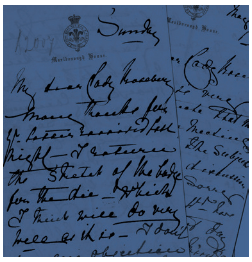
Quarterly Letter

A year in research

Issue 13 | January 2017

Rothschild
Private Wealth



Cover image:
Foreground: Our office at New Court, London
Background: Letters written by Alexandra, Princess of Wales to Hannah, Countess of Rosebery (née de Rothschild) concerning their shared interests in fundraising activities for a number of charities. Courtesy of The Rothschild Archive.

Rothschild Wealth Management
New Court
St. Swithin's Lane
London
EC4N 8AL
+44 20 7280 5000

Publication date: January 2017.
Values: all data as at 16th December 2016.

Foreword

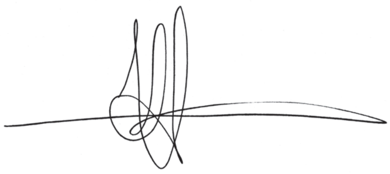
Hillary Clinton sold weapons to ISIS. Pope Francis endorses Bernie Sanders. Actors paid to protest at Trump rally.

These are just three of the countless fake and misleading news stories widely shared on social media last year. One commentator called lies “currently the most powerful weapon in the political armoury”. And Oxford Dictionaries chose post-truth as its international word of the year, an adjective describing situations where “objective facts” are less influential than “appeals to emotion and personal belief”.

What does this climate mean for investing? In the short run, financial markets are not immune. Persuasive stories and emotions shape investor sentiment. This triggers the buying and selling that moves market prices. For months, sometimes years, objective facts can take a back seat.

Fortunately, in the long run, the investment world has some built-in defences. Like gravity, the fundamentals of economics and accounting have a strong pull. Asset bubbles eventually burst. Ponzi schemes collapse. When exposed, market manipulation and false accounting get punished.

Amid all the political change and uncertainty, it’s easy for investors to lose perspective. Rather than speculate on what 2017 might bring, we use this Quarterly Letter to go under the bonnet on our investment research, highlighting how we strive to get a better grasp on the truth.



Helen Watson
CEO, UK Wealth Management

A year in research

Presenting highlights from four of our investment research trips in 2016

Andrew Ng is Chief Scientist at Baidu Research and an associate professor at Stanford University. In the field of artificial intelligence, he's a world leader in his specialism of deep learning. Ng founded and led the Google Brain project and is a co-founder of Coursera, an online education company.

In an interview with *The Huffington Post*, Ng was asked about how he learns. His answer was clear, and straightforward:

"I read a lot and I also spend time talking to people a fair amount. I think two of the most efficient ways to learn, to get information, are reading and talking to experts. So I spend quite a bit of time doing both of them ... my favourite Saturday afternoon activity is sitting by myself at home reading."

We believe good investment research is about continuous learning. In our investment team, we follow Ng's simple two-pronged approach, spending most of our time reading, and talking to experts.

About 90% of this work is too dry to write much about. A Quarterly Letter on *Trade journals we've read and loved* would send most people to sleep.

Every year we spend thousands of hours reading company annual reports, industry analysis, and fund manager reviews. That's complemented by hundreds of meetings and phone calls with experts in areas we want to learn more about – from insurance claims management to the aviation supply chain to volatility curves.

To understand more about how a company works, we'll often speak to its management, current and former employees, customers, suppliers and distributors. To understand the likely profile of future returns from an investment, we'll spend time on data analysis and modelling cashflows on spreadsheets.

All that sits in the 90%. It's time-consuming work, needing high levels of discipline and patience. There are no shortcuts.

The remaining 10% is, we hope, more interesting for our readers. This covers our research trips and time on the road. It includes company meetings, industry events, conferences and investor days, making the most of the Rothschild & Co network to reach interesting people and develop new insights.

On the following pages, we share the highlights from four recent research trips. The summaries are independent, and there's no unifying theme. In presenting four snapshots rather than one panorama, we hope to illustrate the breadth and variety of our research work, sharing some of what we have learned.

The consumer goods sector in Indonesia

There is a recurring narrative in analysis of the consumer goods sector that runs like this. Local firms in emerging markets will systematically win market share from the dominant multinationals, thanks to their superior local knowledge and nimbler ways of working.

This matters for our existing investments in companies including Unilever and Nestlé and for potential investments we are considering in other consumer goods firms. The rise of local competitors in emerging markets has been a real concern for us, and we designed our research trip to Indonesia so that we could draw conclusions for ourselves.

Over five days, we met 15 companies across the entire industry chain. With Kino, a diversified Indonesian consumer goods firm, we benefited from a factory tour led by the company's Chief Operating Officer. This provided valuable insights in areas including competitive intensity, levels of technological adaption in manufacturing, and processes for quality control.

Unilever Indonesia's Chief Financial Officer provided the multinational perspective. Elsewhere, we met with companies specialising in areas from logistics and pharmaceuticals to media and e-commerce. To put ourselves in the shoes of the Indonesian consumer, we spent time at a street market, suburban mini-marts, supermarkets, and a high-end shopping mall.

This whole process was enhanced by Albizia Capital, a specialist equity manager in Singapore. We invest some of our clients' capital in two of Albizia's funds. In doing so, we see them as partners, not suppliers, and treat them as we would want to be treated if the roles were reversed. Albizia helped us gain access to key people; without Albizia as partners, our analysis and conclusions would have been weaker.

We came away from Indonesia confident that the recurring narrative is mostly wrong.

In the years ahead, we do expect to see some shift in the competitive landscape in the major emerging markets. As household incomes grow and profit pools become larger, competition will become more intense. Today the large multinationals tend to be far more sophisticated in their research and development, manufacturing, management information systems and advertising and promotion. But as local firms grow and become better funded, the multinationals' advantage here is likely to shrink.

Nevertheless, we believe the multinationals can maintain and defend their competitive advantage for decades to come.

While local competitors tend to be nimble and willing to experiment, every manufacturer, distributor and retailer we met emphasised the benefits of scale, even if they themselves were sub-scale. Scale matters much more than flexibility. It gives firms such as Unilever and Nestlé power with retailers, suppliers and distributors and it lowers their distribution costs. Because they sell greater volumes, large firms enjoy greater economies of scale, cutting their per-unit manufacturing costs.

Staggering operational complexity also benefits large incumbents. Businesses operating in Indonesia face major challenges. Some of these are unique to the country, such as reaching customers living on more than 900 islands. But most are common across the emerging markets. How do you distribute perishable goods efficiently in cities with daily three-hour traffic jams? How do you build dependable supply chains when national infrastructure is unreliable?

To survive and thrive, the multinationals have had to master these challenges. For anyone wanting to build a new business that can compete on a large scale, these challenges can prove insurmountable.

Turning to the consumer, our research suggests Indonesians at all income levels associate international brands with superior quality. Multinationals with a long-term presence understand the market and their customers just as well as any local player.

Unilever and Nestlé were repeatedly – and without any prompting from us – held up as the best consumer goods firms in the region. Their future prosperity is in their own hands.

The Money 20/20 conference

Money 20/20 is the world's largest conference for payments and financial services innovation. More than 10,000 people attended the event in Las Vegas in October, including around 1,000 CEOs and 500 speakers.

Trade shows help us deepen our understanding of developments in an industry's ecosystem, including changes that are likely to have an impact five or more years in the future. This is very different from industry conferences organised by banks and brokers, where the focus is often on the next few quarters.

2016 was our second year at Money 20/20. It is a valuable part of our ongoing monitoring and research on our existing investments in payments company American Express and retail banks Wells Fargo and Lloyds. In particular, we are looking for emerging competitive threats from fintech (financial technology) firms. The conference can also be a source of new investment ideas.

This year we covered almost 30 panel discussions and keynote speeches by industry leaders from Google and Facebook to Visa, PayPal and China's AliPay. In the main exhibition hall, hosting close to 1,000 companies, we spent time talking to start-ups and firms across the payments ecosystem to learn about their products and strategies[1].

Our full write-up of the conference runs to 78 A4 pages. Here, we highlight just one theme: a notable change in tone.

Several years ago, the smart fintech start-ups were the innovative top dogs. They were set to destroy the dinosaur banks and the elephantine payment networks, or so the story went[2]. Today, the emphasis is very different. The language is more about partnership than disruption.

Looking at the big picture, innovation in payments is often slow to catch on, or fails completely, because it involves changing consumer behaviour. At the conference, consumer-research firm Mintel provided a helpful reminder: cheques were supposed to be obsolete by 1985.

Apple Pay provides a good contemporary example. At its launch in September 2014, many thought it would bring about a transformation in the payments ecosystem. Apple's CEO Tim Cook said it would "forever change the way all of us buy things". Fast forward to autumn 2016. One of the panellists at Money 20/20 quoted data suggesting that only around one in ten people who use iOS, the operating system for Apple mobile devices, are using the digital wallet. Of the non-users, over half are aware of Apple Pay

1. From the start-ups we spoke to, Minneapolis-based Sezzle stood out with its distinctive business model. The company's payment platform allows customers to pay merchants directly from their bank account, bypassing middlemen and therefore reducing fees. Customers earn cashback and loyalty rewards. "Works like debit. Rewards like credit. A better way to pay."

2. At Money 20/20 there was a clear consensus among the venture capitalists we heard from: a lot of money flowed in to fintech firms at very high valuations. Many of the supporting themes have since run their course, with little of the hoped-for disruption. Lofty expectations minus pedestrian performance usually equals disappointed investors.

but have no desire to use it. A survey by Mintel in the UK painted a similar picture: only 12% of smartphone users have signed up to a digital wallet, and of these only about half actually use the service.

This is not a rallying cry for technophobic complacency. Rather it's an attempt to offer perspective amid a great deal of hype.

Over the next decade, there will be many successful fintech firms. And yet, to varying degrees, most will need to partner with incumbents or use the financial system's existing infrastructure.

For established financial services firms, technological innovation is not synonymous with threat; innovation will present banks and the payment networks with opportunities to strengthen their competitive position. We share the views of Kenneth Lim, founder of Credit Karma: regulation, scale, brand equity and funding costs all give incumbent financial services a long-term advantage.

Admiral Group

Admiral's Cardiff HQ is just two hours west of London by train. Yet, according to the company's management, few investors take the time to visit the insurer, a FTSE 100 firm with a market capitalisation of £5.4 billion.

We like the company because it has many hard-to-replicate advantages, from a robust underwriting discipline to excellent claims management. Staff at all levels are incentivised to think like owners of the business, and the company's unique employee share ownership scheme encourages people to commit for the long term. Capital allocation is shareholder-friendly. And the company is extraordinarily profitable for a property and casualty insurer.

A priority for our time with Admiral's management was to test some of our assumptions about the outlook for the firm.

In UK car insurance (which accounts for roughly four-fifths of Admiral's turnover) the market seems likely to evolve more favourably than we'd previously expected. While competitors including Direct Line and Esure have closed some of the gap, Admiral is well placed to capture more market share, particularly at the expense of diversified multinational insurers. The barriers to successful entry in UK car insurance are also much higher now than they were a decade ago: David Stevens, Admiral's CEO, believes new entrants need to endure years of painful losses, while also attracting enough business to price the insurance risk appropriately.

Elsewhere, we see strong growth potential in Admiral's household insurance business. Here, the company's expense ratio (a key indicator of an insurer's profitability) is much better than the market average, and there is lots of untapped cross-selling potential with Admiral's car insurance customers. The signals from Admiral's international expansion in France, Italy, Spain and the US are encouraging, and these businesses could add substantially to profitability over the next decade.

Our visit also gave us more insight into the Admiral culture, and the way the business runs its operations. On culture, there was consistency across the firm, including a desire to go above what's expected to get things done, and an openness to experiment, test and learn.

At the end of every year, we want to be better stewards than we were at the beginning.

On operations, claims management stood out. It is the firm's largest department, fielding 8,000 calls a day and employing 1,700 people. The focus is on providing excellent service to customers, and getting claims settled quickly. The efficiency of Admiral's processes, and its preference for direct negotiation where an Admiral driver is at fault, helps lower total costs. This in turn supports profitability and gives the company a competitive advantage.

Our in-depth in-person research on Admiral has added to our conviction that the company has strong competitive advantages and opportunities for profitable growth.

New York and Boston

Generating good investment returns, beating inflation, and avoiding large capital losses – all in a world of zero interest rates, unprecedented monetary experiments, growing nationalism and political change.

That, broadly speaking, is the challenge we face. In New York and Boston in mid-November, we spent time comparing notes with investors we respect who are wrestling with the same issues.

Many of our conversations – with investment advisory firms, fund and hedge fund managers, family offices and endowments – focused on the structural ingredients for investment success. Here, a good shopping list would include: a clear investment philosophy; fair fees; aligned incentives between the firm and its clients; and being upfront with clients about what to expect, particularly during difficult periods. Every successful investment house we know has thought carefully about these ingredients.

During our trip, we were struck by the contrast between one of the large endowment funds and some of the boutique investment advisers.

To us, the endowment's managers seemed dogged by unhelpful performance comparisons with other endowments, comparisons focused on short-term relative returns. By contrast, Windhorse, an investment adviser in Boston, has been structured to cultivate a mindset of long-term ownership, while investing in a broad universe of assets in a "cost-effective and user-friendly" way. David Salem, Windhorse's Chairman and Chief Investment Officer, has thought extensively about being "structured for success", managing behavioural biases in investing, and avoiding conflicts of interest.

As a practical follow-on from our discussions with other multi-asset investors, we came away with some ideas we might apply in our own investment processes. These include:

- Making use of online tools such as Watson, IBM's artificial intelligence system.
- Partnering with an investigative journalist to conduct background checks on companies and fund management teams.
- Harnessing new approaches to data analysis in company research.

Protecting wealth was also a prominent theme in our conversations. We believe most bond prices are highly inflated, and that investors need to look beyond bonds to achieve real diversification. While there are no silver bullets, we think part of the answer comes from what might be called anti-fragile investment strategies – strategies that perform well at times of financial disorder and upheaval.

Incorporating these strategies into an investment portfolio is not straightforward. They can perform poorly for years, at times when asset prices are rising.

In New York, we spent a morning with Christopher Cole from Artemis Capital Management, a specialist volatility manager based in Austin, Texas. We have been following his funds for several years now, and our time with him built our understanding, developed the relationship, and added to our confidence in his approach. In the months ahead, we may add one of his funds as a diversifying asset in our portfolios.

Conclusion – why this matters

Our commitment to serious in-depth primary research makes us better stewards of our clients' capital. We believe it also helps us deliver better performance.

Stewardship is a central concept in forestry, and should be central for any wealth manager. It's about the responsible planning and management of resources. A year of good portfolio management might involve some new planting, some harvesting of mature investments, and perhaps some uprooting of securities that are weak. Mostly, however, it should be about tending to the trees in the portfolio that have already been planted, and leaving them alone to grow. Constant uprooting and replanting is likely to damage the long-term health of the forest.

While we are always looking for attractive new investments, we focus most of our research energy and resources on deepening our understanding of our existing holdings.

From another angle: clients commit their capital to us. We, in turn, commit much of that capital to companies and fund managers. To state the obvious, all the businesses and funds we invest in are run by people. We want to know those people as well as we can, and to understand the cultures they have created and operate in. We need to be confident that they will be good stewards. And so we spend time with them, asking questions and learning, to complement our desk-based research.

Turning to performance, our commitment to research:

- Helps us avoid permanent capital losses.
- Gives us the confidence to take decent-sized positions in individual companies and funds.
- Makes us more willing to run our winners. This means holding on to successful investments, including at times when their valuations may appear a little stretched.
- Makes us more likely to hold, or buy, at times when a share price is weak. We want to profit from the market's moodswings, rather than get spooked and sell following a temporary dip.
- Encourages us to be patient investors, focused on a company's underlying performance, or a fund manager's long-term track record.
- Helps us spot red flags, and take action where needed.

This should, in turn, help us deliver stronger returns, as we seek to preserve and grow the real value of our clients' wealth over the long term.

Notes

At Rothschild Private Wealth we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation-first is the right approach to managing wealth.