Nikko Asset Management

QUARTERLY INSIGHTS FROM THE NIKKO AM GLOBAL EQUITIES TEAM

February 2018

Ignore the anecdotes at your peril?

When investing there is no substitute for detailed fundamental analysis, as investors in Carillion in the United Kingdom have just discovered despite us still being in a period of unprecedented easy monetary policy. Anecdotes on the other hand are highly susceptible to the confirmation biases of the recipient. However…sometimes these anecdotes start to form patterns that are too consistent not to be relevant message.

When your physiotherapist asks you unexpectedly whether he should buy bitcoin you ponder why. When share price charts appear to have snow caps whilst profits remain in the foothills you consider some more. When the low cost of money starts to rise, having deliberately supported financial assets for towards a decade, but the equity market appears unperturbed, the concerns increase. In essence, there are various signals to suggest that blind faith in any asset deemed worthy of investing by the marginal investor of today, the index providers, may be entering a period of reappraisal.

This is not to suggest we are attempting market timing, which is not our purpose, but we highlight this as a reminder of what we believe you should be looking for when investing in individual companies. For us, the growth of cash flow, the sustainability and scale of future profitability, the stewardship and governance, and the appropriate use of leverage are all essential elements prior to investing. We describe such companies as Future Quality. Irrespective of the nomenclature, the confidence that these merits will persist over the long term is key.

This confidence is based on our research at the company level rather than predictions on GDP, currencies or other macro relationships. Furthermore we would postulate that many such cyclical predictions may be vulnerable to the usual predictions from the “dismal science” for the sole reason that Quantitative tightening, which has arrived or beckons for many, is just the next stage in the world’s great monetary experiment.

Understand what you buy

It is fair to say that corporate excess and/or questionable management behaviour can exist at any point in the cycle but low cost and abundant availability of capital tends to accentuate these behaviours…until the cycle catches up. J. K. Galbraith in his book The Great Crash famously wrote about the bezzle, or ‘in good times people are relaxed, trusting, and money is plentiful. But even though money is plentiful, there are always many people who need more. Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and the bezzle increases rapidly”.

It pays to keep an open mind to behaviours and combined with knowing where to look fundamentally based active managers can potentially avoid the pitfalls. There is no substitute for detailed fundamental analysis in assessing the quality of management and the financials of a company. A focus on earnings quality, financial strength and an understanding of where accounting assumptions can be stretched can help and, moreover, often cannot be replicated by a ‘black box’.

Most recently the demise of companies such as Carillion in the UK and Steinhoff in South Africa reminds us of the importance of assessing the quality of companies both quantitatively and qualitatively and why it should be integral to a successful investment philosophy and process.

Uncorrelated cycles....opportunities when stock picking

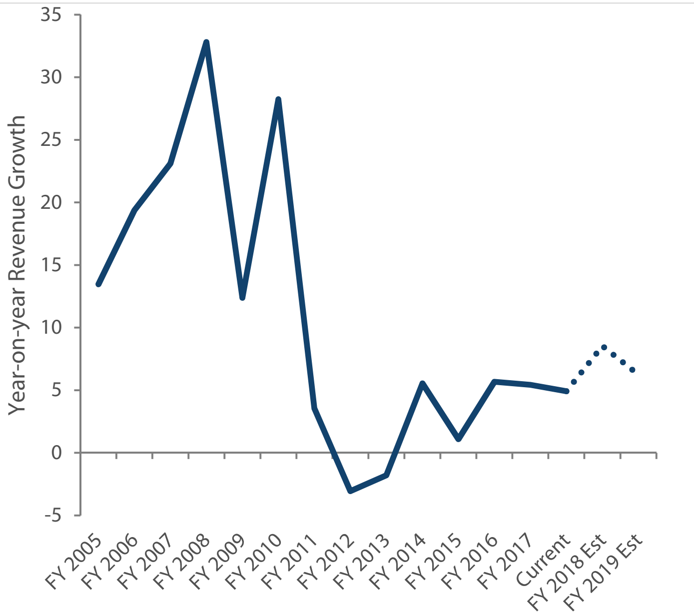
As described earlier, optimism may be increasingly rife in financial assets in general, but one of the pleasures of stock picking is finding the potential nuggets where the recent past has blinded investors to businesses where returns are improving and in a manner wholly independent from the broader economic cycle.

Dolby Laboratories is such an example in our view and was added to our portfolios later in 2017. Every reader is likely to be a licensed user of Dolby technologies, whether through PC's, Televisions or DVD's, as it often one of the industry standards for audio delivery in these mediums. These very products have become mature however, and as a result the sales growth for Dolby as a business has been very pedestrian in recent years. Investors not surprisingly have reflected this in their expectations and the share price has lagged other technology companies considerably over the last 5 years.

Chart 1: Dolby historical performance versus MSCI AC Information Technology

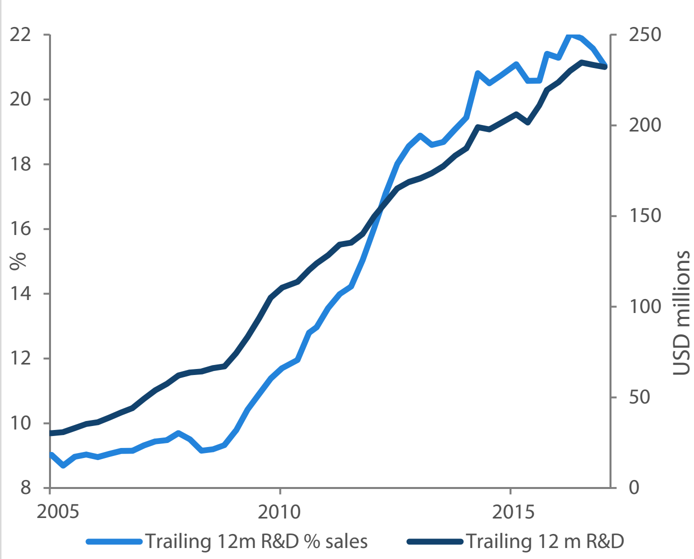
Source: Bloomberg

Chart 2: Dolby historical sales growth



Source: Bloomberg, Consensus Forecasts

However good companies never stand still, and indeed much of the strong cash flow in this business has been proactively invested into R&D for the next generation of audio and vision technologies. The following chart indicates the scale of this investment as a % of sales.



Source: Bloomberg

What has also changed is that we are seeing signs that these new offerings (Dolby Vision, Dolby Atmos, Dolby Vision and Dolby Voice) are seeing accelerating acceptance amongst customers. The announcement by Apple that it will include Dolby Vision technology in the iPhone X and apple TV is an example of this.

Whilst adoption of these as the new standards is far from proven, our belief is that the desire for better experiences amongst consumers will continue unabated, and the degree to which this could accelerate sales growth for this business is still underappreciated. Dolby Cinema with Dolby Atmos sound, is a show case for such trends, and from a modest base the number of cinemas is growing rapidly, with 133 screens open at the end of December and a commitment for a total of 360 in the pipeline. Equally the consumption of these same technologies in a world of streaming is also accelerating, with services such Netflix incorporating them, and providers of TV's and sound bars similarly licensing them in a wider range of new models.

Even with a modest acceleration in growth, this business will generate strong free cash flow, has a cash rich balance sheet, and the durability of margins is likely to be high. As a result this company offers market leading exposure to very specific industry cycle that is not expected to be correlated to the broader economy or the vagaries of bond markets that may emerge throughout 2018 and beyond.

Healthcare Services Group: Consistent Delivery

At times it pays to focus on those companies which offer consistent delivery. These are not necessarily the most 'exciting' companies but offer long term returns for investors by sticking to what they are good at and being managed conservatively through cycles. One such example is Healthcare Services.

Since 1976 Healthcare Services Group has delivered housekeeping/laundry and dining/nutrition services to an ever changing healthcare industry. With strategically located regional and distinct operations around the US the company provides professional management of ancillary services to specifically targeted markets.

CORPORATE FACTS

- More than 45,000 employees
- Company went public in 1983
  Currently traded on the NASDAQ under 'HCSG'
- Company is national in scope, operating in 48 states
- Currently servicing more than 3,700 H&L facilities
- Dining & Nutrition Services Division started in 1999
- Currently servicing more than 900 D & N facilities

Source: Healthcare Services Group

Since its inception, Healthcare Services Group has doubled in size nearly every 5 years. The company has benefitted from long term industry trends which have helped it grow sales organically every year since it started. Specifically, ever changing legislation, the 'graying' of America, the drive for cost containment and managed care. The company deliberately focuses on long term and post-acute care where competition and penetration is lower than hospitals. Consequently the company enjoys both overall industry growth but also the increased penetration of outsourced services within healthcare, ensuring sales growth of over 10% compound over the last five years. Moreover, the company enjoys a greater than 90% client retention rate with a recurring revenue stream and has substantial capacity to absorb incremental business within existing infrastructure.

Market Penetration

	Hospitals	Long Term & Post Acute Care
Number of Facilities	6,900	23,000
Total Expenditures	$774.0 Billion	$149.3 Billion
Housekeeping & Laundry Costs	$23.2 Billion (3%)	$9.0 Billion (6%)
Contractual Management	24%	< 18%
Dining & Nutrition Costs	$46.4 Billion (6%)	$18.0 Billion (12%)
Contractual Management	28%	< 8%

Sources: American Hospital Association, Dept. of Health and Human Services, Center for Medicare and Medicaid Services, Modern Healthcare Survey

Healthcare SERVICES GROUP — SOLUTIONS • PERFORMANCE • RESULTS

Source: Healthcare Services Group

One of the key competitive advantages of the company is its ability to attract and develop individuals with a strong entrepreneurial spirit which has enabled the company to dominate an industry traditionally not known for its professional management structure. A structured 90-day training program prepares managers for an entry level role as an account manager and maintains professionalism. The company places a large emphasis on promoting from within and believes in lifelong learning from the ground up.

Although, given its nature, a low margin business of typically mid-single digit it manages its working capital very keenly and maintains a robust balance sheet with net cash. This adds up to a return on equity of over 20% with sensible capital allocation. The business has established a long competitive advantage period largely by professionalising the industry, enjoys ongoing growth from industry trends and market penetration and whilst the shares are trading at a premium we continue to see strong long term growth opportunities and believe this is deserved.

Conclusion

The likely source of future alpha today is a very important question in our view. The conducive asset markets of recent years have elevated the growth and return expectations that are now implicit in valuations across all corners of the equity market. As a result the search for underappreciated growth has become a more important component of overall returns, whilst the tide that favoured owning everything (benchmark beta) is likely ebbing.

Hence our focus on cycles of improving profitability that are differentiated and generally unique to specific businesses. Furthermore, as the cost and availability of cheap credit will likely dissipate from the "free and easy" levels of recent times, the focus should again be back on businesses that can finance their growth through internally generated cash flow rather than being reliant on leverage.

These typical Future Quality attributes are exactly what we see in the examples of Dolby Laboratories and Healthcare Services described above. As we have said in the past, the rewards for Future Quality stocks may not be short term, but the long term rewards are worth it.

Portfolio positioning

The table below highlights our Global Equity Strategy holdings as of the end of December 2017.

	Portfolio Weight
Consumer Discretionary	**4.57**
Sony Corporation	2.53
Li Ning Company Limited	2.04
Consumer Staples	**8.36**
Estee Lauder Companies Inc. Class A	2.74
Treasury Wine Estates Limited	2.34
Philip Morris International Inc.	2.25
Henkel AG & Co. KGaA Pref	1.04
Energy	**1.28**
Occidental Petroleum Corporation	1.28
Financials	**16.07**
Progressive Corporation	3.46
AIA Group Limited	2.87
SVB Financial Group	2.66
Housing Development Finance Corporation Limited	2.53
Huntington Bancshares Incorporated	2.31
KeyCorp	2.24
Health Care	**21.10**
LivaNova Plc	3.89
Laboratory Corporation of America Holdings	2.51
Royal Philips NV	2.48
ResMed Inc.	2.44
Sinopharm Group Co., Ltd. Class H	2.20
Celgene Corporation	2.18
ICON Plc	2.08
Cooper Companies, Inc.	1.69
Shire PLC	1.64

	Portfolio Weight
Industrials	**14.03**
TransUnion	3.04
Siemens AG	2.54
Healthcare Services Group, Inc.	2.49
Schneider Electric SE	2.13
Weir Group PLC	2.04
Ryanair Holdings Plc	1.80
Information Technology	**19.66**
Microsoft Corporation	4.96
Tencent Holdings Ltd.	3.94
Facebook, Inc. Class A	3.72
Red Hat, Inc.	2.82
Keyence Corporation	2.42
Dolby Laboratories, Inc. Class A	1.81
Materials	**6.65**
Summit Materials, Inc. Class A	2.30
Johnson Matthey Plc	2.29
CRH Plc	2.07
Real Estate	**4.73**
American Tower Corporation	2.79
Ichigo Inc.	1.95
Telecommunication Services	**1.83**
AT&T Inc.	1.83
Utilities	**0.00**
Cash	**1.70**

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.

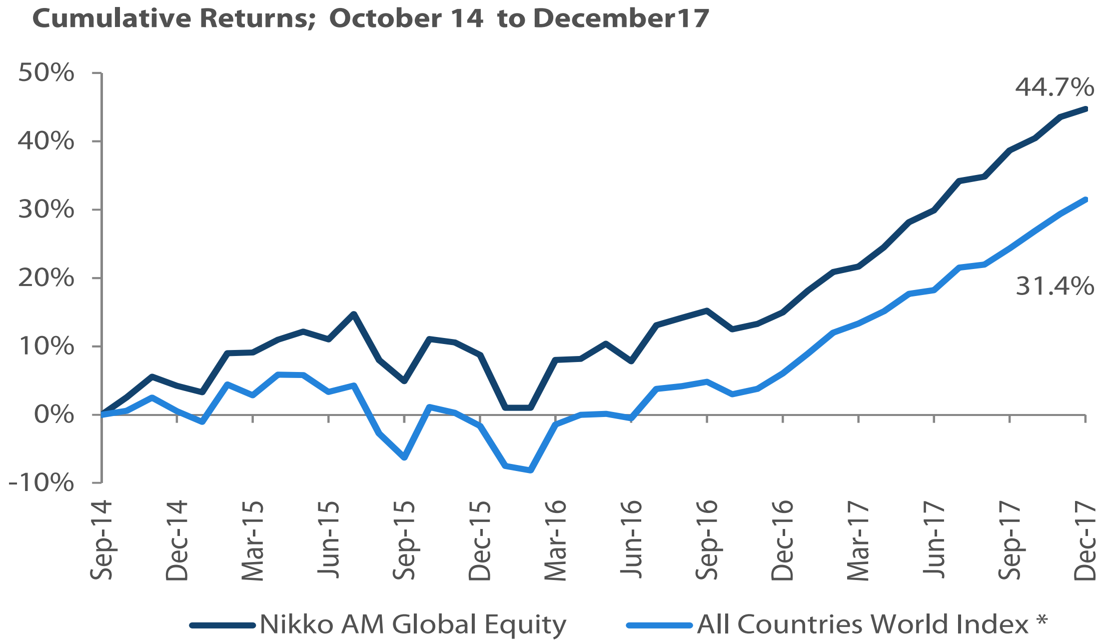
Source: Nikko AM, FactSet as at 31 December 2017

Global Equity Strategy Composite Performance to Q4 2017

Nikko Gross Annualised Returns (USD) %	1 year	2 years	3 years	Since Inception
Global Equity Strategy Composite	25.88	15.36	11.56	12.04
All Countries World Index*	23.97	15.61	9.35	8.78
Excess Return	**1.9**	**-0.26**	**2.21**	**3.26**

SWIP Gross Annualised Returns (USD) %	1 year	2 years	3 years
Global Equity Strategy Composite	21.81	18.25	12.39
All Countries 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 December 2017. 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 December 2017)

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	1.7%	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 provide 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

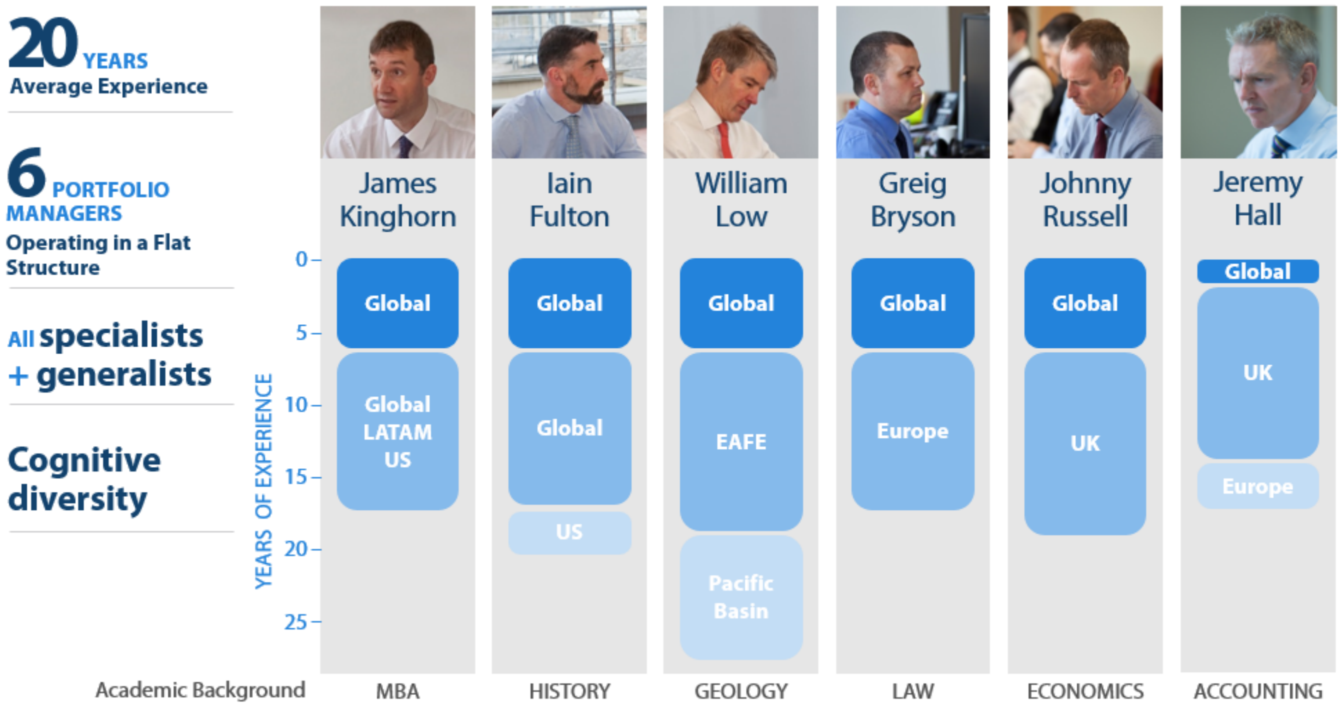
Our six portfolio managers/analysts have an average of 20 years' industry experience and have worked together as a Global Equity team for over six years. The team's deliberate flat structure fosters individual accountability and collective responsibility. It is designed to take advantage of the diversity 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.



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With US$ 211 billion (23.77 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 December 2017.

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