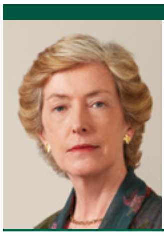
Market Musings

April 2015

*“ **The limbo**: a West Indian dance in which the dancers repeatedly bend over backward and pass under a pole that is lowered slightly with each pass. ”*

American Heritage Dictionary, 2011

Veritas
Investment Management
REAL RETURN INVESTING



Meg Woods
Partner and Investment Manager

From ZIRP to NIRP.

From zero interest rate policies to negative interest rate policies.

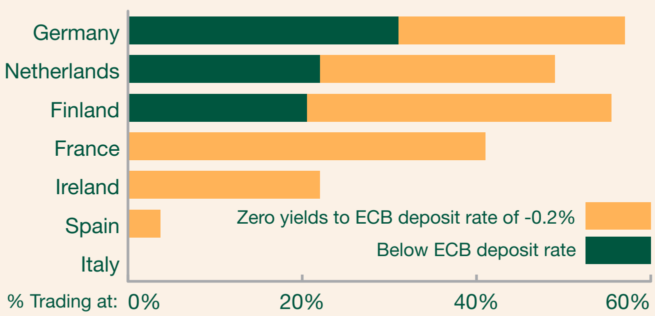
A year ago investors were disbelieving as key Western interest rates approached zero on the back of extended quantitative easing (QE). Assuredly that was the climax of central banks' determination to kick-start growth… wasn't it?

It would appear not. The €uropean Central Bank's President, Mario Draghi, committed at the start of 2015 to purchasing €60 billion of bonds per month, month after month, for 18 months. However, this is more than €urozone governments are issuing! He is reportedly already behind the curve in his programme…

The upshot, rather like limbo dancers trying to squeeze under the bar, has been the introduction of *negative* official interest rates in Switzerland, Denmark and Sweden. Switzerland has even sold 10-year debt at a negative interest rate, the first government in history to do so – and the issue was several times over-subscribed.

The yields-to-maturity of a raft of sovereign and corporate bonds have followed suit. In France to get a 1.5% yield, investors must commit to a 50 year bond. Germany's 30 year government bond yield is now a mere 0.65% compared with the average over the past ten years of 3.4%. Some 57% of all outstanding German government bond debt with a maturity of more than one year now trades on yields below zero.

EUROPEAN SOVEREIGN BOND YIELDS



Source: Citigroup

Mr. Spock's catchphrase, "highly illogical", springs to mind: why would investors *pay* to lend money? Some pension funds and insurance companies have little choice for regulatory reasons. Others may be taking a view that currency appreciation – of, say, the Swiss Franc – will more than make up for the negative interest rate. Yet others may simply be subscribing to the 'greater fool' theory, expecting to sell their bond purchases on at an even lower yield.

The situation is unprecedented. It is disruptive. It jeopardises pensions and savings, as well as encouraging the misallocation of capital to ventures that would be deemed unattractive in a 'normal' world, interfering with the market mechanism.

Bonds historically have been the safe asset, ballast to mitigate the volatility of equities. Now central bankers' experiments with negative interest rates have turned investors into risk junkies. Investors are switching into 20-year and 30-year debt just to maintain their income – but longer maturities sharply increase the volatility risk and potential for loss when interest rates do normalise. If the 30 year German government yield rises by just ½%, investors will lose 10% of their capital.

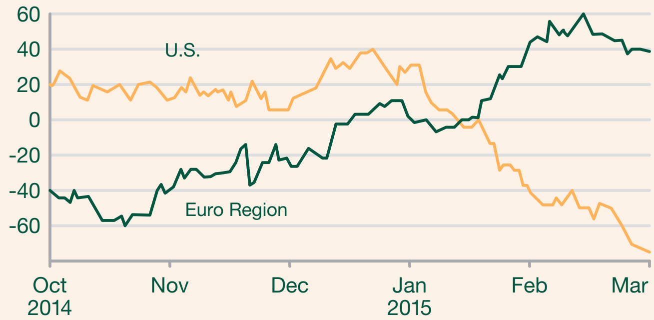
I spy growth?

However, central banks' QE objective has been to buoy consumption and investment, and in this they appear to be having a modicum of success. The growth dominoes are standing up, one by one.

In the United States, households have de-levered and stringent fiscal policy has brought non-financial debt as a percent of GDP under control. A million jobs have been created in the three months to February, and, aided by the fall in oil prices, the consumer is in good shape. Growth figures have sagged recently but this repeats a pattern of first half disappointments after harsh winters; the International Monetary Fund's forecast is for healthy GDP growth of 3.1% in both 2015 and 2016. While the strong dollar has complicated the timing, the Federal Reserve (the Fed) is on track to raise interest rates later this year.

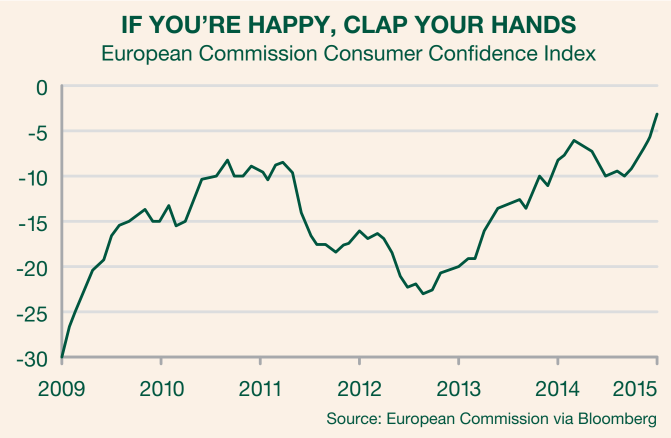
However, it's the €urozone that is now the world's stand-out growth region.

SURPRISE! EUROPE OUTPACES U.S!
Citigroup Economic Surprise Indices



Source: Bloomberg

The €uro may have lost 20% of its value against the US dollar in the past year and Greece's problems continue to dominate the headlines, but consumer confidence is improving at a rapid clip, shoppers are out and retail sales accelerated by 3.7% in the 12 months to January – the fastest growth in almost a decade. Even the rate of change in credit is improving, suggesting that Monsignor Draghi's QE programme is having the desired effect.



However, the outlook elsewhere is less constructive. China remains a significant threat to global growth, with the economy decelerating after years of wasteful fixed investment, debt at alarming levels and the renminbi over-valued. Emerging countries have suffered a currency rout on the back of tumbling commodity prices and the strong US dollar, compounding the challenges of weak export markets.

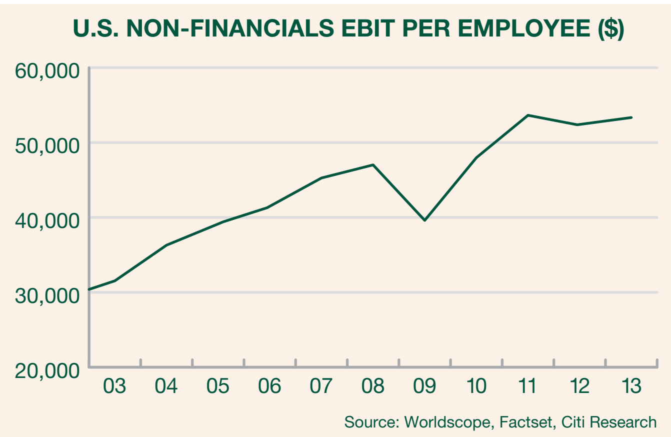
In Japan there is little evidence that low interest rates and a derisory cost of capital are having any impact on domestic spending and investment. The country thrived in the past not because it had a population of 'shop-or-die' consumers as in the US, but because its export growth model worked beautifully. Today that policy is under pressure as the country has few competitive advantages in the face of China moving up the value-added chain. Japan's ageing workers lack the skills for a digital, globalised world.

Thus, despite pockets of good news, prospects for the global economy remain chequered. Moreover, even the one country that has made solid progress in recovering from the 2008 crisis, the United States, now finds the path back to normalcy problematic. The Fed sees growth recovering and has mooted starting to raise interest rates gently – but investors, desperate for yield, have responded by pushing up the dollar, so impairing exports and lowering inflation – and undermining the case for raising interest rates.

Digital disruption

Disruption is evident in many areas, not just in bond markets. Another is technology.

The proliferation of digital technologies has reduced the demand for workers in a range of manufacturing and middle income jobs. Such substitution of labour for capital helps



productivity but does not boost wages. Productivity is a material driver of long term corporate earnings per share, in turn the key to long term stock markets returns. Thus in the ten years to 2013, US-listed non-financial companies reported a 119% increase in profits before interest and tax – but only a 31% rise in the number of employees, indicative of accelerating automation.

In the short term this trend has been helpful to shareholders, providing a strong underpinning to equity markets. The other side of the coin though, has been sluggish labour markets and slower end-demand growth. Machines may make model employees, never taking sick leave or holidays or asking for pay rises… but they do not make good customers.

Global manufacturing labour costs today account for $6 trillion annually and further automation could bring considerable savings. Indeed, automation is a new area of focus in China's 12th Five Year Plan as Beijing grapples with rising manufacturing costs on a number of fronts – wage inflation of 14% p.a. over the past eight years; the projected dramatic fall in the working age population over the next decade as the population ages; the need for standardised quality. Combine these with the declining cost of robotics, and it is unsurprising that China is becoming the fastest-growing market for industrial robots, estimated by the International Federation of Robotics to grow by 25% p.a. between 2014 and 2017, up from 15% p.a. in 2011-13.

The challenge for Beijing however, is that it complicates their efforts to re-balance the economy away from fixed investment towards consumption.

Technology is also upending education, where the surge in costs is pressuring government budgets. American student debt now amounts to an alarming $1.2 trillion. Thankfully the digital age is transforming education, reducing costs and making it more accessible. At the Georgia Institute of Technology in the United States, an online Master's degree in computing costs 'only' $7,000, which compares with the on-campus cost of $25,000. The virtual Khan Academy already has about 10 million pupils, making it the world's largest school. Curious? The web address is www.khanacademy.org.

Opportunity in risk

How does an investor approach these tectonic changes?

Disruption entails risk and opportunities. By understanding the associated challenges, the risks can be mitigated. By taking advantage of the opportunities, the benefits can be maximised. That is what we seek to do at Veritas with the filter of our global thematic approach.

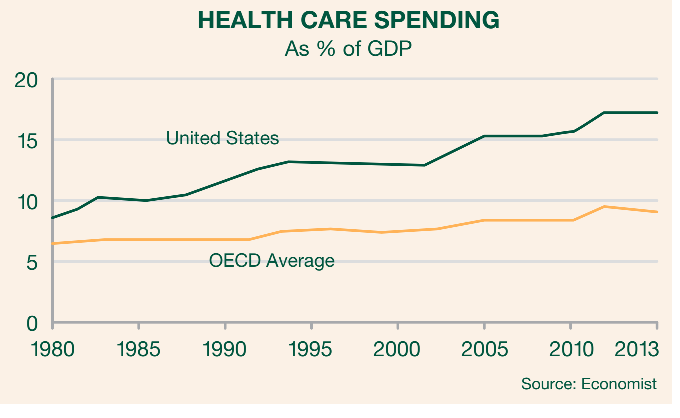
Despite disruption, share prices will follow the underlying path of earnings and free cash flow over time. We consequently strive to invest in financially sound, well managed companies that are growing sustainably and bought at a sensible price in order to achieve the real returns that are our objective for our clients. Valuations are generally full after the rises in markets in recent years but opportunities still exist to reward diligent analysis.

Our global growth themes are currently "structural growth" (healthcare, the connected world, outsourcing) and "scarcity" where pricing power is supported by limits on supply. We also look for "enduring business models" with a moat around the business and a competitive edge.

An industry that is experiencing disruption on a number of fronts but offers multiple opportunities is healthcare.

America's *Affordable Care Act* – 'Obamacare' in common parlance – was primarily designed to bring health insurance to the 40 million+ Americans who didn't have it. And indeed, millions are now looking for health insurance on the new public exchanges, encouraged by employers anxious to cut costs.

However, Obamacare also introduced incentives and penalties to make the country's hideously expensive health services more efficient. It is the most significant re-engineering of America's health system since employers began providing cover for their employees in the 1930s. It is empowering patients and driving health insurers to achieve better value.



Inter alia, hospitals are for the first time required to disclose their prices, throwing the spotlight on unsubstantiated differences. 'Fees for services', in which doctors and hospitals are reimbursed for each test regardless of the outcome (which encourages the number of tests and procedures) is being replaced by payment by results – a flat fee for every successful procedure. By 2020, private health providers must make 75% of payments by results rather than service-based, forcing them to shape up.

As a result of these changes, the rise in health care costs has already moderated, and the number of patients having to be re-admitted to hospital has dropped.

The legislated increase in transparency is heightening competition and pressurising costs and profitability. Efficient providers will have the opportunity to take market share from the weaker operators. At Veritas we have been taking advantage of this (where appropriate to the mandate) through investment in UnitedHealthcare, a leading US health insurer.

UnitedHealth is well managed with the agility to respond to these emerging trends. Their 45 million medical membership, drawn from both the private sector as well as the expanding state-funded Medicaid and Medicare schemes, give the group scale and hence leverage with providers. The group has long been a leader in driving down medical costs.

Its pharmacy benefit management subsidiary, Optum, processes all member prescriptions, astutely surfing the 'Big Data' wave with cutting edge analytics capabilities. It deploys these to analyse both individual patients' medical histories to improve future treatment, as well as comparing the efficacy of individual drugs across many patients, again to raise future effectiveness. Optum uniquely differentiates UnitedHealth from its peers by providing cost effective services and solutions to the broader healthcare marketplace, patients as well as doctors and hospitals.

This combination is a strong competitive moat, building on the powerful structural growth drivers in the health sector of ageing populations, the explosion in chronic diseases, new technologies such as genomics, and the rising availability of healthcare that will underpin earnings. The group's strong cash flow and financial flexibility will enhance shareholder returns via both share re-purchases and dividends.

UnitedHealth very much meets the criteria in the Veritas 'quality of business' check list.

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