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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.

FLOAT LIKE A BUTTERFLY

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'The fight is won or lost far away from witnesses – behind the lines, in the gym, and out there on the road, long before I dance under those lights'[1].

Whilst many investors were preoccupying themselves with the unfathomable outcome of the US-China trade war and reading the monetary policy tea leaves, we recently took time out of our schedules for our annual global equity offsite. The event is a key fixture in our calendars where we decamp to a location out of the office and have extensive discussions on a variety of key topics. The starting point for the day is our enduring belief that we can always get better at everything we do. This ongoing improvement process centres around an objective examination of the two things we can control in investment – our process and our people. Taking a leaf out of Muhammad Ali's book we can't help thinking that the investment fight isn't won in the bright lights of the equity markets and that preparation and continuous improvement is everything.

Although it is impossible to distil all of our learnings from the day in this letter we thought it would be interesting to mention a few key areas. The day started with an analysis of our strategy, how it compares to peers and where we have added value over time. As we have discussed before we feel that any successful investment strategy has two processes, stock selection and capital allocation, and we spent considerable time discussing how we can improve both. This section is always impactful as every member of our investment team, the investment managers and the analysts, were able to express their views on productivity and our two main investment selection tools – the checklist and teardown. The discussion followed with an analysis of the impact that working with our behaviourial consultants, our investment coaches, has had on our capital allocation process and outcomes.

The final offsite topic was our blind spot survey. Every investor in our team is different and everyone has blind spots – areas where our individual psychological make-up can lead to potentially damaging outcomes. To address this we polled the team on our individual blind spots using 10 predefined fields and one open-ended question. One danger of this process is that the brain's amygdala produces a fight or flight response when results are presented. We feel that we succeeded in being able to discuss our blind spots in a constructive and safe way that should allow us to work more effectively together in the future. We feel that radical transparency is a vital ingredient for self-improvement. To close this section we thought it would be interesting to share **some of the key reflections from our 2019 offsite**:

- Global Leaders has more stock specific non-factor risk than our closest peers [2].
- Global Leaders has a different sector allocation than our closest peers [2].
- There is a fine balance between researching new ideas and re-underwriting existing investments.
- Sector reviews are an important discipline.
- The reinvestment rate is a crucial consideration for high return businesses.
- Some perceived blind spots (such as a detail or value focus) bring diversity to our thinking.
- Although subjective, the blind spot survey helped team members verbalise potential areas of weakness.

THE ROAD TO CORPORATE GOVERNANCE HELL IS PAVED WITH GOOD INTENTIONS

Management quality has to be one of the most unoriginal characteristics that investment managers look for. No long-only investment manager looks to invest in companies run by managers who are untrustworthy and poor stewards of their client's capital.

[1]Source: Muhammad Ali.
[2]Source: Bloomberg. Data as of 05/31/2019.

In this regard we are unapologetically unoriginal, but we do feel that our approach is more nuanced than the average investor – principally due to our investment philosophy. The reality is that the managers of any company, like the managers of any investment strategy, are prone to the agency problem where their motives are inherently self-serving and different from the owners of the business – the shareholders who act as principal. Frequently the managers and boards of directors are exposed to asymmetric profiles whereby they can achieve psychological and financial greatness if they succeed, but if they fail their downside is limited with the shareholders, the principals, bearing the economic pain. This risk is acute for us as we look to invest in companies with high sustainable returns on capital and hold them for many years. These businesses are highly cash generative and can produce meaningful amounts of capital. As we frequently mention, a company that can maintain a 20% return on capital will have generated its full balance sheet with profits, and typically free cash flow, after five years. Nowhere is the agency problem more pronounced than in the realm of capital allocation. Ego is pervasive in any business environment and history is littered with management teams that have destroyed significant value with poor capital allocation. It is no coincidence that numerous studies have shown that most acquisitions don't create value and that share buybacks are pro-cyclical as evidenced by the current feast and 2008 famine with the latter being arguably the best opportunity to buy equities this century. So misincentives are high but expertise is also frequently low. Most CEOs and board directors have been trained in a variety of functional roles – as salespeople, engineers, operations specialists or even scientists. The reality is that capital allocation is a different discipline, the discipline of investment, and many corporate managers have had limited experience of deploying free cash flow and balance sheets before they rise to the top of their business. Warren Buffett memorably expressed this lack of expertise:

'Most bosses rise to the top because they have excelled in an area such as marketing, production, engineering, administration or, sometimes, institutional politics. Once they become CEOs, they face new responsibilities. They now must make capital allocation decisions, a critical job that they may have never tackled and that is not easily mastered. To stretch the point, it's as if the final step for a highly-talented musician was not to perform at Carnegie Hall but, instead, to be named Chairman of the Federal Reserve'[3].

In addition to the juxtaposition of high returning businesses with poor capital allocation our investment approach is also at risk from the agency problem due to our investment horizon. We are genuinely long-term investors with a minimum of a 3-5 year investment horizon and a 6 year average holding period since inception. This is against a backdrop where the tenure of CEOs is declining – a recent study of the S&P500 Index[4] showed that the median CEO tenure has declined to 5 years which is less than an economic cycle and comes at a time when most investors are becoming increasingly short-term focused. This set up is diametrically opposed to our focus on long-term compounded returns. To counteract the agency problem we look for managers who have the character and ability to add value that are backed by supportive, yet critical, boards of directors. In many cases both the capital allocation and tenure issues are intertwined. Managers with long tenures typically live and breathe their companies and frequently have significant emotional and financial skin in the game – the antidote to the agency problem. This set-up can create a favourable backdrop for value-creating long-term capital allocators. In addition, long tenures enable us to effectively measure a manager's ability to remain disciplined with free cash flow and balance sheet deployment. Given this backdrop, we actively seek out managers with long tenures who have significant skin in the game. In this vein we have found that founders are frequently forces for good as either executives or directors. Our investments in Alphabet, Charles Schwab, Ctrip.com, CTS Eventim, HDFC Bank and Tencent are great examples of effective founder-backed businesses. In addition we have found that the presence of a founding family can be equally as powerful. Investing alongside the right founding families with meaningful equity exposure frequently nullifies the agency problem as they think like principals rather than agents. Given our focus on investing in companies that produce high levels of capital over long time periods, it is hardly surprising that 37% of our companies have the founder of the founding families still involved in the business and 40% of the remaining 63% of our companies are run by managers with over 10 year tenures[5].

Perhaps we think differently to most investors but we have become increasingly perplexed as to how much pressure modern corporate governance best practice has placed on long-term thinking and skin in the game. One obvious example is the current movement to limit directors' tenure. As mentioned we feel that managers and directors benefit from accumulated experience and have greater alignment with shareholders than their counterparts who are only in it for the short haul. This trend makes no sense to us and we sympathise with Constellation Software's CEO Mark Leonard on this issue:

[3] Source: Berkshire Hathaway, Letters to Shareholders 1987, Warren Buffett.
[4] Source: Harvard Law School Forum on Corporate Governance 2018, Dan Marcec. https://corpgov.law.harvard.edu/2018/02/12/ceo-tenure-rates/
[5] Source: Brown Advisory Calculations. Data as of 06/30/2019.

'*The current movement to limit Director tenure makes great sense if you think your investee company is poorly governed. However if you think the governance is good, then limiting director tenure hurts the company. It is analogous to firing a high-performing employee on their tenth anniversary*'[6].

Elsewhere we also feel the corporate governance pendulum has swung too far with regards to independence. Of course all shareholders should be represented in the boardroom and unbalanced or dictatorial governance structures can be extremely damaging in unscrupulous hands. Indeed we are acutely aware of the dangers of the old boys clubs of yesteryear in the boardroom. Where we think that this has gone too far is when the representation of founding families that support minority shareholders is seen as a negative force. One recent example for us this summer emerged when a corporate governance specialist that advises on proxy voting suggested that we should vote against the re-election of four founding family members of our elevator investment Schindler. The Swiss company was founded in 1874 and we welcome the presence of the fourth and fifth generations of the family as they respect minority shareholders and have meaningful psychological and financial skin in the game (the family owns 44% of Schindler equity). The Schindlers have a multi-generational time horizon that is rare in today's increasingly short-term focused world and we were pleased when the family members were re-elected.

'*In theory there is no difference between theory and practice. In practice there is*'[7].

In theory management quality and corporate governance should be a straight forward subject but in practice it is not. The reality is that the water is muddied by a variety of different interests – both in the boardroom and amongst investors with different time horizons and views on capital allocation (a word of caution – never get into a dividend discussion with an income investor!). The reality is that the corporate governance industry simply can't accommodate the needs of all investors and is staffed by people who have limited knowledge of the companies whose governance they are making proposals on. In this vein we caution against blind box-ticking and encourage other investors to have the courage to engage with their companies and think independently. Only then will forces for corporate good such as long-term thinking and value-creating capital allocation prevail. To close we wanted to return to Schindler and leave you with some thoughts from Chairman Silvio Napoli on the source of his company's enduring success. We hope that you have an enjoyable summer and we look forward to updating you on our progress later in the year.

The Global Leaders Team

'*So, is there another approach and what might it look like? And what might be its purpose? One viable alternative is the board and management working together to create value way beyond the short term. In reality this is nothing new. Several entrepreneurial corporations, and family companies in particular, have applied this basic principle for centuries, generating top performance and outliving their competitors. Recent bank studies show that family companies outperform their peers both in Switzerland and globally, and that consistently over the last ten years. This can be explained precisely by their purpose: family companies feel obliged to preserve wealth for the coming generations. Research confirms that the average longevity of a family company in Europe and in the US is 74 years; that's more than three times longer than their non-family peers, with an average life span of 24 years.*

Schindler, with a history of over 144 years, is a case in point. The Schindler family, who founded the company in 1874, is still the leading shareholder five generations later. Throughout its life, Schindler has adapted, grown, and prevailed over seismic shifts in the industry. It transitioned from steam to electrical power, from relay to microprocessors, and is now evolving in the dynamic digital era. Schindler is a world leader in vertical transportation, even though there are no megacities in Switzerland'[8].

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[6]Source: Constellation Software, 2017 President's Letters, Mark Leonard. https://www.csisoftware.com/docs/default-source/investor-relations/presidents-letter/presidents-letter-april-2018-final.pdf
[7]Source: Yogi Berra (attrib.).
[8]Source: Milestones, Schindler Group Review 2018, Silvio Napoli. https://www.schindler.com/com/internet/en/investor-relations/_jcr_content/contentPar/downloadlist_0_m/downloadList/112_1487135986899.download.asset.112_1487135986899/2018-schindler-annual-report-gr-e.pdf

Past performance is not a guarantee of future performance and you may not get back the amount invested.

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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.

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