Melville Douglas
Quarterly Commentary
Global Equity Fund

/ Q2 2024

Waiting for sitters

The clichéd image of a market operator is someone repeatedly yelling "buy, sell" down the phone whilst frantically flapping their arms about. It all seems exciting, frenetic, and dramatic.

But day-trading should be distinguished from long-term investing. The former has the adrenaline rush of the casino. The latter is more akin to watching paint dry – in a good way.

There is a natural temptation to trade. With the benefit of hindsight, it all seems so easy. Correctly calling the daily ups and downs of the stock market, would make you as rich as Croesus. The reality is that such a feat would require an incredible run of luck – near impossible over a sustained period.

Wonderful investment opportunities are rare. The self-awareness is to realise this. The skill is to identify what they look like, patiently wait for them to turn up and then have the confidence to swing for the fences.

Warren Buffett's classic quote says it all:

> The stock market is a no-called-strike game. You don't have to swing at everything – you can wait for your pitch. The problem when you're a money manager is that your fans keep yelling 'Swing, you bum!'

The discipline is derived by staying true to your investment philosophy and process. The Melville Douglas approach is to identify the world's best quality compounders. There are only about 80 that qualify under our stringent criteria out of an investible universe of 4,000 stocks. At any point of time, we own between 25 to 35 of the highest conviction names within this short-list. Apart from the investment case unravelling or excessive valuation, we will only sell if an even better "sitter" is tossed our way.

The empirical evidence supports the batter who holds back on their swing. A study in 2013 by Martijn Cremers, a professor at the University of Notre Dame, found the best performing US equity fund managers had two common characteristics:

1/ COURAGE OF THEIR CONVICTIONS

The better performing portfolios were meaningfully different from the market index. The Melville Douglas Global Equity fund has high active share relative to its benchmark, i.e. MSCI All Country World index.

2/ LONG TERM

The best performers traded less frequently than their peers. The average portfolio turnover for an active US equity fund is approximately 60% per annum. The Melville Douglas Global Equity fund has turned over only 11% of its portfolio per annum over the past five year. This level of turnover means all the stocks held in the portfolio would theoretically be completely replaced in nine years. This is consistent with our long-term approach.

Why do managers feel compelled to overhaul over half their portfolio every year? There are numerous potential explanations:

1/ DIFFERENCES IN INVESTMENT STYLE

An investment philosophy that is more focused on trading market psychology rather than long-term fundamentals will have higher turnover.

2/ PERFORMANCE CHASING

Chopping and changing the portfolio to buy what is "hot" and sell what's "not" in the hope of achieving good near-term results.

3/ TO JUSTIFY MANAGEMENT FEES

There may be a temptation to trade more often ("Swing you bum!") to justify an active rather than passive fee scale.

The objective of the fund is to sustainably grow its net asset value, rather than hyperactivity. It cannot capture the power of compounding if we constantly switch in and out of the holdings.

When we find a wonderful company, we want to travel on its growth journey rather than get off at the next stop in the hope of finding a better lift.

From our **Fund Manager's Desk**

Author: Sibabalwe Kasi / Senior Global Equity Analyst

It is rare to find industry bellwethers that have not only withstood the world's trials and tribulations for over a century but have thrived. They must be doing something right.

S&P Global fits the bill, with a pedigree spanning from the late 1800s but evolving to become highly relevant to today's financial trends. Its core Standard & Poor's (S&P) credit rating business is an integral part of the debt capital markets plumbing, playing an essential role in quantifying and standardizing potential risk across the world. With the rise of passive investments, its indices business is fast following a similar trend due to its critical nature. Finally, it has leveraged its deep knowledge and financial database to grow a highly lucrative market intelligence business.

In this note we take a closer look at all three of S&P's major businesses – ratings, indices and market intelligence. We will establish what makes them so special and elaborate on why they are perfect fit for the fund's focus on quality compounders.

S&P Ratings

In simple terms, credit rating agencies provide the equivalent of a personal credit score to institutions and governments. The agencies achieve this by:

- Assessing the creditworthiness of a company or country by analyzing their financials
- Assigning a grade from A-D (A representing most likely to repay)
- Communicating these grades to investors to help them decide if the issuer is "safe" or fits their purposes.

But why are issuers so eager to have their bonds rated?

Credit ratings provide value to bond issuers as well as bond investors, creating a double-sided network effect. Bond issuers value credit ratings from Standard & Poor's and Moody's because of their wide acceptance among asset owners and asset managers, particularly important in cross-border bond issuance deals. By getting a bond rating from a market leader such as S&P, the bond issuer usually pays less in interest (often 30-50 basis points in savings per year). This generates even more value for the issuers and makes them less sensitive to S&P pricing changes.

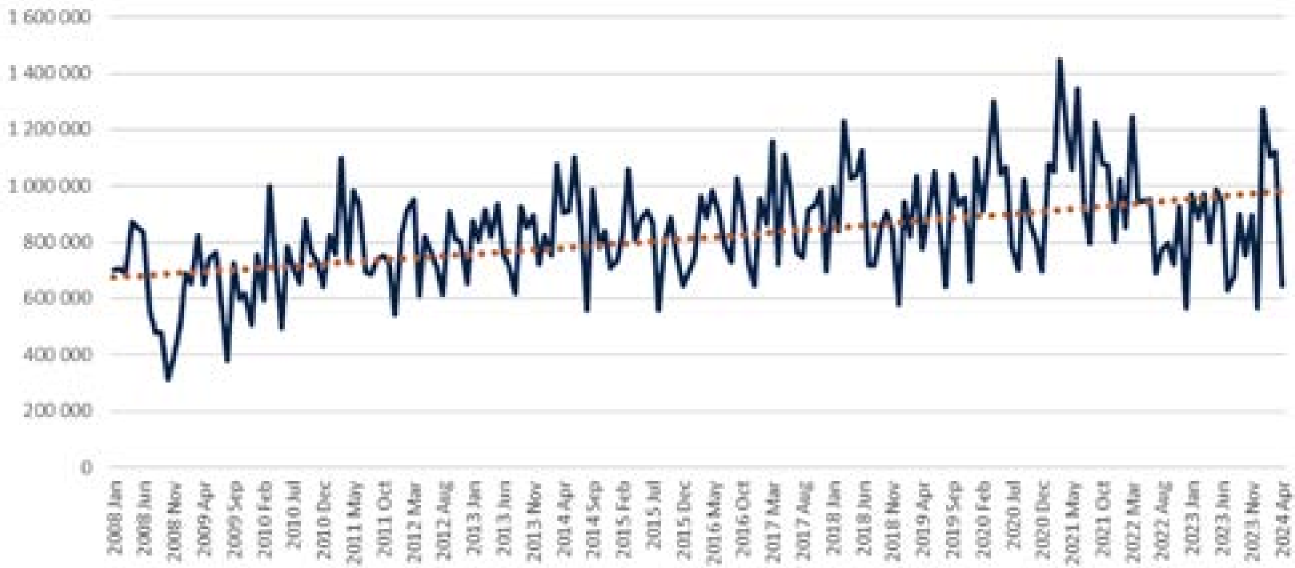
As well as providing a significant value add, the ratings agencies' dominance secures their pricing power. S&P is the market leader with just under 50% share of total issuance value, Moody's second with approximately 40% and Fitch a distant third. These century-old brands have become the language of the bond markets.

Their brands are so strong that even their heavily criticized role in the 2008 financial crisis proved to be only a temporary blip. Much of the criticism centered around the AAA ratings given to mortgage-backed securities that in many cases were comprised of sub-prime loans. The rating agencies failed to account for the possibility of a broad nationwide decline in house prices and how that would impact the performance of the bonds. In the aftermath regulators tightened supervisory powers over the credit rating agencies, but their value to the system was recognised and their business models were by-and-large unaffected.

S&P Ratings comprises 25% of total group revenue and 32% of group operating profit. The higher proportion of profit hints at the impressive margins. Its operating margin of approximately 60% is second only (within the business) to that of S&P Indices.

Bond issuance volume is the key revenue driver for S&P's ratings business. The graph below shows monthly bond issuance in dollars. The first thing one might notice is how cyclical issuance is, unsurprising given its dependence on sometimes volatile macro factors. The second thing you might notice is that the trend is certainly growth, with more dollar credit issuance over time. Having established a growth trend, let us have a look at some of its underlying drivers.

MONTHLY DOLLAR ISSUANCE VALUE



Source Dealogic DCM Loan Monthly

Where is the growth, what drives issuance?

/ Increasing corporate leverage.
Increased leverage is commonly cited as a consequence of historically lower interest rates. The strong free cash flow generation of corporate balance sheets coupled with the large debt capacity and a return to lower rates, should continue to support corporate growth. In essence, the ratings business is a long-term play on the growth of the global economy. More business activity equals more issuance.

/ Growth in private debt markets.
A consequence of the global financial crisis was the pull-back by banks on many lending activities and the development of private debt markets to fill the void. Private debt markets have grown faster than public debt markets in recent years, with private debt growing tenfold in the past decade. While most of this debt is unrated and therefore not profitable for ratings agencies, as this industry grows and attracts greater participation from individual investors via asset managers and carries greater systemic risk, there will be tighter regulation. This in turn is likely to lead to higher demand from private borrowers for issuer requested ratings and credit analysis on private debt.

The structural drivers above are not exhaustive and there are also cyclical drivers. Those would include interest rate levels, credit spreads and corporate default rates. The impact of these cyclical drivers will oscillate between positive and negative, but the most important thing to remember is that they are underpinned by structural growth.

S&P Indices

S&P has built a strong moat with its flagship benchmark - the S&P 500 index. The division is approximately 11% of revenue and an impressive 17% of operating profit. The division's stable and relatively consistent operating margin of approximately 70% is very attractive. It is less cyclical nature also helps compensate for the more volatile ratings business.

S&P monetizes its indices business from three main client categories:

- Exchange-traded futures and options, i.e. index subscriptions, asset-linked fees, and transaction royalties.
- Active asset managers that subscribe their indices for performance measurement
- Exchange-traded derivatives, i.e. generates trading royalties.

Index benchmarks are critical to asset owners, asset managers, and consultants, and they often have little incentive to switch benchmarks. Once an index becomes dominant in a certain segment and has widespread acceptance among stakeholders, it tends to remain that way and that results in pricing power.

The division has increased its revenue from $323m in 2011 to $1.6bn in 2023, a laudable annual growth of 14%. The major reason for this was the increased popularity of passive funds, with the proportion of actively managed mutual funds/exchange traded funds decreasing from 81% in 2010 to just 52% in 2023.

The graph below shows that part of the reason for increased passive popularity, was that passively managed outperformed actively managed for most of that period. Taking a longer-term view, one can see that the results are mixed, with outperformance between the two being cyclical. Nonetheless, the current outperformance should continue to be tailwind for passive investment as a whole and S&P in particular.

ACTIVE AND PASSIVE OUTPERFORMANCE TREND ARE CYCLICAL

Rolling Monthly 3-Year Periods (1989-2023)

As from 12/31/23

Source: Morningstar and Hartford Funds. 2/24.

Market Intelligence

This division can be considered different from its core business but still related. At 34% of total revenue and 24% of operating profit, it is a significant proportion of the business. In essence it provides productivity enhancing news, market and financial data and analytics platforms for investment professionals. Its S&P Capital IQ platform competes with the likes of Bloomberg and FactSet. Once, these systems are embedded in their clients' workflows they tend to be sticky. There is more competition than the ratings and indices businesses, but its products have an excellent reputation, and it remains a very healthy revenue stream.

Conclusion

Quality rhymes through most of S&P's diversified revenue streams. The business has won its spurs through many decades of a strong track record of profitability and growth. Leveraging its strong brand reputation, customer loyalty and excellent market position to achieve truly global reach. All these attributes enable it to capture compound growth over the long term. We believe in investing in quality companies that can withstand the sands of time, because often the more things change, the more they stay the same.

Market outlook

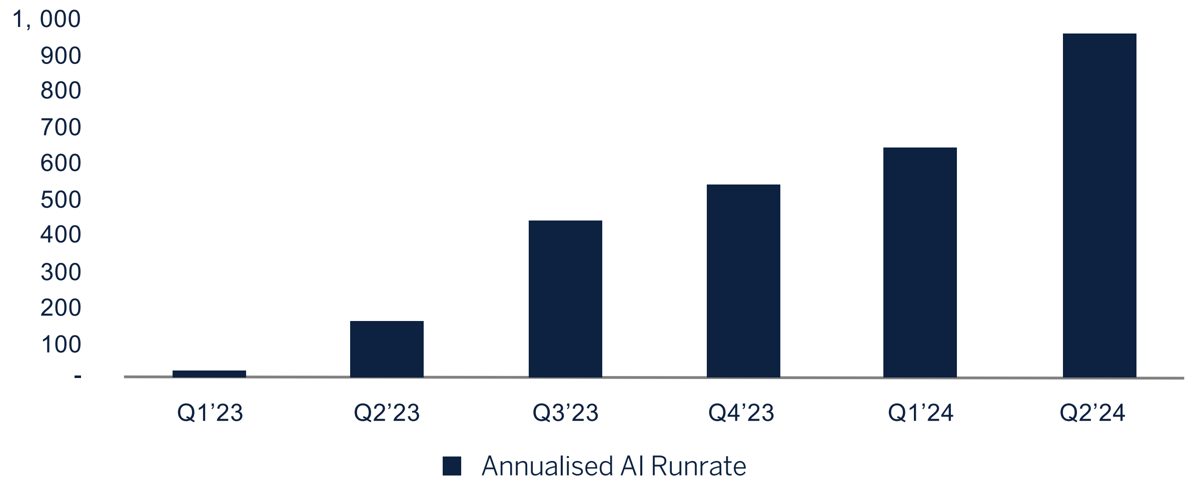
The artificial intelligence (AI) theme has singlehandedly driven markets higher. Almost all the gains in the S&P 500 over the quarter have come from AI-related stocks.

Amazon, Meta, Alphabet and Microsoft have been pivotal in driving AI-related investment demand. These four companies are expected to spend around $200 billion this year and more than $1 trillion over the next 4-5 years. The amount being spent in 2024 exceeds prior super cycle peaks in other sectors, such as the oil majors in 2013 and telecom service providers in 2000.

Most of the current AI capital spending is going towards technical infrastructure, which consists not only of AI-chips but also land, data centres, servers and networking equipment. An example of a beneficiary is Amphenol, one of the holdings in the global equity fund, which provides high-performance cabling for data centres. As shown below, Amphenol's AI-related revenue was de minimis at the start of 2023 and is approaching $1 billion today.

PICKS-AND-SHOVELS SUPPLIER IN THE AI GOLD RUSH

Amphenol AI-related revenue



Source: UBS

Is this growth sustainable? Is it all hype?

Regarding the impact of technology, Bill Gates has been credited with saying "people overestimate what they can do in one year and underestimate what they can do in 10 years". The good news is that there are immediate AI use cases for Big Tech. For example, boosting Meta's content recommendation algorithm or enhancing Google Search. But the concern is that revenue generation is likely to lag huge upfront investments.

One analogy of the AI build-out is a gold mine that has yet to produce gold. We are currently at this stage but next year we will need to see gold being produced, i.e. software applications. Then, the question is whether these software applications are being used by real world companies (e.g. banks, healthcare companies, consumer goods, etc) to boost sales or cut costs. For example, for all its potential, we still need to see evidence that Microsoft's copilot tools are being adopted by office workers as quickly as initially expected.

Although there is a lot of hope riding on the benefits coming through, the good news is that this gold rush is currently being funded by highly cash generative companies rather than, as in the late 1990s dotcom bubble, by capital raisings based on business plans written on the back of an envelope and on valuations based on "number of eyeballs".

Even if there is an overbuild, a saving grace is that Big Tech companies can re-purpose the bolstered compute into their core processes. This contrasts with the dot-com fibre rollouts where we are still lighting dark strands built 25 years ago.

In addition, the demand for this strategically important technology is broadening out beyond the Big Tech names to other industry sectors and governments. Indications of this trend suggested by the most recent Nvidia results underpinned confidence that the AI spending surge has legs.

Previous technology investment cycles generally lasted one to three years. We are past the first year of this cycle. However, if AI is really the next generation of the internet, expect investment intensity to remain elevated for longer.

If AI proves to be a flash in the pan, it is not an undue concern for the Melville Douglas global equity fund. A key linchpin of our philosophy is to diversify growth drivers not only by country and industry sector but also by investment themes. To name a few, these include health and financial innovation, ageing populations, climate change, digitisation, automation, and new ways of consuming and working.

Themes will come and go, but our philosophy remains constant.

It's Personal.

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Standard Bank Group