Market Musings

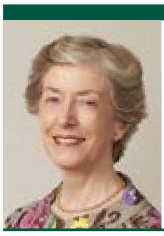
January 2016

“Keep your eyes on the stars… and your feet on the ground.”

Theodore Roosevelt, May 1904
Address at Prize Day at Groton School

Veritas Investment Management

REAL RETURN INVESTING



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The world is in transition.

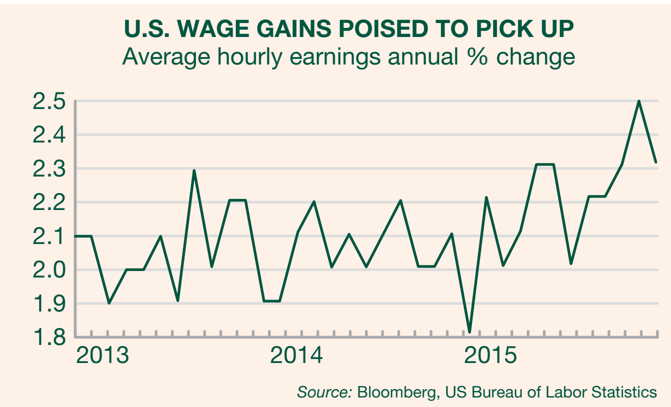
The drivers of growth of the last three decades are fading. Baby boomers are retiring, emerging markets are slowing, the debt super-cycle has run its course. Growth is instead swivelling back to the developed world and from manufacturing to the service sector, led by technological developments and innovation.

The baton passes

China has contributed a hefty 35% of global growth over the past five years, but a fixed investment boom has left the country with a mountain of debt and excess capacity, forcing a deceleration of growth. Imports are consequently falling, undermining the world economy.

The Renminbi's loose link to the strong dollar is hindering exports. Beijing has now switched the peg to a basket of currencies and allowed some deprecation to help restore competitiveness.

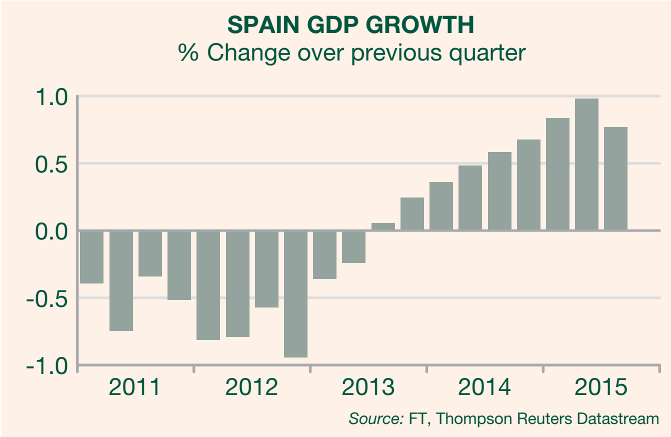
In contrast the Federal Reserve ("the Fed") finally has enough confidence in the U.S. economic recovery to raise interest rates, admittedly by only a token 0.25%, but the first hike in 9 years. This is on the back of rising consumer confidence, strong auto sales, robust online commerce and generally healthy housing demand. The lowest oil price since 2009 translated into a $115 billion windfall for US consumers last year. Unemployment has



halved since 2009 to 5%, deemed to be close to full employment, and wage gains are poised to accelerate.

Further interest rate rises are anticipated in 2016.

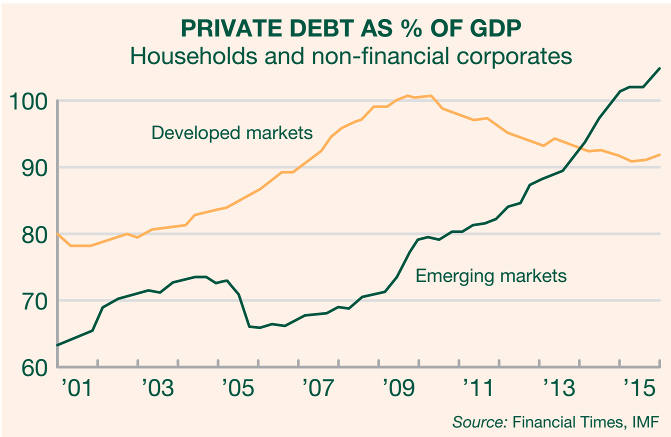
Europe is lagging the US, but trends are similarly constructive. A weak €uro is helping offset the impact on exporters of the slowdown in emerging markets and, unlike the US, the €urozone does not have an energy sector that is being crucified by the weak oil price. Europeans too, have been spending the windfall of lower petrol prices and business sentiment reached an all-time high in the fourth quarter of 2015.



The €uropean Central Bank decided in December that raising its bond purchase programme was not necessary.

The opiate of debt

Disappointingly the globe's debt binge continues, despite the near-death experience of the 2008 credit crisis. McKinsey estimate that the world took on a massive additional $57 trillion in new debt between 2007 and 2014, raising the global debt-to-GDP ratio by 17% to an historic high of



286%. Most of this was in emerging markets – of which a meaningful proportion is in US dollars, the repayment of which is now being pressured by the strength of the dollar.

This has taken place despite the fact that debt leverage has effectively stopped working. In the 1960s, each unit of new debt produced an almost equal amount of new wealth, but this has now fallen to close to zero – which explains why low interest rates and high government deficits have not returned growth to target.

To these figures should be added unfunded pension and entitlement liabilities in the US and Europe of over $50 trillion.

The upshot is an increase in instability and volatility.

Emergence of abundance

Perhaps slower Chinese growth as the country weans itself off wasteful investment is what the world needs? Falling commodity prices transfer income from producers to Western consumers, boosting household spending in the US, UK and €urozone.

Indeed, has the world transitioned from scarcity to accelerating abundance?

- Oil prices are at 11-year lows following huge investment and output increases over the last decade. Technological advances in renewable energy, efficiency and energy storage may prolong these low prices. This would be potent, for example making energy-intensive industries such as desalination more economically viable.

- Capital is abundant as a result of a global savings glut in a period of subdued capital expenditure. Distressed businesses are being kept alive: non-performing loans in America are at the lowest percentage to overall loans since 2007. Share buybacks and M&A are buoyant.

- Communication costs have plummeted by some 98% in 20 years, and there are now 4.9 billion connected devices. Data is plentiful and 'Big Data' is impacting most industries.

- Automation is broadening, augmenting working age populations. There are some skill shortages but labour is generally abundant.

- Manufacturing capacity has been enlarged by emerging market competitors, while marketplaces have expanded online, even reaching such sectors as taxis (Uber) and hotels (Airbnb).

So what is still scarce? Certainly growth appears increasingly elusive as abundance produces deflation, pressuring margins.

However, the world is most certainly not ex-growth. There is much to be excited about as technological developments disrupt transport, energy, healthcare.

New baby

Capitalism is giving birth to a progeny, the *Collaborative Consumer* in the sharing economy. It is a hybrid economy, part capitalist and part sharing. It is being spawned by the astonishing rise of the near–zero marginal cost phenomenon, in turn brought on by the digitalisation of everything. It started with the digitalisation of music: the ability to share music made owning CDs superfluous and reduced the marginal cost of owning music to close to zero.

Consumers turned producers ("prosumers"), sharing videos on YouTube, knowledge on Wikipedia, news on social media and even e-books, all at near-zero marginal cost. Six million students are now enrolled in Massive Open Online Courses (MOOCs), taught by some of the world's most distinguished professors – at near-zero marginal cost. The *Collaborative Consumer* brought the music industry to its knees, upended film and television, and forced universities to re-think their business model.

It was not anticipated that near-zero marginal cost would break the firewall between the virtual world and the bricks-&-mortar economy – but that is now happening.

A new super-Internet of Things is enabling businesses and prosumers to make and share renewable energy, even sell it into the national grid. In Germany over one million homes and small businesses are generating 27% of the country's power. Unlike fossil fuels, the sun collected on rooftops and the wind travelling up the sides of buildings are free. Electricity companies are now looking at changing their business models too…

Today's youth are using mobile communication technology to connect with drivers in car-sharing services. They prefer access to mobility over ownership of vehicles. In the United States, Zipcar gives over 500,000 members the chance to share cars. It is estimated that each car-share vehicle eliminates 15 personally owned cars. The disruptive impact on the transportation industry will in time be profound. Auto manufacturers will re-position themselves to manage mobility and logistics services.

Prosumers are also sharing homes, 3D-printed products, toys, games, sporting equipment at low or near-zero marginal cost. In New York alone, Airbnb's 416,000 guests who stayed in houses or apartments in 2012-13 resulted in one million lost room nights, a meaningful blow to the hotel industry.

The West country's 'Valley News' puts a slightly different perspective on the sharing economy. A taxpayer in Evesham sent his tax return to HMRC, responding to the question "Do you have anyone dependent on you?" with the answer: "2.1 million illegal immigrants, 1.1 million crackheads, 4.4 million unemployable Jeremy Kyle scroungers, 900,000 criminals in over 85 prisons, plus 650 idiots in Parliament and the whole of the European Commission". HMRC returned the form to the man, stating that his response was unacceptable. The man replied: "Who did I miss out?"

Deceptive statistics

The shift from ownership to access means people are sharing more items, so reducing the number of new products sold. This is hugely positive for the environment – but surely not for growth, already elusive in our indebted, ageing world?

Measuring real economic growth in a world where new products are constantly being introduced is difficult, particularly given the growing importance of intangibles – networking, communication, knowledge. Many services are free at delivery. On Facebook, 180 billion hours of communications, photographs, videos and market research (declared consumer preferences) are not accounted for in GDP figures. What would GDP growth rates look like if Facebook charged a nominal, say, $2 per hour? The information sector (defined by the US Bureau of Economic Analysis as software, publishing, film, sound, broadcasting, telecoms, data and information) has exploded in the last three decades – but still accounts for the same 5% of GDP that it did 30 years ago!

If the measurement of growth was corrected, the current preoccupation with slow growth, secular stagnation and poor productivity would surely fade.

Nominal interest rates are widely viewed as historically low because of the weakness of the global economy. Are we not rather in an era of structural, technology-driven deflation which demands great selectivity by investors but which might be viewed as benign?

Stars and feet

Transitions are rarely smooth and the tectonic shifts outlined above have understandably caused market volatility. This has been exacerbated by full valuations after six years of strong price rises.

At Veritas we do not forecast markets; few do it well consistently. Rather our approach to investing against this chequered background dovetails closely with Teddy Roosevelt's thinking in our front cover quote. In our quest for real returns for our clients on a rolling five year view, we "look to the stars" to identify global growth themes – and are excited by what we see. The wave of transformative innovation is self-reinforcing , spreading through economies and impacting corporate earnings, boosting margins at companies benefiting from innovation.

We have three high conviction themes at present:

- online life (the internet, mobile connectivity, social media, smart phone apps. Cash and cheques still account for a staggering 85% of consumer transactions by volume, 50% by value),
- demographic dynamics (young spending, ageing populations) and
- regulation (no explanation necessary…).

However, with the world in transition, it is more necessary than ever to keep one's "feet on the ground" in selecting companies for investment. Hence our continuing pre-occupation with established businesses run by proven management, financially sound with strong cash flows, a competitive moat and the tailwind of a growth theme – all at a sensible price.

A recent addition to portfolios where appropriate to the mandate is Taiwan Semiconductor Manufacturing Company (TSMC), the world's leading semiconductor foundry. TSMC is benefiting from the ongoing demand for smartphones and other connected devices, all of which require increasing energy efficiency and processing power. This is a structural and enduring shift which demands ever more complex semiconductor solutions.

Semiconductors is a scale industry and smaller design houses can remain competitive by using outsourcers such as TSMC to fabricate their design. The foundry market continues to outgrow the wider semiconductor market given the rising capital cost required to manufacture increasingly complex chips and the inability of most semiconductor companies to be able to support this capital cost to produce solely their own designs.

TSMC's long standing track record of technology leadership has resulted in a 65% market share in an industry where scale matters. Over the last decade the company has generated a return on equity of 24% p.a. and grown at 12% p.a. compound. This stellar performance arises out of several key competitive advantages built up in over 25 years of serving the industry, including scale, intellectual property and entrenched client relationships. Together these enable TSMC to generate robust earnings and free cash flows which it reinvests to maintain its technological edge. This creates a virtuous circle that results in remarkably steady margins and returns on invested capital.

Despite its strong cash flow growth, disciplined capital spending, 3%+ dividend yield and best-in-class management, the share has been trading well below our estimate of its intrinsic value due to issues that we believe are short term.

Given TSMC's growth drivers, quality and valuation, we view this as an attractive example of studying the stars while keeping our feet on the ground.

Meg Woods
8th January, 2016

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