nikko am
Nikko Asset Management

QUARTERLY INSIGHTS FROM THE NIKKO AM GLOBAL EQUITIES TEAM

Q1 2018

Thoughts from the journey – Iain Fulton

For the last 22 years I have taken the train to work each day. It's a 25 minute journey south along the East coast of Scotland and across the iconic Forth Bridge to Edinburgh. The 25 minute trip gives me and my fellow commuters' time to prepare for the day ahead and a valuable chance to decompress on the way home. Many books and news stories have been read, countless songs enjoyed, an untold amount of email dealt with, many articles written (including this one) and more recently several movies and drama series have been viewed online. Despite all this, it has often been the conversations I have had with the people along the way which I have found most helpful when it has come to making investment decisions. Resourceful people who are tapping into economic trends are all around us, sometimes we just have to listen. This article aims to tell some of their stories and how apparently chance encounters can help generate investment ideas.

The Big Picture

Clearly when investing, the big picture is important. In the 22 years spent travelling back and forth there have been many significant economic developments. The 1990s technology boom turned to bust, interest rates rose and then they fell. The train kept going. The resultant low interest rate environment in the 2000s combined with financial innovation gave rise to commodity and housing booms around the world and an ensuing global financial crisis as high debt levels turned sour. The internet giants of today were born. Interest rates rose, then they fell (below zero) and central banks printed money on a massive scale. The train kept going.

If we have been in something of a financial 'upside down' for the last 10 years or so with negative interest rates and hugely accommodative monetary conditions, what have been the effects and what might lie ahead? For one thing, my train will keep going and I'd like to be on it so it's important to get a feel for where we are in the big picture and what's coming next. Where are we now? Firstly, asset prices have risen dramatically. Whether it's equities; bonds; property; classic cars; racing pigeons; (yes racing pigeons - an enthusiast from China recently paid almost $500k for a Belgian racing pigeon called Nadine) or works of art; the price of assets all across the spectrum of risk have gone up. Second, the animal spirits so depressed by the financial crisis have largely been restored as businesses reinvest and consumers do what they do best - consume. Third, there are some slightly worrying signs of excess. Capital has been arguably too cheap for too long and at least some of this is being channeled into ventures with highly uncertain outcomes.

My train journey for the last 22 years has itself been a form of mobility as a service. I pay a monthly or annual subscription to receive the largely autonomous service of a very pleasant train journey to and from my place of work. Indeed, the rail infrastructure my train runs on and the fine 19th century feat of engineering it rattles across each day are themselves the product of speculative boom in railways from that era. The grandeur and legacy of that bridge far outweigh the economic benefit to those that constructed it and the investors who financed it. This was obviously an era of great progress but one which saw many bankruptcies and initial investors in many railroad companies around the world almost entirely wiped out. We should take note of history as it so often gives us a clue to what might happen next. Bankruptcies are on the rise again. As the boom of investment in speculative ventures such as mobility as a service takes hold (just as the boom in investment in internet infrastructure in the 1990s did and rail infrastructure in the 1800s also), we should be careful to invest in businesses where we understand what the future profitability and cash flows might look like. The true beneficiaries of railroads were the towns and cities they connected as well as the consumers and businesses who made use of them in the centuries that followed. Likewise, the main beneficiaries of the internet infrastructure boom of the 1990s were the consumers who gained access to cheap data and the internet companies who made business models to take advantage of it. We need to look out for the signs that this might happen again.

Facebook and the conversation about vodka…

Rock concerts are frequently held in Edinburgh's Murrayfield stadium. It's a great venue for live entertainment and proves very popular with concert goers young and old. Travelling home one Friday evening in 2014, myself and a fellow passenger observed a group of young adults heading for a night out at a concert. As is typical, they were having a few drinks before they got there but what struck us was the range of brands they were drinking. These were premium craft products and a far cry from the basic hooch myself and my fellow passenger remembered consuming when we were younger. It turned out my fellow commuter worked in advertising and he had a theory that there was a natural tendency for brands to skip a generation. He said 'What's cool for your parents is almost certainly not cool for the generation that follows. There is a natural desire to rebel or at least do something a little different'.

I didn't think too much of it until 2 months later when I had to take a meeting with the CEO of Diageo – the global spirits and beer company. The company's Smirnoff vodka brand was losing market share in the US to premium craft offerings and at 12% of total company sales this was a serious drag on the performance of the business. I put the commuter's theory to the CEO. He agreed and the CEO told me that Diageo had just launched a $50m campaign in the US to increase engagement with younger adult consumers. My friend was right.

The part that struck us from an investment point of view though was that all of the $50m was to be spent on a combination of online video and social media. By 2014, my daily commute had already shown me that people were spending an extraordinary amount of time engaged with social media and watching YouTube but the meeting with Diageo revealed that advertising budgets were only beginning to catch up with where the audience were. We met with Facebook's CFO in December 2014 and reviewed their proposition to advertisers. It seemed to us that Facebook had a large opportunity for market share gain with very limited cost to the business as all the content on the platform was free and generated by its users.

The ensuing three years were an exciting ride. People kept using the social media platform (be it Instagram or Facebook) in greater numbers and for longer periods of time while the company's results proved that advertisers were shifting budgets dramatically. The cash flows and profitability from the business were substantial and grew rapidly. In 2014, Facebook had revenue of $12.5bn and operating profit and free cash flow were both around $5bn. Capital expenditures were around $1.8bn at that time. The ensuing growth in revenue, profit and cash flow were dramatic as advertising budgets moved in favour of the on line platform. By the end of 2017, revenues had reached $40.6bn while operating profit and free cash flow reached $20bn and $17bn respectively. Despite adding nearly $30bn in revenue and quadrupling profits and cash flow, capital expenditures had gone up at a slower rate as they reached $6.7bn last year. Investors were rewarded for such profitable growth with a rise in share price from $78 to $190 in just 36 months.

Today, the picture has changed somewhat. Advertisers are becoming more experienced with what works and what doesn't on social media and the recent data security issues have caused users to become more wary of how they share information. Regulators are naturally taking notice after such highly profitable growth and Facebook are rightly set to spend aggressively on capital outlays to improve data integrity and users information security. Capital expenditures are forecast by the company to reach at least $16bn and on top of this, the company are investing heavily in content to compete with on line video services. This is all necessary investment to sustain the long term future of the franchise but in the near term, further market share gains are likely to come with lower margins and a lower cash flow return on investment. Such a deterioration in cash flow returns usually means a similar direction for the share price so we chose to watch from the sidelines and sold our shares in January 2018.

Facebook Class A – Price Relative to MSCI AC World

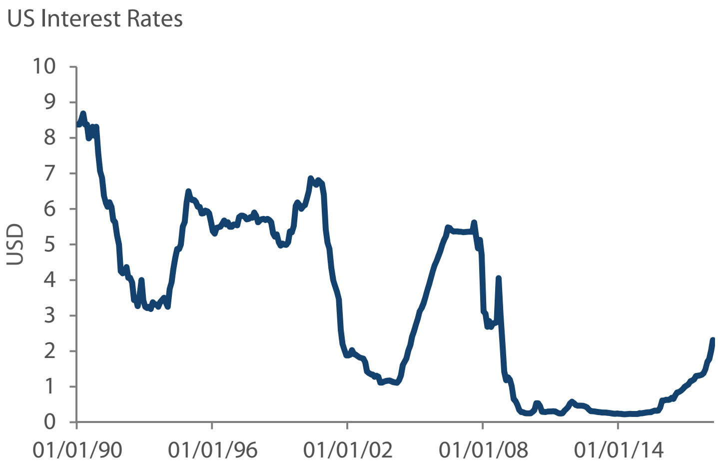
Source FactSet, 18 April 2018

Messages from the attic – Will Low

The picture is also changing before our eyes regarding the appropriate use of debt to finance a business. Low interest rates are now the accepted norm and as we highlighted earlier this has not been the case throughout history. Indeed one of the team was recently clearing out his attic at home from detritus left by the previous owner. Amongst this were some old newspapers from the 1970's, with both the headlines and business sections highlighting why we refer to investment cycles.

The Scotsman November 19th 1974:	
UK Bond Yield:	16.70%
Index Dividend Yield:	11.16%

Bond yields and equity market valuations (in the case of the UK market) in 1974 clearly reflect a different and distinctly more inflationary environment. We are not suggesting that this is where we will end up, but rather as a reminder that the cost of capital environment we are experiencing currently is very forgiving by historical standards. Whatever beckons as a result of geopolitics or from the next stage of monetary experimentation (quantitative tightening), we should be considering the impact of a higher cost of capital. Indeed the rise in LIBOR rates would suggest that for US$ borrowers the cost of borrowing is rising much faster than benchmark rates suggest.



Source FactSet, 18 April 2018. ICE LIBOR - USD 3 Month - Price

As stock pickers we are particularly focused on the impact these trends can have on the free cash flows and growth of the businesses we invest in. In this regard we would highlight the importance of the quality of balance sheets. It will become increasingly important that cashflow is not being used to service higher interest charges on debt. The maturity of existing debt will become more relevant. Receivables should be watched closely to ensure revenue is not being sustained by more generous credit terms for customers.

In simple terms, strong balance sheets will become an important differentiator in the coming years. Versus the index our portfolios exhibit notably lower leverage, with over a quarter of holdings having net cash. More importantly we expect all our holdings in the future to deliver returns above the cost of capital, and hence typically able to fund their future growth through internally generated funds.

Summary

Meantime, we'll keep getting the train to work and listening out for clues as to what we should do next. Right now we're looking at the ongoing rise in global coffee consumption and how we might invest in this trend. The resourcefulness of a recently laid off industrial worker in Fife who started an independent coffee outlet with his wife – operating from a disused cupboard in the train station where my journey begins – tells its own story of how necessity can be the mother of invention. The couple tell me they have never been happier as they profit from their hard work and the global growth in premium coffee consumption. The future cash flows and returns for that industry globally seem to be fairly secure despite it being an industry that may be a little out of fashion with investors right now.

Portfolio positioning

The table below highlights our Global Equity Strategy holdings as of the end of March 2018.

	Portfolio Weight
Consumer Discretionary	**9.3**
Amazon.com Inc.	4.2
Sony Corporation	2.6
Li Ning Company Limited	2.5
Consumer Staples	**9.0**
Estee Lauder Companies Inc. Class A	2.7
Treasury Wine Estates Limited	2.3
Philip Morris International Inc.	2.0
Davide Campari-Milano S.p.A	2.0
Financials	**16.7**
Progressive Corporation	3.6
SVB Financial Group	2.6
Housing Development Finance Corp Ltd	2.5
Huntington Bancshares Inc.	2.3
AIA Group Limited	2.2
Prudential Plc	1.8
KeyCorp	1.6
Health Care	**21.1**
LivaNova Plc	4.1
ResMed Inc.	2.7
Sinopharm Group Co., Ltd. Class H	2.4
Royal Philips	2.4
Anthem Inc.	2.1
ICON Plc	2.1
Laboratory Corporation of America	2.0
Celgene Corporation	1.8
Shire PLC	1.5
Utilities	**0.0**

	Portfolio Weight
Industrials	**12.9**
TransUnion	3.0
Schneider Electric SE	2.1
Verisk Analytics Inc	2.0
Healthcare Services Group Inc.	2.0
Weir Group PLC	1.9
Ryanair Holdings Plc	1.9
Information Technology	**17.7**
Microsoft Corporation	5.1
Tencent Holdings Limited	3.0
Red Hat Inc	2.9
Keyence Corporation	2.6
Accenture Plc Class A	2.4
Dolby Laboratories Inc Class A	1.8
Materials	**6.2**
Johnson Matthey Plc	2.2
Summit Materials Inc Class A	2.1
CRH Plc	1.9
Real Estate	**4.9**
American Tower Corporation	2.7
Ichigo Inc.	2.2
Telecommunication Services	**0.0**
Energy	**0.0**
[Cash]	**2.3**

The holdings shown above are based on a representative account managed by the investment team. Reference to individual stocks does not guarantee their continued inclusion in the portfolios managed by the team. Any references to particular securities are for illustrative purposes only and are as at the date of publication of this material. This is not a recommendation in relation to any named securities and no warranty or guarantee is provided.

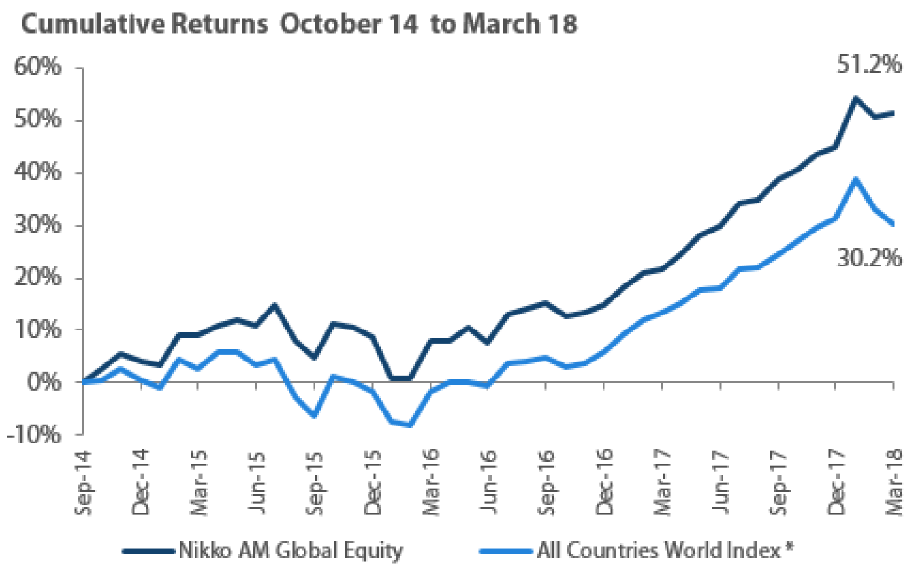
Source: Nikko AM, FactSet as at 31 March 2018

Global Equity Strategy Composite Performance to Q1 2018

Nikko Gross Annualised Returns (USD) %	1 year	2 years	3 years	Since Inception
Global Equity Strategy Composite	24.27	18.32	11.50	12.54
All Countries World Index*	14.85	14.94	8.18	7.83
Excess Return	**9.42**	**3.37**	**3.31**	**4.71**

SWIP Gross Annualised Returns (USD) %	1 year	2 years	3 years
Global Equity Strategy Composite	21.81	18.25	12.39
MSCI World Index	19.07	15.41	10.23
Excess Return	**2.74**	**2.84**	**2.16**

*The track record for SWIP is based on a composite portfolio managed by the investment team whilst at SWIP from 31 March 2011 to 31 March 2014. The team was subsequently acquired by Nikko AM in August 2014. The benchmark for this composite was the MSCI World Index.



The track record for Nikko AM portfolio is based on a composite portfolio from 01 October 2014 to 31 March 2018. The benchmark for this composite is MSCI AC World Index. The benchmark was previously the MSCI All Countries World Index ex AU since inception of the composite to 31 March 2016. Returns are US Dollar based and are calculated gross of advisory and management fees, custodial fees and withholding taxes, but are net of transaction costs and include reinvestment of dividends and interest.

Source: Nikko AM, FactSet, Bloomberg

Nikko AM Global Equity: Capability profile and available funds (as at 31 March 2018)

Available strategies	Global ACWI, Global EAFE, Global ex specific country, Sharia, Dividend	
Available vehicles	UCITS-SICAV, Country domiciled mutual funds, unit trusts, investment trusts and segregated accounts	
Key Features of Global ACWI		Guidelines
Investment Objective	+3% vs MSCI AC World	
No. holdings	40	40-50
Active share	94%	90-95%
Cash	2.3%	0-3%

This is provided as supplementary information to the performance reports prepared and presented in compliance with the Global Investment Performance Standards (GIPS®). Nikko AM Representative Global Equity account. Past performance is not indicative of future performance. Source: Nikko AM, FactSet.

Nikko AM Global Equity Team

This Edinburgh based team provides solutions for clients seeking global exposure. Their unique approach, a combination of Experience, Future Quality and Execution, means they're continually 'joining the dots', across geographies, sectors and companies, to find the opportunities that others simply don't see.

Experience

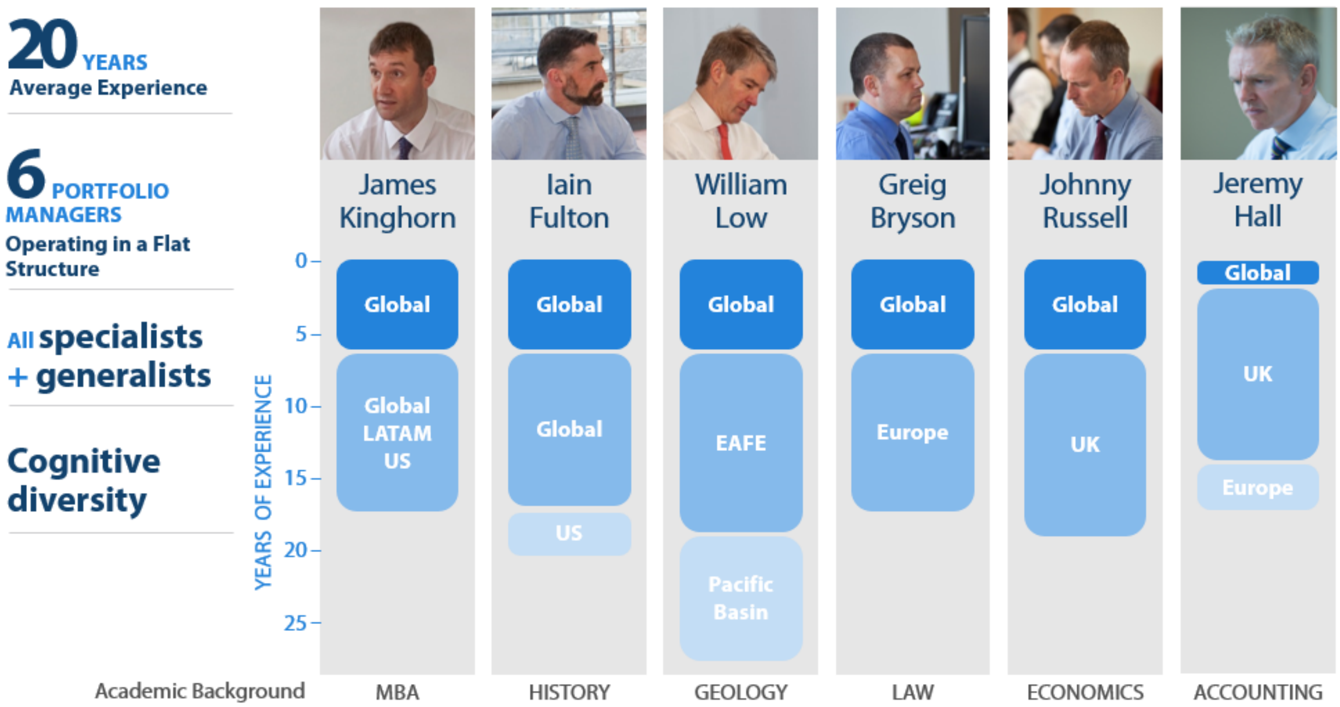
Our six portfolio managers/analysts have an average of 20 years' industry experience and have worked together as a Global Equity team for over six years. The team's deliberate flat structure fosters individual accountability and collective responsibility. It is designed to take advantage of the diversity of backgrounds and areas of specialisation to ensure the team can find the investment opportunities others don't.

Future Quality

The team's philosophy is based on the belief that investing in a portfolio of 'Future Quality' companies will lead to outperformance over the long term. They define 'Future Quality' as a business that can generate sustained growth in cash flow and improving returns on investment. They believe the rewards are greatest where these qualities are sustainable and the valuation is attractive. This concept underpins everything the team does.

Execution

Effective execution is essential to fully harness Future Quality ideas in portfolios. We combine a differentiated process with a highly collaborative culture to achieve our goal: high conviction portfolios delivering the best outcome for clients.
It is this combination of extensive experience, Future Quality style and effective execution that offers a compelling and differentiated outcome for our clients.



About Nikko Asset Management

With US$ 220 billion (23.44 trillion yen)* under management, Nikko Asset Management is one of Asia's largest asset managers, providing high-conviction, active fund management across a range of Equity, Fixed Income, Multi-Asset and Alternative strategies. In addition, its complementary range of passive strategies covers more than 20 indices and includes some of Asia's largest exchange-traded funds (ETFs).

*Consolidated assets under management and sub-advisory of Nikko Asset Management and its subsidiaries as of 31 March 2018.

Risks

Emerging markets risk - the risk arising from political and institutional factors which make investments in emerging markets less liquid and subject to potential difficulties in dealing, settlement, accounting and custody.

Currency risk - this exists when the strategy invests in assets denominated in a different currency. A devaluation of the asset's currency relative to the currency of the Sub-Fund will lead to a reduction in the value of the strategy.

Operational risk - due to issues such as natural disasters, technical problems and fraud.

Liquidity risk - investments that could have a lower level of liquidity due to (extreme) market conditions or issuer-specific factors and or large redemptions of shareholders. Liquidity risk is the risk that a position in the portfolio cannot be sold, liquidated or closed at limited cost in an adequately short time frame as required to meet liabilities of the Strategy.

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