nikko am
Nikko Asset Management

QUARTERLY INSIGHTS FROM THE NIKKO AM GLOBAL EQUITIES TEAM

Q2 2018

¡Salud a los Millenials!

Spending time abroad gives us the chance to see things in a different perspective. It is not necessarily things that we can't observe at home - it's just that different settings stimulate our awareness in a way familiar settings can't always achieve. This is particularly true while on holiday, simply because less time spent in front of a screen or in meetings gives us more time to observe the changing world around us.

Driving through some of the small, white-washed villages in the South of Spain it is easy to think that very little has changed over the last few decades. At least that is until you visit the beautiful Andalusian cities of Cordoba and Seville, steeped in Moorish architecture and history, these iconic places epitomise modern Spain but more generally modern life and changing consumer patterns.

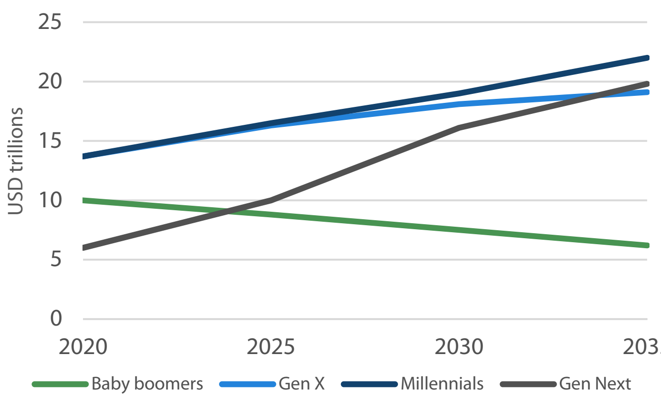
Spain is worth paying attention to - it is the second most visited country in the world (in terms of international tourists), behind France, and also generates the second highest tourist receipts globally behind the USA. In 2017, they attracted 82 million foreign tourists or nearly 7% of all global tourists. In the historic city centres across the country the diversity of the population is second to none. People from all over the world congregate, spend and interact.

It is in places like this (Seville) where you notice changes in consumer behaviour, the "sharing economy" is thriving, if not always welcomed by traditionalists. Over 90% of ATMs and POS terminals in Spain now accept UnionPay while Alipay and WeChat Pay is also increasingly accepted across the country. As recently as 2008 using a credit card was a real challenge in many places. Cycle paths are everywhere and in a just over a decade the percentage of trips by bike in Seville has risen from less than 0.5% to over 10%. Moreover the nature and diversity of the retail and restaurant scene has evolved immeasurably.

None of this is necessarily surprising but observations like this, whether it's evolving transport and payment methods, or changing eating and spending habits, scratch the surface of a much bigger and important shift undergoing the economy, not just in Spain, but across the world.

These observations highlight some of the changes in goods and services that cater to the millennial generation. Millennials account for 27% of the world's population (2 billion) and generate an annual income of $13 trillion or 33% of the global total. Long term consumption trends will be defined by this generation. They will be the biggest market by annual aggregate income for the next two decades and beyond.

Figure 1: Millennials' global annual aggregate income will reign through 2030

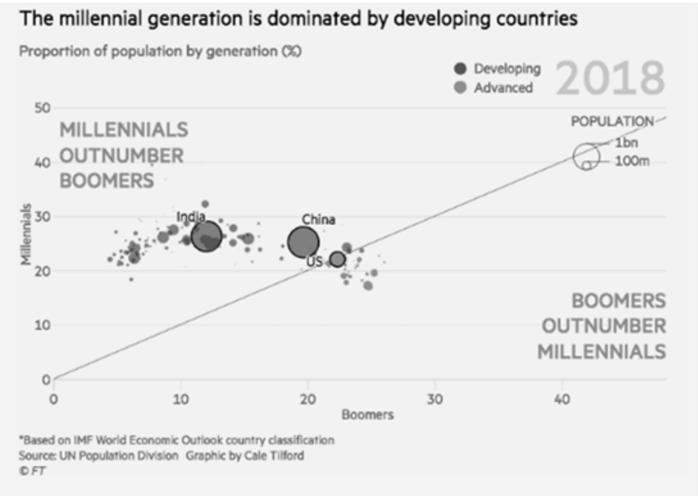


Source: Brookings Institute June 2018

They are the first fully digital generation and will define our economy in the same way Baby Boomers did 40-50 years ago. Millennial preferences will impact all segments of the economy and it is one of today's defining global economic mega-trends investors must understand. Recognising how the economy evolved during the period of the Baby Boomers helps us make more informed forecasts and assumptions for the millennial generation today.

Like many generations, Baby Boomers were very different to their parents, they enjoyed different experiences, embraced new things, were more adventurous travellers and were ultimately responsible for the technological and economic boom of the 1980's and 1990's. Changing spending patterns and consumer behaviour led to the emergence, growth and domination of some of the most world's successful companies of the time including Wal-Mart, Home Depot, Disney, Microsoft, McDonalds, Hewlett-Packard and IBM. These companies were dialled into the changing consumer preferences of the emerging generation.

There are around 90 million U.S. Millennials but this is dwarfed by the millennial population in Asia. In China there are about 330 million Millennials and in India around 360 million. The economic environment for Millennials is very different to that of the Baby Boomers of 1946-1966 when the world was emerging from World War II. For western Millennials, they are in the precarious position of potentially being the first generation to have a lower standard of living than their parents. They have grown up in economies that are over indebted and are still recovering from the aftershocks of the Great Financial Crisis. This is in stark contrast to millennials from emerging nations. Chinese Millennials have grown up in an era of growth, prosperity, economic reforms and openness and are far less encumbered with debt than their western counterparts.



Based on IMF World Economic Outlook country classification
Source: UN Population Division Graphic by Cale Tilford © FT

What Millennials around the world have in common is that they are digitally savvy. They are heavy users of social media and influenced by peers and v-loggers. Mobile content and social media helps shape the brands, goods and services they prefer and aspire to, but they prefer to spend on travel and experiences than brands and goods. They are generally less likely to step onto the property ladder early and prefer to rent goods and services than own them. In stark contrast to Baby Boomers only 15% view purchasing a car as important.

Similarly their attitude to health and wellness is different. They drink and smoke less than other generations, have different eating habits and a more holistic approach to health care. These trends have profound implications for numerous industries. Companies that can adapt and get ahead of these trends will succeed in the millennial era.

However it is the Asian Millennial that will help define the successful companies of the next few decades. In 10 years' time the spending power of Chinese Millennials will reach $3 trillion. Chinese Millennials spent over $560 billon on mobile purchases in 2017, almost 5 times that of U.S. Millennials. They account for 75% of all ecommerce in China. They are an affluent and educated generation. Chinese millennials are 8 times more likely to be college graduates than their parents, travel overseas twice as much as their parents and are more likely and able to use debt. Chinese Millennials are in a position to shape the world in the same way as the U.S. Baby Boomers did in the 1970's and 1980's.

We have just touched on a few examples of how the millennial generation is changing and shaping the global economy. Investors around the world have to be aware and understand the opportunities and threats that this long term theme has on their investments. They need to understand which companies are providing relevant goods and services, which companies can adapt to suit the needs of this cohort of the population and which companies are emerging to fill the gaps.

Our portfolio today includes many stocks that we believe will benefit from this multi-decade opportunity including Sony, Microsoft, Tencent, Estée Lauder, Li Ning, Amazon, AIA, and HDFC to name a few.

So next time you're lucky enough to be sipping a vermut or tinto de verano in the shadow of Cordoba's Mezquita take a minute to contemplate the changing habits of the 2 billion Millennials around the world who are defining our planet.

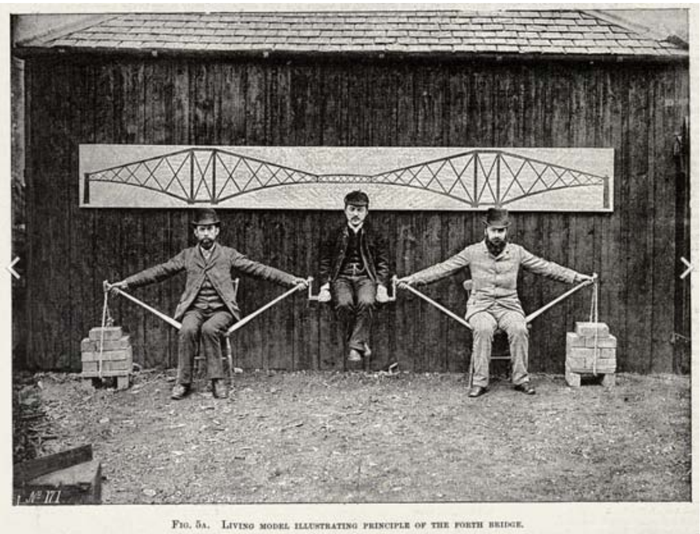
Pioneers of our time

Ever thought what it feels like to be Elon Musk? And I don't mean to have all that wealth – but to have the ambition, creativity and drive to shape a new, better world for us all. His constant questioning of traditional methods never goes unnoticed or goes without debate.

Take Musk's Boring Company as an example. The Boring Company intends to build a 3D network of tunnels between Los Angeles and San Francisco, with significant benefits to society, such as accessing unlimited layers of tunnelling, lower levels of noise and ultimately, he argues, lower levels of anxiety – because walking below a flying car might not be much fun.

He has identified a problem. Continued urbanisation and the introduction of autonomous vehicles is likely to lead to more traffic rather than less. The Boring Company intends to use technology to significantly lower the cost of drilling to the point that tunnelling is the solution and his approach is certainly different.

A recent trip to the National Portrait Gallery in Edinburgh made me realise that every age has their pioneers. As I walked through a display of 19th century photography I stumbled upon this.



Source: https://www.theforthbridges.org/gallery

If you read our last quarterly newsletter, you might recognise the drawing in the background – it's the design of the Forth Rail Bridge, the very same bridge, Iain travels across every day.

This 'living model' for investors had the Japanese engineer Kaichi Watanabe supported between 2 UK engineers, John Fowler and Benjamin Baker. Fowler and Baker represent the cantilevers, with their arms in tension and the sticks under compression. It is CAD software, 19th century style, and probably looked as crazy then as it does now.

In the late 19th century, building bridges was a risky business and designs were painstakingly drawn up and used as the main source for convincing investors to part with funds. The challenges pioneers face today are certainly different though at its core the debate is the same.

As it happens the bridge, a UNESCO World Heritage Site, opened in 1890 and was the result of a speculative boom that saw the introduction of many innovations, many of which we still benefit from today.

Today's pioneers are demanding a different sort of infrastructure boom. On its own, Musk's visions of electrifying the transport system and tunnelling appears crazy. But further innovation in battery and drilling technology, political support and network infrastructure investments (to name a few), means the probability of change for the better is high.

We are undoubtedly living in a time of unparalleled technology innovation and invention – cloud, artificial intelligence, block chain, virtual reality, robotics etc. –and they all represent vast potential for the future of society and business.

But despite the scale of the investment required, there are many ways to lose money hence we are careful to invest in businesses we understand such as the global consultant, Accenture. They are reaping the rewards for leading the consulting market across all of these innovations with digital, cloud and security accounting for nearly 50% of group wide sales. Part of the attraction of Accenture is that they are 'pioneer' agnostic and will win as disruption and change accelerates. We also like their high dividend payout ratio and strong cash generation capability. Without doubt a Future Quality company.

Another business to benefit from the digital boom is Hexagon, a solution provider for digital transformation and a leader in smart transport solutions. They combine their geospatial knowledge with mapping and sensing technology to offer solutions for all players in the autonomous mobility world, whether trains, planes or automobiles.

We have great admiration for the pioneers. But the investors in the Forth Rail Bridge didn't make a dime. The winners were the commuters, such as Iain, or the many tourists to Scotland to see this UNESCO Heritage Site.

We see Hexagon and Accenture as two examples of winners in today's digital driven infrastructure boom. With the right tools and some luck, the pioneer's vision becomes reality and the better world eventually arrives.

Postscript: ESG in the 19th century

The Forth Rail Bridge consumed over 55k tonnes of steel and rivets, took 13 years to build from the early design stage and unfortunately recorded 73 deaths. ESG was obviously not a priority during the Victorian era. Hexagon is also a supplier of CAD software, significantly reducing the time taken to build, the weight of steel used, while also increasing the safety of building large infrastructure projects, such as bridges, today.

Portfolio positioning

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

	Portfolio Weight
Consumer Discretionary	**9.6**
Amazon.com Inc.	4.4
Sony Corporation	3.2
Li Ning Company Limited	2.0
Information Technology	**21.4**
Microsoft Corporation	5.3
Tencent Holdings Limited	2.6
Accenture Plc Class A	2.5
Red Hat, Inc.	2.5
Keyence Corporation	2.4
Dolby Laboratories Inc Class A	2.2
Hexagon AB Class B	2.0
Altran Technologies SA	2.0
Financials	**15.2**
Progressive Corporation	3.4
Housing Development Finance Corp Ltd	2.6
SVB Financial Group	2.6
Prudential Plc	2.3
AIA Group Limited	2.2
Huntington Bancshares	2.2
Energy	**2.1**
EOG Resources, Inc.	2.1
Consumer Staples	**8.8**
Unilever Plc	2.6
Treasury Wine Estates Limited	2.2
Davide Campari-Milano S.p.A.	2.1
Estee Lauder Companies Inc. Class A	2.0

	Portfolio Weight
Health Care	**21.4**
LivaNova Plc	3.9
ResMed Inc.	2.8
Anthem, Inc.	2.7
Royal Philips NV	2.6
ICON Plc	2.3
Laboratory Corporation of America	2.1
Sinopharm Group Co	1.9
Shire Plc	1.6
Celgene Corporation	1.5
Industrials	**11.5**
TransUnion	3.1
Verisk Analytics Inc	2.4
Weir Group Plc	2.2
Schneider Electric SE	1.9
Healthcare Services Group	1.9
Real Estate	**3.6**
American Tower Corporation	2.6
Ichigo Inc.	1.0
Materials	**4.2**
Johnson Matthey Plc	2.4
Summit Materials Inc Class A	1.8
Utilities	**0.0**
Telecommunication Services	**0.0**
[Cash]	**2.1**

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.

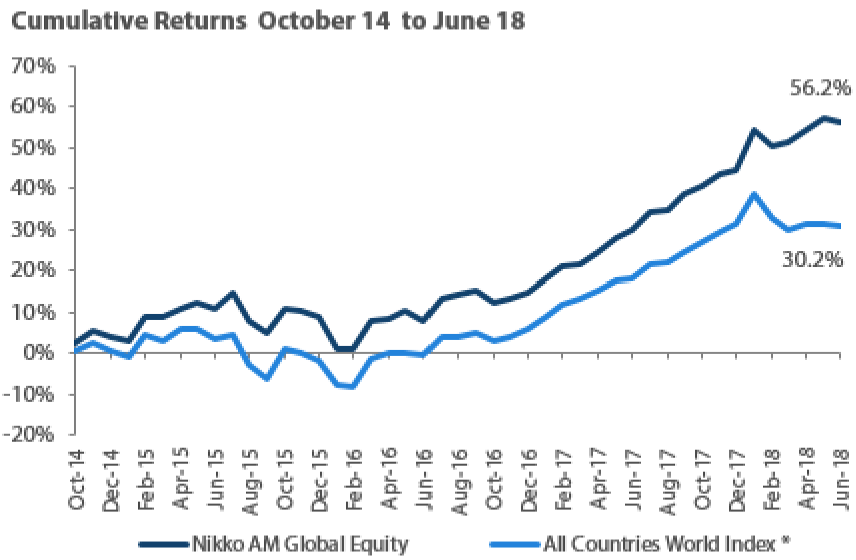
Source: Nikko AM, FactSet as at 30 June 2018

Global Equity Strategy Composite Performance to Q2 2018

Nikko Gross Annualised Returns (USD) %	**1 year**	**2 years**	**3 years**	**Since Inception**
Global Equity Strategy Composite	20.16	20.33	12.02	12.61
All Countries World Index*	10.73	14.68	8.19	7.44
Excess Return	**9.43**	**5.65**	**3.84**	**5.17**

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 30 June 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 30 June 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	2.1%	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 five portfolio managers/analysts have an average of 21 years' industry experience and have worked together as a Global Equity team for seven 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$ 216 billion (23.93 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 30 June 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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