Quarterly Commentary as at 30 September 2019

Melville Douglas

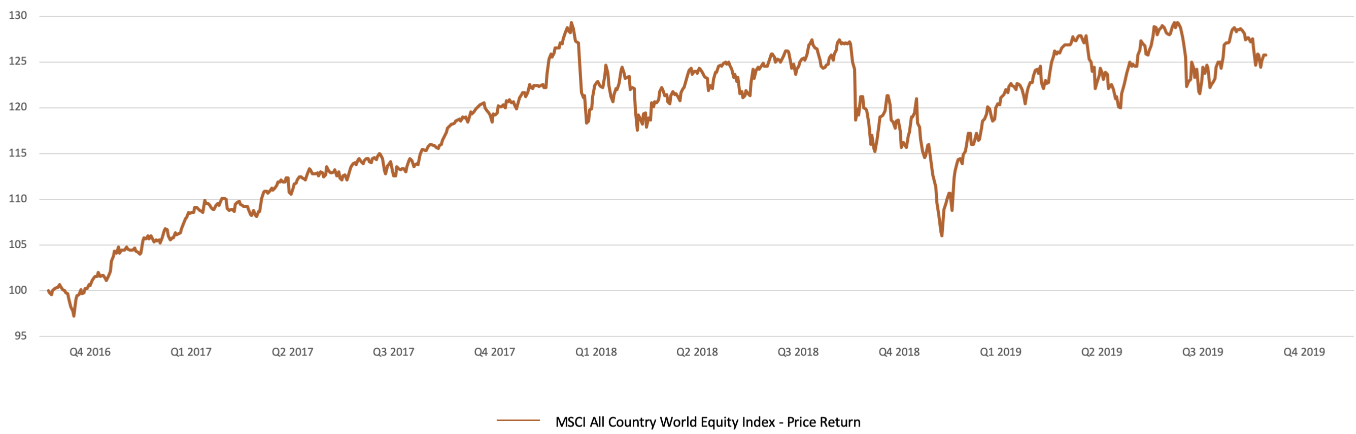
Global Equity Fund

Keep your Eye on the Ball

It was one of the surest bets in the 1999 Rugby World Cup. Powered by the giant Jonah Lomu, New Zealand would steamroll France in the semi-final on their way to raising the Webb Ellis trophy. After all, France had been put to the sword only four months ago by a rather embarrassing 47-points. Halfway through the game, with New Zealand comfortably in control, the impossible happened. France defeated the unbeatable in a stunning comeback.

Like an All Blacks fan in 1999, equity markets have been repeatedly knocked out of the complacent and benign view of the world that had been set in early 2018. US corporates benefited from a boost to earnings fueled by the Trump Administration's corporate tax cuts. The consumer felt good about life and continued to spend – making hay while the sun shines. Global equity markets advanced, reaching all-time highs. The rose-tinted view unraveled as US-China trade tensions escalated and the Federal Reserve tightened policy too aggressively into a global slowdown. 2018 ended in losses and volatility for equity investors.

Global Equities – Volatility, the only Game in Town



Source: Factset

By year-end the pendulum had swung to the other extreme. The consensus view was for markets to remain difficult in 2019.What transpired was a seemingly miraculous comeback with global equities returning 16% over the first nine months of the year. To put it all in context, global equities are still shy of the all-time high reached in January 2018.

Investors would have done better by focusing on the supportive fundamentals rather than what the crowd was saying. Equity valuations were not stretched, earnings growth has been positive albeit slowing, and the consumer side of the global economy has been exceptionally resilient. Central banks have stepped in to try manage an orderly transition towards a lower-for-longer growth environment.

To avoid being caught up in the noise, we are mindful to play the long game and focus our efforts behind identifying quality businesses that have demonstrated their ability to consistently compound earnings over the long run. Amongst the racket and daily tweets, we remain focused on the game while the world keeps watch on the scoreboard.

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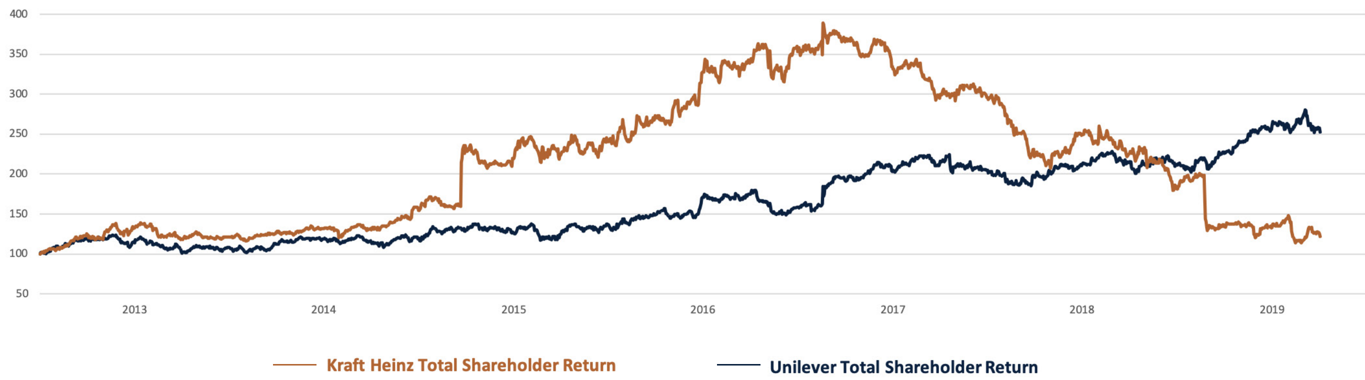
Our quarterly reports regularly explore the investment rationale of one of the companies we own in the Fund, to articulate what we find compelling. This time round we have chosen Unilever.

On any given day, more than 30% of the world's population uses a Unilever product. With such reach in people's lives comes great responsibility. The company has devoted its time, effort and resources behind making sustainable living commonplace. This focus on the long-game was one of the reasons that Unilever's then CEO Paul Polman and its Board of Directors did not hesitate to decline an unsolicited $143 billion takeover offer from rival Kraft Heinz in 2017.

What we need to appreciate is the divergent approaches to value creation embraced by both Unilever and Kraft Heinz. Kraft Heinz's strategy was driven by its ownership, a Brazilian private equity firm called 3G Capital. 3G was more about immediate quick fixes that could yield outstanding results over the short term. Unilever was unashamedly committed to driving long term returns by ensuring the entire business including all stake-holders placed sustainability at the core of everyday operations. Adopting this sustainability focused strategy that would benefit the company, the communities they touch, their consumers, and the environment is what led investors - including us - to believe in the company's ability to consistently deliver shareholder value in the years to come.

Divergent Paths – Unilever and Kraft Heinz Total Shareholder Return



Source: Factset

As with many consumer behemoths, their size and reach often limits their nimbleness. With a revenue line of over EUR 50 billion and operations in every continent, the inherent complexities in managing global brands while ensuring these brands resonate with different consumer tastes has at times proved challenging. We have previously written about the fast changing, increasingly complex world that big branded companies have had to navigate.

Unilever successfully pivoted their business from being over-exposed to developed market food products where growth was depressed, towards higher growth emerging markets that now account for close to 60% of revenue. Countries like India, Brazil and Indonesia have a growing middle-income consumer who is now in a position to purchase everyday basic household goods. The likes of Omo washing powder, Dove soap and Lipton tea appear more frequently in shopping lists.

Another challenge has been the wave of disruption brought by rapid adoption of smart phones. E-commerce has reduced barriers to entry. Expensive advertising – a competitive advantage in the past afforded only to those with deep pockets - is now virtually free via "word-of-mouth" advertising on social media. Unilever was one of the early movers in perceiving this change, either through in-house development or buying in expertise and brands. An example is its purchase of Dollar Shave Club, an online-only brand that had gained massive popularity amoungst the trendiest bearded hipsters in California. What this purchase did was to highlight the need to adopt new ways of thinking to ensure you remain relevant in the eye of the fast-changing consumer.

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Source: Dollar Shave Club

On a mission to transform the business, the company has been actively managing their portfolio having completed over 30 small scale acquisitions since 2015. From Seventh Generation (a plant-based detergents and naturals company) to Pukka Herbs (an organic herbal tea business centered around the health and wellness philosophy), Unilever is determined to support sustainability and ensure their business is managed to the benefit of all stakeholders.

This activity has improved their end-market growth, broadened their exposure to differentiated sales channels, and deepened their reach by appealing to more niche consumer segments. As a well-run company in possession of a dependable earnings base that is supported by the attractive emerging market growth profile, Unilever is well positioned to weather the storm. We believe in the longer-term vision, strategy and growth prospects for the company and it remains a core holding in the fund.

The Tortoise and the Hare

The sharp rotation experienced in September took many by surprise. The valuation gap between the “out-of-favour” value stocks and the “favourite” momentum stocks had become discernibly large. This triggered a sell-off that resulted in growth and quality as a style underperforming value in the month. Over the longer term and certainly year-to-date, growth and quality has far outperformed value – supported by strong underlying fundamentals. We do not aim to position ourselves for every outcome, choosing to take a longer-term stance while staying true to our investment philosophy and process.

As late in the cycle as we find ourselves in, we continue to aim for balance within the fund. To this end, we have selectively increased the exposure to out-of-favour value stocks that have solid growth prospects, whilst ensuring the fundamentals of in-favour growth stocks do no end up being complacent All Blacks. We remain disciplined in finding businesses that are well managed, exposed to industry tailwinds that are supportive of growth, and possess competitive moats. We believe these higher quality businesses are better suited to weather challenges as they have demonstrated their ability to consistently generate shareholder returns over time.