JM FINN

Global investing: a stock picker's perspective

INTRODUCTION

The unprecedented pace of change that is taking place today across the world, thanks in part to huge leaps in technology, can make investing seem a daunting task to the uninitiated.

With many of the world's leading companies listed overseas, access to their share register can be difficult, keeping tabs on them can be time consuming and understanding the effects of foreign exchange on the share price can be confusing.

At JM Finn we invest clients' assets by selecting those companies and funds that have an anticipated return profile that best meets the clients' investment objectives, in the eyes of their investment managers.

These investment decisions are made with the help of our research team, third party analysis and an open and discursive investment approach across the firm. This process empowers our investment managers to make decisive and committed investment decisions.

A core aspect of the firm's investment approach is bottom-up stock picking; that is to say an approach that looks to invest in companies that will be future winners, as opposed to a top-down investor, where you might select the region you want to invest in and then choose the companies. In today's connected and fast changing world, finding the winners needs a wider lens beyond an investor's domestic market. Rather than looking to access global growth via the UK stock market alone, a stock picker has a much larger universe of potential winners if the net is cast across the globe.

In this report we have brought together the thoughts of a variety of authors, both internal and external, that corroborate the view that to take advantage of the structural change taking place across the world, a global standpoint is required.

Although many private investors are unable to buy Chinese-listed equities, that does not mean they should ignore them if they might be the future global leaders. By using a wealth manager with a platform for access to global investments, investors can open themselves up to more opportunity, not forgetting of course, that investing doesn't always mean making money, as stock markets fluctuate; whether you invest in the UK or China, Japan or the US, you may end up with less money than you started with. However, whatever outcome you are seeking from your investments, having a well diversified portfolio across a range of asset classes and geographies is a sensible starting point. ■

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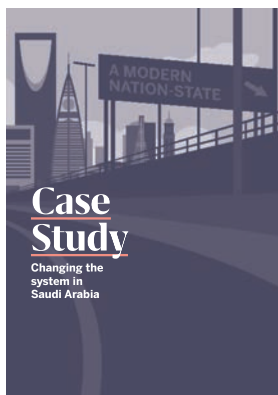

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Hard Darwin

Author
John Royden
Head of Research, JM Finn

HALF OF THE S&P 500 FIRMS WILL BE REPLACED OVER THE NEXT TEN YEARS.

Contrary to popular belief, Darwin did not explicitly say that "it is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is most adaptable to change"; rather, it is an oft-quoted summary of his most famous work. Whilst the idea did grow from the Origin of Species, we can also see the need for adaptability in the cut throat world of corporations and the rate at which they "die" or fade into obscurity. Going bust (usually too much debt), losing market share, being split up by anti-trust legislation and being bought are the most common corporate afflictions.

The rate of corporate turnover is increasing. In 1965 companies stayed in the S&P500 for an average of 33 years. By 1990, it was 20 years, and by 2012 down to 18 years. It looks as if it is heading to 14 years by 2026. That means that at the current churn rate, about half of the S&P 500 firms will be replaced over the next ten years as we enter a stretch of accelerating change in which lifespans of big companies are getting shorter than ever[1].

Why, we ask ourselves? Schumpeterian creative destruction[2] is about the idea that market disruption is being driven by the endless pursuit of sales and profits that can only come from serving customers with low prices, high quality products and services, and great customer service. We now live in more

LIFE CYCLE

complex, faster-moving times where the impacts of globalisation, shifts in technology, the challenges of regulatory compliance and shifts in customer demand are all exacerbated by the speed of information delivery across the internet.

You can see this at the top of the league tables of global stocks, or indices, as well as at the bottom. Looking at MSCI's All Country World Index or ACWI we can see that just five years ago Financials, 20% of the market capitalisation, was just larger than Information Technology (19%). Since then Information Technology has gained a further 13% at the cost of Consumer Staples (-4%), Energy (-6.4%) and Financials (-4%)[3].

Back in 2013, Apple, Exxon, General Electric, Chevron, Nestle, IBM, Microsoft, Procter & Gamble, Johnson & Johnson were the top ten global companies by market capitalisation. Of the top 100 companies, the US dominated with 61% of market capitalisation followed by the UK with 12%. China only accounted for 1%[4].

Fast forward to 2018 and the top ten list runs as follows: Apple, Microsoft, Amazon, Facebook, JP Morgan Chase, Johnson & Johnson, Alphabet (was Google), Tencent, Exxon and Bank of America.

China has now grown to represent 4% (from 1%) of the market capitalisation to the detriment of the

IN NUMBERS

THE RATE OF CORPORATE TURNOVER IS INCREASING

1965

33

1990

20

2012

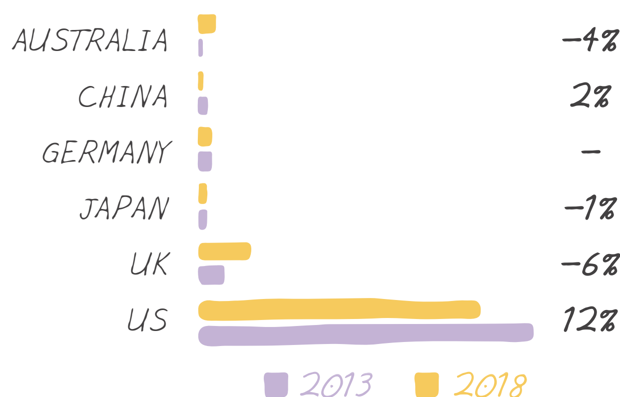
18

2026

14

NUMBER OF YEARS, ON AVERAGE, COMPANIES STAYED IN THE S&P500

Fig. 1. Geographical representation of the MSCI All Country World Index[5]



UK which has seen its share half to 6%. The big surprise though has been to see the share of US companies grow from 61% in 2013 to 73% today. We can attribute that statistic to the growth of the US's technology companies, but did we realise the huge size of the impact?

Casting back further into history, the top ten in 1967 included names like Eastman Kodak, Standard Oil and Polaroid. Run back a century and your list included the now mostly unknowns like US Steel, Bethlehem Steel, Armour, Swift & Co, International Harvester, Midvale Steel and US Rubber. AT&T would probably be the only company that most of us would recognise today.

So where is all this taking us? As the rate of attrition speeds up it would not be beyond one's imagination to think that anti-oligopolistic legislation could account for a cull of the banks out of the top ten. Will that also work for the technology companies to the point where perhaps three of the current six fade to oblivion? Or will it be new companies displacing the old with little more than a download click on a slightly better app?

Whatever happens, you can rest assured that we will be looking for it as we scour the world for investment opportunity and reward, whilst at the same time keeping an eye on those showing the first signs of fatigue, product obsolescence or adverse regulatory change. ■

The Global Economy: the driving forces

FB
AMZN
AAPL
NFLX
GOOG

Author
Neil MacKinnon
Global macro strategist,
VTB Capital in London

China is the biggest foreign official holder of US Treasuries.

Volatility is back on the agenda

The view from the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD) and other forecasting bodies (not always noted for their forecasting accuracy!) is that the global economy is enjoying a broad-based synchronized recovery that can at least extend into next year. Even the Eurozone is catching up after a long period of low growth and high unemployment while the US economy is expected to derive a short-term boost from President Trump's tax cuts and increases in spending, though this seems to be at the expense of prospective trillion-dollar budget deficits and a gross federal debt-GDP ratio that rises to above 100%. America's "twin deficits" and America's reliance on foreign funding, especially from China which is the biggest foreign official holder of US Treasuries[6], is perhaps a reason why the US dollar has been languishing over the last year or so.

The IMF note that Emerging Market Asia will account for half of this year's global growth. China is included in this category though economic growth here is on a longer-run trajectory of declining growth reflecting adverse demographics, a necessary de-leveraging of China's widely-documented credit binge as well as the fall-out from making the transition from an investment-led economy. Japan is recovering but its growth rate is fairly anaemic and the economy is still finding it difficult to move decisively away from a deflationary mind-

set despite, or maybe because of, a long period of radical monetary policies.

It is instructive that a long period of “unconventional” monetary policies has only yet provided a growth impetus, although there are many commentators critical of such policies, described as “Bubble Finance,” in actually creating financial asset price problems and distortions to saving and investment. After the February 2018 sell off in equity markets, at a time of historic extremes in US equity valuations, an increase in volatility may be back on the agenda.

Perhaps the changing political landscape and voter rejection of fiscal austerity and “establishment” thinking paves the way for much looser fiscal policies in the medium term, though record levels of global debt are a constraint and in many cases there is excess leverage. In the Eurozone, the fiscal stance remains the tightest of any of the major economies. Higher inflation is the traditional route used by policymakers in reducing debt accordingly; inflation is creeping up but structural factors such as technological change and the “Amazon effect” in addition to low productivity might keep inflation in check. A return of the commodity super-cycle seems unlikely as the Chinese boom fades and technological change in the energy sector caps oil prices.

For the major economies generally, the decade-long experiment in QE (Quantitative Easing) and zero/negative interest rates is coming to an end. The Fed

SNAPSHOT

THE MOST CROWDED TRADE

#1

A LONG POSITION IN FAANG STOCKS

facebook

amazon

NETFLIX

Alphabet

#2

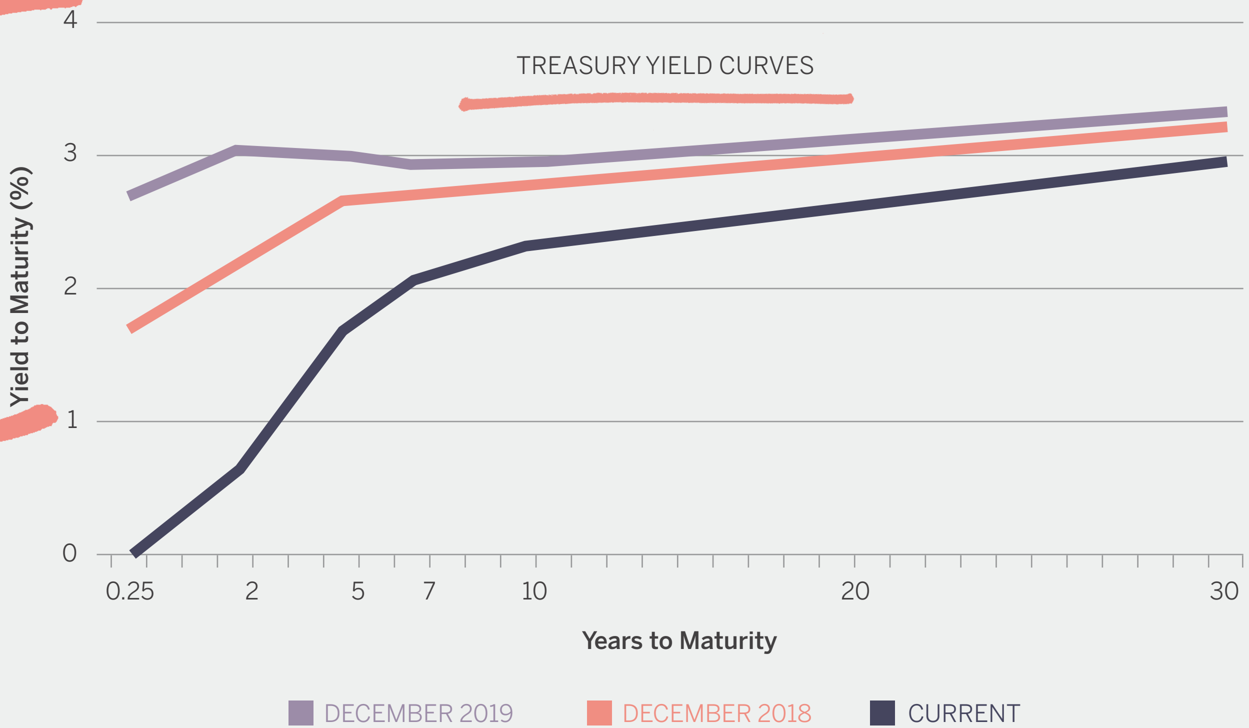
SHORT POSITIONS IN THE US DOLLAR

2ND

Bank stocks are at the 2nd highest over-weight position in the survey’s history

The US Yield Curve

Fig. 2. The US Yield Curve[7]



It is the prospect of a global trade war that is weighing on equity markets

has already started to unwind its US$4.5 trillion balance sheet that mainly consists of its purchases of US debt and by October 2018, the liquidity withdrawal will amount to an annualised US$600 billion. The new-look Fed under Jerome Powell seems to have a more hawkish tilt and three 0.25% rate hikes are already discounted but a fourth hike, in conjunction with the aforementioned liquidity withdrawal, might be a step too far.

The flattening in the US yield curve, a traditional indicator of a US recession, is suggesting that the markets are perhaps becoming more worried about growth risks rather than inflation risks. Economists who believe that money supply growth determines nominal GDP growth (a view that is absent at most central banks) note that currently global money supply growth is at its lowest since November 2007, thus presaging at some point later in 2018 slower economic growth and subdued inflation.

More recently, it is the prospect of a global trade war resulting from a more protectionist US trade policy that is weighing on equity markets. The latest annual Bank of America Merrill Lynch (BoAML) Fund Manager Survey cited a global trade war as the main "tail risk" followed by "stagflation" as global growth expectations for respondents in the survey was at its lowest since July 2016; and more importantly inflation expectations are at their highest since June 2004. Retaliatory action from the EU and China against the imposition of US tariffs on steel and aluminium imports and threats against EU car imports, as well as a US$60 billion surcharge on a range of Chinese products, endanger the consensus view of continuing expansion in the global economy.

As far as the UK economy is concerned, the range of economic calamities envisaged by Project Fear propagandists on the back of the Brexit referendum vote, such as recession and higher unemployment, failed to materialize. I suppose they continue to live in hope; not that Brexit abolishes the business cycle. Brexit is about taking control as an independent sovereign state over laws, regulations and our borders with the freedom to negotiate our own trade deals and take advantage of prospects in the global economy. We are not the only ones to think this, as the results of the recent Italian elections made clear.

Whether the transitional deal with the EU actually delivers a proper Brexit or a "vassal state" I will leave to readers' discretion. In the meantime, an interesting result from the BoAML Fund Manager Survey is an all-time low in exposure to UK equities suggesting a "buy" for contrarian investors. The most crowded trade is a long position in FAANG stocks followed by short positions in the US dollar. Bank stocks are at the 2nd highest over-weight position in the survey's history. Interesting times ahead! ■

Emerging Markets: still a relevant catch all asset class?

Author
Cherry Reynard
Five-time winner of the AIC freelance journalist of the year award (2011, 2012, 2013, 2014, 2015) and six-time winner of the IMA freelance journalist of the year award (2008, 2009, 2010, 2011, 2013, 2016), Cherry has co-authored a book – Investing in Emerging Markets; the BRIC economies and beyond, published in 2010.

How helpful is the term 'emerging markets'? In theory, it suggests that countries have certain common and recognisable characteristics, but the emerging markets universe today is far more diverse than this catch-all would suggest.

While the short-hand has been to see all emerging markets as cyclical, commodity-dependent and dollar-sensitive, that is not the reality for many developing countries. The 'emerging markets' classification incorporates countries at vastly different stages of economic development. South Korea remains on the cusp of being considered a developed market, while Pakistan has only just lost its 'frontier' tag.

There are clear differences in how these countries generate wealth. Russia remains largely dependent on natural resources to fuel its economic growth, while China has become a hotbed for innovative consumer technology as it moves away from its historic dependence on manufacturing.

Emerging market countries have varying exposure to hard currency, which in turn determines their vulnerability to changes in developed market monetary policy. For example, Turkey, Argentina and Peru have almost half of their outstanding bonds denominated in foreign currency. This may be positive or negative at different times, but it gives the country a different profile to, say, India, which has less than 5%[8].

At the same time, countries that are reliant on foreign inflows to support their debt are also exposed to international sentiment. Companies with a strong domestic market for their government debt, with well-established pension funds and insurance sectors, are likely to find ready buyers, whereas those who depend on the favours of foreign buyers are dependent on global conditions.

They also vary in the extent to which they are exposed to the US. Mexico, for example, should be a natural beneficiary of the US fiscal stimulus, for example, though there remain uncertainties around the North American Free Trade Agreement (NAFTA) deal. That might also spread to other parts of Latin America. However, its effect is unlikely to be felt to any great degree in Eastern Europe or in parts of Asia.

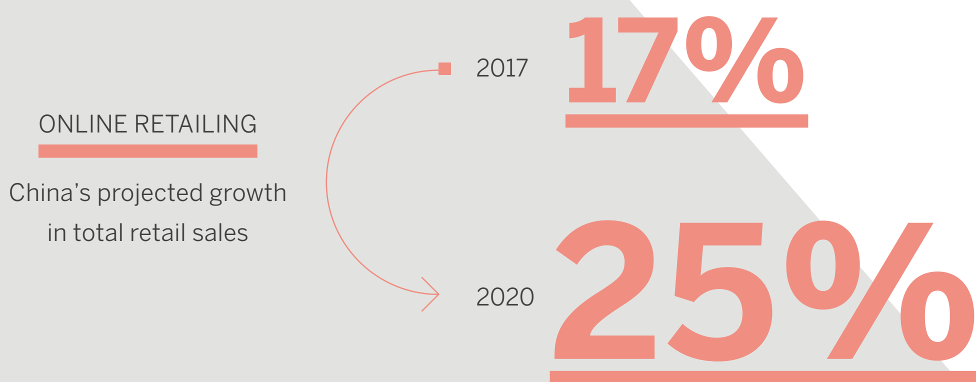
It also extends to the adoption of technology. At over $1trillion, China is now the largest ecommerce market in the world. Online retailing in China is expected to grow from 17% of total retail sales in 2017 to 25% in 2020[9]. 52% of Chinese consumers shop on their mobile on a daily or weekly basis. This outpaces the 46% that shop in-store[10].

THE ADOPTION OF TECHNOLOGY

China

+$1trillion

The largest ecommerce market in the world



CONSUMER SHOPPING

Countries that are reliant on foreign inflows to support their debt are also exposed to international sentiment

A similar pattern is emerging in India. The Indian e-commerce market is expected to grow to US$200 billion by 2026 from US$38.5 billion last year and cross US$ 50 billion this year. India has widespread internet and smartphone penetration, which creates an easy path for the spread of ecommerce[11]. While Russia's ecommerce market is growing fast, it remains a minnow at around $8.8bn[12]. Brazil's ecommerce market is larger, but still in the early stages of development.

This creates different opportunities. The MSCI China now has 41.5% in technology, notably in its two flagship internet companies, TenCent and Alibaba (18.5% and 12.6% respectively). Materials are just 4% and energy is just 2.6% of the index. In contrast, the MSCI Brazil has 37% of its market capitalisation in financials, and six of its top ten holdings. Materials and energy also feature heavily, with a lowly 2.1% in technology and 1.7% in healthcare.

Russia perhaps conforms best to the traditional idea of a commodity driven emerging market. Its economy is still largely reliant on oil and other natural resources. Energy is 48.5% of the MSCI Russia index. There are no technology companies large enough to find a place in the index and its consumer sector is nascent – just 3.6% of the index[13].

For 2017, this meant that although the aggregate performance of emerging markets looked strong, it masked huge disparity in the performance of individual companies. Just looking at some of the largest companies, Alibaba's share price doubled over the year, while that of Russia Oil giant Gazprom – the largest company in the Russian index - dropped 16%. Brazilian brewing giant Ambev rose 35% over the year (source, FT, 12 months to 31 December).

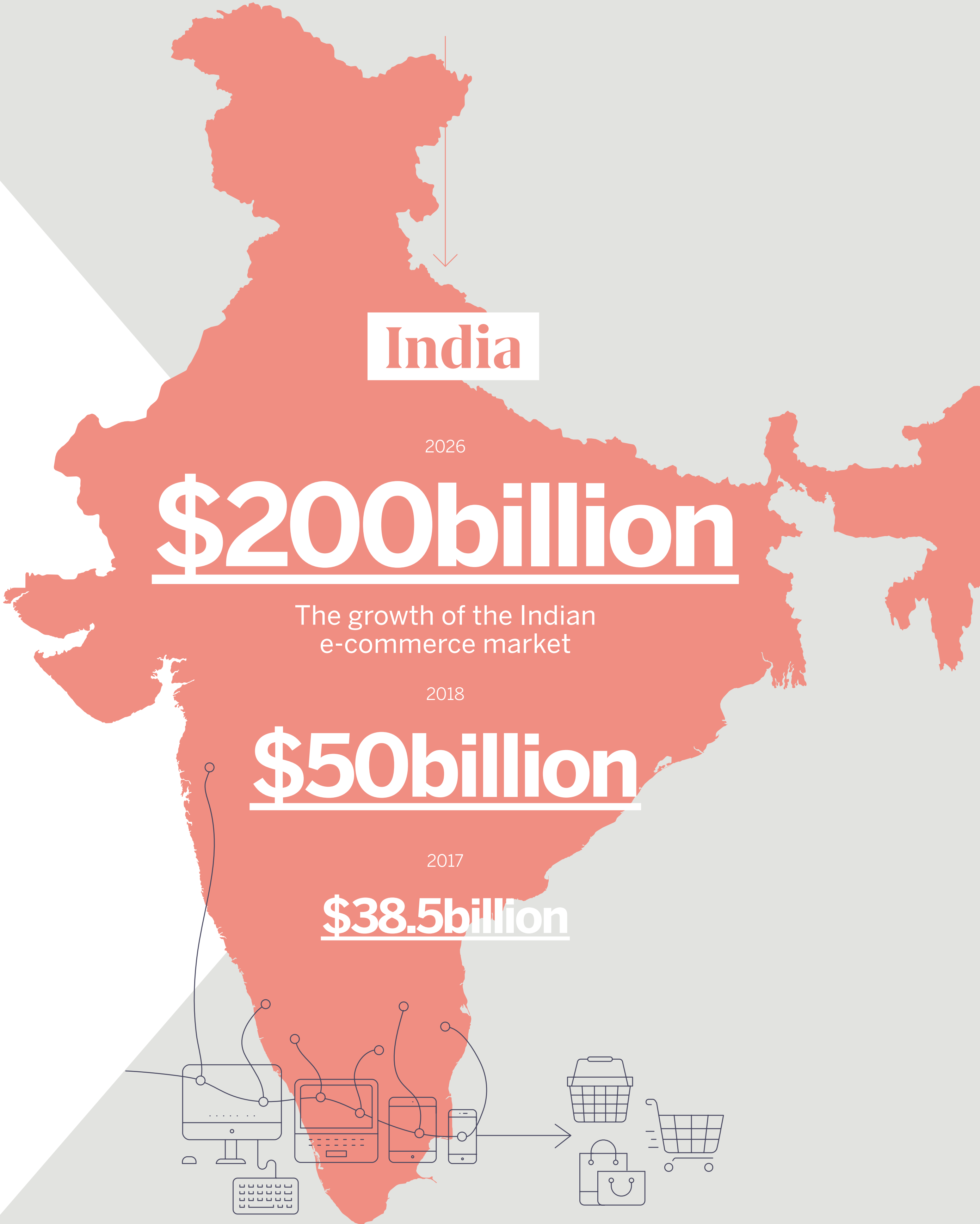
This disparity in the returns for individual companies drove significant differences between individual countries. Last year, Asian markets soared, largely driven by the large Chinese Internet names, but emerging market fund managers who had directed capital to more 'old economy' areas fared less well.

The key point is that emerging markets present very different opportunities at different stages of the economic cycle. This disparity may become more acute as global monetary policy shifts or the effects of US tax cuts are felt around the world.

The solution is to treat emerging markets not as an homogenous grouping, but to dig deep and look for the strongest companies. Emerging markets are increasingly home to companies that are global leaders – Alibaba and TenCent are closely watched by US competitors, who recognise that they are driving new innovation; Samsung continues to prove a worthy rival to Apple, while Taiwan Semiconductors heads its sector.

Emerging markets are no longer a good opportunity just because it's the right time in the cycle, they offer good opportunity because they are home to fast-growing companies and sectors that often don't exist elsewhere. A nuanced, stock picking approach is likely to be the best way to capitalise on the opportunities presented across these diverse countries. ■

E-COMMERCE MARKET



WIDESPREAD INTERNET AND SMARTPHONE PENETRATION CREATES AN EASY PATH FOR THE SPREAD OF ECOMMERCE

Changing the system in Saudi Arabia

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BCA is a world leading provider of independent investment research. Since 1949, the firm has supported its clients in making better investment decisions through the delivery of leading-edge economic analysis and comprehensive investment strategy research.

Saudi Arabia is in the throes of a painful reform process as it attempts to shift from one of the world's last feudal monarchies to a modern nation-state.

The Saudi state badly needs to diversify away from oil. It has also suffered a series of humiliating setbacks internationally as a result of US withdrawal from the region.

However, structural reforms require substantive changes to the political and social system. Three parallel efforts are under way:

— **Curbing the religious establishment:** Since April 2016, Saudi Arabia has severely curbed the powers of the hai'a - the country's religious police. More broadly, the country's long-term "Vision 2030" reform blueprint relegates religion to a more constrained role. Secular education is to be improved.

— **Taking charge of the political and economic elites:** The detention of members of the Saudi royal family in 2017-18 was part of an ongoing effort to curb the powers of the "landed aristocracy" and bring it under the control of the ruling Sudairi branch of the royal family. Power consolidation under King Salman is meant to put Crown Prince Mohammad bin Salman in full command to drive the reforms. Pervasive corruption is to be cut back, being one of the key supports of vested interests.

— **Rallying the public:** The regime faces popular unrest due to economic pressures and the fact that the youth share of the population is 57%. The goal is to allow more room for social change, technological savviness, and consumer and service sector growth. The role of women in the economy will be promoted.

In the short run, the reform agenda adds political uncertainty to Saudi Arabia, as well as geopolitical uncertainty to the broader Middle East as sabre-rattling with Iran may rise.

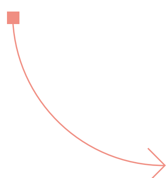
In the long run, Saudi Arabia's attempt to become a modern nation-state is positive for the country and its economy. Any failure would be negative for internal stability with risks to oil production if social unrest were to increase.

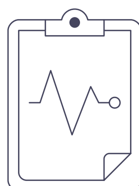
What are the investment implications of the above? Saudi Arabia's domestic instability gives it a powerful interest to maintain "OPEC 2.0," i.e. cooperation with Iraq, Iran, Russia and other oil producers to cut production. The kingdom and Russia have maintained production discipline in 2017 and extended their deal to the end of 2018, with an option to review quotas in June 2018. My view is that Brent prices should average $67 per barrel over the year. In the second half, however, the combination of surging production from US shales, and higher production from OPEC 2.0, could reverse the draw in global inventories, pushing Brent to an average $55 per barrel in 2019.

While geopolitical risks may add upside to oil prices this year, we do not expect events to cause supply shocks that trigger a global recessionary impulse. Both Saudi Arabia and Iran remain focused on internal stability, which incentivises them to cut production and avoid outright conflict. One of the main exceptions to this uneasy equilibrium would be if the US Trump administration were to cancel the 2015 Iranian nuclear agreement in early May. ■

Putting it into practice:

A practitioner's view





Author
Matthew McEneaney
Investment Director, JM Finn

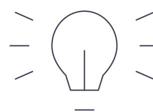
Matthew puts global investing into the context of his clients' investment objectives.

Globalisation appears to be an irreversible trend

My client has sterling liabilities; therefore, it is appropriate to hold sterling assets. I still smile when I hear these words. Anyone who lives or spends time in the UK inevitably has sterling liabilities. However, I would challenge the notion that the real cost of goods and services, whether school or care home fees, motor vehicles, household goods, or even the luxury food items we have become accustomed to consuming is driven by factors dependent on domestic resources or economic conditions in this country.

Even a cursory glance at our balance of payments figure reveals a heavy and rising deficit on all but invisibles, i.e. financial services. In other words, there is enormous scope for importing inflation, through both raw materials and finished products, driving price increases in this country over which we have little control. At a very basic level, whether the investment objective is the preservation or creation of wealth, I consider it a fundamental concern to drive or protect capital value in global terms, which I call "global spending power".

Globalisation appears to be an irreversible trend and the last two or three decades have seen the emergence of giant global corporations across many sectors of the market. The most recent and obvious example being the technology stocks, now amongst the world's largest. Quite apart from



I am drawn to the transparency and focus achievable through investing in individual stocks

Investing in the best global businesses will **by no means** be to the exclusion of UK companies

the investment opportunity these businesses offer, they also provide the means to disseminate vast quantities of data. Our industry is a major beneficiary, giving us instant access to facts and opinion which not so long ago was either unavailable or so rudimentary that it came in the form of printed cards which were updated from time to time. Whilst it is usually helpful to be able to meet with the management of companies in which we invest, from a practical perspective there are few other barriers to looking beyond our shores and selecting the most promising stocks in the global universe. I am drawn to the transparency and focus achievable through investing in individual stocks rather than geographical funds, where it can be more difficult to assess cyclical positioning and business exposure to particular economies, as opposed to simply being quoted there. This fits in with our long-standing practice of bottom up stock selection within a broad asset allocation framework, differentiating globally by sector, rather than country of quote.

Leading multinational businesses tend to be efficient allocators of capital and when they have products or services which are universally saleable, they will invest in those regions where the demographics or demand is most attractive. About two thirds of the revenue of the FTSE100 stocks is generated outside of the UK and good examples of businesses with a focus on growth markets are Diageo and Unilever. Both are strong in the Indian market where the discretionary spend of the burgeoning middle class is rising rapidly.

Our market has more than its share of global mining businesses, whose performance is not linked to the UK economy. Conversely, sectors such as Information Technology have little representation, making it necessary to look in international markets. There are also important sectors such as pharmaceuticals where London quoted global businesses such as AstraZeneca and GlaxoSmithKline have performed less successfully than many of their peers listed overseas. Investing in the best global businesses and achieving diversification across the major sectors of the equity market will by no means be to the exclusion of UK companies, but it is unlikely to be exclusively in them either.

In the immediate aftermath of the referendum in June 2016, the London market became differentiated between businesses with non-sterling revenues and those with a domestic focus. The former category outperformed materially as a result of the weaker pound, whilst the latter has continued to underperform even after some recovery in sterling due in part to concerns over our economy, the expectation of higher interest rates and, in the well represented utility sector, the prospect of political or regulatory pressure.

At that time, the benefit of an internationally diversified portfolio was material, with an immediate boost to sterling investors from currency movements alone. The UK's position in the international pecking order remains under threat from both the uncertainty Brexit brings and the inexorable growth of nations with better demographics and rising flows of inward investment. Our economy is still home to innovation and world-class businesses with access to sophisticated capital markets but we cannot assume that this will always be the case. In such circumstances, having a global approach to both asset allocation and stock selection is not optional, but a responsible way to reduce risk and improve diversification in a world and our place within, which is evolving at a breath-taking pace. ■

Why our backyard is too small

Author
Theo Wyld
Research Analyst

We find ourselves in the UK with a universe of multi-national companies, the majority of which derive most of their earnings overseas

For a long time, the London Stock Exchange has been a desirable place for a large number of aspiring global companies to list their shares. The reasons for which are plentiful; depth of capital, time zone, integrity of the exchange, trust in the UK legal system, to name a few. One of the consequences of this is that we find ourselves in the UK with a universe of multi-national companies, the majority of which derive most of their earnings overseas. I think this has provided a convenient excuse for many investors not to venture abroad when considering potential opportunities. However, as I hope to show later on, this attitude has drastically reduced the probability of buying the best businesses out there.

Let's assume that, for simplicity, liquidity constraints require a market capitalisation of a company to exceed £500m. In this case, our UK-listed investable universe totals 441 (this takes the FSTE All Share combined with those large enough that list on AIM)[14].

This number jumps to 2208 when we include the Russell 3000 Index (c.98% of the investable US market). Including Japan adds 909 more, and those non-UK from the European index, the STOXX 600, takes the total to 3556. I won't continue on around the world, but you get the picture that the UK is just a fraction of even just the developed markets, in terms of number.

But are these overseas equities only more numerous but no more dominant? To illustrate this, I broke out the universe described above (US, Japan, Europe) by sector and then ordered them by market capitalisation. As shown in the table adjacent, it is clear to see where the UK pulls its weight and the many sectors in which it does not even feature. Taking Information Technology as a specific example: this sector represents 19.0% of the MSCI All World Index[15] but just 2.1% of the FTSE All Share. In fact, you have to go down to number 104 on the list by market capitalisation before you hit a UK listed company in the sector (Sage plc). This is an example of where it is next to impossible to gain sufficient exposure relative to a global benchmark by restricting yourself to UK plcs.

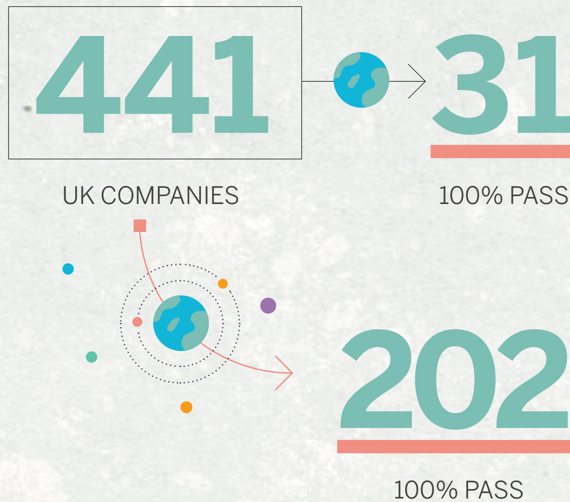
Sector	No. of UK companies in top 10
Consumer Discretionary	0
Consumer Staples	2
Energy	2
Financials	0
Health Care	0
Industrials	0
Information Technology	0
Materials	3
Real Estate	0
Telecommunications Services	2
Utilities	0

What we can do is give ourselves the best possible chance by casting the net wide in search of the best businesses

By now, you are probably thinking 'bigger doesn't necessarily mean better' – and you're right to do so. But what constitutes a 'better' company? This is highly subjective, but I have listed below a few key metrics that I look at to screen for a 'quality' company. There will always be exceptions to the rules below but the hope is that this filter weeds out many of the poor businesses in the universe. The metrics broadly speaking focus on returns on investment, balance sheet strength, earnings growth, and cash conversion.

Filters	
Market Cap Threshold (£m)	500
ROC (min %)	10
5 yr. av ROE (min %)	10
adj. ND/EBITDA (max)	5
Interest cover (min)	4
Fixed charge cover (min)	2
3 yr. EPS CAGR (min %)	5
3 yr. FCF margin (min %)	8

If we run our 441 UK companies through this criteria, we find that 31 pass all eight tests. However, if we use our extended universe that number rises by over 6.5x to 202. As I said earlier, this sort of analysis relies greatly on what sort of business one is looking for, and which attributes one places more importance on. But, hopefully this gives a feel for the increase in catchment that comes with widening the net.



Universe of companies	
UK	31
Global *	202

*UK, USA, Japan, Europe (ex-UK)

It might now be useful to discuss a real world example of where taking a global view paid dividends for shareholders over the long-term. We have an investment-focussed book club here at JM Finn, and our March publication was the biography of legendary investor Sir John Templeton, written by his niece and nephew (Investing the Templeton Way). I will steal their affectionate name and refer to him as Uncle John from now on.

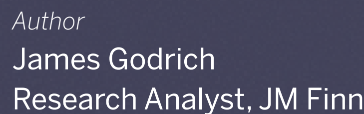
I won't try and summarise his life, apart from anything because I recommend you read the book, but rather pick out a few highlights of his career when his willingness to look outside the comfort of his own US universe reaped great reward. I think Uncle John is a particularly good example because 'his country views are the result of an assimilation of bottom-up analysis rather than starting with some view of the top-down level on the country's GDP, outlook for employment, or the like.'[16] I.e. he is directly picking from the larger addressable universe of companies.

In the 1960s there was a view amongst US investors that the US was the be all and end all. Uncle John, never to pass up on a bargain or afraid to get his hands dirty, identified Japan as a market vastly under-researched and unloved. Various accounting difficulties and lack of information provided an easy excuse for many to shun the region, but Uncle John was unperturbed. He ended up investing heavily in selected Japanese equities and rode the meteoric rise over the next few decades, selling out before the, then, bubble burst in the 1990s.

South Korea in the late 1990s was a similar experience both in reasoning and reward. In these instances his track-record pulled away from the majority of his US mutual fund peers and he solidified his reputation as a legendary investor. Admittedly, a significant portion of his outperformance can be attributed to analytical skill and insight, but there's no doubt in my mind that his more global outlook played a large part.

We can't all hope to be even a fraction as successful as Uncle John, but what we can do is give ourselves the best possible chance. And that is by casting the net wide in search of the best businesses, in the best geographies, offering the best potential returns to shareholders and therefore to our clients.

What are the effects of FX?



Author
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Translational FX risk arises when a foreign subsidiary converts its financial statements into the reporting currency of the parent company

A passive FX strategy allows currency returns to impact the overall portfolio without intervention

In a universe of sterling denominated investments, shareholder returns are made up only of returns from the underlying holdings. But in a world of global investments, shareholder returns are made up of both returns from the underlying holdings and returns from the foreign currency in which those investments are held.

If we first consider the impact of foreign exchange (FX) on returns from the underlying holdings, we might begin by analysing the events following the Brexit vote in June 2016. In response to this event the UK's two main indices, the FTSE100 (the largest 100 stocks by market cap) and the FTSE250 (the next 250 largest stocks by market cap) moved in opposite directions. Whilst the long term political and economic pros and cons of the vote can and will continue to be debated by both sides, one undeniable short term impact was on FX through the immediate and sharp weakening of sterling.

One week after the vote, and following that sterling devaluation, the more global FTSE100 index celebrated a, mostly FX driven translation tailwind as it rose 2.6% from its pre-Brexit level. However, over the same time and as a result of that same sterling devaluation, the more domestically oriented FTSE250 index suffered from an FX transaction headwind and was down more than 6% from its pre-Brexit level.

Translational FX risk arises when a foreign subsidiary converts its financial statements into the reporting currency of the parent company. What this means is that where Diageo, for example, convert their overseas earnings into sterling (either actually

or for accounting purposes), the movement in FX may cause a gain or a loss depending on the time at which revenue was received versus the reporting date for the accounts.

This was highlighted in June 2016 where any recent earnings from overseas subsidiaries would be translated at the next reporting date with some impact from the now weaker sterling. Overseas revenue would be worth more in sterling terms and hence would inflate reported earnings. As a result, the more global earnings from the FTSE100 drove the index higher.

Transactional FX risk however looks at the financial impact from a currency move between the points at which a purchase is made in one currency and settled in another. To understand the impact on a business we could consider, for example, a UK buildings merchant, such as Travis Perkins, who might import the vast majority of its stock, therefore making payments (purchase) on inventory in overseas currency, before selling (settling) those same goods to domestic customers in sterling.

In June 2016 following the sterling devaluation, a number of UK businesses were left with an effective increase in sterling costs from product lines denominated in foreign currency. At this point they were forced to make a decision to raise prices and risk market share loss or suffer a contraction in margins. The result of this was greater pressure on the more domestically focussed FTSE250.

So whilst we as investors have always considered returns from the stocks in which we invest, another consideration in a world of global investing is of returns from the foreign currency in which those investments are held. This is a form of translation FX risk, similar to that experienced by businesses.

If we imagine a scenario in which a Labour election victory causes another significant devaluation in sterling, our overseas investments will see a positive currency return as their earnings and share price are translated back into our domestic currency. Good news for our overseas investments, not such good news for our holidays!

However on the contrary, a successful Brexit and a united Conservative party might see a different outcome where sterling continues to strengthen from its, still recent, lows. The result here is that overseas earnings translate into fewer pounds and currency returns act as a headwind to our global investments.

This additional risk therefore implies a further layer of decision making for us as investors.

A passive FX strategy allows currency returns to impact the overall portfolio without intervention. This would be appropriate for investors who believe that FX markets are broadly efficient and that returns from currency will be mean reverting in the long run.

An active strategy on the other hand can come in various forms, but would be appropriate for investors who either consider the FX markets to be inefficient or who are more concerned with short term fluctuations. Active strategies could vary from an investor who looks to entirely hedge out

TRANSACTIONAL FX RISK: TRAVIS PERKINS

Sweden

Norway

Finland

€

Travis Perkins PLC

£

UK

TRAVIS PERKINS

TRANSLATIONAL FX RISK: DIAGEO

(mainly through the use of complex derivatives), and therefore remove currency risk from their investment, to one who would look to use active currency management to increase currency risk as an additional source of alpha generation.

Whilst we would not look to use derivatives to hedge out currency risk in direct equity investments, we may use hedged lines of third party funds to benefit from a macroeconomic view. For example, in the recent past we had taken the view that Japan as a region would be a good investment, driven by a strong dollar and weak yen making Japanese exports comparatively cheaper. Under this assumption any returns driven by the underlying holdings could have been offset by currency losses so we would have chosen to have bought the hedged line of a third party fund.

In a world of global investing the question remains for our underlying holding returns – what are the inherent translational and transactional risks within the underlying business and how does the executive team manage this? However we must also ask ourselves how does the currency return impact our global investments and how should we best manage this as an investor in overseas securities? ■

QUESTION?

We must ask ourselves, how does the currency return impact our global investments and how should we best manage this?

The US, the UK and company creation

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Partner, Baillie Gifford

James is partner at Baillie Gifford and manager of the Scottish Mortgage Investment Trust, one of the UK's largest investment trusts, with more than £6 billion of total net assets as at December 2017.

I'm sitting in the sunshine with a fashionable coffee at the Cool Cafe in Menlo Park Business Park. There are Teslas in the car park and I'm waiting for my Lyft after meeting the extremely impressive new CEO of Grail. Grail may be able to make most cancers curable. So I'm living the clichés but what's the substance? Why doesn't this happen in Britain? Is it chance or more serious?

The best conceptualisation that I've heard of why new companies flourish comes not from the left coast of America but from the right side of China. Robin Li of Baidu opines that 3 characteristics are required: lots of nerds, serious venture capitalists and markets of scale. Everyone now has nerds and most venture capitalists at least pretend to be global. This leaves us with markets at scale. For sure China and America offer this but nowhere else does; it's conceivable India will but it's already been colonised by Sino-America before this can be clarified. So perhaps we just need to accept this and move on. QED so to say.

But although this is appealing I don't think it's fundamentally sufficient. Out of modesty I think Robin Li neglects the most critical factor of all: founder and firm motivation. After all as our government endlessly tells us global Britain isn't excluded from international markets and most certainly not from those of American hegemony. Indeed at times we're welcomed as being neutral outsiders with the right language. ARM has benefitted hugely from not being a US company. Spotify is beating Apple, Amazon and the music labels without being troubled by its very Swedish values.

So my prevailing belief is that new British companies fail to compete at scale because they deserve to fail not because they are doomed to do so. To put it more bluntly: they are unsuccessful because they (and we) are unambitious- indeed unfit for purpose.

Such a strong view needs considerable justification. That's why I started with Grail. At one remove this could – should - have been a British success story based not in Menlo Park but in Cambridge. As Kevin Davies relates in 'The Thousand Dollar Genome' next generation genomic sequencing was literally invented in a pub in Cambridge. The resultant company was called Solexa. It was eventually bought by Illumina for $600m as a scientific success but total commercial failure. Illumina in turn spun off Grail with the ambition of finding a universal test for cancer via liquid biopsy and generating a substantial value creation for shareholders. Illumina itself is now valued at $37bn.

But there's another avenue to explore before I visit Illumina tomorrow. Roche tried to buy Illumina for $6 billion in 2012-13. Illumina has determined leaders but no controlling founders or families. Yet the bid failed. Why? Because three institutional shareholders refused to sell. We were one of the three. Roll this forward to 2016. SoftBank tried to buy ARM - almost certainly Britain's sole serious shot at building a global technology platform. SoftBank succeeded. We were the largest shareholder but we were alone as opposing active managers (L&G index funds were willing to fight too). But there wasn't a quorum. There was a recommendation from Board and management to sell. Mr. Son rejoiced and went on to say that ARM would be as valuable as Alphabet.

Hacker Way
Willow Road
amazon
TESLA
300

The examples roll onwards on both sides of the Ocean. We don't need to speculate as we know what happens. SkyScanner was - is - a great business but, CEO apart, the owners wanted to sell. The only decision was to become Chinese rather than American.

But we also need to refine the US perception. This isn't about America: it's about the profound contrast between the US of Wall St, Washington and Trump and the US of the West and of immigrants. The former is at least as short-term greedy and long-term stupid as are the British mentalities. The latter pairing is totally different. Jeff Bezos driving to Seattle, Mark Zuckerberg deserting Harvard, Steve Jobs returning to Apple are all just as momentous but intrinsically Western epics as Cowboy legends. They are also predominately immigrant stories far from the establishment. Why is South African Elon Musk in California? He's clear it's because people like him can dream there, although the general American dream is long over statistically speaking. Britain doesn't understand that outliers matter. Yet another tragedy of Brexit is that London in the age of Trump could have become the natural home of the determined potential genius. That's no longer possible.

So I think there isn't even much need to speculate as to our failings versus the Western fringe of America. We fail at every level - from management softness, to investment feebleness to societal love of the safe return over the spectacular possibilities. I see nothing on the horizon to change this terrible record. It's very sad.

Jeff Bezos driving to Seattle, Mark Zuckerberg deserting Harvard, Steve Jobs returning to Apple are all just as momentous but intrinsically Western epics as Cowboy legends.

CHANGE

Change – for better or for worse?

Author
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Consultant to JM Finn

When I started in the business of advising private investors on how best to structure their portfolios, the available choices were very limited and comparatively simple. Equities, gilt edged securities (or government bonds as we'd probably call them today) and cash - sterling, of course – were all that were available. Back in the mid-1960s, the provisions of the 1947 Exchange Control Act applied. Many will remember this as limiting what you could take out of the country if you were travelling abroad. But for investors it imposed severe penalties on straying outside the UK for your investment opportunities.

While investing overseas was possible, it was expensive. Foreign currency had to be purchased through what was known as the Dollar Premium account, which fluctuated according to demand. I recall that it could stand as high as 50% - perhaps even more, meaning that to invest a pound abroad, you had to pay £1.50. The sting came when you came to sell as 25% of the Dollar Premium was surrendered to the government, amounting to a tax that could rob you of more than 10% of your investment.

The supply of corporate bonds was also limited to the private investor. No bond funds existed, as I recall, and this market was viewed as suitable only for the professional investor, as like as not to be a pension or insurance fund manager. This did change, with ICI launching two bond issues while I was working on the floor of the London Stock Exchange, aimed in part at private investors.

Regulation was more limited then, too, and discretionary management of private client portfolios was comparatively rare. I was fortunate in working for a progressive firm when I started out in the City which embraced the concept of taking investment decisions for its clients. Back then a discretionary agreement consisted of a single sentence – "I wish you to manage my investments on a discretionary basis" – followed by the client's signature. No mention of attitude to risk or investment objectives. But back then the universe of private investors was actually quite small.

It all changed when Margaret Thatcher came to power, encouraging wider share ownership and greater competition. The Dollar Premium surrender was abolished, closely followed by the repeal of ECA '47, as it was known. Investing abroad – whether as a company or an individual, became easy and eventually the norm as the concept of a Global Village took hold. Meanwhile, the number of individuals owning shares ballooned as privatisations and demutualisations – each accompanied with extensive advertising campaigns – helped establish share ownership amongst a much wider constituency than the very rich.

TELL SID

THE BRITISH GAS PROSPECTUS WILL BE PUBLISHED ON NOVEMBER 25TH.

If you see Sid tell him

Many might not remember the date, but ask anybody who remembers the 1980s about Mrs Thatcher's privatisations, the Tell Sid campaign will be uppermost in their minds. The plan was to increase share ownership across the country such that it wasn't just for the wealthy. And it worked. Thanks to a £30m publicity campaign British Gas shares were the talk of the country as people scrambled to get a piece of the action. The campaign, with its strapline, "if you see Sid, tell him" helped see the number of shareholders in the UK rise to more than 11 million people.

QUOTE

When I started out on the floor of the London Stock Exchange, news could take days to filter through to investors. Today it is pretty much instantaneous.

Internationalisation and the encouragement of competition led to what became known as "Big Bang" in 1986, when traditional boundaries were swept aside and City firms were swallowed up by financial giants, many foreign. Against such a background, the cosy self-regulation exercised by the Stock Exchange became obsolete and so a regime of more formal regulation was ushered in. Financial services regulation has seen many changes too and I doubt anyone could have foreseen thirty years ago the extent of the way in which lives of both investors and practitioners would have been impacted.

But the availability of choice and the degree of professionalism exercised within the financial services industry have enhanced the investment landscape during my working life. Many asset classes that once were only available to the very wealthy can now be accessed by investors with more limited means – such as commercial property and private equity. Even hedge funds have endeavoured to widen their appeal, though they are not suitable for many investors.

New asset classes have emerged, with funds investing in specific sectors, such as infrastructure, now on offer. Highly specialised funds, in terms of geographic coverage, market capitalisation and even industry specific, allow portfolios to be constructed in a very targeted manner. Different investment styles can be accommodated within funds and in bond markets the choice has become positively overwhelming.

All this must be considered a plus, even if it presents a bewildering array of options to the investor. Little wonder, then, that discretionary management of private investors' portfolios has become such a big business. And there is another change that affects us all, but is particularly relevant to the investment world. Technology has speeded the availability of information and made more efficient the execution of trades. When I started out on the floor of the London Stock Exchange, news could take days to filter through to investors. Today it is pretty much instantaneous.

I feel privileged to have worked in such a dynamic industry for so long. It is wrong to try to label change as being for the better or the worse. Change is inevitable. No doubt in another half century someone will be reflecting on the way in which the investment world has changed during his or her working lifetime. In the meantime we are fortunate to have the world as our investment oyster and a professional capability to help us take advantage of it. ■

The FTSE No Man is an Island

Author
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A defence of London-listed equities (that make up the FTSE All Share) and an argument for why I continue to invest in FTSE stocks is an important aspect of any global investing paper.

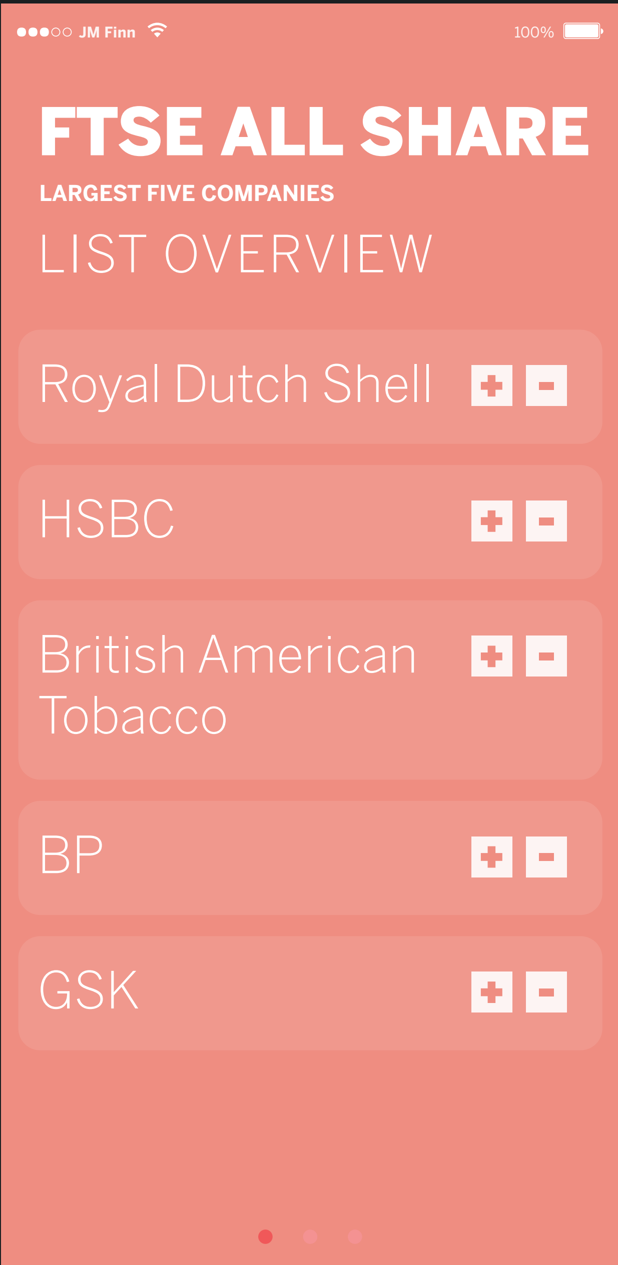
The FTSE has almost never been as unpopular as it is now – the FT, BBC and Economist seem to have been running almost exclusively negative headlines on the UK ever since the Brexit referendum. A survey of global investors made by Bank of America Merrill Lynch in January 2018 showed that the UK was the least popular global asset class of all. Conversely, global banks (such as JPMorgan and Goldman Sachs) and cash are currently the most wanted assets for fund managers. In a recent article, the FT quoted a European private equity investor saying: "It would be nice if we had a UK government that actually has a strategy ... there is no strategy."

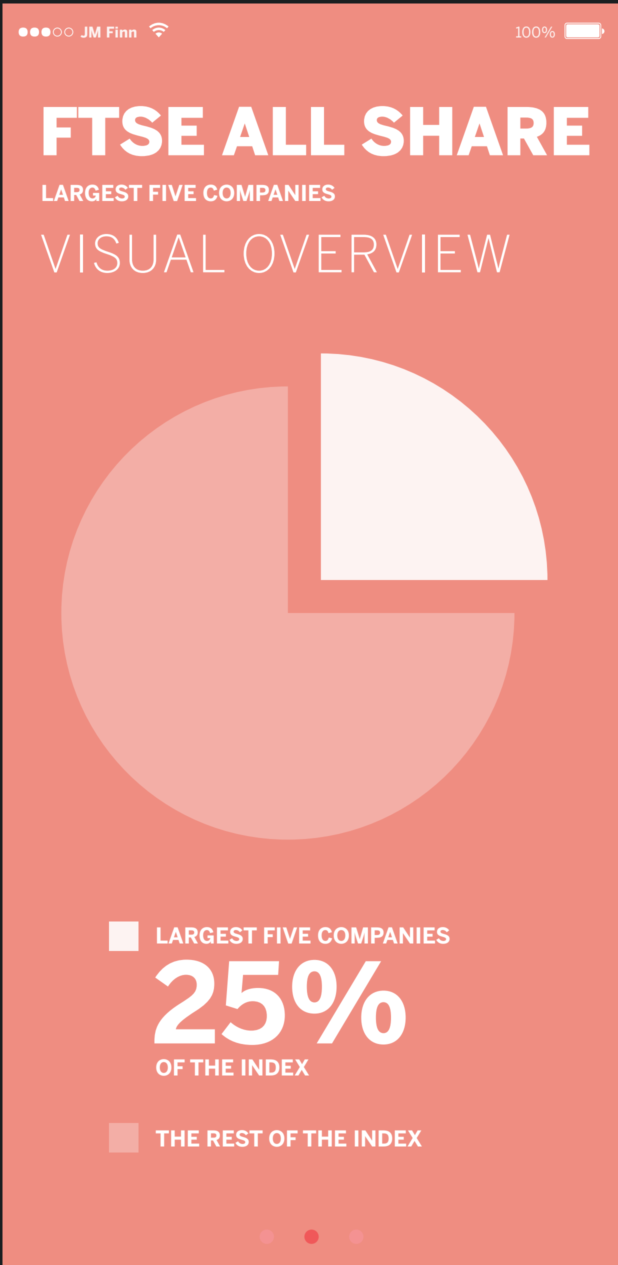
I will revisit this comment later, but it clearly typifies the consensus view on why international investors are shunning UK equities. I am a natural optimist and believe that investors are forgetting many of the features that make London markets an attractive place to put your savings.

Firstly, London is a heavily regulated market where investors have a meaningful voice. It is easy to grumble about regulators and the seemingly never-ending new rules that they appear to be devising at the moment, however the primary aim of regulators is positive – the FCA's website states that their target is to strive for "Financial markets [that are] honest, fair and effective so that consumers get a fair deal". Few markets offer such a level of protection to investors against both government and corporate misbehaviour. As in any market, questionable characters emerge in London also (Mike Ashley, Philip Green and Fred Goodwin come to mind) but they are in a minority and, to a greater or lesser extent, they are answerable to the law and the public. Compare this to Korea, where Lee Kun-hee remains as Chairman of Samsung despite being in a coma and on trial for millions in tax evasion, or India, where Vijay Mallya (aka "The King of Good Times") continues to operate many businesses while also resisting multiple billion dollars of charges for financial crime. No market is perfect, but some are more perfect than others. Investors in London markets can be confident that their assets have a robust level of oversight.

Along similar lines, the UK Government certainly has its problems but I am confident that shareholders need not worry about their assets being seized by Downing Street. To return to the above comment from a European private equity investor, a weak Government with a lack of strategy is not necessarily an issue for investors taking a long

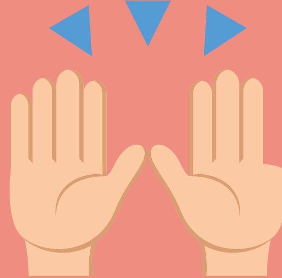
Many of these international businesses found within the FTSE are true global leaders in their field

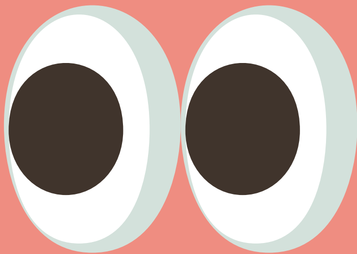




JM Finn 100%

#UK INVESTING





term view. Vladimir Putin and Xi Jinping clearly have a strategy, but this seems to involve increasing their own power and both have form when it comes to procuring private assets for the state. A government should be afraid of its people and, I would argue, Mrs May is just that. Leading FTSE companies such as HSBC, Shell and Unilever have survived through far worse political situations than we currently have in Westminster and will do so again.

Many of the companies listed in London should not be considered to be "UK equities" in the traditional sense. If a worst case scenario did play-out and Britain fell into ruin, then the international nature of many FTSE companies should allow for business to continue largely unchecked. For example, the largest five companies in the FTSE All Share (Royal Dutch Shell, HSBC, British American Tobacco, BP and GSK) make up around 25% of the index[17] – the weighted average exposure of these businesses to UK revenue is just 11%, or put differently, they make 89% from their international operations. The FTSE consists overwhelmingly of global businesses whose future is largely unaffected by the domestic UK economy – they just happen to be listed in London for historic reasons. Furthermore, many of these international businesses found within the FTSE are true global leaders in their field, be it the world's largest premium spirits maker (Diageo), Asia's leading insurer (Prudential), or two of the three primary iron ore miners (Rio Tinto and BHP Billiton). Equity investors should remember that they are trading in the shares of individual companies and not just relying on the fortunes of the country where these shares are listed.

I believe that markets are inefficient because we are all human and humans tend to move in crowds. This is good news because it presents opportunities to those that are brave enough to be different when they feel that the risk is worth the reward. As I pointed out earlier, "the crowd" of many fund managers that took Bank of America Merrill Lynch's survey has little interest in the FTSE at present. In 2015, this same survey showed US equities as the largest underweight – the S&P 500 has since risen almost 40%.

At the start of 2016 China and commodities were least popular – the price of iron ore doubled over 2016 on the back of a surprise recovery in the Chinese economy. This is all easy to say in hindsight, but my point is that the market has a tendency to overreact and that being a contrarian can be fruitful. Peter Cundill was a fantastically successful investor based out of Canada in the mid/late twentieth century, known for his bravery to invest in unloved areas of the market. Cundill famously began each year by visiting the worst performing stock market over the previous 12 months in search of bargains – if Cundill was still alive today he may well have been on a flight to Heathrow.

I continue to look for investment ideas in the FTSE because I am happy that London provides a secure marketplace through which to trade and where the Government and regulators are sensible. Of course, it is important to maintain a balanced portfolio invested across a range of asset classes and geographies. Within this asset allocation UK equities continue to play an important role. We are lucky enough to have a diverse selection of both domestic and leading international companies listed in London and our future investment returns should not be at the mercy of Brexit negotiations over the long term. Now may in fact be a wonderful moment to be contrarian and show some support for the FTSE. ■

Understanding finance

Market Cap

Number of shares * Price per share

An important consideration for liquidity purposes. Whilst some businesses may show all the characteristics of an excellent investment, the small size of a business can sometimes prove a limiting investment factor. We only want to spend time researching businesses whose shares we can actually buy and sell.

Interest Cover

Earnings before interest and tax/interest

Default risk is the chance that a company is unable to make interest payments on their debt obligations. A business with low level of Net Debt/EBITDA at a very high rate of interest may face a greater default risk than a more highly geared company facing an exceptionally low rate of interest. Interest cover is a good way to capture this risk.

Return on Capital Employed

Earnings before interest and tax /Capital Employed

Measures profits generated as a proportion of the capital base (debt + equity). We as investors would like to deploy the minimum proportion of our equity to any business for the maximum possible return (profit). Investing in a business with a high and sustainable ROCE often gives us the best chance to do that. We use EBIT as it allows comparison of businesses with differing levels of debt and in different tax jurisdictions.

Fixed Charge Cover

Earnings before interest and tax + Fixed Charges/Fixed Charges

Fixed charge cover takes the interest cover ratio a step further to include fixed charges such as lease payments as well as interest expense. A company with a large store estate for example, which it might fund through operating leases rather than debt, should have this sometimes large expense taken into account.

Net Debt/EBITDA

(Debt-cash)/Earnings before interest, tax, depreciation and amortisation

Provides a measure of strength of the balance sheet. Just as someone earning £100,000 per year would be more comfortable with a £500,000 mortgage than someone on £20,000, a business with a small amount of debt as a proportion of earnings would be more comfortable than vice versa.

Return on Equity

Net income/Shareholders' equity

ROE measures net income as a proportion of shareholders' equity. As with ROCE we look for businesses able to generate significant profits with limited equity investment.

EPS CAGR

Measures the compound annual growth rate (CAGR) of earnings per share. A high quality business should be able to grow earnings either through revenue growth (price or volume) or margin improvement (cost reduction) or a combination of all of these.

FCF Margin

Free cash flow/Revenue

Whilst all financial metrics have the opportunity to be massaged by accounting practice, we believe that cash is the ultimate arbiter of value creation. Free cash flow margin measures the amount of cash generated by a firm as a proportion of revenue.

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Why our backyard is too small

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The FTSE – No Man is an Island

[17] Source: Bloomberg

Important Notes

Investment involves risk. The value of investments and the income from them can go down as well as up and investors may not get back the amount originally invested.

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