

# Sanlam Global High Quality Fund

## 2018 Year Review Newsletter

### Summary

2018 was an award-winning year for our Sanlam Global High Quality Fund, scooping best fund in the City of London Wealth awards, best fund manager in the European Wealth Briefing awards and winner in both the Investors Choice and Private Asset Managers awards.

But while industry recognition is always pleasing, meeting our objectives is what really drives us. As we approach the fifth anniversary of the launch of this fund, we now have \$1.2 billion of assets under management, and it continues to consistently outperform the sector average.

This report gives an overview of the fund performance in 2018, from the macro-economic environment that influenced our investment decisions and affected the performance of the fund, to our investment philosophy and how that works in practise.

### Industry recognition



### Fund review

We always felt that 2018 could be a year of consolidation. If we analyse our portfolio today, we see even more potential than we did a year ago thanks to adding companies with more potential upside to their intrinsic value, while selling companies that we felt had reached fair value.

#### Performance since inception

Year-on-year, the Fund has continued to outperform the MSCI World Net Total Return index, and the sector average. Since it launched in February 2014, the Fund has achieved a total return of 85% – almost double the sector average.

Cumulative performance	2014 *	2015	2016	2017	2018	Since Inception
Sanlam Global High Quality Fund*	12.5%	12.1%	28.7%	17.5%	-2.9%	85.2%
MSCI World Net Total Return (GBP)	11.4%	4.8%	28.3%	11.7%	-3.1%	62.2%
Sector Average	6.7%	2.9%	23.9%	13.9%	-5.7%	46.1%

\*C Share Class GBP (as at 31/12/2018). Fund launch was 28/02/2014. Past performance is not a guide to future performance.

While 2018 proved to be a difficult year across the sector, we contained the losses, and we feel our portfolio is well-positioned for the medium to long term as we continue to monitor how our companies execute on their strategy and compound value for us as shareholders.

**Please note:** Where this fund is acquired through a portfolio management service, additional charges may be applied by the portfolio manager. The comparison index is the MSCI World Index with net dividends reinvested. Sector Average is the IA global.

Fund performance is calculated on a NAV to NAV basis, net of charges and assumes net income is reinvested. Since investors may be liable to external fees, charges and taxes, the illustrated returns are not meant to provide a measure of actual return to investors. Class C shares are only available to those investors who have a separate investment management mandate with the Investment Manager. Sources: Sanlam UK, MSCI, Morningstar GBP returns since fund inception on 28 February 2014 to 31<sup>st</sup> December 2018.

## Macro environment



Last year was one of highs and lows. Early in the year markets saw an unexpected increase from an already high base thanks to the much-awaited synchronisation of global growth, which had been missing since the 2008 financial crisis.

By the end of the year investors were given a stark reminder that global economic risks are building, and nothing can be taken for granted.

### January to March

After a positive January, investors were reminded of the importance of valuation for the rest of the quarter as equity markets experienced their first major correction in two years. Despite excellent company earnings and synchronised global growth, the combination of rising bond yields and elevated valuations in many share prices gave investors the jitters.

Strong economic growth and higher inflation forced central banks to end quantitative easing and raise interest rates for the first time this decade. Investors became nervous that this could threaten riskier assets and began to question the valuation of equities.

### April to June

Markets settled down in the second quarter, seemingly coming to terms with the economic uncertainties ahead. Global growth was driven mainly from the US where there was an increase in investment spending thanks to president Trump's tax cuts, relatively low interest rates and an increase in fiscal spending. Meanwhile, China continued to grow at a healthy rate despite the ongoing trade negotiations between the two countries. This growth was fuelled by continued urbanisation, as well as a growing demand for products and services as the population benefited from increased wealth across society.

### July to September

With the US performing strongly, and interest rates on the rise, we started to see a reversal of money that had been flowing into riskier emerging markets. The trigger point for this came when the spotlight fell on Turkey and the sudden fall in the Turkish Lira. For an economy that had borrowed massively in US dollars for a "growth at all costs" economic plan, the outcome was brutal. This then spread to Argentina and most other emerging markets as money continued to flow back to the US. China also fell victim to this pull back, further exacerbated by the rapid escalation of the US's trade war threats.

### October to December

October saw another market correction, mainly driven by the prospect of higher future inflation thanks to a tight labour market and the subtle but noticeable uptick in oil prices. The US 10-year yield moved out to 3.2% and markets sold off across the board. There was something of a recovery in November, although emerging markets and Europe came under continued pressure as the month progressed. Towards the end of 2018, the US Fed indicated that economic strength may require monetary conditions to tighten more than markets anticipated. Investors started to question how sharply economic growth might slow, which gave rise to losses across both bonds and equity markets.

## Outlook

Thanks to last year's market corrections, equity valuations are now at more palatable levels, assuming companies' profits maintain their growth trajectory.

There are some definite pockets of attractive long-term valuation opportunities, with some emerging market stocks having been sold indiscriminately, and somewhat unfairly, down. In addition, some of the technology names in the US, such as Facebook, are now giving excellent entry points.

There are still some concerns, as the US is clearly now in the mature stages of its economic cycle.

The key question remains: how will the world adjust to an environment of higher interest rates? Inevitably it will result in stress for both countries and companies that have excessive debt levels, hence we are very comfortable with our approach to focus on good quality businesses with a strong balance sheet.



## The essence of our investment philosophy

A robust and coherent investment philosophy is key to the success of our fund, with an approach grounded in three core principles:

- **Principle 1: A strong focus on owning quality companies**  
This forms the bedrock of our investment philosophy as it's important to hold a portfolio of quality businesses for the long-term (at least 3 years). Our analysis focuses on industry and company-specific advantages in order to gain a thorough understanding of the overall profitability of a company over a full business cycle. We believe this is necessary to find a good business that can sustain high performance over the longer term.
- **Principle 2: Capital allocation is fundamental to the creation of long-term shareholder value**  
We believe that how a company allocates its capital allocation is key to sustaining long-term value so invest in companies that have low capital requirements and seek to achieve attractive returns on capital in excess of their costs. This means they can maintain or expand their competitive advantage. Understanding incentives for management provides an indicator of how committed they are to allocating capital in order to produce long-term shareholder value.
- **Principle 3: the power of compounding forms the basis for achieving sustainable and consistent outperformance**  
Our long-term investment horizon, and focus on quality, leads us to select investments that we believe can compound returns. Typically, this is derived by returning excess cash flow to shareholders through dividends and share repurchases. The important element is the snowballing effect of compound earnings on reinvested earnings, which is a very powerful contributor to total returns. An investor not only receives capital appreciation, but also any dividends that accumulate and the potential significant impact from net share repurchases over time.

## Investment philosophy in practice

Below are examples of how our core investment principles have influenced our ongoing investment decisions (please note that these are not recommendations but are examples of how we implement our core principles, and how they work as part of a wider portfolio rather than as individual investments):

### MASTERCARD: The importance of valuation

MasterCard is one of the original investments since the fund was launched and is a good example of a high-quality business. The company operates in a duopolistic market alongside Visa and, as a result, benefits from stable pricing. The business model does not require large amounts of capital to grow as the company can accommodate one transaction or one million transactions without spending extra money. This means that more money (what we call free cash flow) is left over for investors in the longer term.

That said, poor, decent and great businesses all have market prices which we have to evaluate against our assessment of intrinsic value. MasterCard is firing on all cylinders, growing sales in excess of the market's expectations. The concern is that overly optimistic sales growth is being reflected in the current share price.

With no fundamental change to the business prospects and competitive position of the company, the question then comes down to valuation. What price do we estimate the business to be worth? The assumptions in our financial model meant that the shares were trading above what we believed them to be worth. Our process dictates a strict sell discipline that came into effect. We trust our process to find a replacement or we simply wait until MasterCard offers compelling value for our clients once again

### JOHNSON & JOHNSON: Stable cash flow and a high return on capital

Investors in Johnson & Johnson have reaped handsome rewards over any time period worth measuring. Since the fund's launch in early 2014 to the end of December 2018, Johnson & Johnson has delivered returns of 59% in US dollars versus 24% for global equities.

So, why is this company able to deliver returns to its shareholders which seem to defy what is otherwise available to passive investors? Johnson & Johnson have maintained very high returns on capital over the last decade. This means that for every dollar that they re-invest back into the company, they are getting higher positive returns on those investments than the average stock in the market, and these returns are broad-based. Some come from internal initiatives such as developing a new drug (organic growth), and some from acquisitions (inorganic growth). Whether the growth is organic or inorganic, Johnson & Johnson have been able to make good returns on these investments. High returns on capital combined with a growing stream of cash flow available to shareholders leads to good outcomes when a combination of these factors can be maintained over time.

We believe the company's ability to grow is set to continue given its cumulative \$53bn spend on research and development over the last six years alone. Looking ahead we calculate that earnings before interest and tax will grow to \$30bn by 2020 versus \$17bn in 2012. This equates to a compound growth rate of 7% per annum, not very impressive to the average observer but very compelling for a long-term investor given the high returns on capital currently maintained by the company.

## FACEBOOK: Long-term growth potential over short-term woes

During the year we decided to initiate a position in Facebook. A quick scan of the broadsheets will confirm that Facebook is a company that has been in the news for the wrong reasons. The most serious issues include the Cambridge Analytical scandal, hiring a PR company to spread misinformation about certain critics, and their platforms being used by Russian hackers to influence western elections. The share price has de-rated more than 20% since the beginning of the year as a result.

So why the investment? The largely negative coverage of Facebook's business has clouded many of the bullish drivers that are still underpinning the stock's growth.

We believe that the market is ignoring what an attractive business Facebook is in the long-term. There are now more than 2.6 billion people that use at least Facebook, Instagram, WhatsApp or Messenger each month (these platforms are owned by Facebook). Each interaction allows the company to collect data which then allows advertisers the chance to target consumers ever more efficiently. Positive network effects have entrenched this advantage – the value of each of these services to each individual user increases as more users join over time. If all your friends are on Instagram, that platform is more attractive than if only half of them use it. It is this virtuous cycle of sustained growth that entrenches Facebook's competitive strength.

Given this strength we think that these platforms are still considerably under-monetised. Messenger and WhatsApp are currently not monetised at all. This is despite more photos, videos and links being sent on these two platforms than Facebook's other social sites. Instagram is still in experimental stage, with the company looking into different ways to make impact with Stories. And Facebook itself has more levers to pull, be it with groups or video. With only 44% of media advertising spend currently in digital, we feel the revenue growth opportunity is still significant.

Whether Facebook ends up being a good investment is yet to be seen. However, we feel we are invested in a company with huge growth potential at a very reasonable price. We have been here before, most notably with Google. In 2014 Google was being penalised for its poor corporate governance structure. We felt concerns were overdone and once a restructuring took place at the search engine giant, a re-rating soon followed. If we can invest in a high-quality company with what we see as an overly depressed valuation, we will take that opportunity every time.

Source: Bloomberg

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