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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.

Indian Supply-Side Sidesteps

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Whilst most Northern Hemisphere investors headed to the beach in high summer we took the opportunity to visit one of the most exciting emerging markets—India. Although the subcontinent was characteristically hot and sticky in August the monsoon rains did little to dampen our positive impression of the country's economic prospects. Our visit coincided with the 70th anniversary of India's independence from Great Britain and it is quite astonishing to think that the country has emerged from the sectarian horrors of Partition in 1947 into an economic powerhouse that is arguably the brightest sustainable engine of growth in the overused BRIC (Brazil, Russia, India, China) acronym. Indeed the IMF has forecast 7.4% GDP growth for India in 2018 which outstrips China's 6.5% and the rest of the BRIC pack where expectations are much lower. One of the main reasons for optimism in India is the demographic dividend that should see GDP growth continue to outpace China's in the coming decades. India has a young population with over 65% being under the age of 35[1] and by 2020 the average age is expected to be 29 relative to China's 37[2]. Amazingly over the next 50 years India's labour pool could rise by 54%[3]. This demographic tailwind is not risk-free—jobs are needed for the burgeoning population. Policymakers need to do more to foster employment and stem the historical economic leakage in the system. In this regard, we believe that initiatives like the recently implemented goods and services tax are positive steps in the right direction. Nevertheless India has significant economic optionality and a balance sheet that is enviable. Indeed our impression is that India's success is the policymaker's game to lose with mismanagement, bureaucracy and politics ultimately being the key impediments to the country harvesting its economic fruits.

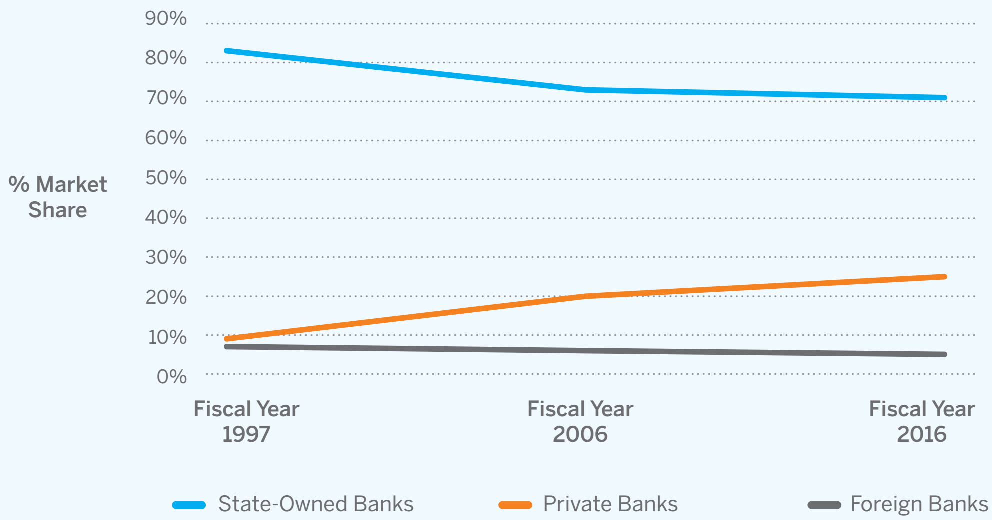
The temptation with investing in any emerging market is to focus solely on the 'penetration game.' The familiar selling point is per capita consumption of any good or service with the prospect of normalisation to a more developed economy frequently being the source of much excitement. From beer consumption in Mexico to per capita toilet bowl penetration in Mongolia, emerging market investors are drawn to the same story. Of course these statistics are important, but they ignore different rates of development and crucially the evolution of the supply side within industries. As Warren Buffett reminds us, human nature is to compete away excess economic returns. Emerging market investing has been littered with examples of value destruction where investors have been side-swiped by an increasingly competitive supply side as they are blinded by the allure of the penetration game. Greed and fear are not monopolised by developed market investors. This potential pitfall was front and centre in our minds during our trip as our main Indian exposure is through our investment in HDFC Bank. At a high level, banking is a levered play on an economy and investing in a well-run bank with a history of underwriting and capital discipline that is exposed to the double whammy of economic growth and the penetration game can be very lucrative. HDFC Bank possesses these qualities and benefits from first-mover advantage in an industry that has traditionally been dominated by state-owned banks whose lending activity was effectively a covert form of state aid. The real risk to the HDFC Bank investment case is not that Indians don't open bank accounts and take out mortgages but more that the state-owned banks reinvent themselves at a time when private banking competition picks up. Accordingly this was a key focus of our trip and the 'road to Damascus' moment came in a lengthy discussion with one of the largest state banks. During this slightly surreal conversation we realised that despite much rhetoric and grandstanding the reality was that India's state banks still lack both underwriting and cost discipline to pose a significant long-term threat to the private banks. The state banks control 71% of the Indian market (see chart on the next page) and despite recent news of another much needed capital injection from the government there is nothing to suggest that a material supply-side shift is imminent as the penetration game plays out in Indian banking.

1 Source: Census 2011
2 Source: Ernst & Young LLP. *Reaping India's Promised Demographic Dividend - Industry In Driving Seat*
3 Source: McKinsey & Company. McKinsey Global Institute *Global Growth: Can Productivity Save The Day In An Aging World?*

As mentioned earlier, the excitement of the penetration game is not solely restricted to emerging market banks. During the India trip we met with a number of consumer goods companies. The per capita consumption of fast-moving consumer goods in India lags most other large developing markets—a fact that is not lost on local and international players alike. Indeed one of our more eye-opening meetings was with local player Jyothy Laboratories which has come from nowhere to secure 19% and 12% shares of the Indian liquid and bar dishwasher detergent markets respectively. The secrets to Jyothy's success have been its fast-paced innovation and proximity to its customer base—both benefits of a small company culture and short decision-making structures. Jyothy Laboratories serves as a lesson to all multinational companies looking to exploit the penetration game. Earlier in the trip we received an update on Unilever's response to the rise of local competition during our meeting with its Indian subsidiary Hindustan Unilever. Refreshingly, Unilever's "Connected 4 Growth" program is designed to replicate the fast-paced innovation and local understanding that come more naturally to smaller, nimbler local players like Jyothy Laboratories.

Indian Banks: Market Share of Advances

The chart below shows the evolution of the market share of loans between the state-owned, private and foreign banks over the last 20 years.



Source: Bernstein Research

Investors love stories which is human nature and part of the narrative fallacy. Few investment stories are more powerful than the emerging markets penetration game which makes barrier to entry and supply-side analysis vital. In addition, adding margin of safety by buying assets at discounts to intrinsic value is crucial to preserve our clients' capital in case the penetration game slows and the competitive environment intensifies. Accordingly valuations for most high-flying Indian private banks and consumer goods companies provide little support in the event of slowing growth. As an example, the average Indian fast-moving consumer goods company currently trades on less than a 2%[4] projected free cash flow yield which to us provides little support if the penetration game status quo doesn't hold. With this in mind we wait patiently, like the Indian mugger crocodile on the riverbank, for further opportunities to increase our exposure to this exciting economy.

Sustainable Perspectives

At a time when the active management industry is being questioned by the blind world of passive investing it is gratifying to see one positive trend emerging in the investment industry. Environmental, social and governance (ESG) considerations are being

4 Source: FactSet®

increasingly embraced by clients from around the world. ESG has many manifestations and if the movement continues, we remain hopeful that capital will continue to flow into shining examples of corporate citizenship.

To us, the Global Leaders team, sustainability is more than a fad—it is primarily good business sense that lies hand-in-hand with value creation. We are long-term investors and we focus intently on the customer as the core of our business analysis. Capitalism can create an unbridled fixation on profits and ignoring ESG issues can create significant business risks. In an ideal world we would never sell any of our investments as we would let each franchise compound forward for decades. Accordingly, to us ESG is very much a matter of perspective. It is not possible to create value over the long term if a company is damaging the environment or society with poor governance that fosters egregious and reckless behaviour. In the U.K., BP's 2010 Macondo oil spill disaster and Sports Direct's exploitative employment practices are obvious examples of when environmental and social issues undermine a franchise's ability to generate long-term cash flow. We, the Global Leaders team, take an equally dim view of companies that damage their customers. For this reason, we have never invested in tobacco companies despite the addictive nature of nicotine having fostered powerful economic engines in many cases. Over the very long term, we believe tobacco companies will shrink out of existence as they continue to kill their customers. It is all a matter of perspective—the core of sustainable investing is sustainable value creation.

Our investment process centres on finding win-win relationships between the customer and the company whereby the customer gets something special from the company and the company is rewarded with outstanding economics. We find these outstanding customer outcomes in many industries but a number of our holdings provide something special for the customer that also has a significant environmental or social benefit. Our Japanese catering equipment investment Hoshizaki is a case in point. The company makes the world's most efficient icemakers for the catering industry. A Hoshizaki ice maker can last up to twice as long as rival brands and due to its unique stainless steel double evaporator, each ice maker delivers significant water and energy savings. This is a clear win for the customer who saves on operating costs and capital investment, Hoshizaki benefits from selling more ice makers and the environment benefits from less energy, water and raw material consumption. Another example would be Edwards Lifesciences whose novel Sapien TAVR heart valve is positively influencing society by improving quality of life whilst also saving hospital costs and resources to the efficiency of the procedure. Our pursuit of the win-win between the customer and the company frequently leads us to invest in companies where there is a third win for either the environment or society as a whole.

To us, the ESG movement in investment is a breath of fresh air and makes perfect business sense. Embedding ESG considerations into our investment analysis not only mitigates our clients from business risks that can easily be ignored in the capitalist pursuit of profits, but also helps us invest in companies where there is a triple win among the customer, the company and society or the environment. Indeed we view this trend as being a positive step forward towards long-term thinking and away from the goldfish-esque myopia that still afflicts most short-term investors. In addition, we welcome the maturation of the sustainability movement away from blunt negative screens towards a more holistic and intelligent conception of positive capitalism. One example in Global Leaders is our investment in aero engine specialist Safran. The French company enjoys 75% market share of the narrow-body engine market through its CFM International joint venture with General Electric. Incidentally it is highly likely that a Safran engine powered the aircraft that took you on your last short-haul holiday. Safran generates less than 10% of its revenue from a legacy defence business which would have made any potential investment fall foul of most old-school negative ESG screens. This would be a crude violation that ignores the huge benefit that Safran's new engine will deliver—the new LEAP power plant boasts a 15% fuel and CO2 saving and a 50% NOx reduction relative to the previous generation of engines. This is a huge environmental business advantage and epitomises the triple win that we discussed earlier and accordingly we are happy investing in Safran despite its defence exposure. It is refreshing to think that the ESG debate has progressed so that the sustainability characteristics of an investment like Safran are considered in totality by investors.

To us, sustainability in investment is more than a fad—it is a welcome recalibration of perspectives that is here to stay. Indeed we enjoy discussing our ESG approach with all clients and prospects and we expect the sustainability debate will continue in the years to come. We hope that you have an enjoyable and profitable remainder of 2017 and we look forward to sharing more Global Leaders thoughts with you in the New Year as the strategy heads towards its third birthday in May 2018.

The Global Leaders Team

GLOBAL LEADERS PORTFOLIO MANAGEMENT

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