STRATEGY MATTERS

European strategy update – Spring 2015

Global growth: scope for multiplying returns

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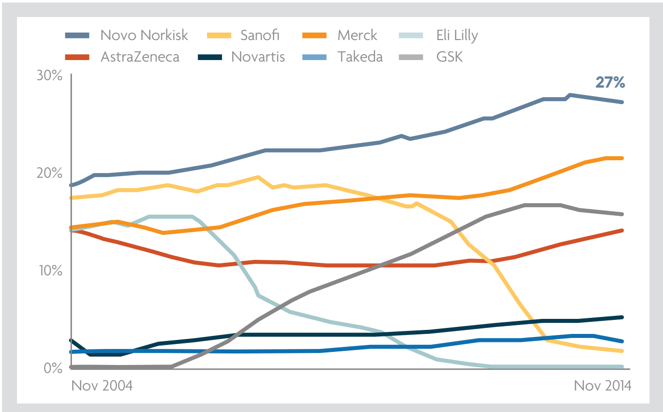
A far-reaching customer base

In addition to the all-important pursuit of a strong, market-leading business franchise in a growth area, one of the key elements I look for when I invest is a global business model. As an investor seeking to generate consistent long-term returns without the need for high turnover, owning companies that have a winning business and a far-reaching customer base is, in my view, a worthwhile strategy to pursue. This is not to say that the global business model is a panacea: it's certainly not fool-proof. If we look back at the past year, any number of European companies with global operations have suffered, whether due to their exposure to the slowdown in China, reduced demand for luxury goods or the fall in the price of oil. But for many of my holdings, the ability to roll out products and services across different regions without the need for too much costly, country-specific innovation, offers excellent scope for growth.

Secular trends can underpin long-term growth

Some of the companies I hold in the healthcare sector in particular embody this proposition. Fresenius SE is a German holding company of four legally independent businesses that provide healthcare products and services for dialysis (a field in which it is a global leader), private hospitals and the medical care of patients at home. With a complex web of sales operations, it operates in over 100 countries and has more than 80 manufacturing facilities. The bulk of sales derives from Europe and North America but nearly a fifth come from faster-growing regions in Asia Pacific and Latin America. I believe the company's tremendous knowhow and experience puts it in a great position to generate superior treatment outcomes in developed markets while in emerging markets, growth is directly linked to healthcare spending per capita. While growth trends driven by rising numbers requiring dialysis are likely to underpin secular growth in the long-term, it is sales of intravenously-delivered generic drugs and nutrition for critical-care patients in the US that is likely to drive growth over the next few years. That, and the increasing need for diabetes and obesity treatments. Another of my holdings that I think is well-positioned to take advantage of this trend is Novo Nordisk, which was recently granted approval by the US Food and Drug Administration for the reformatting of one of its existing drugs as an obesity treatment, Saxenda. While the US authorities have traditionally been disinclined to pay up for such treatment, obesity is now a problem of such magnitude in America that they are having to reconsider. Additionally, the company tells me that China's clampdown in contracting to multinationals appears to have thawed, making it easier to get the necessary approval to sell new drugs there.

Diabetes care: global market share



Source: Novo Nordisk, February 2015.

Aim to minimise macro-economic impact

Many of the companies I own have managed to generate earnings growth, however incremental, despite the difficult macro-economic background in the eurozone. In challenging times, these tend to be the holdings that investors turn to in order seek mitigate risk, but when the economic environment improves, they start to look a little expensive and investors search elsewhere.

"Conviction and patience are important for my style of investment which focuses more on secular trends than specific timing."

My portfolios tend to be resilient in difficult periods for markets as a result of this tendency, but ultimately, I aim to invest in such a way that we are subjected as little as possible to the vagaries of macro-economic shifts. That is not to say that we can take our mind off the future and what it might bring, but rather than focus on currency swings and monetary policy, we instead look more towards company-specific developments.

Focus on key company characteristics

While the European Central Bank's asset-quality review and the latest European Banking Authority stress tests ostensibly provided reassurance about the health of the banks and thereby confidence that monetary policy – and most significantly quantitative easing – should drive equity markets, we remain sanguine. As asserted above, our investment style is not based on any easy 'macro' improvement in domestic eurozone markets. Rather it is based on an unremitting adherence to key company characteristics that have historically served us well in a range of economic scenarios: strong products or services; pricing power; secular demand growth; an international franchise; and an ability to shape the company's future. Changing consumer behaviour together with technological advances creates plenty of challenges and opportunities; we believe that our process for identifying them is still an appropriate one.

Strategy

Investment philosophy

Within the broad universe of European equities, I am attracted to a very specific type of company. It will typically offer a unique product or service that either generates or has the potential to generate a degree of resilient, recurrent demand. Success on the global stage helps, as it should mean a company is less likely to be affected by domestic issues when they arise. Such companies typically share a number of characteristics: the underlying business model seems strong; they are not captive to the whims of governments or regulators, their business models travel well; they have an abundance of intellectual property and they tend not to carry too much debt. All these characteristics aim to ensure that a company should be a winner 'through the cycle' i.e. that it can ride out macroeconomic turbulence and prosper in a range of scenarios.

Conviction and patience are important for my style of investment which focuses more on secular trends than specific timing. It is vital to understand the fundamental workings of a company, right down to company culture and institutional behaviour. Adequate access to the management team is crucial, as it allows me to make judgements regarding honesty and accountability that are particularly important when it comes to persevering through some of the more difficult times a company might face. If I am confident in the strength of a company's business franchise and in the way that it is run, it makes it a lot easier to exercise patience when markets are going against you and there are many examples where this has proven advantageous for my portfolios as a result.

Investment focus

When investing for the long-term, as I do, it is important to have a good understanding of secular trends: the likely impact of technology, globalisation and politics, for example. This I consider to be the 'super macro' picture and it underpins many of my investment decisions. The macroeconomic backdrop, however, is less important for my investment style, because it is my view that successful business models tapping into favourable 'super macro' trends can survive, indeed thrive, in different macroeconomic conditions. For example, I can point to a number of companies I held through the credit crisis that are stronger than ever today.

Investment process

Given the emphasis I place on understanding the way in which a company works, attending company meetings and getting to know management teams is of course an integral part of my investment process. It is vital to feel that I can trust the executives at the helm of any company that I invest in and one of the benefits of my longevity in the asset management business is that companies are more inclined to afford me the access that I ask for. Company structure is important, in terms of transparency – I am attracted by successful, proven business models. Beyond that, it is a case of having what I consider timeless, defensive characteristics: a structural advantage, differentiated products or services, cost and revenue flexibility, recurrent and visible demand. Sector-wise, I rarely invest in utilities or commodities, likewise retail and financials, although I am interested in what I would term 'alternative financials' such as Provident Financial (a small-loan business) and Leonteq (a white-label financial products provider). The areas in which I find many of my ideas are technology, healthcare, industrials and the media. Where possible, I tend towards 'winners' – stocks I consider market leaders with particular advantage either in terms of a differentiated product or else a strong market position that should allow them to capitalise on a long-term trend. Global scope is important as it reduces local macroeconomic risk for a company and broadens the opportunities for these businesses, especially where they sell standardised products or services. The development of digital technology is another theme I pay close attention to, transforming as it does those businesses that apply it astutely.

I believe my strategy is very different to most of my retail European peers and investors should avoid seeing it as a way to "play" Europe. Europe is home to many 'world-class' businesses and I focus on trying to identify them. I tend to keep things quite concentrated, typically holding around 30-35 companies. I look to hold these stocks for the long term and therefore tend to have a low turnover. To the greatest extent permitted, I seek to invest in companies whose prospects depend as far as is reasonably possible on their own efforts and not on factors beyond their control.

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