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 we believe deliver superior customer outcomes.

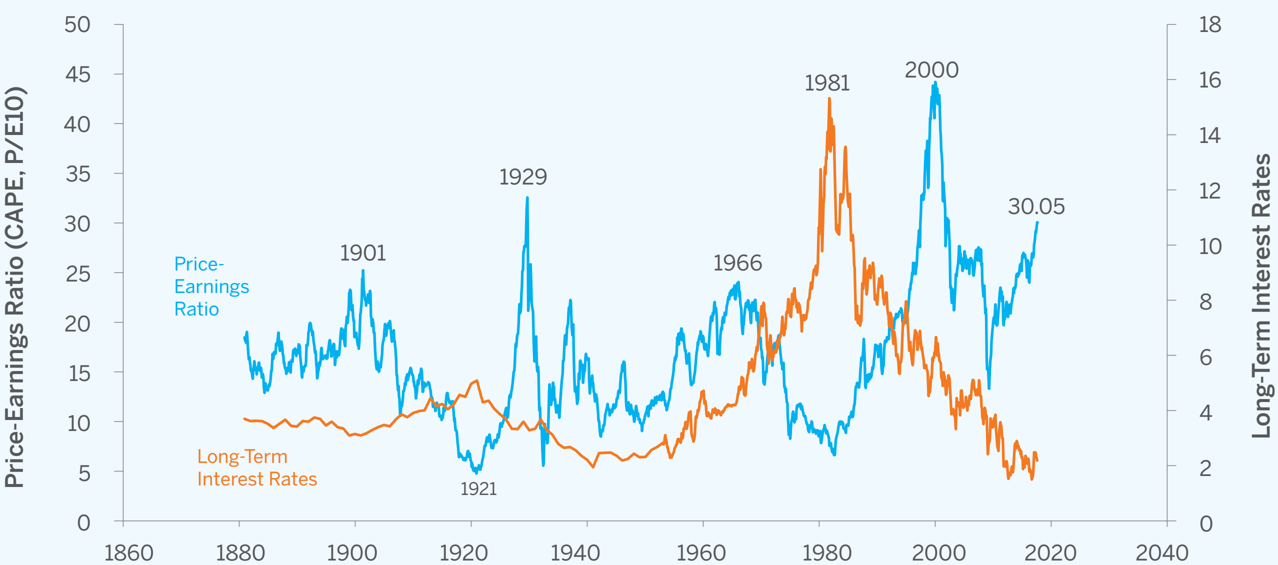
The Caped Crusade

Despite the existence of a multitude of ever-present risks, today's current market euphoria seems to know no bounds. Investors continue to shrug off geopolitical turbulence and the potential for rising interest rates to provide the economic equivalent of a cold wet towel on a hot summer's day. Accordingly, global equity markets continued to make new highs in the second quarter. Against this backdrop we are frequently asked about the sustainability of the current market environment. This question is at the front of many investors' minds and we firmly believe that it is incredibly difficult to accurately forecast economic ebbs and flows and their impact on market sentiment. It is however easier to take the market's temperature and it is clear that despite elevated markets, volatility is low and aggregate equity market valuations are above historical averages. Much focus has been placed on Robert Shiller's cyclically adjusted price-to-earnings (CAPE) valuation tool that suggests that U.S. equity markets are trading at elevated levels. As you can see below, 30x CAPE is a level we haven't seen since the aftermath of the irrational exuberance of the tech bubble.

Robert Shiller's Cyclically Adjusted Price-to-Earnings (CAPE) Valuation Tool

Shiller's CAPE valuation tool suggests that U.S. equity markets are trading at elevated levels relative to history.

January 1, 1871 - July 1, 2017



Source: http://www.econ.yale.edu/~shiller/data.htm
Stock market data used in "Irrational Exuberance" Princeton University Press, 2000, 2005, 2015 updated. Robert J. Shiller

We are acutely aware of the limitations of using price-to-earnings in isolation as a yardstick of value as it is primarily valuation shorthand. The multiple needs to be seen in the context of a franchise's growth, return on invested capital (ROIC) and the rate at which these returns fade toward its cost of capital. Nevertheless multiples are an inescapable part of the equity market lexicon and recent discussions with other investors suggest that, just as grey can be the new black in the fickle world of fashion, 20x price-to-earnings is the new previously acceptable 15x. Without a demonstrable improvement in the long-term earnings power for many businesses, it increasingly feels that investors are happy to bear higher levels of risk by essentially paying more for the same level of long-term growth, returns and fade. Although we have no unique insight as to when the current equity market party will end, we are encouraged by the underlying economics of the Global Leaders strategy. As mentioned, we recognise that price-to-earnings is an incredibly blunt instrument and, although there is no substitute for discounted cash flow analysis, we prefer EV/EBIT (enterprise value of a company divided by its earnings before interest taxes) and free cash flow yield as shorthand valuation approaches. With this in mind, the Global Leaders strategy has an aggregate projected median EV/EBIT multiple of 16.5x which is a modest premium to its benchmark of 14.0x. Using free cash flow yield, the premium is even smaller with the strategy trading on a historic 4.4% yield which is an almost indistinguishable premium to the global equity market that trades on 4.6%. For this modest premium our investors are getting close to double the sales growth (8.2% versus 4.3%) and more importantly close to double (17.9% versus 8.8%) the ROIC of the market. We are hugely encouraged by these characteristics and they give us confidence in the future of the strategy as investors can't ignore the prospect of buying more productive and fade-resistant Global Leaders' assets on a free cash flow yield that is close to the global equity market. More importantly on an absolute basis we think that paying a 4.4% free cash flow yield for durable returns and 8.2% sales growth feels like an attractive total return in this environment. Coming back to the question of how much life resides in the current equity bull market we try not to predict the future but we take comfort from our conviction that the Global Leaders strategy remains attractive in both a relative and absolute sense once all of the valuation dots have been joined. Whilst CAPE and discussions with other investors give us cause to question today's investment zeitgeist, we are encouraged by the strategy's underlying fundamentals and remain confident in the future.

Node Limits

On the Global Leaders team we are constantly looking for a 'win-win' relationship where a customer forms a special relationship with a company and rewards that company with outstanding economics of high returns and consistent free cash flow generation. We like our companies to fortify this special relationship with multiple economic moats to prevent any competitors from entering their marketplace and disrupting that special bond that they have with their customers. Warren Buffett[1] first coined the phrase 'economic moat' and we believe that franchises can have up to six types of moat. The moat that most investors typically think of is intellectual property, such as a brand, which is an intangible asset moat in our framework. An obvious example would be Heinz tomato ketchup which has significant brand power, a quality not lost on owners 3G Capital and Buffett himself, and it is no coincidence that Kraft Heinz has been able to generate in excess of 30% margins[2] in its European business – a level of profitability that is meaningfully ahead of its competitors. Heinz ketchup has 80% share in the U.K., Kraft Heinz's largest European market, and the British consumer's affinity for the distinctive red sauce has been cultivated for generations. The relationship is so strong that Heinz has been able to maintain dominance of the U.K. ketchup market and resist the deflationary powers of the food retailers better than peers. Accordingly this intellectual property-derived economic moat provides a meaningful deterrent for any new mass market-branded ketchup maker in the U.K.

The ketchup example demonstrates the power of branding and although intellectual property remains a durable source of competitive advantage we are increasingly finding another source of economic moat – networks. The network effect is when any business system becomes stronger, and the moat widens, when more users enter that system. At its simplest a network business is composed of two components – a node and a connection. The node is the customer or supplier and the connection is the number of other customers or suppliers to which the node is connected. The beauty of the network effect is that as the number of nodes grows and the number of connections increases, the network generates a flywheel-esque momentum that becomes self-reinforcing. Network businesses can either be one or two-sided and typically they can create formidable moats as any new entrant would have to capture all of the nodes in the network. This becomes harder as the number of connections increases.

We invest in multiple network businesses that frequently use a platform to increase the number of nodes and connections in their systems. Obvious examples include payment specialists Visa and MasterCard. Currently more than 3 billion Visa cards have been issued by financial institutions and they are accepted at 44 million merchant locations globally. As the institutions issue more and more cards, the number of users (nodes) grows and form connections with the multitude of merchants who accept Visa. As new users join, nodes are added to the other side of the network as more merchants accept Visa as a method of payment with the help of their financial institutions. As the number of nodes in the Visa network increases so do the connections as the users, merchants and banks interact with each other. In reality, the power of the Visa network resides not only in the number of nodes but more importantly in the connections between the nodes. The connections are the glue that bind the system together and they fortify any network moat against potential entrants.

1 'A truly great business must have an enduring "moat" that protects excellent returns on invested capital. The dynamics of capitalism guarantee that competitors will repeatedly assault any business "castle" that is earning high returns.' Source: Warren Buffett, 2007 Berkshire Hathaway Letter to Shareholders.

2 Source: Company reports. 2016 33% Constant Currency EBITDA Margin.

In the case of Visa, any company looking to meaningfully disrupt the network would need to dislodge both the nodes and the connections that bind them together. This is a seemingly difficult and almost impossible task resulting in many two-sided networks ultimately operating in a winner-takes-all marketplace. One notable example would be Google, which has seen its share of the internet search engine market rise from 34% in 2004 when it went public, to 87% in the U.S. and 91% in Europe in 2016. The network effect creates powerful moats and in the Global Leaders strategy we have significant exposure to both traditional one-sided networks, like Schindler and Safran, as well as the more obvious two-sided technology-centric network franchises of Google, Facebook, Priceline, MasterCard and Visa.

Given the strength of the network effect, we constantly reappraise the sustainability of this form of moat and assess the risks to which we are exposing our clients by investing in these assets. As in any organisation, complacency can have a damaging impact in a network business. A company that becomes complacent about its competitive advantage and forgets the importance of its customers can destroy a lot of value if left unchecked. One telltale sign would be a lack of innovation and free thinking that would ultimately end up in competitive forces chipping away at the nodes in the network. In this instance, commoditisation would eventually beckon and the network would erode over time. With this in mind we constantly monitor our network investments for innovation and customer focus.

A bigger and more topical risk is the spectre of regulation. A winner-takes-all market can attract the scrutiny of regulators who probe market dominance. Historically information empires have been regulated on two grounds. The first is price, where the monopoly business is deemed to be abusing its market position by charging too much for its goods and services. The second is what Tim Wu calls the Kronos effect:

'In antiquity, Kronos, the second ruler of the universe according to Greek mythology, had a problem. The Delphic oracle having warned him that one of his children would dethrone him, he was more than troubled to hear his wife was pregnant. He waited for her to give birth, then took the child and ate it. His wife got pregnant again and again, so he had to eat his own more than once. And so derives the Kronos Effect: the efforts undertaken by a dominant company to consume its potential successors in their infancy. Understanding this effect is critical to understanding the Cycle, and for that matter, the history of information technology.'[3]

As Wu mentions, the Kronos effect centres on when a company consumes innovation and any entrepreneurial endeavour that is considered a threat to preserve the status quo. In our view, the best example from history is AT&T's suppression of the telephone answering machine in 1934 due to a fear that the technology could supplant voice calls. When we think about the network businesses in which we invest, it is hard to argue from a consumer perspective that there is evidence of either price gouging or the Kronos effect. The sticking point is that although in theory regulators are the champions of the consumer, in practice they are also extensions of the political architecture. What is perhaps a bigger risk is national interest regulation dressed up as economic regulation. With this in mind we are acutely aware that Google's recent €2.4 billion EU fine was a shot across the information giant's bow. It is easy to forget the historical backdrop and associated paranoia that a powerful data-centric information organisation can produce in a country like Germany. National security could become an even bigger source of regulatory risk given the winner-takes-all nature of network markets and the likelihood that the future of many information empires will reside in either American or Chinese hands.

Coming full circle back to network business models, complacency and regulation are enduring dangers. Regular contact with management teams, competitors and suppliers provides some insight into these risks with our valuation discipline providing further downside protection. It is incredibly hard to second-guess politically motivated regulation but investing in companies with strong balance sheets at discounts to intrinsic value provides a margin of safety. The network effect is a powerful moat and it is one that requires investors to think differently when it comes to risk and reward. Indeed today's networks require us to adapt our standard economic thought practices to both the upside and the downside. To do this, Joshua Cooper Ramo suggested, while speaking at our NOW London conference last month, that we need to develop a seventh sense to understand how networks evolve. We hope that you are having an enjoyable summer and leave you with Ramo's advice for understanding the network age that we live in:

'The Seventh Sense, in short, is the ability to look at any object and see the way in which it is changed by connection. Whether you are commanding an army, running a Fortune 500 company, planning a great work of art, or thinking about your children's education, this skill marks an understanding of power now.'[4]

The Global Leaders Team

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3 Source: *The Master Switch* by Tim Wu, page 25.
4 Source: *The Seventh Sense* by Joshua Cooper Ramo, page 36.

GLOBAL LEADERS PORTFOLIO MANAGEMENT

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