Investment Insight

WORLD STARS FIVE YEAR INVESTMENT REVIEW AND OPPORTUNITIES FOR 2018

Our World Stars global equity portfolio turned five years old on 1 October. As we close this turbulent and yet profitable year and look forward to the next, we want to reflect on the investment performance of the World Stars – what worked and what did not – and offer our outlook for 2018 and beyond.

Our goal for our equity portfolios is to preserve and increase the value of family, trust and charity assets by generating returns of 8-10% per year or more over the long-term by investing in great global companies that offer both quality and value. Quality for us is the strength of a company's business, the potential and structure of its markets, its competitive advantage, its ability to grow profitability over many years, its management and its balance sheet. Value is the ability to buy that company at a price that allows us to achieve our goal. After all, compounding means that 8-10% per year results in a 50-60% increase in value over five years and 115-160% over ten.

The value of long-term investing

Our regular readers know that we are adherents of Philip Fisher and his "Common Stocks and Uncommon Profits." Written in 1958, it is a masterpiece of simplicity and common sense.

On the power of quality and growth, Fisher writes:

> Finding the really outstanding companies and staying with them through all the fluctuations of a gyrating market proved far more profitable to far more people than did the more colourful practice of trying to buy them cheap and sell them dear.

On the power of holding on to great companies for as long as they have value:

> [A]s … a stock rises to, say, 50 or 60 or 70, the urge to sell and take a profit now that the stock is "high" becomes irresistible to many people. Giving in to this urge can be very costly.

And, of great relevance to us today, on the dangers of trying to time the markets and the fear of volatility:

> [The reason given most frequently for not buying] is the conviction that a general stock market decline of some proportion is somewhere in the offing. [P]ostponing an attractive purchase because of fear of what the general market might do will, over the years, prove very costly.

We have come to espouse these precepts through experience and through learning. They are the basis on which the Stern family has invested its financial wealth over the decades and on which we carry on this legacy for the family and for our other clients.

World Stars portfolio performance and its drivers

Over the five years since its inception, our World Stars portfolio rose 64% in cumulative terms, equating to 10.4% p.a. in US dollars and net of our standard fees It has continued to perform well since then and was up 72% in cumulative terms and 11.1% p.a. at the end of last month.

At the five-year mark, the portfolio comprised 22 positions that fulfil our requirements for quality and value. As the charts below show, while all of them were listed in the US or in Europe, benefitting from developed market corporate governance and established markets,

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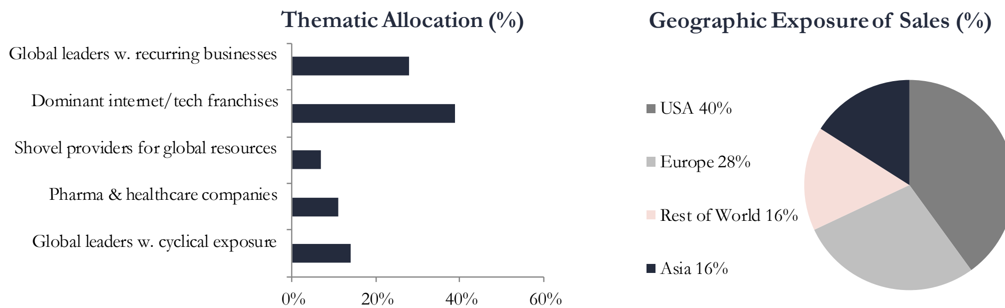
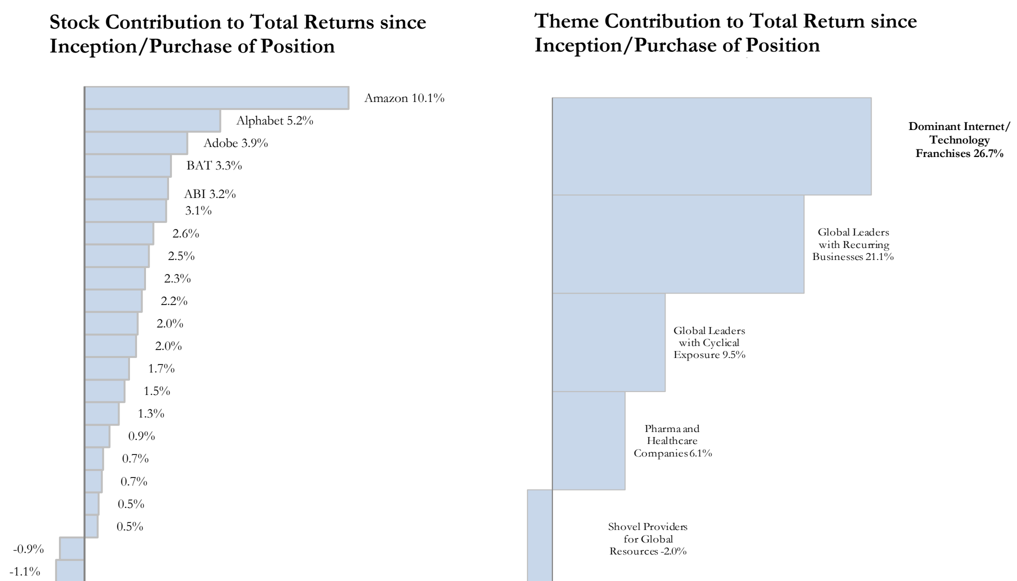
their businesses are global in reach. We classify companies into thematic groups that describe their drivers of their underlying businesses and competitive positions.

In part because of their strong performance, dominant internet and technology franchises that are driving digital transformation (including Amazon, Alphabet and Adobe) accounted for approximately 40% of the portfolio, while global leaders with recurring businesses (including Nestlé and Anheuser Busch) accounted for 30%.



It is striking that the contribution of the two largest thematic groups over the past five years has been broadly balanced. Internet and technology companies contributed 26.7% while consumer companies contributed 21.1%. Amazon, Alphabet and Adobe have been the top individual performers. Internet and technology companies continued to perform strongly and contributed over half the returns this year. They still have tremendous growth and earnings capacity and represent great value despite their significant outperformance. Their inclusion in Stern family portfolios is perhaps our greatest contribution to adapting the family's historic approach to the opportunities and challenges of our time.

Global leaders with recurring businesses like BAT and Anheuser Busch have also done well. Their share price performance has been more muted recently due primarily to the slowdown in consumer spending in the US, Europe and major emerging markets like China, India and Brazil due to different issues. However, their underlying businesses have continued to grow and we expect them to do better with improvements in many of their core markets.



Equally striking is the lesser but still positive contribution from the healthcare and industrial and resource-related companies that have been out of market favour and the slight negative contribution by resource-related companies. Pharma and healthcare companies have recurring revenues driven by growing demand for better health care across the world and increasing incomes to pay for it, as well as by the R&D and innovation of the companies themselves. Global leaders with cyclical businesses have similar business strengths as those with recurring businesses but are subject to cyclical pressures which have started to improve, warranting our holding, but which we expect to turn around more significantly in the next several years. Finally, the shovel providers to global resource demand are equipment and service providers to the oil and mining industry that have been impacted by the reduction in investment and the decline in oil prices since 2014, but have strengthened their businesses through cost cutting and through acquisitions.

Although we believe in concentrated portfolios in which each stock is expected to contribute to performance, the analysis highlights the importance of having a reasonable diversification across industries and other factors. As we comment below we think this will hold us in good stead in the year to come.

Political risk is still significant but economic growth is good and getting stronger

Our overall assessment has not changed. The outlook for our investments remains supported by a healthy global economy. In the US, the economy continues to grow driven by a robust labour market, healthy levels of consumer spending and the ongoing pick up in industrial activity. Progress by Congress in pushing through tax reform with a lower corporate rate and incentives to repatriate cash held overseas has the potential to further support investment levels going forward. And though the Federal Reserve will tighten interest rates, its new upcoming leadership remains committed to doing so in a measured, data driven way that reflects the underlying economic growth environment. In Europe, we are continuing to see improved momentum, led by Germany and a reform powered France. In emerging markets, China maintains a broadly healthy economic pace, India is progressively emerging from the effects of demonetisation and commodity related economies are stabilising.

The main risks remain geopolitical, with ongoing provocations by North Korea and a fluid political climate in the US. In Germany talks to form a coalition government collapsed when the liberal FDP party withdrew from negotiations, though we still believe that continuity with a broad coalition government is the most likely outcome. Catalonia in Spain seems to be settling to a quieter status quo, but the underlining currents of division remain at the forefront of European politics and beyond. Reforms in Saudi Arabia are encouraging but we remain aware of the kingdom's delicate ruling balance dynamics and indeed of the fragile broader regional forces.

We would like to discuss two particular issues that we should consider in terms of their impact our portfolios. The first is US tax reform, recently passed and signed by President Trump, will deliver a short-term bump to corporate earnings in the US and a series of anticipated and frankly unanticipated consequences for companies that export or have significant operations or cash holdings outside the US. Our experience is that they have

limited impact over anything but the short-term because companies are much more driven by their businesses and not by one-off step changes to their reported earnings and/or even to their actual cash flows. This was true for changes in reporting for stock based compensation over the past couple of years and it is likely to be true for the long-term impact of the current tax reform.

The other issue is the potential impact of government and regulation on big data, artificial intelligence and blockchain. Governments, central banks and regulators are only at the very beginning of understanding the impacts each of these will have and how to address them. Regardless of the impact blockchain technology will have on many aspects of financial services and other areas, the stunning increases in prices that cryptocurrencies have achieved this past years are having a profound impact on investor psychology. A sudden loss of confidence, whether through deliberate or inadvertent actions by industry participants, disruption of the trading and custody infrastructure (as in the bankruptcy of major exchanges) or government intervention, could lead to a broader sell off in technology that could be sharp and sudden not because of concerns about how the companies themselves may be affected but by investors selling their positions and reinforcing their concerns.

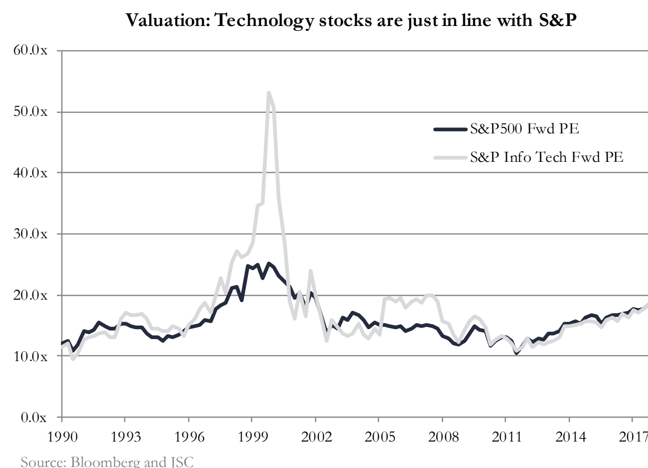
Company fundamentals are also good and getting better

Going back to Fisher and to the lessons from the last five years, we have great conviction in how our companies and their shares will perform over the long-term.

Politics have the potential to disrupt markets but have not quite succeeded yet given the strength of the underlying economies, our companies and their businesses.

Fundamentally we think that most if not all the stocks in our portfolios have the prospect of doing well next year. Whether it is consumer related businesses benefitting from strengthening economies in the US, Europe, China, India or Brazil in addition to their usual growth from population growth, innovation and pricing power, technology companies expanding their franchises through innovation, penetration and disruption, healthcare businesses returning to growth from improving their pipelines or products or industrial and resource industry suppliers enjoying greater industrial investment from maintenance, replacement and improvement of capital equipment, they should all be able to grow their sales, earnings and cash flows.

As the chart shows, despite their performance the valuations of tech stocks in the S&P are nowhere near the levels they were at during the "internet bubble" of the late 1990s. They are broadly in line with the wider market despite their higher growth and visibility. It should moderate any talk of non-existent tech bubbles bursting and should mean that any "underperformance" due to sector rotation by large benchmarked institutional investors, amplified by trend-following managed futures funds, should be limited and would constitute a further absolute and relative buying



Source: Bloomberg and JSC

opportunity.

Quite how they will do next year is another issue. George Soros calls it "reflexivity" and has charts to show how to find the highs and lows: Markets move in part because of how investors look to position themselves in order to relatively outperform one another and beat their benchmarks over a coming quarter or a year. Fisher calls it "the colourful practise" of trying to buy cheap and sell dear.

In practise this means that there can be significant sector rotation that impacts stocks in the short-term. This is what happened to the consumer and industrial stocks in our World Stars portfolio at different times over the past five years and it could mean that our internet and technology stocks do less well than other stocks that are in parts of the market that have been out of favour, in particular financials and industrials.

We are happy about the current composition of the World Stars portfolio. Its significant positions in consumer and technology businesses should continue to do well even if they will not "outperform" and its still reasonable positions in industrials and resource suppliers should do better. We have made a limited number of significant changes to the portfolio over the past years year and have identified stocks that we may change through next year depending on their performance and valuation.

As the World Stars portfolio shows, by sticking to what we know and drawing conclusions from our contact with the companies we invest in, their customers and suppliers, as opposed to market strategists and other top down sources, we have been broadly right about our companies and our portfolios over the past five years, even if some of them have taken longer to perform and others have yet to shine.

We have every reason to believe that we will be right over the long-term as well, and may even be right about next year if the positive global economic environment is not unduly impacted by geopolitical events and if institutional and private investors realise that equities, and in particular shares of the companies we own (or very similar ones) are among the only assets they can buy to generate returns that will allow them to preserve and increase their wealth over time.

Christopher Rossbach
December 2017

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