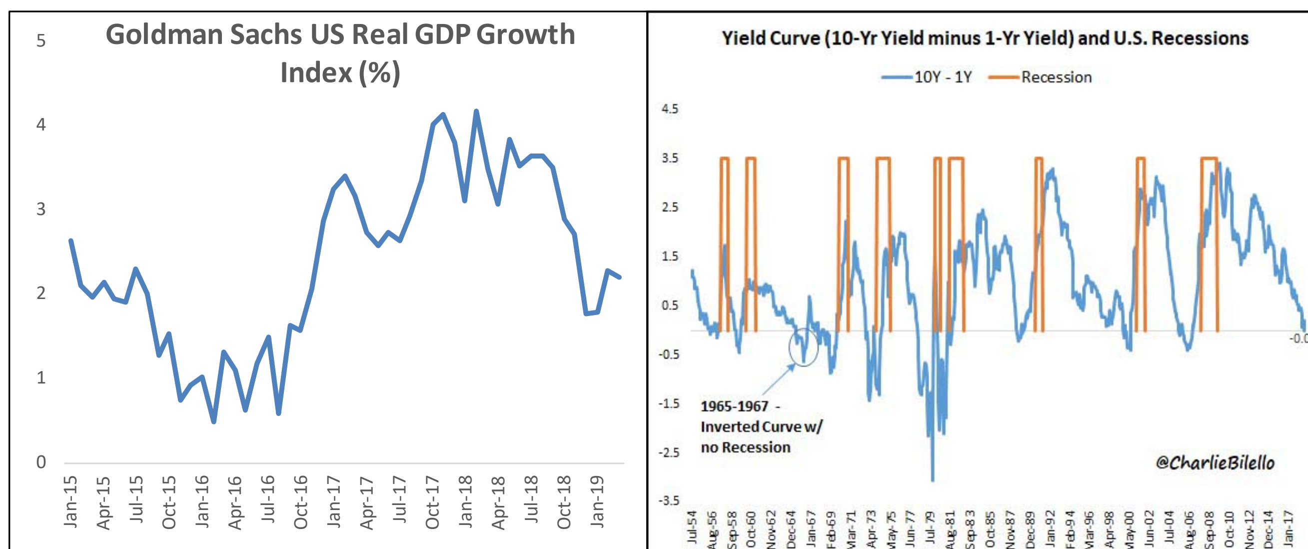
Manager's Letter
1st Quarter 2019

Peter Robson

After a very weak performance in the last quarter of 2018, global equity prices have rebounded very strongly in the first three months of 2019. The markets' concerns about slowing global economic growth and a tightening liquidity event appear to have abated thanks to several factors, such as the Federal Reserve's decision to stop raising rates while easing back on quantitative tightening and the potential for a resolution to the trade dispute between the US and China. China was the best performing market in the first quarter, thanks to some monetary policy loosening by the PBoC and some signs that the slowdown in economic growth had been arrested. In terms of global sectors, the best performers were Technology and Mining. More defensive sectors, such as Telecoms and Utilities underperformed while Financials suffered from a flattening of the yield curve. The improvement in growth outlook has been positive for our investment style, though the strategy remains wary about the speed of rebound that equity prices have enjoyed.

In the first quarter, our best performing investments were Chinese technology names (such as **Ctrip** and **Momo**) and those exposed to energy (such as **Modec**, **Siemens Gamesa** and **US Silica**). By contrast, our worst performers were small-cap names in Europe where growth disappointed (such as **Tele Columbus**, **Seeing Machines**, **Zooplus** and **Xaar**).

We expected US economic growth to slow in 2019 given the tax cuts which boosted growth in 2018 were unlikely to be repeated. The difficult year-over-year comparison was exaggerated by the longest federal government shutdown in history from December 22nd until January 25th. Evidence of slower growth is visible in the purchasing managers' index, which declined in the second half of 2018 and has not materially recovered, and the yield curve which inverted (a yield curve is inverted when it becomes cheaper to borrow longer term than it is shorter term) in March. This has historically been a leading indicator of an impending recession.



Source: Bloomberg

We expect the growth outlook to moderate for the US and continue to add positions in companies that are less economically sensitive. In the past quarter, we initiated positions in healthcare (**DaVita** and **Inogen**) and technology (**Universal Display**).

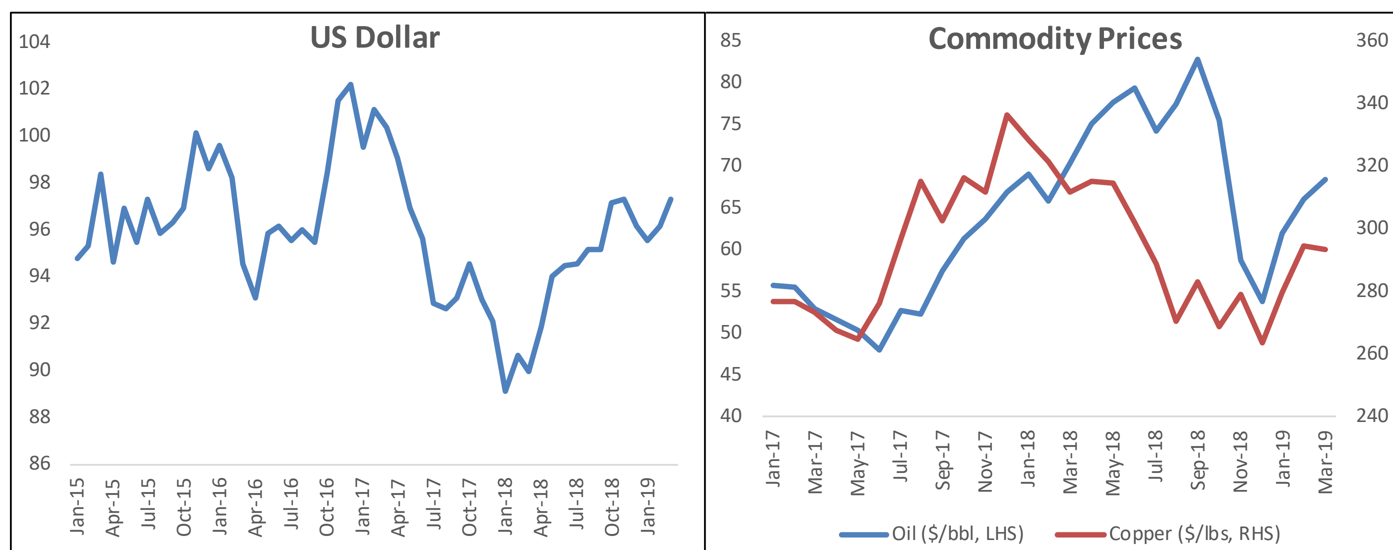
DaVita – DaVita’s primary business is the provision of kidney dialysis services for patients with chronic kidney failure in the US. It operates within an effective duopoly in a market that is growing steadily thanks to ageing population and lifestyle factors. The stock de-rated in the second half of 2018 thanks to a risk of regulatory change that would negatively impact patient economics, but we believe sentiment is now overly negative and that attractive fundamentals remain. In addition, we expect DaVita to receive a significant cash windfall in the first half of this year, from the sale of its non-core managed care business, which could be used to boost growth and/or be returned to shareholders. The company trades on 10.2x 2020 earnings.

Inogen – Inogen is the leading global producer of portable oxygen concentrators (“POCs”), primarily used in the treatment of chronic obstructive pulmonary disease (“COPD”). POCs are a highly disruptive technology with many benefits to the patient over traditional tank-based systems at a lower overall cost. We expect growth to remain very strong for many years as COPD diagnoses increase and POC penetration expands. The company trades on 39.3x 2020 earnings.

Universal Display – Universal Display is a leader in the research, development and commercialization of organic light emitting diode (“OLED”) technologies and materials, which are currently used in high end smartphone and television displays. It holds all the key patents for the technology and earns a royalty stream from manufacturers. After a relatively weak 2018, we expect growth to accelerate in 2019 – returning to its longer-term trend. This will be helped by technology advancements that will reduce the cost of OLED production, making it more price competitive vs. existing technologies. The company trades on 42.3x 2020 earnings.

However, while the yield curve inversion worries some investors, most fears of an imminent recession have been placated by a more dovish US Federal Reserve. Jay Powell, Chair of the Fed, has suggested that that 2019 will be the first year since 2014 in which it will not raise interest rates (and a proportion of the

market believes they will cut rates this year)[1]. The Fed has also announced that from September it will automatically stop reducing its balance sheet, further improving the liquidity environment in global capital markets. Despite a significant loosening in the monetary policy outlook the dollar actually strengthened over the first three months of 2019.



Source: Bloomberg

The improved economic outlook has supported the prices of both oil and other commodity materials, such as copper. Oil has been further supported by promises from Opec to engage in further production cuts, further political issues in Venezuela and the risk of further US sanctions on Iran. The improvement in oil price has been positive for our investments in **Modec** and **US Silica**, while the improving outlook for copper triggered new investments in **Turquoise Hill** and **Ero Copper**.

> **Ero Copper** – Ero is a Canadian copper mining company with operations in Brazil. The company is well positioned to benefit from production growth and declining operating costs at its active mines, in addition to having high longer-term growth potential from extensive reserves. Growth should also be supported by price as copper demand exceeds supply. The company trades on 11.1x 2020 earnings.

Along with the change in messaging from the Federal Reserve, increased confidence on the Chinese economy also drove the recovery in equity prices in the first quarter. Growth in the Chinese economy continues to slow, particularly in certain sectors such as autos, but there were signs in March that growth has stabilised with the rebound in the purchasing managers' index. The stabilisation appears driven both by the People's Bank of China's decision to cut the required reserve ratio to stimulate growth and the increasing confidence that the US and Chinese governments will resolve their trade dispute in the near future. The change in perception of China's growth outlook drove a significant rally in domestically-listed stocks in the first quarter, and also benefited our investments in Chinese technology firms listed in the US, such as **Ctrip** and **Momo**.

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[1] *Federal Reserve statements https://www.federalreserve.gov/*

Source: Bloomberg

While fears of a slowdown in the US and China are abating, the economic environment in Europe continues to deteriorate. Business confidence deteriorated further in the first quarter of 2019 and the European Central Bank was forced to keep rates on hold and lower their growth expectations for the region. This slowdown has been driven to Europe's export exposure to China and the deterioration in the auto market following the new emissions standards that were introduced in the wake of the 2015 emissions scandal. The deceleration in growth across Europe has hit the performance of some of our small-cap investments and in the past 3 months we sold our position in **Biocartis**.

Source: Bloomberg

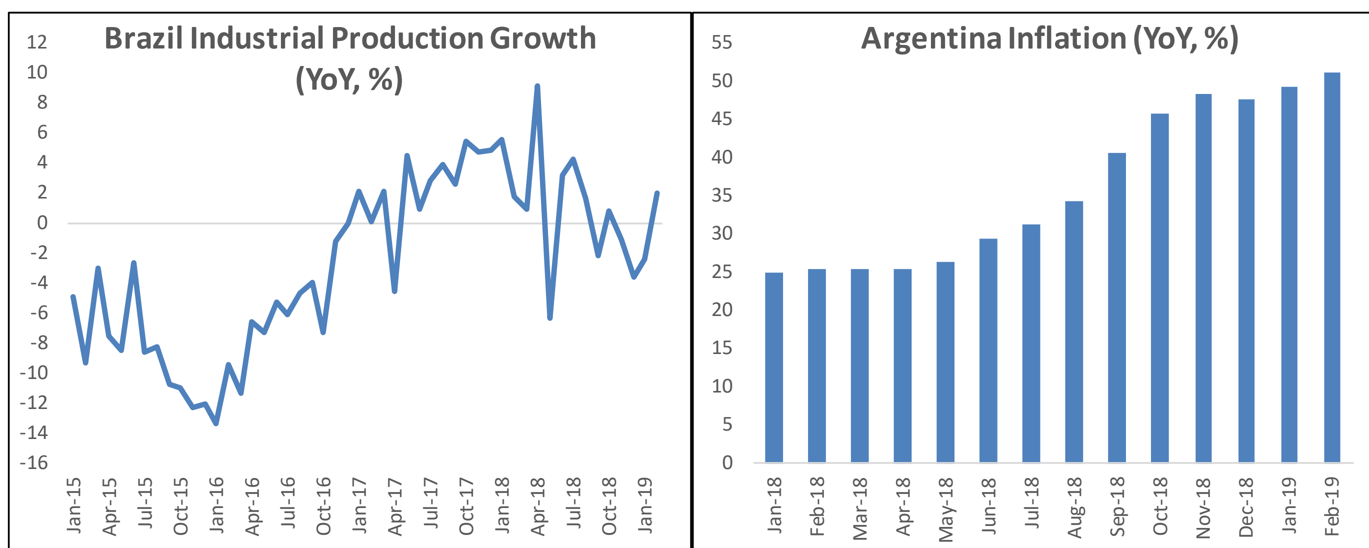
Business confidence in Europe has also been impacted by the political uncertainty stemming from the UK regarding Brexit. Members of Parliament have now voted against Prime Minister May's withdrawal agreement three times but have also not reached a majority on any of the other options open to the government, creating significant uncertainty regarding the country's eventual relationship with the EU. Britain was due to leave the European Union on the 29th March but this was postponed to the 12th April if no agreement by Parliament is reached, or the 22nd May if Parliament could finally agree to May's agreements. The latter looks extremely unlikely but there remain a range of potential outcomes, with a

softer Brexit (i.e. one where Britain remains part of the customers union and possibly the single market) currently looking the most likely.

Politics is also a key theme in India. Polling for Prime Minister Modi's Bharatiya Janata Party has improved ahead of this year's election, in part thanks to the Prime Minister's response to the hostilities with Pakistan. However, the BJP are unlikely to win another outright majority so is likely to have to form a coalition with other centre-right and right-wing parties. There continues to be some concern regarding the property sector and the financing of that sector. RERA (the Real Estate Regulation Act) has made it significantly more difficult for smaller players to operate, putting pressure on those developers and those financing them. However, the demand for affordable housing in India remains robust so we believe this will lead to consolidation in the market, which is beneficial for those large players, such as our investment in **Prestige Estates**. There remain interesting long-term growth opportunities throughout India and in the past three months initiated a position in **Zee Entertainment.**

> **Zee Entertainment** – Zee is one of India's largest media and entertainment companies, and is involved in the development, production and broadcasting of television shows, movies and music over satellite and the internet. We expect the company to continue to achieve strong growth driven by increasing TV penetration, price inflation and higher advertising spending. We also expect an international entertainment company to take a strategic position in the company, which should be positive for the stock. The company trades on 22.0x 2020 earnings.

In Latin America, economic data for both Argentina and Brazil disappointed somewhat during the first three months. Financial markets were very optimistic about the potential for growth to accelerate in Brazil following the election of Bolsonaro as President on October 28, 2018. However, there is increasing concern about the President's ability to pass much-needed pension reform and analysts have downgraded their growth forecasts for 2019 from ~2.5% at the start of the year to ~2% now. In Argentina, there is concern that a weak economy raises the possibility of former left-wing President Cristina Kirchner beating incumbent President Macri in the Presidential elections in October. These fears should abate if the Central Bank's currency trading band is successful in stabilising the peso and if the rate of inflations begins to decline.



Source: Bloomberg

Outlook

Following a tumultuous fourth quarter, equity prices have rebounded in the first three months of 2019 as if nothing happened, with the MSCI All Countries World Index almost back to levels last seen at the end of September. While there were good reasons for equity prices to recover this quarter, such as the change of messaging from the Federal Reserve, there were also valid reasons for the declines in the fourth quarter of 2018 – growth has slowed across major geographies, we are 10 years into an economic expansion cycle, and there is deep distrust between the world's two largest economies.

At this point we believe the most exciting opportunities lie in Emerging Markets. The US is the furthest through its economic cycle, as demonstrated by the fact that the yield curve has now just inverted. Despite this, US equity markets continue to trade at a significant valuation premium to Emerging Markets. We believe EM relative outperformance should be supported by a more benign interest rate environment and potentially a weaker dollar if the US economy does continue to slow from the fiscal sugar rush of 2018.

Due to the uncertain economic backdrop we continue to focus on investments where the earnings acceleration is driven by company-specific factors and structural investment themes.

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