

Global Equity Observer

Compounding Through the Noise

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | MARCH 2018

The first quarter has offered a welcome return to some sort of normality after the volatility-free markets, which have risen in a straight line for the last few years. Some of the excited, and excitable, recent commentary is more of a reflection of the excessive calm previously, rather than anything too violent actually happening. To put the movements in context, the MSCI World Index was down a mere 1% in the first quarter, and information technology was actually up. The best news is that the potential melt-up in markets that was building at the start of the year, which would doubtless have been followed by a very nasty meltdown, has been avoided.

That said, even after the recent pullback, valuations are still high, with the MSCI World Index above a 15x multiple of the next 12 months' earnings, which are themselves assumed to have risen by double-digits. The business cycle is getting pretty advanced in the U.S. at least, and there are significant risks as monetary policy gets more normal and trade policy threatens to get much less normal. Nine years into a bull market is clearly a good time to think about downside protection; mind you, for us any time is a good time to think about downside protection!

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“Nine years into a bull market is clearly a good time to think about downside protection...”



The good news about equities, cutting through all the complexity, is that there are only two ways to lose money... if the earnings go away or if the multiple goes away. We believe that our portfolios are well-placed on both risks, and should continue to offer the combination of compounding plus relative downside protection they have shown for the last two decades.

The primary driver of downside protection is that our portfolios' earnings should be resilient in an economic downturn. The companies' combination of recurring revenues and pricing power means that their sales and margins hold up well in tough times. Our flagship Global Franchise/Brands Strategy passed the acid test in the global financial crisis, with earnings actually rising over the 2007-9 period, not something the market could boast. It is true that our portfolios have seen a rising weight of information technology, but backtesting performance suggests that they should still be resilient, even before considering how the arrival of the cloud has increased the amount of recurring revenue at software companies. An example of this is a multinational software corporation that we own, which makes enterprise software to manage business operations and customer relations. The recurring revenue has risen from 43% to 63% of the total revenue since 2008 and, in gross profit terms, the recurring element has risen from 52% to 70%.

As for valuation, our global portfolios are at a premium against the market using forward price/earnings, or as we prefer to call them, guesses about lies. They are guesses because estimates are on average 8% too high on earnings one year in advance (two years forward the error rises to 14%) and lies because the

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earnings used are 'adjusted,' or as we like to call them, 'earnings before the bad stuff,' or in our more cynical moments, 'earnings to get management paid.' In 2016, U.S. adjusted earnings were 25% above the 'real' generally accepted accounting principal (GAAP) numbers. The companies in our portfolios are less likely than the market to disappoint significantly on earnings because of their inherent stability, and are also less prone to shunting losses 'below the line,' either from restructuring charges, write-offs or share-based compensation.¹ As such, much of the premium disappears on a clean earnings basis. Indeed, on our favoured measure of cash flow yield, our

global portfolios are at a modest 5-9% premium (depending on strategy) to the MSCI World Index, for some of the highest quality companies in the world.

The sharp relative derating that the key consumer staples sector has suffered over the last two years (going from a 40% to a 16% premium to the market on the next 12 months' earnings) has been a headwind for performance but has reduced the portfolios' valuation risks, improving our confidence in the portfolios' robustness in a downturn. The sector with the most resilient earnings in a global slowdown, which makes up a significant percentage of the portfolios, is at its cheapest versus the market since the global financial crisis, and is at a negligible 3% premium to the MSCI World Index in free cash flow terms.

Our strategies look to compound wealth over the long term, by owning high-quality companies that compound their earnings steadily at reasonable valuations. They look to keep the lights on, rather than shoot them out. We would argue that in an uncertain world, this is an attractive proposition, particularly as you do not really have to pay up for the relative certainty.

¹ Source: Morgan Stanley Investment Management; as of March 31, 2018.

RISK CONSIDERATIONS

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing

in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Option writing strategy.** Writing call options involves the risk that the Portfolio may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the Portfolio forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price, but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the Portfolio's call option writing strategy may not fully protect it against declines in the value of the market. There are special risks associated with uncovered option writing which expose the Portfolio to potentially significant loss.

INDEX INFORMATION

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

DEFINITIONS

Free cash flow is a measure of a company's financial performance, calculated as operating cash flow minus capital expenditures. The **price-earnings ratio (P/E ratio)** is the ratio for valuing a company that measures its current share price relative to its per-share earnings. The price-earnings ratio is also sometimes known as the price multiple or the earnings multiple.

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