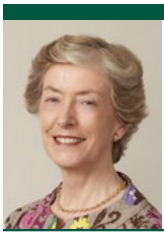
Market Musings

October 2015

“When the winds of change blow, some build walls while others build windmills.”

Ancient Chinese proverb

Veritas
Investment Management
REAL RETURN INVESTING



Meg Woods
Partner and Investment Manager

Greece may have receded from the headlines but investors did not put their worry beads away in the third quarter.

They were exercised by three things.

The first was the possibility of the U.S. Federal Reserve (the Fed) raising interest rates for the first time in nine years on the back of the recovery in the economy... by a token ¼%. This is not large! Indeed, it would have been seen as a sign of confidence on the part of the Fed and a positive first step on the road to normalcy. However, Chair Yellen obviously had not yet seen Ben Bernanke's new book about his time at the helm of the Fed, "The Courage to Act"… The Fed sat on their hands again in September. Investors fretted and markets fell. A week later Yellen felt moved to re-assure Congress that the economy could indeed withstand a rate hike. Markets recovered.

Yellen claims the decision to hike is data-dependent: does she not mean market-dependent?

The primary reason for the Fed to have hiked is not the strength of the economy (which is still uneven). Rather it is the distortions that such an extended period of low interest rates are causing. Companies that should not survive are being kept alive by these low rates. Investment is taking place in industries that would not otherwise warrant it, resulting in unwanted surpluses and pressure on prices, deflation rather than the desired inflation. Those behaving responsibly – savers – are penalised. Pensioners who ten years ago had anticipated a comfortable retirement now face diminished circumstances with annuity rates shredded.

The bull in China's shop

The second worry for investors was China's tumbling stock market and the depreciation of the renminbi (Rmb). However, both arose out of Beijing's efforts to free up their markets – something the West welcomes in theory!

The stock market soared as it was opened to Hong Kong and foreign investors, exacerbated by margin debt, a bubble that had to burst – but even now it is up by 50% over the past 12 months.

Beijing's subsequent announcement that market moves in the Rmb would play a greater role in setting the actual exchange rate is in the hope of being included in the IMF's special drawing rights in 2016, a huge and very desirable status symbol in Beijing's eyes. China's share of world trade has gone from 10.5% in 2010 to 15% this year and the renminbi has appreciated by 33% in that time. It gave back only 3% of that in August!

The IMF would in turn welcome the world's fourth most used payments currency as lending legitimacy to its international currency basket. Only the US$, sterling and the €uro are more widely used; the 'redback' has now overtaken even the ¥en.

Thus, put into context, both the Fed interest rate hike and China's stock market and exchange rate moves should be interpreted constructively rather than as a reason to fret.

The cycle of growth

The third issue worrying investors, manifest in collapsing commodity prices, does however warrant greater attention.

GDP growth in the 1980s and 1990s was above long term averages due both to the Baby Boomer population bulge entering the workforce and to the opening up of Eastern Europe after the fall of the Berlin Wall. In the Noughties the growth baton was passed to the emerging world, led by China's extraordinary urbanisation and fixed investment spree, as well as the rapid expansion of global trade.

This growth was facilitated by debt, initially in the private sector, then transferred to the public sector post the credit crisis.

Now these trends are reversing. The Baby Boomers are approaching retirement, so spending less. Exuberant fixed investment in the emerging world, particularly China, has resulted in excess capacity; governments, with Beijing at the forefront, are scrambling to re-direct growth to domestic consumption. However, this is a slow process due to cultural barriers: the Chinese are a nation of savers, not spenders.

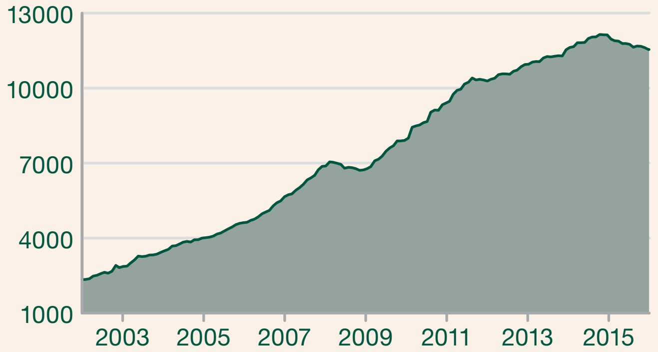
Global trade has ground to a halt with Western consumers increasingly focused on services rather than things. The 'Cloud' has replaced filing cabinets and servers. Smartphones are doubling up as cameras. The demand for Asia's manufactured exports is waning.

Debt has reached irresponsible levels. In China a whacking 23% of GDP goes merely to paying the interest on the country's debt!

The emperor with no clothes

Liquidity is squeezed in the slipstream of these trends. Asia's current account surpluses that have buoyed incomes and domestic liquidity for some 20 years are disappearing. Global foreign exchange reserves are falling, pummelled by capital outflows as investors retreat back to the safety of the West and as emerging countries, including China, defend falling exchange rates.

GLOBAL FOREIGN RESERVES (US$BN)



Source: Bloomberg

Foreign exchange reserves are widely viewed as an asset – but are in fact only an accounting book entry with no substance. When an exporter, say in China, exports widgets to the UK, the British importer wires sterling in payment. China's central bank, the People's Bank of China (PBoC), facilitates the transaction by printing Rmb to complete payment to the local exporter and puts the sterling received on the shelf. When the opposite transaction takes place, the PBoC uses some of that sterling to pay the British exporter on receipt of Rmb from the Chinese importer. If exports exceed imports, there will be residual sterling on the PBoC's shelf. However, the *value* of this sterling has been paid away.

How then can the PBoC invest this left-over sterling (a.k.a. foreign exchange reserves) into, say, US Treasuries? Quite simply, it is double counting. It is effectively printing money. This emperor has no clothes.

For the period of the Noughties, China's massive foreign exchange surpluses – the left over foreign currency – were substantially invested in U.S. Treasuries, usefully earning interest. This was credit creation on a massive scale, contributing significantly to the global savings glut – and which was of course subsequently augmented by quantitative easing (QE).

Now the American QE tap has been turned off – and global foreign exchange reserves are falling. It's a double whammy that adds another headwind to those already challenging the globe, notably ageing populations and elevated debt levels.

Walls and windmills

Some investors will choose to respond to these winds by hunkering down and building walls, as per our front cover quote. At Veritas we prefer to build windmills. We embrace these winds of change via our core conviction themes to direct our investment in our quest for real returns, ahead of inflation, for our clients.

Of course we are vigilant to the macro backdrop, but at present it serves to reinforce our belief in the importance and validity of our current themes of structural growth (innovation, healthcare) and scarcity, which gives pricing power in a potentially deflationary world. It also underlines for us the importance of our longstanding predilection for established, financially sound companies with proven management and a moat around the business, bought at a sensible price.

Innovation continues apace, is even accelerating. The disruptors find themselves disrupted.

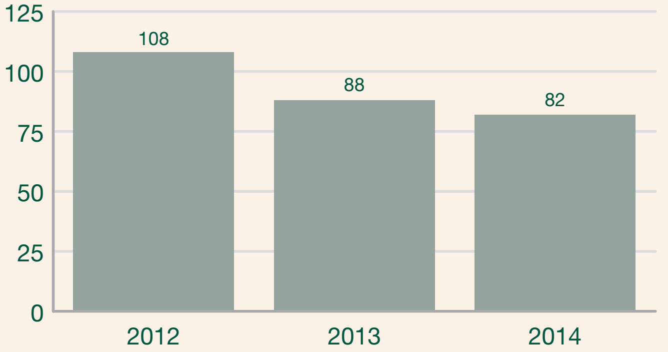
Immunotherapy manufacturers are being disrupted by the advent of generic competition through biosimilars.

Fracking in the gas industry was one of the biggest disruptive innovations in the energy sector, opening up commercial opportunities for oil and gas reserves that had previously not been viable. Now however, Floating Liquefied Natural Gas (FLNG) – viz. the siting of a natural gas liquefaction plant on a (very big) ship – will enable natural gas to be converted on the high seas to its liquid form, so reducing its volume by circa 1/600th and making its transportation economic. The first FLNG vessel is scheduled to be commissioned by the end of 2017. This is forecast to start opening up vast tranches of hydrocarbon supply, put at 52% of proven ex-North American natural gas reserves. Thus about half of the world's natural gas has not hitherto been exploitable – but is anticipated to become so in the foreseeable future.

Drones, initially used by the military, are increasingly being adopted commercially, for example for small parcel delivery. The consumer / personal drone market is ripe for take-off too, and could mirror the exponential growth of the personal computer market. Farmers could use drones to monitor crop growth, insect infestation and areas in need of watering at a fraction of the cost of manual aerial surveys. Film makers get more dramatic pictures from a drone which can fly lower than a helicopter over disaster scenes, for example. Geographers are able to produce accurate 3D models of landscapes. Naturalists can count nests without disturbing the wildlife. The most popular Christmas present this year is expected to be 'Lily', the flying camera – the way that future family photographs will be taken at barbeques. More than one million drones are forecast to be sold this year.

The threat of technological change to consumer staples retailers is far greater than that from discounters such as Aldi and Lidl. E-commerce has ushered in the 'infinite shelf' with e-retailers' offerings not limited to physical store shelves. Rather they can stock a much broader range of products in low cost warehouses, or even source – as Amazon does – from a multitude of smaller suppliers. The cost savings are feeding through to prices and challenging traditional retailers.

PRICE PER KG OF CONSUMER STAPLES



Source: Bain, Goldman Sachs

Manufacturers are now selling the capabilities of the equipment they produce as a service rather than the physical equipment. For example, Philips, known for its light bulbs, has just signed a 10-year agreement with the Washington Metropolitan Transit Authority (WMTA) to provide lighting services in 25 parking garages, including contractual responsibility for all light bulb replacement. With the cost of sensors and digital monitoring having plummeted, Philips can economically monitor remotely when light bulbs burn out. The WMTA expects to save $2million per annum in maintenance.

Capturing disruption

We are excited by technological disruption as a theme. We believe passionately that it will continue at an explosive rate – regardless of the slowdown in China, regardless of ageing populations, regardless of debt levels. Share prices will always reflect underlying free cash flow in the longer term, and structural growth will benefit the share price over time.

One such company in which we have invested where appropriate to the mandate is Cognizant Technology Solutions. Their mission is to help clients navigate the rapidly changing technology landscape to capture the digital high ground. Management is disciplined in reinvesting back into client servicing capabilities, and offer a pragmatic approach to building digital backbones for businesses powered by social, mobile, analytics and cloud technologies (the SMAC stack). Massive amounts of data can now be processed inexpensively to reveal user behaviours, interests and desires.

Management has focused particularly on two industries undergoing profound change, the financial sector and healthcare. Together these account for 70% of revenues. The financial sector demands cost optimisation, regulatory compliance, real time risk monitoring, and fraud and trade surveillance. Healthcare faces reform, stretched budgets and shifting responsibilities between payers and providers. The upshot of this specialisation is that Cognizant has been able to far outgrow its peers, even in difficult years such as 2009 and 2010 when their revenues grew by 40% and 33% respectively.

Cognizant has worked with Nissan to develop an application providing customers with mobile access to connected services such as remote door lock/unlock, roadside assistance, stolen vehicle reporting and speed alerts. UBS retained Cognizant for its 'Crowd-on-the-Cloud' capability to live test a new app. This was achieved with a quick turnaround time at minimal cost. British Gas partnered with Cognizant to unravel complex legacy billing systems and streamline customer processes. The upshot has been improved billing accuracy, lower operating costs and greater customer satisfaction. Cognizant has transitioned Loblaw, Canada's largest retailer, to a digital environment encompassing Web, cloud and mobile technologies, including anytime/anywhere computing platforms.

Cognizant is a 'windmill' company.

Meg Woods
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