Global Leaders Strategy

Brown ADVISORY
Thoughtful Investing.

QUARTERLY LETTER | FOURTH QUARTER 2016

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

On a Swing and a Prayer

Although this is only the fourth Global Leaders quarterly investment letter, it feels like a lot has happened in a relatively short space of time. 2016 was far from uneventful and the final quarter delivered an event that prompted a market reaction that even overshadowed the Brexit fireworks of the second quarter. 2016's crescendo was of course ushered in by Donald Trump's victory in the U.S. presidential election on November 8th and culminated with investors shrugging off pre-election scepticism and embracing the new commander-in-chief's proposed economic policies with open arms. Accordingly, equity markets posted strong gains in the last eight weeks of the year leaving many flirting with all-time highs by the time Mariah Carey entertained the crowds in Times Square on New Year's Eve. This episode demonstrated that Keynes's animal spirits are alive and well and that equity markets, spurred on by investor sentiment, continue to shoot first and ask questions later. One of our favourite analogies that characterises the schizophrenic nature of investor sentiment comes from investment sage Howards Marks. Marks describes investor sentiment as a swinging emotional pendulum that drives market performance. Euphoria and depression are at opposite ends of the pendulum and although it oscillates at various rates it rarely stays at extremes for long:

'Investment markets follow a pendulum-like swing: between euphoria and depression, between celebrating positive developments and obsessing over negatives and, thus between overpriced and underpriced'.

Concerns over the state of the Chinese economy and the shock and then positive interpretations of Brexit drove significant movement in the pendulum in 2016 with the days following Trump's victory seeing the last big swing of the year. Sentiment turned on a knife edge, scepticism turned to optimism and perhaps most importantly the fear of losing money was replaced with the fear of losing out. As long-term investors we look through the quarterly volatility but we are nevertheless focused on understanding the potential long-term impact that the new administration could have on the cash flows that our investments produce. Much of this analysis centres on probability weighting different scenarios and working out how much of the supposed good news is being priced in by equity markets. As we have discussed in previous letters, human beings have a tendency to extrapolate current trends into the future in a linear fashion, but as we know the world doesn't work in a linear fashion due to human behaviour. Whilst we acknowledge that the world has changed following November 8th we are also cautiously focused on where we see realistic value. As we mentioned in relation to the recent fixation for valuing equities with bond-like qualities relative to bonds, human beings have the ability to instantly change their simplified linear view of the future. In reality nothing lasts forever in the equity markets despite it often feeling like everything does. Although we refrain from making detailed macro-economic predictions one thing is certain – Donald Trump's victory wasn't responsible for the last ever swing of Marks's emotional pendulum and, like night follows day, the oscillations will continue. Against this backdrop we are focused on balancing the new-found euphoria with a sobering examination of risk and reward in order to generate attractive long-term returns for our clients.

An Apple-Shaped Diamond a Day

The events of the final quarter of 2016 resulted in what some commentators have dubbed "the great rotation" as investors focused on stocks with perceived value qualities over those with growth qualities. Perhaps the most noteworthy example was the underperformance of technology companies during this period. In the U.S. the S&P technology index materially underperformed the main index in the fourth quarter and core Global Leaders holdings like Taiwan Semiconductor Manufacturing Co. (TSMC) and Microsoft (MSFT) lagged the post-Trump bounce despite there being no discernible change in the long-term outlook for cash flow generation for each company. In most instances investors were choosing to sell the same cash flow stream for less to fund investment elsewhere. One part of the argument to justify this rotation is that most technology stocks trade on high valuation multiples giving them longer durations than the market and a greater amount of value ascribed to the future in cash flow terms. As investors priced in rising long-term interest rates following the U.S. election the logic was that companies with significant amounts of future value were worth less in today's terms. This is a valid argument especially for companies that were trading at or above fair value with significant amounts of that value tied up in a less valuable future. However both TSMC and Microsoft were not fairly valued and traded inexpensively on free cash flow yields that were substantially higher, and therefore cheaper, than the global market. This pendulum swing of the fourth quarter of 2016 reminds us of investment strategist Richard Bernstein's simple notion from the early 1990s that the product that is bought and sold in equity markets is nominal earnings growth and the macro-economy affects the supply of earnings growth:

'If superior profits growth became scarce, one would think that investors would be willing to pay higher prices to obtain ownership in the companies that can indeed produce superior growth. Conversely, if earnings growth was abundant, investors might be foolish to pay high prices for an abundant resource. In other words, there are periods during which investors treat earnings growth like diamonds because earnings growth is deemed to be so scarce, and there are times when they treat it like apples because it appears so abundant'.

Although there are merits to this simplification, the reality is that the style boxes of growth and value are very blunt instruments as the treatment of technology stocks in the final quarter of 2016 demonstrates. Indeed one could convincingly argue that higher economic growth in the U.S. would actually increase demand for the enterprise software and mobile-device chips that Microsoft and TSMC sell. Categorising every investment either as growth or value is a simplified monochromatic way of looking at the world – like watching television in the 1950s everything is either black or white. In addition, growth and value are typically defined by two variables – earnings growth and the price-to-earnings multiple. Companies with above-average earnings growth and price-to-earnings multiples are typically characterised as growth with the opposite for perceived value stocks. Again this seems like another one-eyed view of the world, as solely looking at these two variables ignores each company's return on invested capital (ROIC) and fade – the time it takes for these returns to be eroded by competitive forces to the cost of capital. ROIC is a measure of financial productivity and it shows how efficient a franchise is at generating free cash flow. As an example, two companies could produce identical earnings that are expected to grow at the same rate making them trade on identical price-to-earnings multiples. However Company A could require 10x the amount of capital investment than Company B to generate its earnings. Clearly Company B generates more value by creating more free cash flow as it requires substantially less capital investment than Company A to generate the same amount of earnings, yet in the one-eyed world of growth and value they are treated equally. Much of this boils down to our belief that markets are inefficient over the short term but are more efficient over long periods of time. Blanket selling based on overly simplified two-dimensional perceptions of style will undoubtedly result in inefficiencies as we witnessed in the final quarter of 2016. Indeed, the rise of passive investing and style-factor strategies are likely to accentuate these periods of inefficiency and turbulence. As long-term investors we need to keep a ball of Odysseus's wax, that we discussed in the last letter, close at hand ready to stuff in our ears when the financial sirens of temptation call. We remain focused on what should be an increasing stream of opportunities to invest in outstanding companies at significant discounts to intrinsic value.

Coming back to the black and white view of the world one question we are often asked is – 'are you growth or value investors?' Our process centres on buying customer-focused franchises that have wide economic moats and generate significant amounts of free cash flow. A company that uniquely satisfies its customers will typically be rewarded with repeat business, pricing power and new customers looking to consume its goods and services. One output of this relationship is growth – the Global Leaders strategy has substantially higher earnings growth than its benchmark index.

On this definition we are growth investors but we are also crucially aware of our conception of value which is more refined than the classic definition. To us, value is not simply about low earnings multiples – it is about in-depth cash flow based analysis where free cash flow generation, as signified by ROIC, and duration, measured by fade, are brought into the equation. We believe the best investments have fade-resistant returns that foster free cash flow generation and a significant amount of the fair value in the foreseeable future. So we are value-focused investors but not in the classical low-multiple conception. The Global Leaders portfolio has a price-to-earnings multiple that is marginally above the market but the portfolio has superior cash flow generation capability and is more resistant to fade which after all is what is supposedly expressed in an earnings multiple.

Coming back to Richard Bernstein's simplified definition of growth and value, we are looking for companies that have diamond-like qualities and that are not only priced like apples but are also productive and have long shelf-lives. It is these last two attributes that are often overlooked when the emotional pendulum swings. It is our belief that this should create significant opportunity for the investor who can think outside of the style box in the increasingly volatile world we live in. We hope that you have a profitable start to the year and look forward to updating you on our progress in 2017.

The Global Leaders Team

GLOBAL LEADERS PORTFOLIO MANAGEMENT

MICK DILLON, CFA
Lead Portfolio Manager

BERTIE THOMSON, CFA
Co-Portfolio Manager

INVESTMENT ENQUIRIES

WALTER BECKETT
wbeckett@brownadvisory.com

KERYN BROCK
kbrock@brownadvisory.com

POLLY CORRY
pcorry@brownadvisory.com

CHARLIE VAN STRAUBENZEE
cvs@brownadvisory.com