Manager’s Letter 4th Quarter 2019

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The Strategy has had a slightly disappointing quarter, in that it has underperformed the benchmark. That said, **the result for the whole year is highly satisfactory**. The recent underperformance can largely be attributed to the large rotation from growth stocks, to lower value, defensive counters, which took place in early September, and which left growth shares somewhat unloved throughout the last few months of the year. The catalyst for this change of tone in the market was a sharp rise in bond yields (which had been declining inexorably), provoked by expectations of higher inflation, accelerating growth in the USA, and a more “hawkish” Federal Reserve (in contrast to the loosening in July). This, as is invariably the case, sparked an enthusiasm for “value” stocks, at the expense of “growth” equities, and indeed low P/E stocks massively outperformed high P/E stocks in September. Given that, as we have a growth stock Strategy, underperformance in these circumstances is inevitable.

There was also a **significant rally in mining, energy, and semi-conductor stocks**, which we rarely, if ever favour, as their earnings are extremely cyclical, and for the most part, the returns which they generate rarely meet our requirements. Throughout the period, the Strategy has been heavily weighted towards America and Asia.

The enemy guns had fallen most heavily upon the US crewmen. **Medical technology suffered especially**, with **Exact Sciences** and **Dexcom** both carried down to the sickbay, while technology, as is always the case, took some punishment, with **Appian**, **Chegg**, **Rapid 7**, and **Match Group** all bleeding heavily by the end of the encounter. But it is important to keep things in perspective, and although **Appian** lost 20% in September, it came in the wake of a 51% rise in August, and for the first nine months of the year the majority of our US holdings have seen exceptionally strong performance, and we remained optimistic that recovery was likely, should third quarter results prove good.

And indeed, so it proved, with **the highlight of October being the third quarter results season in America, which generated more than its usual heat and light**. As ever, the slightest miss in earnings brought about extremely harsh treatment. **Servicemaster**, the provider of pest control services, notably termites, preannounced some very disappointing results, causing a 20% fall in the shares. The stock was held for its defensive growth characteristics, and, perhaps unsurprisingly, we had failed to anticipate the appearance of a particularly aggressive and destructive termite from Formosa, which has apparently led to greatly elevated claims. As is usually the case when a stock sustains such serious damage, we consigned his body to a watery grave. In his stead, we started a holding in **Copart**, the leading provider of auction and related services for the automotive salvage industry. **Exact Sciences** also struggled, ahead of results, which proved unjustified, given that third quarter sales were 85% higher, and earnings rose 21%. The company continues to spend very heavily on sales and marketing. Those apart, the rest of the

American watch performed creditably enough, with **Visa** and **Pool Corporation** making good progress, while **Dexcom**, **Keysight Technologies**, and **Zoetis** also traded higher in October, recouping some of September's losses.

One of the more significant events of the second half of 2019 was a **reconnaissance expedition to China in September**. Despite the negativity caused by slowing economic growth, and the Sino US trade dispute, we returned greatly encouraged. While the rest of the world obsesses with both these issues, not a single company referred to them, although, to be fair, given our concentration on consumer facing stocks, none of the companies, which we visited is either a manufacturer or an exporter. Pleasingly, two of the most encouraging meetings were with existing holdings, namely **China International Travel Services**, which dominates the country's duty-free industry, and **Yihai International**, which makes flavourings for hot pot recipes. Despite the supposed growth slowdown, outbound travel continues to grow strongly, and duty-free expansion continues apace. Hot pot restaurants continue to enjoy a huge following in China, and the opportunity remains considerable. Indeed, during the visit we made a victualling stop at **Haidilao**, which runs almost 500 such establishments, (also a sister company to **Yihai**), and found it both very agreeable, and extremely popular. The reality is that consumption in China, which is the Strategy's sole focus, remains robust.

Indeed, much of the outperformance in October was generated by the **recent recruitment of some of these new Chinese sailors to the ship's company following the research trip**. In this respect, we have been taking a somewhat contrarian approach, since China is only very rarely viewed positively, and by the end of October Chinese holdings comprised almost a third of the Strategy. Our new investment in food delivery leader, **Meituan Dianping** started life very sharply, gaining 17% that month, while hot pot flavourer, **Yihai**, and hot pot restaurateur **Haidilao**, were up by 15% and 7% respectively. While **Yihai** has been a very gallant member of the ship's company for over a year, **Haidilao** only joined the crew that month. It operates almost 600 hot pot restaurants in China and is planning to grow very rapidly. The other significant contributor was another new recruit, **New Oriental Education**. In our opinion, **New Oriental** has an excellent and very defensible business, reliant as it is on physical learning centres, as opposed to online tutoring. The stock gained 10% over the month. The only slight blemish in the Chinese watch in October was some merely adequate results from duty free shopping giant **China International Travel**, (-1.6%), while **Tencent** continued to drift, closing 3% lower.

In Europe, German financial services provider **Hypoport**, preannounced buoyant traffic figures for their online platform, causing the shares to rise by 23%. This prompted us to take a little profit, although at year-end it remains a sizeable position, given that the shares have more than doubled over the year.

November saw a few more companies releasing figures, and indeed that **month's Star Performer Award was shared by Axon Enterprises and Dexcom**. **Axon** makes Taser weapons to subdue troublesome, often riotous and dangerous people, as well as body cameras, mostly worn by policemen, to record their troublesome activities. While reassuring, rather than inspiring, the third quarter results sent the shares, up by 44%. Regular readers will recall our longstanding enthusiasm for **Dexcom**, the maker of life changing devices, which monitor blood sugar levels in diabetics. Their third quarter revenues rose by 48%, and margins improved substantially. All of that, together with an optimistic outlook statement, saw the shares 47% better over the month.

We also recruited two old friends back aboard ship in November, in the shape of **Freshpet** and **Intuitive Surgical**. As the name suggests, **Freshpet** is the leading purveyor of fresh food for increasingly humanised, fussy, allergy prone, and spoiled domestic pets, (or perhaps it is the owners!). **Intuitive Surgical** is the maker of the now ubiquitous Da Vinci robotic surgical devices, which are becoming rapidly more sophisticated, allowing them to be used in ever wider surgical situations. We also bought **Resmed**, which provides devices to treat Sleep Apnea, (snoring). This is a company, which we have met on many occasions over the years, and which, to our cost, we have owned only briefly, many years ago. Sleep Apnea is very widely acknowledged to be a highly debilitating condition, and **Resmed**'s devices remain the treatment of choice. All three have made a good start to life aboard ship, and they replace **Chegg**, which was not entirely satisfactory, **Match Group**, which was extremely profitable, and the similarly successful shoe retailer, **Bata India**.

December was much less eventful, with very little corporate news, and the Strategy underperformed slightly. This was due as much to profit taking amidst a good many of the Chinese names, together with a greater degree of caution towards US growth stocks, which overall, have enjoyed an extremely good year. Much to our surprise, there have also been some very rich prizes to be taken in European waters in the last quarter, and unfortunately, we have allowed these opportunities to pass under our guns without firing a shot. The temptation to chase all treasure galleons is always acute, but we have allowed good fire discipline to be a little costly in this instance.

But we remain fully invested and quite optimistic. We would also expect that the Strategy will continue to be focussed on America and Asia, which are, in our view, the two most promising growth markets[1]. This is because our sharp-eyed lookouts are still finding plenty of fat treasure ships in these areas, which we hope to bring within range of the guns when wind and tide allow. Indeed, our battle pennant is already streaming from the masthead, with the first skirmish of the year very much imminent, as US companies begin to report their full year results towards the end of January. As ever, much will depend on how that goes, given that the US market usually sets the tone for markets throughout the world.

Data and information as of 31st December 2019

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[1] *No guarantee of results or performance*