Global Leaders Strategy

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The Global Leaders Strategy invests in a concentrated portfolio of market-leading companies from across the globe that deliver superior customer outcomes. The strategy reached its one-year anniversary in May and to provide insight into our investment approach, the Global Leaders team is pleased to share some thoughts in their inaugural quarterly letter found below.

Keeping It Simple

We live in an information age, and nowhere is it more obvious than in the field of investment. Digitalization has combined with man's enduring desire to turn £1 into £2 to create an unparalleled amount of financial information that can make any investor feel as if he or she is drowning in data at times. Against this backdrop, we have chosen to focus our investment process on a relatively small number of core principles that are powerfully uncomplicated and draw heavily on the very essence of business. We believe that we can create value for our clients and outperform over time if we employ these principles in a concentrated portfolio of exceptional companies from around the world and let them compound for many years. In an ever more complex financial world, we feel that it is increasingly important to keep it simple.

The Importance of the Customer

"It is the making of repeat sales to satisfied customers that is the first benchmark of success."

- Philip A. Fisher

It's easy to lose sight of the essence of commerce: the simple act of swapping one good or service for another that predates securities markets and forms the basis of all our daily lives. At its core are two parties—a buyer and a seller—and successful private enterprise depends on the seller being able to sell his or her good or service to the buyer at a higher price than it cost. Some businesses are able to go further, by delivering something special to their customers so that not only do those customers return again and again, but the business is also able to maintain higher profits than its peers. It is these businesses that are of particular interest to us.

Our investment process starts with us putting ourselves in the minds of the customer. We focus intently on the outcome being delivered: What does the customer get out of it? Is it truly superior? Is the relationship sustainable? We spend a considerable amount of time examining the different strategies that each franchise employs, in an effort to deduce whether the company has a competitive advantage that will enable it to keep satisfying its customers in a way that others can't. Breadth of research is an important aspect of this analysis, and where possible, we spend as much time as we can with competitors, customers and suppliers assessing how wide each company's economic moat is. We aren't looking for companies that simply provide good outcomes resulting in a relative competitive strength. We are looking for those companies that provide goods or services that satisfy the customer in a unique way that gives the company a dominant and sustainable position among its peers.

Returns Matter

Delivering an exceptional customer outcome isn't easy; competitor behavior and the ongoing challenge of managing product lifecycles are constant headwinds. But evidence suggests that some companies are able to achieve this win-win relationship, and this shows up in their return on invested capital, or ROIC. ROIC receives considerable attention as a complex measure, but very simply, it gives investors an idea of how much profit is being produced for every £1 of capital (debt and equity) that is invested in a company. To illustrate the point, investors in a company with a 10% ROIC get 10p of profit produced for £1 of capital invested, whereas investors in a company with a 20% ROIC receive 20p for every £1 of capital invested. In this example, the 20% ROIC company is twice as effective as the 10% company at generating profits for every unit of capital invested. This distinction is important, as the customers of the 20% ROIC company are in essence allowing the company to produce a higher return because they perceive that they are receiving something special from the company that they can't get elsewhere. A good illustration of this is seen in the cosmetics industry. Branded makeup and lipsticks achieve 70% to 80% gross margins on products made from commodity chemicals, resulting in 15% to 20% ROIC for the leading global players. These products deliver a daily outcome which sees consumers returning multiple times per year to their favorite trusted brand.

This is the win-win relationship that we are looking for. What is illuminating is that companies with high ROICs are often able to maintain a high ROIC for meaningful periods of time. Consultant McKinsey & Company produces a decadelong study monitoring the ROIC of the companies in the S&P 500 Index. As you can see below, its findings from the 2003–2013 period show that 83% of the companies that produced a ROIC in excess of 25% in 2003 still produced a ROIC in excess of 25% a decade later in 2013.

EMPIRICAL RESEARCH: HIGH ROIC TENDS TO SHOW PERSISTENCY (SO TIME CAN BE ON OUR SIDE)

S&P 500 INDEX, ROIC, 2003–2013 DATA BASED ON A MCKINSEY & CO. INC. STUDY, "VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES"

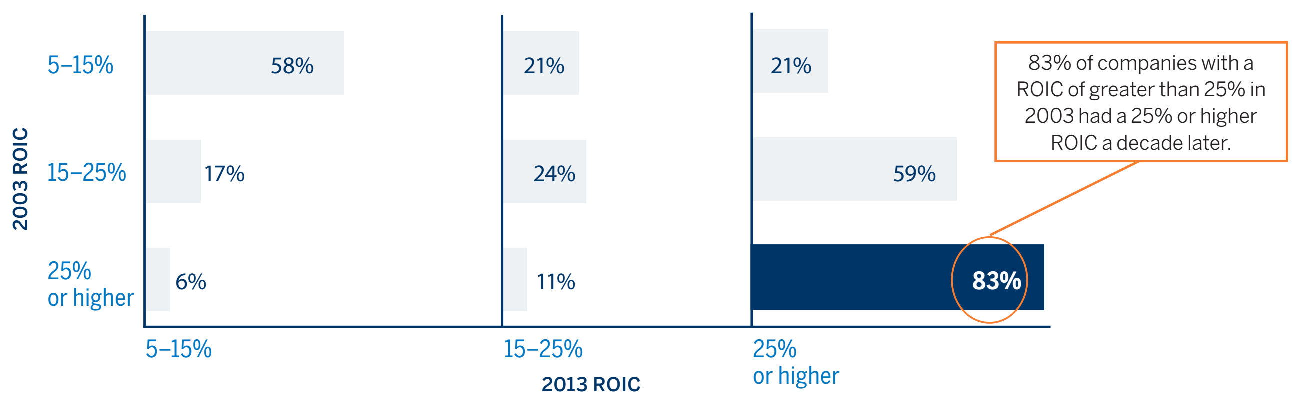

Chart reproduced with permission from McKinsey & Co. Inc. as featured in the book, "Valuation: Measuring and Managing the Value of Companies, University Edition." 6th Edition, 2015.
ROIC is calculated as the percentage without goodwill. Please see the end of this presentation for important information.

These data fly in the face of standard economic theory that tells us that excess economic profits get competed away—meaning that if I open a lemonade stand and make high profits, then over time, more lemonade stands will open up on my street, with each new entrant offering lemonade at lower prices until all of the excess return that I had been making gets eroded away. In the real world, the lemonade stand paradigm does not apply to companies with superior customer outcomes. If management teams focus on the customer with a clear strategy, a distinctive business model and a wide economic moat, then high-return companies can remain high-return companies for many years.

This all sounds fascinating, but how does it relate to making money for clients? We believe that maintaining a sharp focus on the customer outcome and how it is expressed in return on invested capital give us two distinct advantages that should lead to attractive long-term outperformance for our investors.

A Differentiated View on Valuation

The long-term sustainability of high ROIC enables us to have a differentiated view on valuation, as these franchises are more likely to be able to resist external pressures than lower ROIC companies. The investment community is still overly focused on short-term earnings despite the fact that more than 90% of a company's net present value (NPV) is derived from beyond the next two years. Very simply, net present value is the sum of all the cashflow that a company generates in the future, and it forms the basis of valuation of most companies. In the lemonade stand analogy, the net present value of the business would be the total amount of cashflow that is produced from all lemonade sales in the future, expressed in today's money. On this basis, if the lemonade stand can keep making the same level of healthy profits and cash flow for 20 years, it will be more valuable than if rival vendors force the lemonade stand to reduce prices so that profits and cash flow halve over a ten-year period. In net present value terms, there is a big difference between the two outcomes yet most investors still overly focus on the first two years in the future. In our valuation process, we assess both today's return on capital and how that might sustain or fade over the long term, which we think differentiates us from the majority of investors. In investing, differentiated thinking leads to differentiated returns for investors. We are acutely aware of the risks of overpaying for unsustainable returns which is why a thorough examination of each franchise's economic moat and the unique factors that prevent new competitors entering a market place are key parts of our risk management process.

Seeking Fewer Forecasted Errors

Despite the myriad of Wall Street soothsayers that try to convince us otherwise, we feel that consistently predicting how the economic future is going to unfold is incredibly hard to do. The more variables we have to predict, the more likely we are to make forecast errors. Focusing on companies that deliver exceptional customer outcomes that are expressed in high and sustainable returns on capital tilts the forecasting odds in our favor.

Patience Is a Virtue

Patience is an overlooked quality in investing, and we are cognizant of the danger of activity for activity's sake when the franchise quality and value stars are misaligned. Like the crocodile on the riverbank, we are happy to wait patiently until the right investment opportunity presents itself. We plan to discuss predicting the future, valuation and the various types of economic moats in more depth in future letters.

Our Promise to Our Investors

We feel that our investment approach is the antidote to the increasingly complex financial environment that we live in. We acknowledge that many active managers have failed to deliver the excess returns deserved by their clients. We promise our clients that we will remain true to our principles and hand-pick a relatively small number of franchises with win-win customer relationships and attractive risk-reward profiles that collectively have the potential to outperform the market. From Silicon Valley in California to the Ruhr Valley in Germany and the Three Gorges in China, we will search tirelessly for the optimum selection of companies that possess these characteristics. We believe that it will be a rewarding journey for our investors, who should benefit from a clear and disciplined approach that can deliver attractive returns that can compound for many years. We look forward to updating you on our progress in the coming quarters.

The Global Leaders Team