Market Musings

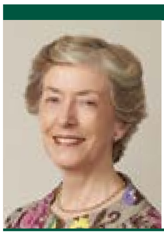
October 2016

"It is not the strongest of the species that survives, nor the most intelligent. It is the one that is most adaptable to change."

Charles Darwin, *"Origin of Species"*, 1857

Veritas Investment Management

REAL RETURN INVESTING



Meg Woods
Partner and Investment Manager

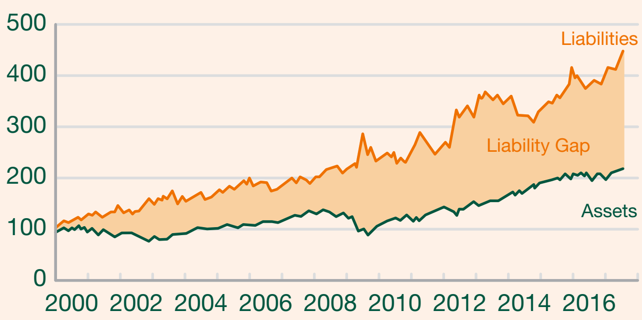
Liquidity, liquidity everywhere, and not a bond to buy…
(with apologies to Samuel Taylor Coleridge's *Ancient Mariner*.)

As central banks seek to jump-start growth with low and negative interest rates that are deeply unattractive to investors, bond issuance is nonetheless running at its fastest pace in nearly a decade as governments and companies binge on debt. *Dealogic* reports that $4.9 trillion of global debt has been issued in the eight months to end-August this year. Even Italy, the €urozone's *bête noire* economy with non-performing loans running at 20% of GDP, was able to issue a three times oversubscribed 50-year 'Methuselah' bond at just 2.8% p.a. *Negative* yielding investment grade bonds totalled $11.6 trillion at 30th September, according to Barclays.

However, there is increasing push-back against low and especially negative rates. The pensions and insurance industries are particularly hard hit. Both pledge to pay certain sums in the future, sometimes many years hence, against which they hold assets today – but when bond yields fall, the cost of those promises rises. The Financial Times (FT) highlights the case of Bernard Skipek, a retired teacher in America who has been hit by an 87% jump in the premium on his long term care insurance policy in just two years, and his experience is typical.

Pension funds have the added challenge of longer life expectancies. Again drawing on the FT, the average life expectancy of a person born in 1916 was 53.5 years; for those born in 2016 it is 82 years. US pension assets have increased by 105% since 1999 – but liabilities have soared by 278%. As below, liabilities are now *double* assets.

US PENSION ASSETS AND LIABILITIES (REBASED)



Source: FT, Ryan ALM Inc

A popular metric used to be that savers who put away 8% of their income every year for 40 years would be able to build a retirement income of 75% of their final salary. This was based on assumed real returns, above inflation, of 5.5% p.a. If however future returns are lower by, say, 2% at 3.5% p.a., savers will need to put aside 15% of their income each year – almost double – to achieve the same outcome.

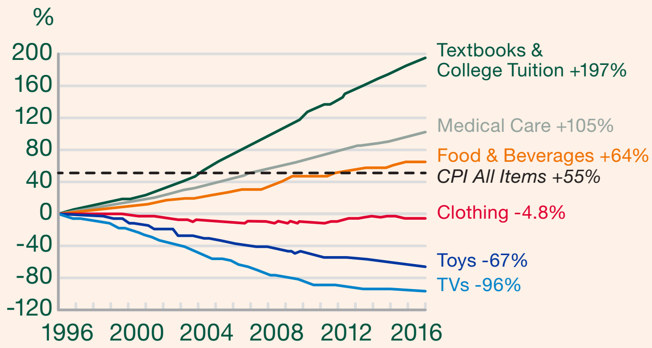
Low and negative interest rates are a slow but massive train crash.

Deceptive prices

Central bankers appear insouciant, blinkered in their determination to get inflation back up to their arbitrary target of 2%. Inflation however remains stubbornly benign. Why hasn't it responded more robustly to these gargantuan levels of stimulus?

An examination of the distribution of price increases in the United States reveals extraordinary diversity.

PRICE CHANGES 1996 TO 2016



Source: U.S. Bureau of Labour Statistics

College tuition and textbooks have *tripled* in price in the past 20 years as the baby boomers' children, encouraged by government student loan programmes, created more students than there were seats. Medical care has doubled. Foodstuffs are up by a heady 64%.

At the other end of the spectrum, the price of toys, outsourced to the lowest cost parts of the world, has plummeted by 67%. Televisions now cost a fraction of what they did in 1996 on the back of technological innovation and manufacturing economies of scale.

Structural trends would seem to be a stronger driver of price levels than monetary policy.

The other challenge to central bankers in their fight to boost inflation has been the very sharp fall in the oil price – but this may be changing. Oil reached a low roughly a year ago and the fall is working its way through the year-on-year numbers. Another factor that is outside the control of monetary policy.

Goldilocks

The world is running out of patience with central bankers: seven years after the credit crisis, their policies still have not achieved their goal and the side effects are extremely damaging.

Talk of tapering is starting to be heard. The Federal Reserve is weighing the timing of their next 0.25% interest rate rise. Mr Draghi, President of the €uropean Central Bank, was recently summoned to Berlin to account for his loose money policies – which are welcomed in his native Italy, whose economy is struggling, but are not appropriate for the €urozone's stronger economies, especially Germany.

Once the French Presidential elections are out of the way next May, €urozone tapering may well commence in advance of key German elections in October.

And central bankers can wind down quantitative easing with dignity: global economic fundamentals are improving.

In the US, a tightening labour market is feeding through to rising wages, propelling consumer confidence to its highest level since August 2007. Home ownership is at a multi-decade low and sales of newly built homes are surging.

US NEW HOME SALES

Source: Thomson Reuters Datastream

In the €urozone, quantitative easing has depreciated the €uro, boosting competitiveness. Spain's brisk recovery is led by exports, while in Germany the service sector is strengthening.

In China too, the government's pro-growth measures have helped stabilise growth. Lower mortage rates and downpayments have buoyed housing, which has filtered through to commodities: the Bloomberg Commodity $ Index up by 10% this year to the time of writing.

Only in Japan have the central bank's efforts failed, unable to offset the headwind of seven consecutive years of a declining population.

For the time being therefore, the world is in a benign 'Goldilocks' state, with both growth and inflation neither too hot nor too cold.

Fundamentals to the fore

Monetary stimulus has helped boost asset prices since the credit crisis, with too much money chasing too few investment opportunities. The withdrawal of this tailwind, coming on top of the headwinds of an ageing, over-indebted world, will make the backdrop more challenging for investors.

At Veritas this is however not deterring us in our quest for real returns for our clients, ahead of inflation. Over time, a company's share price will always reflect the underlying progress in earnings and cash flows, and so we focus on long term wealth creation by companies. We ferret out established businesses run by proven management, financially sound companies with strong and growing cash flows, a moat against competitors, all at a sensible price.

Our approach of investing in global quality has stood our clients in good stead, and we are delighted that this has been recognised with the Citywire 2016 'Steady Growth' investment performance award.

Digitally effective

We use global growth themes as a funnel to help narrow the investable universe and identify attractive sectors. Our current three high conviction themes are:

- online life,
- demographic dynamics, and
- regulation.

We continue to marvel at the innovation in technology, and increasingly in our analysis of companies, we are focused on the impact from digital disruption.

Technology has changed the way we live, and the pace of change is accelerating. The key disruptive technologies are mobility, social media, cloud computing and data analytics. How CEOs respond to the challenges and the need to innovate is critical for an investor to assess. We are indebted to Roger Camrass, Visiting Professor at Surrey University and one of the pioneers of the internet, for sharing with us his insights on how to do this based on numerous interviews with the top management of both established companies and start-ups.

Roger reminded us that, because of the ubiquity of technology, the old rules no longer apply. Consumers' interaction with retailers, banks and other providers through a growing range of channels affect their experience. They prefer the recommendations coming out of social networks to those of experts. Social media can be used by management as a tool to encourage peer recommendation of a product and customer loyalty.

Changing customer behaviours drive the need for innovation and new technologies provide the tools. For example, the healthcare sector is being upended by wearable technologies and telemedicine. Utilities are made hugely more efficient by smart metering. Manufacturing is discovering 3D printing. Tobacco has e-cigarettes. The connected car opens up a spectrum of digital possibilities, from preventive maintenance to safety and convenience in travel.

Thanks to 'Machine Intelligence', companies can gain detailed insights into a customer's consumption patterns and choices. 'Big Data' is flooding the world with information from every source – humans, homes, cars – but unstructured information has little value; Machine Intelligence is the mechanism that transforms the data into genuine sources of new value. The combination of Machine Intelligence, Big Data and Interconnectivity can aid decision-making and help generate new sources of value. Companies that have embraced all three are at an advantage. Products and services can be better adapted to individual need and the supply chains that deliver these can be more efficient and agile.

Nimble new disruptive competitors have emerged. Their key advantage is that they are not encumbered with legacy systems in creating new products and services. The cost of starting a digital company has tumbled from $5 million in 2000 to just $5,000 in 2015. Because of technology, new entrants can have global reach at the outset and tend to identify changing trends rapidly, innovating in response to changing consumer behaviour.

We ask management when we meet with them whether the game-changing technologies are a threat to their current business model – or an opportunity. Innovation is no longer just 'nice to have'; it has become a core component of business strategy.

Kaizen

Our task as investors is to understand the way that companies have set themselves up for responding to digital disruption and delivering innovation. In most managements, there is a natural inertia, a resistance to change, an assumption of 'steady state', encouraged by legacy systems. Microsoft fell into this trap a handful of years ago, but new CEO Satya Nadella, appointed in 2014, got the business back on track with the introduction of the cloud and of subscription pricing with software auto-updates. The transformation has been reflected in the share price (to the benefit of our clients).

Innovation is a culture. Management must understand the ecosystem within which the company operates and foster a culture of responsive innovation. Google, another Veritas favourite, epitomises this as evidenced by, for example, YouTube, Google Glasses and the driverless car.

Digital is not just about technology, however, and we also seek to understand the governance structure, inter alia establishing whether they have a Chief Information or Technology Officer on the main Board.

Effective digital organisations will be customer centric with agile, automated structures. Innovation needs the oxygen of speed. Management will prefer the flexibility of small, incremental projects to large ones, and ensure they have the requisite technology capability – all with a strong central governance system.

The Japanese business philosophy of continuous improvement, *kaizen*, is the effective digital organisation's norm.

Digital addition

A company that we have recently introduced into client portfolios is Thermo Fisher Scientific, the world's leading supplier of high-end analytical instruments, laboratory equipment, software and consumables to the life sciences sector. Their mission statement is to make the world healthier, cleaner and safer.

Their portfolio includes innovative technologies in such fields as mass spectrometry, allergy testing, environmental monitoring and genetic sequencing in applications such as cancer therapeutics. Their products help accelerate research and ensure consistency of results. They improve customer productivity, reduce costs and drive decisions based on better data analysis. Management continuously increases capabilities in technologies and leverages their extensive global channels to stay on top of customers' emerging needs. They work closely with the academic world to stay at the cutting edge.

With their strong technology portfolio in scientific analysis, Thermo Fisher is also benefiting from another core Veritas theme, Regulation. The rise of health & safety and quality controls across many industries, particularly food and drug manufacturing, and ever tighter environmental monitoring of air and water purity, is an enduring, non-cyclical trend, into which Thermo is well placed to expand.

We view Thermo Fisher as an effective digital organisation, a quality company with predictable cash flows, also benefiting from the tailwinds of ageing populations and rising incomes that are driving the healthcare sector.

Meg Woods
11th October, 2016