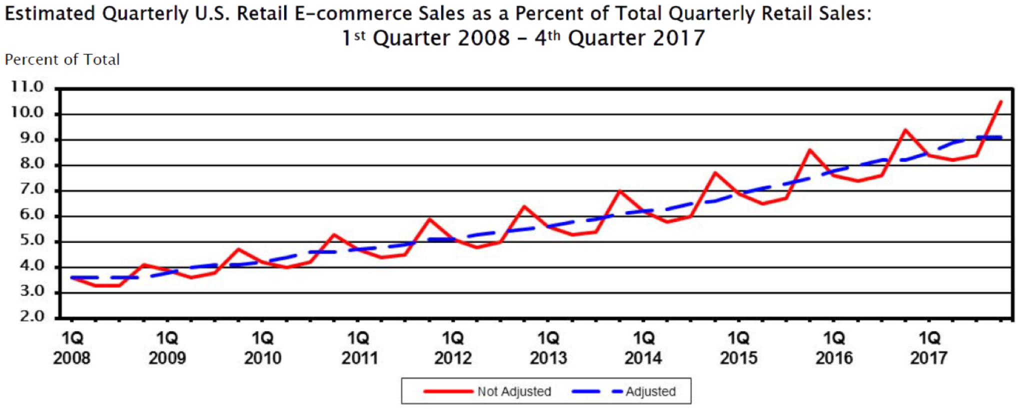
As a result, one of the more attractive business models that has evolved from the network model is the multi-sided platform. Beyond the initial investment to build the platform and the cost of maintenance and innovation, the economics improve the more users the platform attracts. Examples of this model would be Apple's iTunes Store (connecting artists and app developers to buyers of Apple products), or the online advertising models favoured by Alphabet and Facebook (where advertisers pay for access to the data of platform users, in order to better target their marketing budget at users that are more likely to act on the advertising they see).

The online advertising model in particular is a development of the Information Age. It is a business model that would not have been possible without the building blocks mentioned above. It is reliant on the consumer willingly offering up information about themselves to enjoy a 'free' service, with the implicit cost being that the information they offer will by segmented, analysed, and used to slot the user into a demographic that advertisers may wish to address.

As the recent revelations around Facebook and its handling of consumer data shows, it remains a space fraught with a lot of uncertainty around what data may be collected, and with whom it may be shared – and how informed consumers are about all of this. The recent revelations have come at a time when lawmakers, society at large and politicians seem to be in agreement that some form of regulation is required. As such, we would not be surprised to see this as an eventual outcome – it is a risk we have accounted for in our assessment of the investment case for these companies, as well as our valuation.

Even then, if the regulation were to be draconian enough to effectively break the economics of the multi-sided platform model explained above, it is worth remembering that Alphabet and Facebook have billions of users because their product is free. For hundreds of millions of users, the information they can access on these platforms is invaluable, and they cannot afford a 'paid-for' version of Google search or Facebook that ensures their information is not shared or sold.

Equally, a business such as Amazon – which has definitely had a substantial impact on traditional retailing – exists because it gives users a wide selection, competitive pricing, and convenience. Given the fact that e-commerce as a percentage of total retail spending in the US is only around 9% of adjusted retail spend, the outlook for e-commerce growth in the US (and elsewhere) remains attractive.



Source: US Department of Commerce, Quarterly Retail E-Commerce Sales, 4th Quarter 2017

Late in the quarter, US President Donald Trump aired some specific issues he has with Amazon. While it is not clear whether any regulation will emanate from this, here too we think that anything but the harshest of regulatory intervention will see the business survive and continue to grow. It is also worth remembering that Amazon runs Amazon Web Services – the largest player in the provision of Infrastructure-as-a-Service in the public cloud market. This business is almost completely independent of Amazon's retail activities and generates substantial cash flows. Moreover, it is exposed to a completely different secular trend playing out in the enterprise IT space (the adoption of cloud infrastructure) and will likely not be caught up in any regulation of the retail business, were such to occur.

Thus, we do not think the investment case for internet business models are broken. As mentioned earlier, we have taken many of the risks outlined above into account and have been selective about which companies we own. Of the so called FAANG stocks – Facebook, Amazon, Apple, Netflix and Google (now Alphabet, but FAANA is a much less catchy acronym!), we only have exposure to Amazon and Alphabet. Of the Chinese equivalent names (BAT, for Baidu, Alibaba and Tencent), we only have exposure to the latter as at quarter end. Given that the Chinese internet regulatory landscape is very different from the one in the US, UK or EU, we are much less concerned about regulation for Tencent.

This also raises another point: not all IT names are created equal from a risk perspective. Visa and MasterCard are both classified as information technology companies, though we see very little overlap between their business cycle and that of 'traditional' IT or internet businesses. Equally, Microsoft and Oracle serve a very different consumer – mostly enterprise IT departments and their in-house users. While data privacy regulation will affect their cloud business to a modest extent, their business models are not nearly as exposed to the concerns currently being raised.

A more reasonable criticism of some of the large IT businesses is that their tax affairs are structured so that they legally pay the minimum amount of tax in certain jurisdictions by using a variety of methods to shift profits to low-or-no-tax jurisdictions. This is almost an essay on its own, but suffice to say we would not be surprised to see the effective tax rate of some large cap IT names to move up modestly over time, and incorporate such risk into our valuations.

In closing, we still think that the larger technology sector remains attractive, and certainly set for growth in future. Our exposure looks markedly different than the IT index, given our assessment of risk and potential reward. We will continue to manage our position based on the longer-term outlook but are very much aware of the nearer-term risks.

Brief thoughts on global trade

No comment on the equity markets of the first quarter of 2018 would be complete without at least addressing the very real concerns of a potential US/China trade war that flared up in the last few days of March.

In short, we do not think we can add much to the debate other than to say that rising protectionism has historically had a negative impact on GDP growth, and we see no reason why any such measures taken now would have a different outcome. Moreover, we definitely think that trying to position the fund to be protected against (or take advantage of) any particular outcome is a futile exercise until the final terms of any trade actions taken by either the US or China is known.

Given that the US has a period of open public comment before any proposed tariffs are made final (and that several of the largest US multinationals stand to lose out substantially in any trade war scenario, they will certainly avail themselves of the opportunity), there is scope for the extent of the tariffs to be dialled back. Moreover, both the US and China have indicated at least a willingness to negotiate before resorting to tariffs, meaning that the situation may yet be de-escalated. Nevertheless, should a worst-case scenario come to pass, and the US and China engage in a full-blown trade war, we cannot but see it having a negative and immediate impact on corporate profit growth as well as synchronized global GDP growth.

It is worth pointing out that the fund doesn't have much direct exposure to the type of sectors the proposed tariffs are looking to protect – mostly labour-intensive manufacturing or primary industries. There is always the risk of escalation beyond the current scope, and we continually evaluate the situation and position the fund accordingly.

Buckle up

In taking stock of where we find ourselves post the first quarter of 2018, it pays to take a step back.

Barring any substantially growth-crimping trade war between the US and China, the fundamental economic growth outlook remains reasonably attractive. However, the risks have certainly increased from 31 December 2017 to today. All else being equal, the risk-reward profile looks less attractive than what it did three months ago.

Beyond the fears of a trade war, we are also aware of the macro-economic issues. The fact that central banks are set to withdraw liquidity towards the end of 2018 looms large, and combined with rate increases, the potential for policy error remains elevated. In this environment, the rising cost of capital can not only have a real impact on actual economic growth, but also on valuations.

As stated previously, we remain focused on any change in trend of the business cycle. Should we shift from a late cycle expansion into a slowdown, we would be much more defensive in our positioning.

Nevertheless, we are very cognizant of the volatile market we find ourselves in, and at present find that we are more cautious on deploying capital, preferring to wait for a larger margin of safety before allocating to any particular stock. We are also reviewing the fund rigorously to ensure that, as far as possible, we own a diversified list of businesses we believe can weather any period of economic downturn, should this happen.

We close, as always, with a re-affirmation of adhering to our philosophy: picking good businesses that will stand the test of time and grow their cash flows, based on the fundamental attractiveness of the operating assets and the valuation we are prepared to pay for it. With that said, we would advise investors to buckle up. 2018 is likely to be a far bumpier ride than 2017.