Global Leaders Strategy

QUARTERLY LETTER | THIRD QUARTER 2016

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

Dead Calm

After the fireworks of Brexit the third quarter was less dramatic. Although the summer months are traditionally a quieter time of the year we, the Global Leaders team, have been busy sharpening our analytical pencils and meeting a number of existing and potential portfolio companies from all four corners of the globe. Whilst we think that trying to second guess the short-term evolution of the economic and financial landscape is fraught with danger, our summertime activities were illuminating for a couple of reasons.

Accommodative monetary policy continues to distort asset values with our world of global equities being just as susceptible to these forces as sovereign debt, prime real estate and Picasso paintings. This is hardly new news but our interactions with investors and companies at numerous meetings this summer reinforced our belief that the valuation bar seems to have been definitively, and in some minds permanently, reset for most investors. We will discuss the value vs valuation paradox later in this letter.

What is perhaps more insightful than prevailing investor sentiment are the discussions we had with a handful of management teams that have a history of prudently allocating capital and the ability to ignore the corporate equivalent of peer pressure – Warren Buffett's "institutional imperative". One notable example is a recent interaction that we had with a leading Scandinavian financial services group that has launched a bid for a smaller rival at a discount to the target's share price. This might sound perverse but under local law the move, if successful, will give the acquiring company flexibility to opportunistically increase its ownership at lower price levels. The messaging here is symbolic and one that we are increasingly hearing from experienced capital allocators that both good and bad assets are becoming overvalued and balance sheet optionality is important. With many equity markets flirting with all-time highs these discussions do make us question the longevity of the current status quo. It is our belief that the psychology of commitment means that human beings are good at spotting trends but are slower at changing their stance to fit these trends. In the real world actions speak louder than words and some actions speak louder than others.

As mentioned earlier we are not market timers or macro-economic soothsayers. We are fundamental bottom-up investors looking to buy a small number of exceptional businesses at discounts to intrinsic value and hold them as they compound value for shareholders. We are nevertheless cognisant of the external environment and the broad acceptance of higher valuations, which implies lower future returns, and our discussions with a handful of proven contrarian capital allocators make us question the sustainability of the current environment for asset prices. All of this comes at a time when exogenous risks seem to be increasing. Brexit execution, the Italian referendum, the Deutsche Bank seifenoper* and the US presidential election are just a small selection of the growing smorgasbord of risks that could potentially upset the investment apple cart. With this in mind we continue to focus on where we see value and the amount of deferrable demand we are exposing our clients to in the Global Leaders portfolio. Clearly the customer relationship is much stronger for a provider of business critical software that is consumed via subscription than it is for a housebuilder whose core product is highly deferrable. It is our belief that investments that combine highly deferrable demand with hefty premiums to intrinsic value present significant risks to investors' capital in today's uncertain world.

*Soap opera

WACC-Y Races

The Global Leaders' investment process hinges on four key tests – franchise quality, quantitative metrics (we have to see it in the numbers), management quality and investability. Any potential or current investment has to satisfy all four tests and with a concentrated-portfolio approach and the whole world to select companies from, we feel that we can afford to be disciplined on all four in order to deliver outstanding long-term returns for our clients. For us, risk in the portfolio is principally a company's failure of one or more of our tests which would lead to a permanent impairment of our clients' capital. More often than not failure of one of the four tests can impact the other three. The most obvious scenario is when deteriorating management quality rapidly puts pressure on a franchise's ability to provide value to customers which shows up in the numbers and ultimately affects the underlying value of a company. As we look around the world today investability is the test that is becoming increasingly harder to pass.

Investability centres on our conception of value as the whole premise of investment is based on buying an asset for less than you think it is worth. Paying more than you think an asset is worth is an act of charity as you are essentially transferring part of your wealth to an often faceless counterparty. It is important to make the distinction between value and valuation. Value is a subjective interpretation of an asset's worth whereas valuation is a framework that investors use to assess, often relative to history, whether to buy or sell. By investability we focus more on value than on valuation by working out what we think the intrinsic value of a company is and patiently waiting for a significant discount to that value to present itself before investing.

As mentioned earlier, the concept of value is subjective and this is why we see risk in our investment universe right now. To us, value (an asset's worth) is best expressed by the net present value of the future cash flows that a company produces. Simplistically, net present value is calculated by discounting these future cash flows at a certain rate to account for the time value of money (£1 today is worth more than £1 in 10 years' time). The discount rate or cost of capital, which is comprised of a company's cost of equity and importantly their cost of debt, is what we see as being the most contentious. The simplest form of net present value is a perpetuity calculation which assumes that the present cash flow continues forever. To get a present value for a perpetuity we have to divide the cash flow by an assumed cost of capital. So if a company generates £100m of cash flow forever its value will be worth £1111m (£100/9%) using a 9% WACC, £1250m using 8% WACC and £1429m using 7% WACC. Hopefully you get the picture – the lower the rate the higher the theoretical asset value. Herein lies the nub of our concerns about value right now. Current monetary policy hinges on historically low interest rates which have resulted in ultra-low costs of debt for most companies. The temptation is to use the currently low cost of debt to derive a low rate to discount future cash flows and in part this is what has driven the huge asset price inflation of recent years. Crucially by plugging current rates into a net present value calculation investors are assuming that current conditions will last forever. Of course it is human nature to extrapolate current trends into the future in a linear fashion, whereas the reality is that the world doesn't work in a linear fashion due to human behaviour. It is this extrapolation that has made value, as we define it, a lot harder to come by today.

Market timing is incredibly difficult which is why we leave that discipline to others but we do feel that it is pretty bold to assume that current conditions will continue forever. Part of our caution stems from our experience of previous equity market cycles when investors were so excited by the seemingly endless new paradigms that they embraced new-fangled valuation metrics. We remember enterprise value-per-click being floated as a way to value internet companies in the late 1990s before the dotcom crash. We also remember being urged to use leveraged buyout "LBO" models in the debt-fuelled private equity mania of 2006-07. At extremes the temptation to abandon our investment principles and bend our own rules increases. One discussion we had with an investor recently included a response of "you are never going to buy anything in consumer staples if you use that cost of capital". This interaction spoke volumes about what rules you need to bend in order to find value in consumer staples right now. We continue to struggle with the lengthy payback periods that are increasingly reflected in the equity values of certain toothpaste and food producers. In nearly every case the outlook for long-term cash flow growth has not materially improved which implies that investors are simply paying more for the same thing.

The final point to make on our conception of value and why we are happy to use what we define as a normal cost of capital to appraise investments is that it provides our clients with an extra margin of safety that should protect their capital. It is our belief that the future is inherently unknowable and resisting the temptation to embrace historically low costs of capital will provide downside protection if the seemingly unpredictable happens and conditions change. If a company looks undervalued using a 9% cost of capital it will look even more undervalued using 8% or 7%. Whereas the reverse is true for a company that looks undervalued using 7% might well be overvalued using 9%.

We started this letter by mentioning the symbolic importance of the actions of a handful of managers who have proven themselves to be prudent capital allocators. We too have to ignore the peer pressure of the institutional imperative and not bend our beliefs to fit in with the crowd. In investment there are times when it is important to take a leaf out of Greek hero Odysseus's book by putting beeswax in your ears and tying yourself to the mast of your process in order to deflect the numerous Siren calls that emanate from the financial world. When it comes to conceptions of value we feel there has never been a more prudent time to deploy the beeswax and rope than now. We hope that you have an enjoyable rest of 2016 and we leave you with one of investment sage Howard Marks's favourite adages which resonates with us in the current environment:

"What the wise man does in the beginning the fool does in the end."

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