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Global Leaders Strategy

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The Global Leaders Strategy invests in a concentrated portfolio of market-leading companies from across the globe. We believe that companies that combine exceptional outcomes for their customers with strong leadership can generate high and sustainable returns on invested capital (ROIC) which can lead to outstanding shareholder returns.

ISN'T EVERY INVESTOR A VALUE INVESTOR?

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One of the recurrent themes that investors focus on is style—specifically growth and value. This question reached a crescendo this quarter as there was a reversal in fortunes for value investors as companies with supposed 'value' characteristics generally outperformed their 'growth' counterparts in September. Like many things in investing we continue to be bemused by investor preoccupations and we find that the classic 'value' and 'growth' style boxes are misleading. We frequently get asked which side of the growth vs value line we reside on. To us the most obvious response to the question is—isn't every investor a value investor? This seemingly flippant response stems from our conception of the essence of investing where to us, the core of the activity is buying an asset for less than you think it is worth. Paying a premium to perceived fair value is a different activity—speculation. The speculator relies on greater fools to pay more than them in order to generate a return. Accordingly we spend our time looking for companies that we feel are undervalued. The classic style boxes revolve around shorthand valuation techniques which we think are very dangerous. Indeed the primary requirements for companies to enter value exchange traded funds are price-to-book (PB), price-to-earnings (PE) and price-to-sales (PS) ratios[1]. As we have mentioned many times (How we value Global Leaders), we believe it is misleading to distil the value equation into a single number or ratio because it omits a large part of the economic picture. Vital ingredients such as return, growth, cost of capital or equity and fade are generally ignored when you look at a single number in isolation. As an example let's look at one metric that the value style box aficionados gravitate towards—price-to-book. The table below uses a standard text book definition of the relationship between return on equity (ROE), price-to-book and cost of equity (using an artificial 8%) and assumes constant growth and returns—i.e. no fade. As you can see a company that can grow its net income at 5% could either have no value (0x PB) or be worth 8.3x (830%) book value (equivalent to a company's net assets) depending on whether its perpetual return on equity is 5% or 30%. Using the same example and applying a similar textbook definition for price-to-earnings you can see a similar relationship—the same company that is growing its net income at 5% either has no value (0x PE) or could trade on 28x PE depending on whether its perpetual ROE is 5% or 30%. The reality is that shorthand valuation techniques are the product of a variety of different financial ingredients—companies with high PB, PE and PS ratios can be undervalued and companies with low PB, PE and PS ratios can be overvalued. Accordingly looking at companies through the traditional value and growth multiple framework is like looking at the Mona Lisa through a telescope the wrong way round—the picture is incomplete and misleading.

P/B	Net Inc growth		CoE = 8%			
RoE	3.0%	4.0%	4.5%	5.0%	6.0%	7.0%
5%	.4x	.3x	.1x	.0x	-.5x	-2.0x
10%	1.4x	1.5x	1.6x	1.7x	2.0x	3.0x
13%	1.9x	2.1x	2.3x	2.5x	3.3x	5.5x
15%	2.4x	2.8x	3.0x	3.3x	4.5x	8.0x
20%	3.4x	4.0x	4.4x	5.0x	7.0x	13.0x
25%	4.4x	5.3x	5.9x	6.7x	9.5x	18.0x
30%	5.4x	6.5x	7.3x	8.3x	12.0x	23.0x

P/B = (RoE-g)/(CoE-g)

P/E	Net Inc growth		CoE = 8%			
RoE	3.0%	4.0%	4.5%	5.0%	6.0%	7.0%
5%	8.0x	5.0x	2.9x	.0x	-10.0x	-40.0x
10%	14.0x	15.0x	15.7x	16.7x	20.0x	30.0x
13%	15.2x	17.0x	18.3x	20.0x	26.0x	44.0x
15%	16.0x	18.3x	20.0x	22.2x	30.0x	53.3x
20%	17.0x	20.0x	22.1x	25.0x	35.0x	65.0x
25%	17.6x	21.0x	23.4x	26.7x	38.0x	72.0x
30%	18.0x	21.7x	24.3x	27.8x	40.0x	76.7x

P/E = (1-g/RoE)/(CoE-g)

Source: Brown Advisory
The tables above are based on a hypothetical company using the standard definition of the relationship between return on equity (ROE), price-to-book (PB) and cost of equity (using an artificial 8%) and assumes constant growth and returns—i.e. no fade. The right hand table applies a standard definition of price-to-earnings. Both examples show a similar relationship, a company that is growing its net income at 5% either has no value (0x PE) or could trade on 28x PE depending on whether its perpetual ROE is 5% or 30%.

[1] iShares S&P 500 Value and Vanguard S&P 500 Value ETFs both rely on these ratios.

Coming back to the recent past, the events of September have prompted more than one client to ask us how we feel the Global Leaders strategy would perform in the event of a 'value' rotation. We have no ability to second guess how investor sentiment will shift and our whole approach is based on our belief that markets are inefficient over short time periods. If the next equity market gyration swings towards companies whose only attraction is that they trade on low multiples we feel such a move would ultimately be transient if it isn't supported by the other financial ingredients—principally returns, growth and fade. Indeed such a move could create meaningful opportunity for the long-sighted investor as high quality companies with seemingly high multiples could become undervalued as investors overly obsess about low multiples and ignore their attractive return, growth and fade qualities. Indeed we feel that fade is one of the most overlooked qualities in investing and as the above table demonstrates there is an evergreen temptation to think that current returns and growth last forever. The reality is that competitive forces typically fade these characteristics for the average company which is why we place so much emphasis on customer relationships and economic moats. Indeed classic value investors can easily get themselves into hot water if a company's return profile, that the undervaluation argument is built upon, erodes or doesn't mean revert. To us this is one reason why industries that have traditionally been happy hunting grounds for self-styled value investors have proved so difficult recently. Disruption has called into question the durability of return profiles in areas such as media, banking, oil and gas and retail. Finally Global Leaders is a long duration equity strategy—we are hyper sensitive to value and take significant comfort from the fact that the strategy trades in line with the benchmark (FTSE All World Index) on our preferred shorthand valuation technique Free Cash Flow (FCF) yield but, bringing the rest of the picture into the frame, it has substantially higher ROIC, growth and fade characteristics than the average company in our universe[2]. These qualities are what should ultimately drive long-term value regardless of which way the style box wind blows over the short term.

THE EMOTIONAL INVESTOR

'Evolution does not care about objectivity – it only cares about fitness'.[3]

As regular readers of our letters will know we acknowledge that human beings are uniquely disadvantaged for the activity of investing (The Investing Ape). Our thought processes and behaviour have been shaped by millions of years of evolution which has furnished us with a toolkit that is designed to help us perform two tasks, survival and reproduction, neither of which is particularly helpful for investing in undervalued assets and allocating capital. Given this base line realisation we spend a considerable amount of time thinking about how human behaviour can impact investment returns. Recently we were lucky enough to host Dr. Tali Sharot at a client event in London. Dr. Sharot is a cognitive neuroscientist at University College London, director of their Affective Brain Lab and author of a number of books on how the brain works including our favourite: *The Influential Mind*. She has spent many years studying two biases that we are, unfortunately! very familiar with—optimism bias and confirmation bias. Optimism bias is our tendency to overweight the role of probability of positive outcomes and underweight the probability of negative outcomes—the latter is what we call the 'it-will-never-happen' syndrome. Optimism bias is a natural survival instinct but it evaporates under stress—which is why equity market bubbles can dramatically turn into busts. We are also very familiar with confirmation bias—the human propensity to seek out information that confirms existing beliefs. As Dr. Sharot mentions—when was the last time you managed to change someone's political beliefs in a discussion with facts? Long-held beliefs are deep rooted in all of us. This bias is particularly potent in investing as the temptation is to continually seek out information that supports our current views on each investment thesis. Interestingly, naturally analytical people (we'd categorise ourselves here) are particularly susceptible to confirmation bias due to their ability to twist information to fit the existing narrative:

'If you perceive yourself as highly analytic – someone who has a strong ability to make use of quantitative data and a good reasoning capacity – embrace yourself. People with stronger analytic abilities are more likely to twist data at will than people with reasoning ability'.[4]

One of the most eye-opening topics we discussed with Dr. Sharot was how emotions can influence our decision making and our recollection of certain events. Emotional responses start in the region of the brain that is important for signalling arousal—the amygdala. Once stimulated the amygdala sends signals and the other parts of the brain interpret the current activity. This part of our brain is programmed to respond quickly before a situation has been fully processed—a vital evolutionary response when survival is the primary objective. Interestingly emotion is also a key communication tool which is also grounded in evolution—when exposed

[2] Source: Factset. As of 30th September 2019 the Global Leaders Representative Account had a FCF yield (median NTM ex. financials) of 4.1% vs 4.1% for the benchmark, sales growth (median historic) of 9.2% vs 7.2% and ROIC (LFY ex. financials) of 25.7% vs 10.1%. This is provided as supplemental information.
[3] Source: Alchemy: The Surprising Power Of Ideas That Don't Make Sense, Rory Sutherland
[4] Source: The Influential Mind, Tali Sharot

to certain stimuli a collective has a unified response which is termed 'synchronisation'. One noteworthy experiment was conducted by the Weizmann Institute of Science in 2004 when subjects had their brains analysed using MRI machines whilst being shown the spaghetti western The Good the Bad and the Ugly:

> *'A pattern seemed to emerge before their eyes: the moments in which brains had a strong tendency to "unify" were the emotionally charged moments in the film. In the face of events that cause suspense, surprise, and elation, one person's brain looked a lot like another's. Emotion was "hijacking" a large portion of people's brains and doing so in a uniform manner'.*[5]

We, the Global Leaders team, already have a term for a pre-programmed emotional response: 'The Amygdala Hijack'[6]. What was illuminating from our discussion with Dr. Sharot was to think about how such a response could occur in the collective whereby there is mass synchronisation between equity market participants—both negative and positive. Just as in the reversal of optimism bias a mass Amygdala Hijack has the propensity to exacerbate short term market moves—a phenomenon that underpins one of our core beliefs—that markets are inefficient over short time periods. This is not a new realisation but one that can be frequently overlooked—indeed it reminds us of Charles Mackay's nineteenth century work 'Extraordinary Popular Delusions and the Madness of Crowds'.

We touched on the role of information and how too much information, especially price and performance, can lead to myopic loss aversion in a previous letter (Turn On, Tune In and Drop Out). Dr. Sharot points to evidence that dopamine is released in the brain when we expect information and when we unexpectedly receive information. Dopamine is the same currency the brain uses for tangible rewards like food, drink and sex as it uses for information. This connection is also based in evolution as advanced knowledge is necessary for survival but in today's world it can be particularly damaging. As investors we are exposed to a deluge of information from flashing prices on a Bloomberg terminal, to the talking heads of CNBC and overflowing email inboxes. This set-up is particularly damaging as the dopamine release encourages regular checking of prices, performance and news which in turn exposes us to myopic loss aversion when our evaluation period (typically hourly or daily) is misaligned with our planning horizon (3-5 years for us). Dr. Sharot adds colour to this phenomenon as we are naturally predisposed to good news over bad news. In many instances, such as screening for debilitating diseases, we prefer ignorant bliss—a natural insulation against myopic loss aversion in downcycles. Interestingly studies have shown that retail investors check their trading accounts with increased frequency as equity markets rise. Dopamine is powerful and it is easy to build ourselves up for a fall exacerbated by the evaporation of optimism bias. In many ways we are feeding the dopamine beast and loosening our psychological armour when we frequently check prices and performance over short time periods.

The most important realisation from our ongoing exploration of the role of the human mind in investing is that acceptance is the key step to improvement. However hard we try we cannot overcome millions of years of evolution—it is naive to think that any investor is immune to bias, emotion or the dopamine-inducing effect of information. It is equally naive to acknowledge this relationship and to assume that we will recognise these forces when they happen. We try to avoid such ostriching and accept that many of our responses are pre-programmed and the product of evolution. Self-reflection is an overlooked quality in investing and acceptance enables us to develop what Dr. Sharot terms 'policies', 'behavioural rules' in our language, which enable us to limit the damaging impact of human behaviour in the hot state in which we can frequently find ourselves. We have found that using a behavioural coach backed up by data and journaling has been helpful for formulating rules. In addition seeking out other investors with conflicting views and assigning a devil's advocate in investment case reviews have all been helpful for fighting confirmation and optimism bias. Dialling out of the information flow remains an evergreen challenge. Despite these efforts we will continue to develop new rules and seek to educate ourselves about ourselves. With this in mind we take much inspiration from the Ancient Greek aphorism that was inscribed on the Temple of Apollo at Delphi—'Know Thyself'. We hope that you have an enjoyable rest of 2019 and look forward to updating you on our progress in 2020.

The Global Leaders Team

[5] Source: The Influential Mind, Tali Sharot
[6] This term has caused much amusement within the team as 'Amygdala' sounds uncannily like the name of one of the portfolio managers, Mick Dillon, when said fast enough!

Disclosures, Terms and Definitions

Year	Composite Total Gross Returns (%)	Composite Total Net Returns (%)	Benchmark Returns (%)	Composite 3-Yr Annualized Standard Deviation (%)	Benchmark 3-Yr Annualized Standard Deviation (%)	Portfolios in Composite at End of Year	Composite Dispersion (%)	Composite Assets ($USD Millions)	GIPS Firm Assets ($USD Millions)*
2018	-2.2	-2.8	-9.6	11.0	10.5	2	N/A	303	30,529
2017	35.1	34.0	24.0	N/A	N/A	2	N/A	77	33,155
2016	-0.6	-1.4	8.0	N/A	N/A	2	N/A	38	30,417
2015**	1.2	0.7	-4.4	N/A	N/A	2	N/A	24	43,746

**Return is for period May 1, 2015 through December 31, 2015

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2. The Global Leaders Composite aims to achieve capital appreciation by investing primarily in global equities. The strategy will invest in equity securities of companies that the portfolio manager believes are leaders within their industry or country, as demonstrated by an ability to deliver high relative return on invested capital over time. The minimum account market value required for composite inclusion is $1.5 million.
3. This composite was created in 2015.
4. The benchmark is the FTSE All-World Net Index. This index is a free float market cap weighted index representing the performance of the large & mid cap stocks from the FTSE Global Equity Index Series. The index covers Developed & Emerging Markets. Base Value 100 as at December 31, 1986. "FTSE®", "Russell®", "MTS®", "FTSE TMX®" and "FTSE Russell" and other service marks and trademarks related to the FTSE or Russell indexes are trademarks of the London Stock Exchange Group companies. An investor cannot invest directly into an index. Benchmark returns are not covered by the report of the independent verifiers.
5. As of January 1, 2019, the composite benchmark was changed from Russell Global Large-Cap Net Index to the FTSE All-World Net Index. The change was applied retroactively from the composite inception date. The Russell Global Large-Cap Net Index was decommissioned as of 12/31/2018 and is no longer published.
6. Composite dispersion is an equal-weighted standard deviation of portfolio returns calculated for the accounts in the composite for the entire calendar year period. The composite dispersion is not applicable (N/A) for periods where there were five or fewer accounts in the composite for the entire period.
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8. The three-year annualized ex-post standard deviation measures the variability of the composite (using gross returns) and the benchmark for the 36-month period ended on December 31. The 3 year annualized standard deviation is not presented as of December 31, 2015, December 31, 2016 and December 31, 2017 because 36 month returns for the composite were not available (N/A) and the composite did not exist.
9. Valuations and performance returns are computed and stated in U.S. Dollars. All returns reflect the reinvestment of income and other earnings.
10. A complete list of composite descriptions, policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
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ROIC is a measure of determining a company's financial performance. It is calculated as NOPAT/IC; where NOPAT (net operating profit after tax) is (EBIT + Operating Leases Due 1-Yr)*(1-Cash Tax Rate) and IC (invested capital) is Total Debt + Total Equity + Total Unfunded Pension + (Operating Leases Due 1-Yr * 8) – Excess Cash. ROIC calculations presented use LFY (last fiscal year) and exclude financial services.

FCF Yield is a measure of financial performance calculated as operating cash flow minus capital expenditures. FCF yield calculations presented use LFY and exclude financial services.

Sales Growth rate is based on reported company revenue for the past three years at the end of the current quarter, provided as a historical average.

Price-Earnings Ratio (PE) is the ratio of the share of a company's stock compared to its per-share earnings.

Price-Sales Ratio (PS) is the ratio of a company's market capitalization divided by the company's total sales or revenue.

Price-Book Ratio (PB) is calculated by dividing a company's stock price by its book value per share.

Return on Equity (ROE) is a measure of financial performance calculated by dividing net income by shareholders' equity.