Global Leaders Strategy

QUARTERLY LETTER | SECOND QUARTER 2016

The Global Leaders Strategy invests in a concentrated portfolio of market-leading companies from across the globe that deliver superior customer outcomes.

Brexit Stage Left

The British electorate's vote on 23rd June 2016 to leave the European Union was undoubtedly the pivotal event of the second quarter and the most fitting subject to start with in this investment letter. The decision initially sent shock waves through global markets, but an eerie sense of calm returned in the following weeks as expectations set in that yet more monetary stimulus would soothe the latest bout of financial stress. Whilst the timing and mechanics of the UK's withdrawal from the trading bloc are uncertain, the precedent for the remaining 27 member states has been set with the future of the European Union already being called into question in certain parts of the continent. There are many permutations for the future of Europe and we feel that attempts to accurately forecast the lasting economic and political outcomes is incredibly difficult, possibly dangerous. The events, however, do serve as an excellent reminder of the dangers of political risk in certain investments. What is clear to us at least is that we could be in for a protracted period of uncertainty and that an important precedent has been set in Europe. Against this backdrop we continue to intensively scrutinise the Global Leaders portfolio and evaluate the risks that we are bearing for our clients as we aim to achieve attractive long-term returns. Part of this process involves us refocusing on the core relationship that each of our franchises has with its customers and what the second, third, fourth and fifth derivative impacts certain events can have on each of these companies, and the portfolio as a whole. Whilst we look for independent positions within the portfolio, experience has taught us that it is the less obvious, seemingly lower-order correlations that create unforeseen risk in times of stress. Like an iceberg floating in the ocean, it is the risk that you can't always see lurking below the waterline that can cause the most damage to our client's capital. Brexit serves as an excellent reminder of the importance of rigorous risk management and downside protection as we sail through foggy seas.

Thanksgiving Came Early This Year

Whilst the events of 23rd June 2016 have far reaching ramifications for the future of the European Union what is perhaps more interesting is the level of shock and surprise that most investors experienced following the vote despite the outcome being incredibly close to call in the days leading up to the referendum. Bloomberg's Brexit Poll Tracker, which aggregated all available public polls, showed 46.2% support for remain, 44.3% for leave with 9.5% undecided on 22nd June, one day before the vote. One can argue about the predictably of polls but the outcome was much closer to an even-money wager than the black swan event that some of the post-Brexit price actions suggest. Given these facts why did the result engender such a reaction? One possible reason is the psychological power of hope over probability. As part of our survival instinct, human beings feel pain at least twice as much as pleasure, and in certain instances hope can overtake reality in uncertain situations as we avoid the thought of crystallising pain in our minds. It is our belief that the majority of investors were hoping that the perceived pain and emotional distress of Brexit wasn't going to happen. In our world we know that the triumph of hope over reality can create significant damage to our client's capital if left unchecked. One obvious example is loss-aversion, where investors hold onto losers for too long to avoid the pain of loss, as we naively hope that we can get back to break-even. On Global Leaders, we have a rule where we automatically initiate a fact-based review when an investment falls 20% below our initial purchase price in order to fight the damaging effects of loss-aversion and hope. We recognise that hope can cloud an investor's judgement. Hoping that something isn't going to happen, whether it is Britain leaving the EU or a permanent destruction of capital, doesn't change the likelihood of it actually happening.

As well as hope, the Brexit episode also reminds us that the future is inherently unknowable. While it is human nature to extrapolate current trends into the future, the reality is that the world doesn't work in a linear fashion. The temptation to anchor on the current status quo of the UK being part of the EU was too hard for most investors to resist. Even in the face of the poll data many assumed Brexit was unthinkable. Again this overreliance on the extrapolation of current trends into the future features heavily in investment. It is all too easy to think that XYZ company can keep growing at its current rate into the future or that a certain set of conditions will continue forever. Perhaps the best example of this in recent times is the evolution of the oil price with some of the world's largest oil companies making multi-year, multi-billion dollar investments based on expectations of an $80-100 barrel oil price in 2014 just before the price of Brent crude started its tumultuous decline to less than $30 barrel earlier this year. Indeed, we can remember having an in-depth discussion with the CFO of one of the world's largest supermajors in 2014 with the manager making a convincing fundamental argument that a price range of $80-100 barrel was almost certain for the foreseeable future. Like Brexit, the status quo didn't hold and the current trend was also broken by more seemingly unpredictable human behaviour, in this instance it was OPEC. Both of these episodes highlight the dangers of extrapolating current trends into the future and the unpredictability of human behaviour with both reminding us of Nassim Taleb's Turkey parable:

> *'A turkey is fed for a thousand days by a butcher; every day confirms to its staff of analysts that butchers love turkeys "with increased statistical confidence." The butcher will keep feeding the turkey until a few days before Thanksgiving. Then comes that day when it is really not a very good idea to be a turkey. So with the butcher surprising it, the turkey will have a revision of belief – right when its confidence in the statement that the butcher loves turkeys is maximal and "it is very quiet" and soothingly predictable in the life of the turkey.'*
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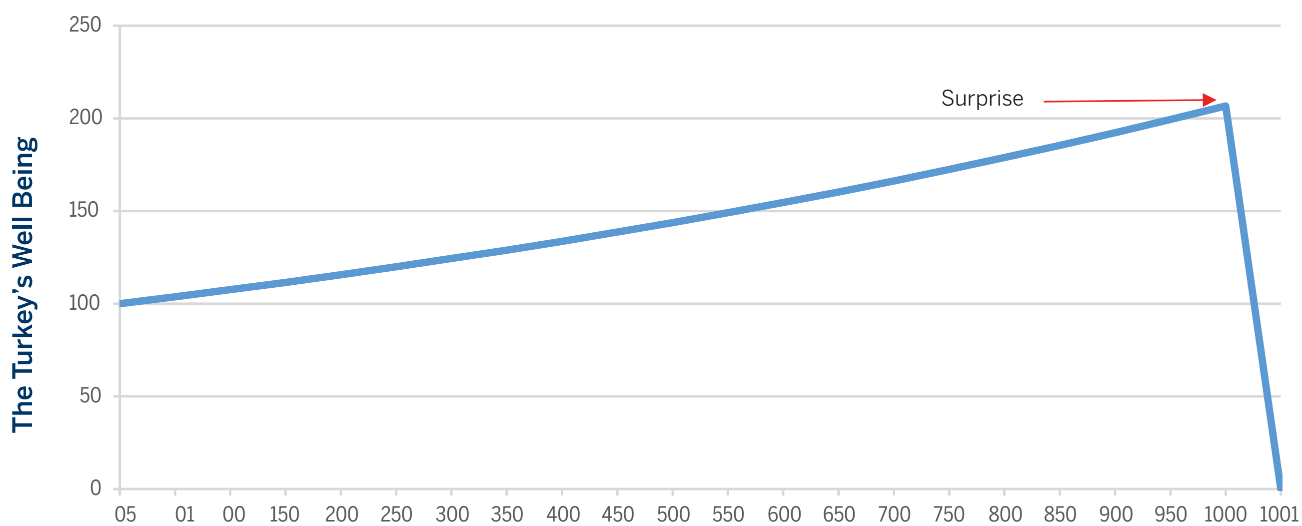
> - Antifragile, Nassim Taleb, page 109

1000 and 1 Days in the Life of a Thanksgiving Turkey



Source: Brown Advisory.

The moral of the turkey story is that we need to stop clucking, to consider a range of outcomes and not to assume that the status quo will hold despite the recent past being a highly tempting guide-point for the future. In investment a key part of this is risk management and opening our minds to different scenarios that could exert pressure on both our franchises and the portfolio as a whole. In addition, we feel that our investment process helps reduce, but not eliminate the unpredictable. We focus on franchises that deliver superior customer outcomes that are expressed in high and sustainable returns on invested capital. As we discussed in the previous letter high-returning companies have a statistically higher probability of remaining high-returning companies for extended periods of time if they possess the qualities that we seek. Crucially, the emphasis is on probability as certainty in investment is a turkey-esque quality. Even great companies are exposed to the unpredictable as the world changes and human nature intervenes but we feel that buying high-returning companies with sustainable competitive advantages should tilt the odds of a more predictable outcome in our favour.

In addition to the statistical persistency of these franchises, we also look to protect our client's capital by investing in companies at discounts to intrinsic value – building in some of the 'margin of safety' that Warren Buffett and Seth Klarman espouse. It is our belief that value stems from the present value of a franchise's cash-flows which inherently means that investors looking to appraise a company have to make certain predictions about the future cash-flow generating ability of that company. Like the turkey, such predictions can be dangerous as despite how our minds are wired, the world doesn't work in a linear fashion. Given our conception of value the less we pay for a future stream of cash-flows the more insulation and downside protection we can give our clients in the event that the future doesn't unfold as we expect it to. This is no mean feat as current monetary policy has created a number of valuation distortions in certain parts of today's equity markets, but we feel that our focus on running a concentrated portfolio of 30-40 companies, and our global opportunity set, means that we shouldn't have to compromise on valuation. Turning a blind eye to valuation not only limits the upside potential for our clients, as investment centres on buying something for less than it's worth, but it also provides less downside protection in the event of the seemingly unpredictable becoming reality.

As we touched on earlier, what is perhaps equally as important for protecting capital against the seemingly unpredictable is putting in place checks and balances to help limit the impact when it actually happens. Interestingly the same human behaviour that makes the world unpredictable can also destroy capital through behavioural biases like loss-aversion. In investment, as in many walks of life, we can literally be our own worst enemies. Although our investment process and thorough risk management strive to insulate our client's capital, we cannot completely eliminate the inherently unpredictability of human nature that can express itself in events like Brexit or the evolution of the oil price. Our investment process does contain a number of rules to make sure that we have a systematic response when the unexpected happens. Our ambition is to avoid being one of Lee Freeman-Shor's rabbit investors, a term he coined in his excellent book 'The Art of Execution.' These rabbits get stuck in the headlights, paralysed by their behavioural biases when the future doesn't unfold as they expect it to. We share Freeman-Shor's view that execution and unrabbit-like behaviour are key ingredients for long-term investment success. We will discuss the damaging forces of investor psychology further in future letters and hope that you have an enjoyable and an entirely predictable rest of the summer.

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