Global Leaders Strategy

Brown ADVISORY
Thoughtful Investing.

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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.

Fair Weather Friends

At a high level it looks like the unbridled euphoria that gripped equity markets in the fourth quarter of 2016 bubbled over into the start of 2017 with global equity indices reaching new highs at the end of the first quarter. If we dig a little deeper, what is perhaps more interesting is that recent gains have been propelled by new areas of equity market leadership. In our last quarterly letter we wrote about sectoral rotation into economically sensitive industries that were tarred with the value brush as investors embraced the fledgling policies of the new US administration. Equity markets shoot first and ask questions later and it reminded us of how investors have an overly simplified black and white view of the world over short time periods. This quarter it feels as if Howard Marks emotional pendulum has twitched again with several areas that lagged the post-election rally posting strong gains at the start of 2017. From a Global Leaders perspective two areas stand out in this respect. Expectations of higher levels of economic growth, associated rising interest rates and a diminishing regulatory burden contributed to strong performances from US financials in the last months of 2016. Conversely concerns about the impact of an ever-strengthening dollar and perceived episodes of economic mismanagement, most notably in India with demonetisation, resulted in Asian financials lagging their developed market peers. In a similar vein the perception that there was an absence of value in all technology companies, regardless of the fundamentals, resulted in the sector also underperforming in the fourth quarter 2016. The irony of the first quarter is that the equity markets did a complete volte-face with our Asian financials and technology holdings posting strong gains. This episode is an excellent reminder of a couple of core Global Leaders beliefs. Firstly, we believe that equity markets can be hugely inefficient over short time periods and a quarter is an incredibly short period of time. As most market participants work themselves up into a frenzy every three months it is important to remember that a quarter is only thirteen weeks. Indeed, our ambition is to try and ignore the short term and focus on the long-term cash flow generating ability of the franchises in which we invest our client's capital. Such a dogged focus on the horizon should enable us to exploit bouts of short-sightedness and we added to a number of our Asian financials and technology holdings in the rotational melee of the fourth quarter of 2016.

In our quest for a combination of superior economics and attractive valuations, we identify franchises that have wide economic moats and the ability to grow because they keep satisfying customers with their goods and services. Generally, these businesses are less susceptible to the vicissitudes of the economic cycle and are exposed to structural rather than cyclical growth drivers. It is our belief that the vital ingredients of superior economics and attractive valuations can only be ignored for so long by investors. With this in mind it is inevitable that periods of inefficiency will continue in the future and it's quite possible they will last for longer than a quarter. We take comfort from our belief that if we are doing our homework and remain disciplined on valuation these periods of inefficiency will be short-lived and our investors will be rewarded with superior long-term performance as our companies keep compounding their excess economic returns and their attractive attributes become increasingly reflected by the equity markets. Against this backdrop we continue to question whether we have exposed our clients to the optimal blend of businesses with outstanding economics and attractive valuations. In this regard we have an exciting research schedule for 2017 that promises to uncover more Global Leaders franchises whilst we maintain a critical eye on our existing investments.

The Investing Ape (Homo Investus)

In today's increasingly sophisticated world of algorithmic trading, smart-beta and gamma-hedging, we think it is always important to remind ourselves how ill-equipped we are in evolutionary terms for the activity of investment.

According to most experts, modern man evolved 150,000 years ago yet it wasn't until 1602 that the first fixed capital joint-stock company, the Dutch East India Company, started trading in Amsterdam. It is startling to think that modern man has only been investing in his or her current form for 0.3% of the current evolutionary cycle. This is equivalent to less than three months (or a quarter!) of the expected 80-year life of a person living in the developed world today. In short Homo Investus is totally ill-equipped for the activity at hand and is instead relying on a selection of sensory and behavioural tools that have evolved to ensure survival at a time when we were living in caves or roaming the savannah. To compound matters for Homo Investus, to materially evolve it seems that he or she would need to devote his or her entire existence to investment as well as ensuring that successive generations of his or her family continue investing for millennia. I suspect this is a course of action that even the most ardent investment aficionados would find hard to stomach.

The obvious question is – *if man is so ill-equipped to deal with investing why don't we leave it to machines?* The answer to this question is incredibly complex and will most likely occupy several of our quarterly letters in the future but two core counter arguments for human involvement spring to mind. Firstly, the vast majority of quantitative strategies rely on extrapolating the past into the future and as we know the past is not an accurate predictor of the future due to human behaviour. Just ask anyone who worked in the risk department of any investment bank in 2008. In addition, as long as human enterprise exists human beings will be involved in running companies which will require human beings to provide judgement on what these companies are worth. A computer cannot ascertain strategic choices in areas such as capital allocation or competitive positioning without knowing the motivations of the human beings involved in making those decisions. In this respect it is hard to see human beings getting completely displaced in investment, and we suspect that the next downturn will reveal the shortcomings of quantitative strategies that have whole-heartedly outsourced human judgement to machines.

We have written before about the damaging effects the human mind has in investment as due to evolution we can literally be our own worst enemies at times. Our belief is that investment excellence is the product of a defined set of principles that form a repeatable process that can crucially evolve over time. One of our favourite behavioural finance thinkers is James Montier who also advocates the importance of an investment process:

'Focusing on process seems to lead to better decisions. The same is true in investment. Focusing upon process frees us up from worrying about aspects of investment which we really can't control – such as return. By focusing upon process we maximize our potential to generate good long-term returns'.

We, the Global Leaders team, have developed our investment process to include a number of checks and balances that intentionally short circuit some of the damaging behavioural biases that Homo Investus has been gifted by evolution. One of the most damaging of these traits is loss aversion when our survival instincts dictate that we feel pain at least twice as much as pleasure and we try and avoid it at all costs. This is a vital instinct when you are being chased by a sabre-toothed tiger but it can be of less use when contemplating a losing equity investment. We have a rule to make us grasp the nettle of loss aversion which dictates that if an investment falls 20% below our initial purchase price we have an automatic review process which leads to one of two decisions – we are either buying more of a good thing or we are cutting through Homo Investus's urges and are crystalysing a loss by selling. The aim of this rule is to limit the impact of loss aversion, which is one of the most damaging behavioural traits in investment, on our client's capital and it is one of multiple checks and balances that we employ to help Homo Investus make better decisions.

Of course having an investment process doesn't guarantee investment success. Indeed it would be possible to construct a system that produces consistently disastrous results. What is absolutely crucial about any process is that it is constantly examined to ensure that each component is still relevant and that it contributes to investment success. There is an obvious danger of outcome bias when a good outcome is viewed as the product of a good decision, and the role of luck is under appreciated in investment, but a wide enough sample set can give a reasonable picture of the merits of certain parts of any process. Indeed we recently analysed and reflected on the Global Leaders investment process at our annual off-site meeting. Incidentally our 20% drawdown rule had more often than not, but not always!, led to positive outcomes for our client's capital. We will continue testing this and all facets of our investment process in future years.

What is perhaps equally as important as having an evolving investment process is implementing it in an environment where refinement and optimization of the process is actively encouraged. The danger in any large organization is that processes become overly rigid and so engrained that they are never changed regardless of the outputs. In extreme cases any suggestions of refinement can be met with accusations of heresy and betrayal. The reality is that for any process to succeed it needs to be implemented in the cultural equivalent of a progressive mercantilist democracy, where ideas are cultivated for the common good, rather than a totalitarian regime where dissention is met with recriminations and ultimately exile. In this context, and also coming back to the role of technology, we continue to ask ourselves how we can use technology in a collaborative manner to reduce risk and improve results for clients. As investors we need to iron out the most damaging traits that Homo Investus has inherited with systems that continually develop in the evolutionary blink of an eye that we are each practicing this activity of investment for. We hope you have an enjoyable and productive second quarter and leave you with an excerpt from Jeff Bezos's recently released annual letter. When it comes to process, the Amazon founder and CEO is a man after our own heart.

'Good process serves you so you can serve customers. But if you're not watchful, the process can become the thing. This can happen very easily in large organizations. The process becomes the proxy for the result you want. You stop looking at outcomes and just make sure you're doing the process right. Gulp. It's not that rare to hear a junior leader defend a bad outcome with something like, "Well, we followed the process." A more experienced leader will use it as an opportunity to investigate and improve the process. The process is not the thing. It's always worth asking, do we own the process or does the process own us? In a Day 2 company, you might find it's the second'.

The Global Leaders Team