Investment Insight

INVESTMENT THEMES AND OPPORTUNITIES IN 2019

As we enter 2019, we continue to be constructive on the global economy despite the fact that growth is expected to slow somewhat worldwide from the strong growth we have seen over the past several years. We also are alert to the current geopolitical turmoil, which is likely to intensify over the next couple of months, and to central bank policy decisions, which could impact upon this view.

However, we believe that our investments have strong prospects and that they can do well this year. Our focus is on the quality and value of the assets we own, and this should allow us to weather the increased volatility we have witnessed and look at it as an opportunity, not a risk. Our outlook is almost entirely consistent with what we thought at the beginning of 2018 and we expect it to prevail this year as well.

In the following, our investment team offers our views on some of the issues we see and how they may impact our investments. From an equity perspective, we believe there are many drivers that should lead our companies to do well, both from a cyclical and secular perspective. In particular, we think healthcare is likely to be an area of increased interest and performance, especially in the life sciences industry. From a credit perspective, we are expecting another volatile year in Emerging Market, but expect to use this to our advantage. Inflows have already been strong as spreads reach attractive levels, although we remain vigilant given the number of political risks on the horizon for emerging markets in 2019.

By sticking to what we know, identifying global companies that have strong fundamentals and attractive valuations and keeping a long-term perspective, we expect our portfolios to be resilient and allows us to take advantage of market movements.

EQUITIES

Life sciences

The first things that springs to mind in thinking about innovation in the broad healthcare industry, are the blockbuster drugs and next generation medical devices coming into the market. However, one of the most exciting and consistent areas within the industry lies with those companies that enable scientific research to actually take place initially. The life sciences industry is a $110 billion market that provides analytical instruments, consumables, and services to customers across the pharmaceutical and biotech, government and academic, industrial, clinical and diagnostics markets. They are effectively the “pick and shovels” suppliers that equip the labs performing a wide range of real life applications, including not only biomedical and drug discovery research but also materials science research, consumer product testing, food and beverage safety testing, forensics and environmental monitoring.

The industry benefits from solid secular trends including the rapid growth in demand for vaccines, strong pharma and biotech pipelines, a growing focus on precision medicine, more accurate and cost effective diagnostics, solid government support for scientific research including China’s 5-year plan and Europe’s Horizon 2020 program (which is about to be increased from €80 billion to €100 billion), increased focus on air and water quality, and monitoring and food safety testing.

Importantly, the industry benefits from a typical razor blade model, with a significant portion of sales coming from consumables sold to an installed base of instrumentals and equipment. In fact, a typical consumables revenue stream can equate to 2-3x the instruments purchase price and the typical life cycle can be five to seven years. It is also an industry that benefits from high barriers to entry given regulatory requirements, and the need to not only ensure critical instrumental performance levels and quality of output, but also the growing need for global distribution, specialised sales, and service infrastructure. Coupled with ongoing technological innovation in the space, this all translates into high recurring revenues, solid pricing power, healthy gross margins and robust free cash flows.

One business we think excels in this sector is *ThermoFisher*, the world's leading and most diversified life sciences company, which has an 18% market share, double the size of the nearest competitor. The company has a strong innovative track record, supported by the largest R&D budget in the industry at $750 million. It has a leading presence in emerging markets, with 20% of revenues coming from markets like China, India, Russia and Brazil. It has also been a consolidator in this still fragmented industry, with milestone acquisitions including Fisher Scientific in 2006, Life Technologies in 2013 and Patheon in 2017. The business is in a virtuous cycle of capital deployment, leveraging acquired products across its global platform and further share gains, enabling it to achieve above market growth rates. Finally, its diversified end market exposure across healthcare, academic, pharmaceutical and biotech, industrial, and diagnostics markets offers a cushion against any volatility, macroeconomic or otherwise. For the year ahead we believe those healthy dynamics will continue in line with the company's long term target of 4-6% organic growth, ongoing operating margin expansion, and double-digit earnings growth. In short, ThermoFisher is a sparkling gem that has great prospects for growth and value generation.

Katerina Kosmopoulou, CFA

Technology

> "It ought to be remembered that there is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things. Because the innovator has for enemies all those who have done well under the old conditions and lukewarm defenders in those who may do well under the new."
>
> – Niccolo Machiavelli

Looking back at 2018, we feel that Machiavelli aptly sums up the barrage of criticism faced by the large tech companies throughout the year. In particular, *Facebook* was relentlessly criticised by the media, the very institutions that are experiencing declining audiences as greater time is spent on social media platforms. We also saw the European Commission introduce GDPR and fine *Alphabet* more than €4 billion over Android as it grappled with regulating and managing these US tech companies operating in Europe.

Regulation and privacy are important issues. However, we believe it is of the utmost importance that innovation is not stifled and that any measures are proportionate and not draconian. *Apple* is just one of many examples of how important innovation is. Apple has been among the most innovative valuable companies in the world. At the start of 2019, it reached a peak in terms of selling their iconic iPhones. The iPhone is undoubtedly a great product. However, the innovation and incremental improvements in new models each year have not been enough to attract greater users at higher price points. Despite introducing new product lines such as the Apple Watch and AirPods, nothing has yet been sizeable enough to diversify away from the iPhone.

By contrast, the technology companies in our portfolio continue to innovate and diversify into new categories outside of their core. For example, Alphabet has Waymo, the self-driving car business, which has been pegged at a value of greater than $150 billion as it takes the lead in the autonomous car race. Or take *Amazon*, no longer just an e-commerce company, but also the leader in cloud computing with AWS, which is estimated to be worth more than $350 billion on a standalone basis, is putting significant resources into healthcare and other initiatives as we noted in our insight last year.

Amongst this backdrop, we urge patience with regard to this innovation. It comes in waves. The next great wave will most likely come from artificial intelligence and machine learning. However, these technologies are still at nascent levels as the companies discover and build applications for them. Cloud computing has only become mainstream over the last several years yet the promise has been apparent for more than a decade. That is why we think that the some of the large tech companies could consolidate this year as they come off an extended period of hyper growth and position to set themselves up for the next technology era in the coming years.

Healthcare was one of the first areas that *IBM* used for Watson (i's artificial intelligence supercomputer). As we wrote, we think that healthcare will become an area of greater focus for tech companies and innovation. For example, Verily, the subsidiary life sciences company of Alphabet, recently raised $1 billion in funding. This follows Amazon's move into healthcare with their PillPack acquisition, as well as joining up with JP Morgan and Berkshire Hathaway on a healthcare venture. The technology sector has already innovated and disrupted the retail, financial and transport (Uber, Waymo et al) sectors and we think that healthcare is likely to be next in line.

Giles Tulloch

Luxury Goods

2018 was a year of two halves for the luxury goods sector. The optimism on buoyant global demand in the first half of the year was replaced by worries about the economic slowdown in China. This was led by the US/China trade war and potential slowing demand from the key Chinese consumers, who made up one third of global luxury goods consumption and half of the sector's growth. The sector ended the year having de-rated from a forward price to earnings ratio (PE) of 23-24x in June to 16x and is now trading at a 15% discount to its historical average.

Source: Grand Pacific Department Store, Beijing by Zhixin Shu

Despite the adverse sentiment, demand is still visible. On a recent trip to Beijing during the Christmas holidays, I visited a mid-tier department store on a Sunday. The store was very busy and packed with shoppers. Rather than struggling sales counters, as would be expected following the weakening Swiss watch export data in recent months, or fears that smart watches have decimated the luxury watch industry, brands such as Tissot and Longines had a healthy stream of customers, as seen in these photos.

We see the structural trend of rising income and growth in the middle class in China and in other emerging markets continuing. The aspiration of consuming luxury goods and enjoying the experience is very much alive. The Chinese economy may slow but it is inexorably moving towards more consumption.

Source: Grand Pacific Department Store, Beijing by Zhixin Shu

As we enter 2019, we expect the luxury sector growth to normalise from the very high level of the last few years. This growth is supported by the Chinese government's stimulus, aimed at boosting domestic consumption through personal income tax cuts and a reduction in import duties. We see a shift away from offshore to domestic onshore consumption as the cut to import duties and a weaker currency reduce the regional price gap between China and the rest of the world, as well as the crackdown on Daigou (the business of buying goods overseas for re-sale inside China without paying the import duty) at the border by the customs authorities.

We prefer soft luxury with a diversified product portfolio to hard luxury where cost per item is substantially higher, and hence profits are more cyclical. The 30-35% de-rating of the sector last year presents an outstanding buying opportunity for long term shareholders. An eventual resolution of the trade war between China and the US also offers an attractive option for further sector upside.

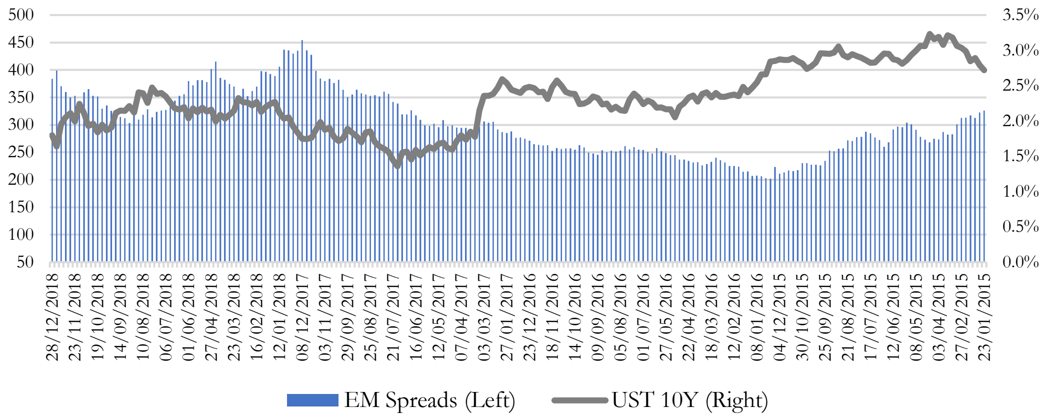
Zhixin Shu, CFA

EMERGING MARKET BONDS

The beginning of the year is the time when economists, strategists and just about everyone else tries their best to come up with likely scenarios for the year ahead. We have a wide range of forecasts and predictions to choose from but will continue to follow our own convictions.

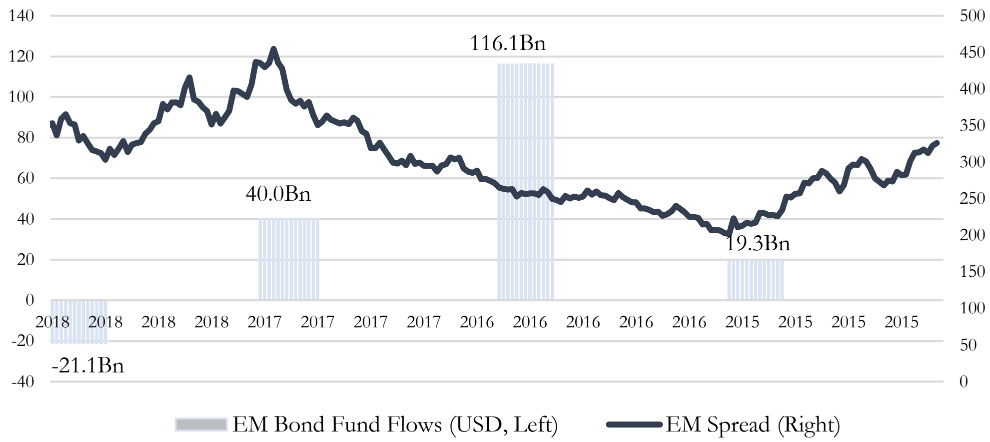
A year ago, we were concerned with the tightness of emerging market (EM) spreads and the risk of global inflation causing a sharp correction at the long end of the curve. EM spreads did indeed widen as evidenced in the chart below, but US Treasury (UST) 10-years ended the year only 28bps higher at 2.68%, after hitting 3.24% in early November. Every time the UST 10 year was flirting with the 3% level, EM bonds sold off.

2015-2018 EM Spread, UST 10y



2018 was initially the continuation of 2017, with strong inflows in EM mutual funds and ETFs, a movement later reversed in the second part of the year. Still, 2018 was a net positive year ($19bn inflows) and 2019 is starting on a strong note with over $3bn of inflows already year-to-date.

EM Spreads and EM Bond Fund Flows



Turkish and Argentinian bonds suffered a significant re-pricing after a sharp depreciation of their currency, a painful and necessary remedy to reduce their current account deficits and pressure the authorities to address fiscal imbalances. Both countries remain vulnerable, but yields are appealing.

In this respect, we were able to quickly react to the Turkish crisis and position our portfolios on flagship, solid names, that became opportunities because of the sell-off. The volatility around the Mexican elections and closely watched announcements by the newly elected president created some attractive entry levels on names we had been watching for a while. Throughout the year, we boosted our oil allocation, getting four oil E&P credits through the investment committee.

We are prepared for another volatile year in 2019 but remain confident that as soon as spreads reach a certain level, the asset class will attract inflows. It will be another eventful year in terms of elections (Nigeria, Ukraine, India, South Africa and Argentina all have general elections) and we are closely watching a number of top companies in countries that might not transition smoothly through the election cycle.

Our credo has remained the same: investing in companies committed to financial discipline, in sectors able to benefit from the growth environment, and with low refinancing risk given their business model and capital structure. That is our definition of quality and value for Emerging Market Bonds and by sticking to it we can weather price volatility, capture income from coupons and look to take advantage of opportunities as they arise.

Catherine Blanc-Adams

January 2019

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