Market Musings

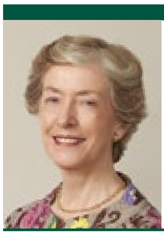
July 2016

> *I said to the man who stood at the Gate of the Year*
> *'Give me a light that I may tread safely into the unknown.'*
> *And he replied, 'Go out into the darkness, and put your*
> *hand into the hand of God*
> *That shall be to you better than light, and safer than a known way.'*

Foreword to *"The Servant Queen, A tribute For Her Majesty's 90th Birthday"*
Penned by Elizabeth R. quoting a poem by Minnie Haskins (1908)

Veritas
Investment Management

REAL RETURN INVESTING



Meg Woods
Partner and Investment Manager

On 4th July after a nearly five-year journey, NASA's solar-powered Juno spacecraft achieved orbit around Jupiter, "king of our solar system" according to NASA. Jupiter was the first of the solar system's planets, born 4.6 billion years ago, and is so massive (300 times the size of earth) that its formation influenced everything that followed, including the birth of our planet. By going below Jupiter's clouds, Juno aims to solve the mystery of Jupiter's core and so shed light on earth's origins.

Juno's venture into the unknown is typical of a number of other more terrestrial adventures at present. For example, did you realise that money is being created out of thin air?

Central banks around the globe embarked on "quantitative easing" (QE) post the credit crisis, buying trillions of dollars of bonds in their efforts to jump-start an over-indebted, ageing global economy. The reach of these programmes however goes much further. For example, the Swiss National Bank (SNB) in its regulatory return discloses that in its $54 billion portfolio it owns shares in 2,600 American companies, including 14.5 million shares in Apple, 11.6 million in Exxon Mobil and 4.5 million in WalMart.

This is how it works. The gnomes at SNB, the Swiss central bank, in an attempt to keep their exchange rate down, make a book-keeping entry with a keyboard click which creates Swiss Francs to sell for €uros. With the €uros, they buy US dollars – which they invest in US Treasuries and equities. As *Grant's Observer* adroitly explains it: "the SNB is buying equity interests in real companies with money it whistles into being."

In Japan, the Bank of Japan is now a top 10 shareholder in 90% of the Nikkei 225 Stock Average. It owns one-third of outstanding Japanese government bonds (JGBs); if they continue at this pace, the JGB market could disappear early in the next decade!

The ripple effects on markets and incomes of these experimental policies are spreading. On the positive side, the gnomes are lifting equity and bond markets. On the negative side, insurance companies and pension funds are struggling to match long term liabilities with ever-decreasing fixed income yields; deficits are widening. In Germany, BaFin, the financial services watchdog, has warned that pension schemes might soon be forced to cut retirees' benefits.

As a result of central bank action around the globe, almost $12 *trillion* of sovereign debt is priced on negative yields. The €uropean Central Bank (€CB) has added corporate bonds to its shopping list, and already $36 billion of corporate debt is also on negative yields. With an average negative yield of -0.24%, investors are *paying* governments and companies $29 billion annually to own their bonds. Just 5 years ago, the average yield on these bonds was +1.23% and investors were *receiving* income of $148 billion p.a.

Thus instead of boosting incomes, central banks are shrinking them.

Little wonder then, that GDP growth in the developed world remains muted – further challenged by the internet's 'Amazonification' of the retail market, the drag on wages of the proliferation of robots, the increase in life expectancy as a result of rising standards of living and medical advances. The expenditure and debt to GDP ratios of many governments are rising rapidly because they are paying the increasing costs of socialised medicine and pensions of ageing populations out of current income.

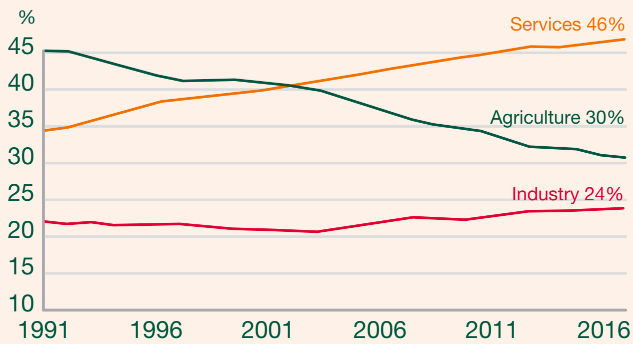
As per our front cover quote, policymakers are treading into the unknown.

Swing to services

Central bankers also appear not to be paying adequate attention to the increasing importance of the service sector in the composition of GDP growth.

Over the past quarter of a century, 75% of the one billion jobs created globally have been in services. The services sector has consequently risen from 34% of the global economy in 1991 to 46% in 2016, from 60% of developed economies to 75% now.

SERVICES SHARE OF GLOBAL EMPLOYMENT



Source: ILO, Macquarie Research

This has been predominantly at the expense of agriculture, where more efficient farming practices have enabled greater crop output with fewer labourers.

Indeed, services will increasingly drive the global outlook on the back of three structural trends.

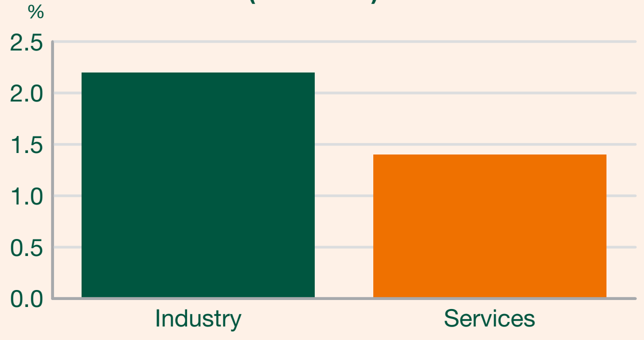
- As incomes rise, a higher proportion of consumption goes to services. This will particularly play out in emerging economies as they expand. In China for example, there is exponential growth in tourism, restaurants and entertainment.
- A rising percentage of the world's population will be over 65 in coming decades. Older generations have the physical assets they need – homes, furnishings – and instead consume more services – leisure activities, healthcare.
- Because of the higher labour content, inflation in the services sector has been greater than in manufacturing. Simple mathematics therefore points to a rising share of GDP.

Significantly, services output is much less volatile than industrial output because services consumption is more stable: it is easier to postpone the purchase of a car or washing machine than a doctor's appointment or haircut. Services tend to be continuous – utilities, gym membership – therefore less vulnerable to being cut in a downturn. Services are less exposed to inventory cycles: goods can be stockpiled and inventories rise and fall, but services are provided on a real time basis and not stored. Inventory cycles magnify upturns and downturns.

As services rise in relative importance, business cycles and employment will be less cyclical and support longer expansions. This has implications for monetary policy.

The downside is a drain on developed world productivity because output per employee is significantly higher – and growing faster – in manufacturing than in services.

ANNUAL GROWTH RATE IN U.S. PRODUCTIVITY (1995-2015)



Source: BEA, BLS, Macquarie Research

Investors should note that service economies centre on knowledge-based industries and investment will therefore increasingly be directed towards information technology, research & development and intellectual property rather than factories and machinery. Software spending is forecast by the International Data Corporation to rise by a robust 6.7% p.a. over the next five years.

Policy makers' soul-searching over the sluggish recovery in capital investment and productivity post the credit crisis would seem to overlook these significant secular shifts, as are investors fretting that the US recovery in its seventh year is geriatric.

Resilient recovery

Despite the headwinds to growth imposed by central bankers, the world economy is exhibiting resilience, as evidenced by the uptick in the Global Leading Indicators Index.

In the United States, house prices are almost back to pre-crisis levels and consumer spending growth has bounced sharply from a disappointing first quarter. In the €uro area, the Purchasing Manager Index is firmly in expansionary territory. Across the Pacific, concerns over China have receded and

GLOBAL LENDING INDICATORS INDEX

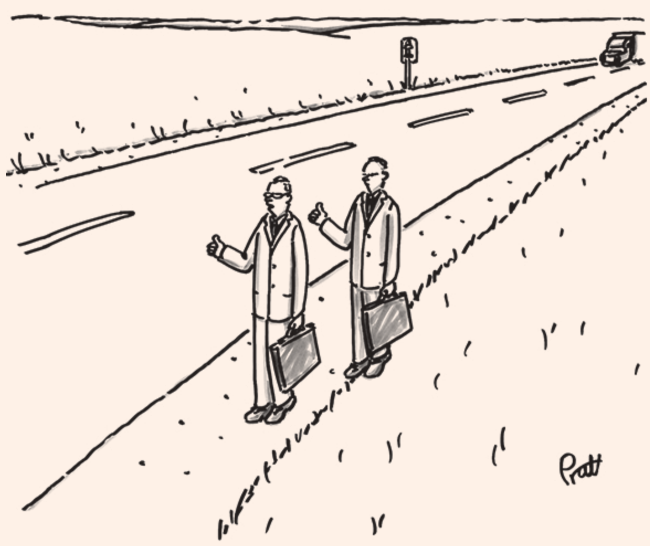
Source: IMF, Goldman Sachs Research

growth of 6.5% is forecast for 2016. Japan however, is struggling with the persistent strength of the ¥en and Mrs Watanabe's refusal to loosen her purse strings despite negative interest rates. And the UK is stepping into the unknown with a messy €uropean divorce.

Accelerating innovation

The challenges to investors posed by prolonged monetary policy experimentation, on top of an ageing, indebted global economy, will induce market volatility.

At Veritas however, in our quest for real returns for our clients, ahead of inflation, we try like Juno to look behind the clouds to focus on long term wealth creation by companies. We continue to marvel at accelerating innovation in technology, producing exciting progress in transportation, energy and healthcare.



"Well, the good news is, the self-driving car is already at the meeting."

Source: Harvard Business Review

These tectonic shifts and secular growth trends form the basis of the global themes which we use to narrow the investable universe.

Our current three high conviction themes – which are consistent with the increasing importance of services to GDP growth – are:

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

Within these themes, we ferret out established businesses run by proven management, financially sound companies with strong cash flows, a moat against competitors, all at a sensible price. We note that our approach of investing in global quality has stood our clients in good stead during recent market ructions.

However, even structural growth needs to be approached with open eyes, watchful of pitfalls. One such cautionary note is developing in healthcare, despite the powerful demographic growth drivers of ageing populations and rising emerging market incomes. The sector is challenged by escalating costs on the one hand, with patient numbers rising steadily as populations age, versus on the other hand budgets pressured by fiscal deficits.

Ikigai

Japan is 25 years ahead of other developed nations in contending with ageing populations. Some 25% of the Japanese population are over 65 years old and have the highest life expectancy of any large country in the world. How have they coped? The answer is: remarkably well! They work longer, stay healthier, care for their elderly better – and have found ways to pay for it.

In Japan, as in China, older people command a respect born of Confucian tradition, in contrast to Western societies where they tend to be marginalised. Japan has the highest provision of day centres for the elderly in the world; municipal parks have replaced swings and roundabouts with equipment aimed at elderly fitness. They focus on how robots can help take care of the elderly.

The Japanese quit work several years later than the OECD average. In Japan 4G refers not just to mobile bandwidth but also to multi-generational working – four generations in one workplace. Those who are forced to retire earlier often go on to second careers, even if menial and less well-paid. Masaya Shin, a retired headmaster, practices and teaches kendo, a martial art sparring with bamboo swords, with the motto: ‘Let’s do kendo until we are 100’. He’d like to study Meiji history – ‘but there’s so little time’. For him, the secret of long life is *ikigai*, a reason to live.

The cost of care for the elderly is greatly helped by lifestyle: most Japanese eat a healthy, fish-based diet and consume less processed food and sugary drinks than Westerners. Obesity is far less prevalent, as is drug abuse. People don’t just live longer, they stay healthier.

The upshot is that spending on healthcare per capita in Japan is amongst the lowest in advanced nations despite the demographic headwind: total expenditure on healthcare in the US is 17% of GDP, in Japan it is 10%. Japan does not have the pressure on healthcare budgets that Western nations do.

Optimising care

In Western countries therefore, investors need to screen for companies that can advance higher quality care while improving efficiency and cost control.

One such company in which we have been invested for some years which has stood clients in excellent stead and which we still hold is UnitedHealth. The group has two business platforms, health insurance to employers in both public and private sectors, and health services via its subsidiary, Optum.

Optum’s major asset is a massive medical data bank, comprising the medical health and claims records of 200 million lives. Using innovative analytics, Optum arms physicians with information about each patient’s history, as well as tools to use the medical data to improve diagnosis and treatment, insights into the progression of diseases and forums for the collaboration of research.

Arming the physician with information and insight is the single most important influence on how care is delivered, its outcome and what it will cost the system and consumers. Optum also helps identify patients that meet the criteria for clinical trials, historically a time consuming and expensive process.

The company offers its products on a risk basis, assuming responsibility for health care costs in exchange for a monthly premium per individual served. Optum thereby enables care providers to transition from traditional fee-for-service core delivery to performance-based delivery. It also engages customers in managing their health, including guidance and programmes to help them maintain healthy lifestyles.

Thus Optum’s focus is on modernising the health system, helping drive higher quality, improving employer efficiencies and performance, so reducing costs. UnitedHealth very much meets the Veritas investment criteria.

This requirement to drive efficiency in healthcare provision is a theme with many years to run and Gemma Paramor has joined the Veritas Investment Management team to deepen our experience in the sector. Gemma studied Biological Sciences at Oxford and was a healthcare analyst for over a decade before moving to Veritas.

Meg Woods
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