Letter to Shareholders – Value Equities

Q3 2015

Dear Investor,

The global market tumble towards the end of the period under review meant that markets registered their worst quarter in four years. Over the three months to end September, our global value funds fell by 11%, which was 2.5% worse than the global benchmark, the MSCI World – although they remain ahead of benchmark when measured over the year-to-date.

For most of the summer, Developed Market equities seemed relatively immune to the rapid drop in commodity prices, declining Emerging Market equities and the slowing growth in China. In mid-August a new bailout deal for Greece was agreed, and many market participants breathed a sigh of relief as a Grexit was averted. Just a week later, however, things turned sour as the fall in China's stock markets spread around the world. On 'Black Monday', August 24th, equity exchanges tumbled from Europe to the US. Indeed, on the New York Stock Exchange the so-called 'circuit breakers', which are designed to slow down dramatic selling or buying, were triggered more than 1200 times during the day. The markets calmed somewhat after China took action, with its central bank cutting interest rates.

Correction or a new Crisis?

Sudden drops in stock markets are often justified, for example by excessive valuations just before a crash, or by economic realities looming just down the road. But markets can also often overreact to short-term events. Not every sudden fall translates into a full-blown crisis or indicates further downturns ahead. The obvious question regarding recent events is whether we have witnessed a market correction, adjusting valuations to reflect current risks, or whether we are looking at a crisis scenario, and the beginning of a bigger downturn for equities.

The last major market pullback was in 2011, when the US credit rating was downgraded by Standard & Poor's and fears raged of a Euro-zone breakup. This time, there are various stories spurring fear, perhaps best summed up by the head of the International Monetary Fund, Christine Lagarde, who, in late September, noted that: "There is good reason to be concerned about the global economy, as the world economy confronts a host of problems, including a refugee crisis in Europe, and with two major economic transitions at the center of attention: China's transition to a new growth model and the normalization of U.S monetary policy."

China slowdown fuelling global worries

Chinese growth has been structurally slowing for a while. This must be taken in context. At the most simplistic level, China has a vast economy which has been growing rapidly for many years. The size of the economy – the base – is quite simply larger, and one would expect the pace of growth to ease over the years. Meanwhile, China is attempting to transform its economy from a model which relies heavily on being the 'factory for the world', driven by exports and commodity-guzzling infrastructure investment, into a more mature and sustainable model with more reliance on private consumption. From a long-term perspective, we see this as a positive shift, which ultimately could justify higher valuation multiples for the Chinese market.

But, of course, the transitional phase will not always run smoothly. Early in 2015, we saw Chinese stock markets – particularly mainland listed A-shares – rally to extreme levels. This was driven mainly by exuberant individual investors, but arguably the government seemed a willing observer, with higher valuations perhaps giving the potential to refinance state-owned companies at attractive levels. This rise struck many –

including ourselves – as excessive, and in our Emerging Market funds we reduced exposure to China. As we now know, the rally reversed swiftly.

More recently, economic data out of China has not been encouraging. There is always an element of debate about the accuracy of certain Chinese macro data, but whether looking at official figures or underlying components which are considered more trustworthy, neither offers a rosy picture at present. The same has been true in many Emerging Markets, and investment flows into Emerging Markets – generally strong over the last decade – have reversed. An added factor is, of course, uncertainty over a Fed hike and its impact on emerging currencies. For China in particular, the sheer scale of its economy and trade links mean knock-on effects are inevitable. Just as any easing of consumer demand from Developed Markets impacts on Chinese production, so any slowdown in Chinese manufacturing, infrastructure investment and construction has major impacts on global markets for most commodities.

We know that China has the toolbox to intervene, and its leaders are not afraid to use it. The challenge, of course, is finding the balance between supporting the economy in its current form via classic measures, and continuing to rotate the economy towards the desired new model. The picture is not entirely bleak. There has been much concern about the Chinese housing market, but we note figures suggesting that the recent moderate price decline has led to a significant increase in volumes sold. This implies that underlying demand is reasonably solid. In the short-term, any stimulus that might be introduced could achieve stabilisation in economic data and would likely be well received in global stock markets. Chinese stock markets themselves seem likely to remain volatile, but we do note that valuations appear to factor in a considerable amount of negativity.

We should also remember the potential of politics to bring rapid change. Within Emerging Markets, Brazil and Russia stand out as having suffered severely in the last year for reasons which are ultimately political (elections in Brazil, foreign policy for Russia). But there are also positive changes. Within Developed Markets, we have written many times of the impact of Abenomics in Japan, while in India, PM Modi is an example of the dramatic positive effect that a reform agenda can bring.

US Rate Hike

At September's meeting the Fed kept interest rates unchanged, delaying normalization plans in the light of deteriorating global economic conditions and the release of ambiguous US data. However, the general expectation remains that US policy will tighten late this year, or early next.

We have mentioned before how the low interest rate environment has led to both low nominal borrowing costs and to an unsustainably low discount rate being used to calculate equity valuations. It has contributed to a search for yield, and supported financial risk-taking and higher valuations of certain growth and defensive stocks in particular. There is also concern regarding the potential impact on various Emerging Market currencies. Here, however, we generally find that those countries considered most vulnerable a few years ago are in rather stronger positions now. So it is a challenge for the Fed to gently start the normalisation of interest rates without creating financial market disruptions, and this is obviously a major focal point for markets.

Having said that, we should remember that we are talking about moving from 'extremely easy' policy to just 'easy' policy. We shouldn't forget that the first Fed rate hike for nine years is actually a positive event, triggered by improved economic conditions. For value investors, there is the potential for a supportive blend of improving macro conditions, combined with gentle increases in the discount rate, which can shift market performance back in favour of value equities.

While all eyes rest on the US, we should keep in mind that there are still accommodative monetary policies implemented elsewhere, which support European recovery and Japanese growth. We note that the global risk appetite seems very limited going into the fourth quarter, but sentiment indices urge contrarians like us to start buying. Indeed, panicky market environments have historically often been good times to invest.

Doomsday or Opportunity?

Our contrarian value philosophy forces us to screen for, and analyse, investment opportunities in areas where sentiment is poor, knowing full well that sentiment can stay poor or get even worse before it gets better. The best bargains are often found when investors overreact to bad news, and doomsday scenarios become reality much less frequently than they are predicted. Similarly, we are usually sceptical about stock market darlings that apparently can do no wrong.

Within our portfolios, a strong contributor in the recent quarter was Germany's Koenig & Bauer, which perhaps provides an illustration that one should be careful of extrapolating doomsday predictions.

The company is a family-controlled maker of printing presses with a dominant global market position and a strong balance sheet. It is a typical example of Germany's engineering power. But being a solid company with a proud history does not necessarily make a great investment case, especially if it's in a structurally-challenged industry. In the last decade, sales of book and newspaper printing presses declined sharply and overcapacity in the industry led to a price war. The third largest player went belly up, and the largest competitor almost followed suit. As these events unfolded, between 2010 and 2012, there were plenty of people pronouncing the death of the newspaper and, as a corollary, the death of printing presses. Koenig & Bauer saw its earnings deteriorate sharply and huge restructuring was needed. Its share price declined from EUR 30 in 2007 to EUR 6 at the bottom.

But the company had a near monopoly in banknote printing presses, with extremely high profitability and a fortress balance sheet. This helped it through a successful restructuring, reducing its legacy business from two-thirds of revenues to 15%. Meanwhile, the company found new growth drivers: machines for printing on packaging materials like glass, foils, plastics and cans. The share price has recovered sharply in 2015, returning close to levels last seen before the downturn.

Challenging conditions often offer opportunities to invest. One must use sober analysis to consider the risks, and while it is not always clear how the dust will settle, it can benefit the patient investor who is able to use time to advantage instead of seeing it as an enemy. Since the previous stock market peak was reached in mid-2007, Koenig & Bauer has in fact outperformed most European stock indices. This year this German security is up 165%, of which 30% was achieved in the difficult third quarter.

Dieselgate

One German company that has had a tougher time lately is Volkswagen. This automotive giant appears to have used 'defeat device' software to rig cars to cheat emissions tests whereas, under normal conditions, they can produce up to 40 times more NOx than allowed. VW shares plummeted, and many other car makers have felt the pain as well. We don't invest in VW and, since we find it difficult to estimate a worst case scenario, we are probably not about to either.

That cars produce more nitrogen oxide, and that real world fuel economy and emissions levels are different from test environments, seems to be an industry issue. Deliberate cheating is, arguably, on a whole new level, and it is difficult at this stage to judge how much Volkswagen will suffer from now on. Revenues and profits will be hit, depending on the extent to which customers shift allegiance to other brands. The balance sheet will be hit by fines and refit costs, which could lead to higher borrowing costs, in turn hurting profits. Investment plans are already being cut, which can have an impact on sales further down the line. It is also conceivable that this could have an impact on a fragile European recovery, because car production is such a big part of the German economy, but we would not overstate that risk. At a simplistic level, one carmaker's loss might be another's gain.

Of course, when scandals like this erupt, from an investment perspective important questions are: 'Could you have seen this coming?', or: 'Could anything have been done to reduce the risk?' This is something we take seriously. In recent years, the growing Responsible Investment movement has focused attention on "ESG considerations in investment". ESG stands for environmental, social, and governance issues. To some people, this seems like a nice-to-have concept. To us, it's a crucial part of managing investment risk. The scandal at VW, for example, is directly related to both environmental issues (emissions control), social issues (misleading customers), and governance issues (how did management let this happen?). It is a clear example of the massive financial impact these issues can have.

When we invest, we try to get a clear picture of the material risks that companies face in these areas, and to gauge whether management understand these risks, and are taking steps to manage them. We could not have foreseen the VW scandal, but on other occasions, we have managed to reduce certain risks through thorough ESG analysis. As active owners, we also aim to work with portfolio companies to manage those risks. As an example, over the last couple of years we have been working closely with a large Japanese telecoms company to strengthen the substance and transparency of its anti-corruption and bribery policies and reporting. This process of constructive dialogue has led to significant improvements. More details can be found in our Responsible Investment Review.

Of course, adding ESG risk analysis to an investment process doesn't mean one can guarantee that portfolio investments will never be involved in a scandal. But it does mean that one gains a clearer understanding of these risks, with a view to monitoring and managing them – and managing risk is what investment is all about.

Portfolio composition

During any given year, we analyse many more names than we choose to invest in. This leaves us with a long list of potential investments that compete with existing holdings to enter a portfolio. Sometimes a name from our list of ideas suddenly presents less downside risk, or more upside, and that is how we use market gyrations to optimize the portfolio. In our global portfolios over the review period, we have added four new investments in the US and sold three European stocks and one Japanese.

As a result, the main geographic features of the global portfolios have changed slightly during the quarter and we have increased our US exposure at the expense of Japan and Europe. For some time, we have argued that the combination of valuations and fundamental potential made Europe and Japan relatively compelling investments compared to the US. To some extent, this has been justified. From spring 2014 to summer 2015, on a local currency basis, the US market was relatively flat compared to Europe, and especially compared to Japan. The US dollar did appreciate, so in Euro terms the US market rose roughly as much as Japan, and rather more than Europe. We continue to see considerable potential in Europe and Japan, but having seen that potential priced in to some degree in the last year, it is not surprising that the opportunity set tilts somewhat more towards the US.

From a sector standpoint, our new investments – of which two are in Healthcare – have also decreased our risk relative to benchmark. Meanwhile, our exposure to Industrials and Consumer Discretionary remains meaningful as fear of global growth deceleration seems to weigh on valuations while fundamentals are robust – a situation which bodes well for eventual further economic recovery.

Beyond that, all funds are diversified in terms of catalysts and risk exposures. When considering new investments, they must naturally compete with existing holdings in terms of fundamentals and risk/reward. It may be that we wish to accommodate a compelling new position without significantly changing a portfolio's exposures to underlying risks and catalysts, in which case we may sell an existing position with similar characteristics but a less compelling risk/reward profile.

Outlook

The recent tumble in the markets has caused volatility to spike and increased investor uncertainty. Market corrections have occurred many times in history, and they will continue to occur. But, as we have noted before, the intrinsic value of a stock often does not move as fast – or even in the same direction – as market prices. In fact, we embrace market instability for the opportunities it creates.

Admittedly, falling asset prices are sometimes the precursors to prolonged economic downturns. That's not how we see it this time. But even if it were to turn out to be the case, our investment ideas should be able to maintain, and hopefully increase, intrinsic value – even at the bottom of the business cycle. Our goal is to be as prepared as possible by paying cheap prices for companies with high degrees of financial and operational viability. By taking a long-term view of our investments, we are able to see past the 'noise' in the markets and pay attention to the underlying fundamentals of stocks instead.

While economic headwinds remain, the core businesses, strong balance sheets and sustainable cash flows of many global companies continue to make them compelling long-term investment opportunities for patient investors. Admittedly, we have not been paid for our efforts in the last three months, but we continue to believe that buying undervalued assets while protecting against permanent losses is a recipe for success.

In closing, we remain confident in the outlook for the current fund holdings. We are grateful for your trust and support and we look forward to writing to you again at the end of the year.

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