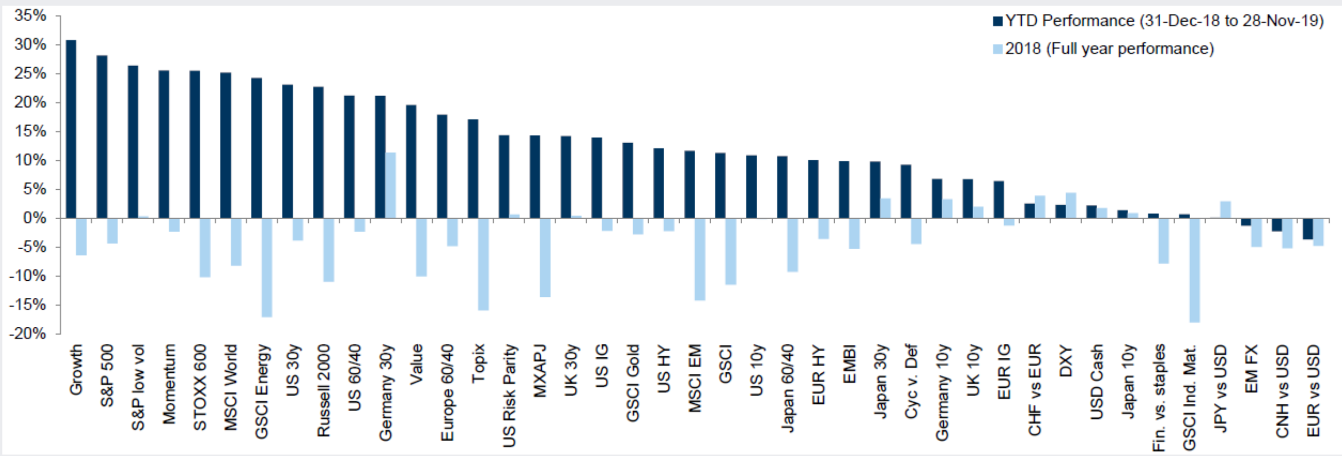
Manager’s Letter
4th Quarter 2019

Jacques Berghmans

1. Economic and market environment

2019 ended up being an excellent vintage year for the world financial markets. Most asset classes delivered positive returns with some, such as US equities performing very strongly. European-based investors who bought American stocks got an additional return boost from the Euro underperformance compared to the US-dollar. Even long maturity government bonds, which we think will eventually destroy significant value for the long-term investor, generated positive returns in 2019. For the typical Belgian ‘balanced’ investor, who owns an unhedged portfolio mixing large capitalization stocks with corporate and government bonds, the past year was an excellent one.

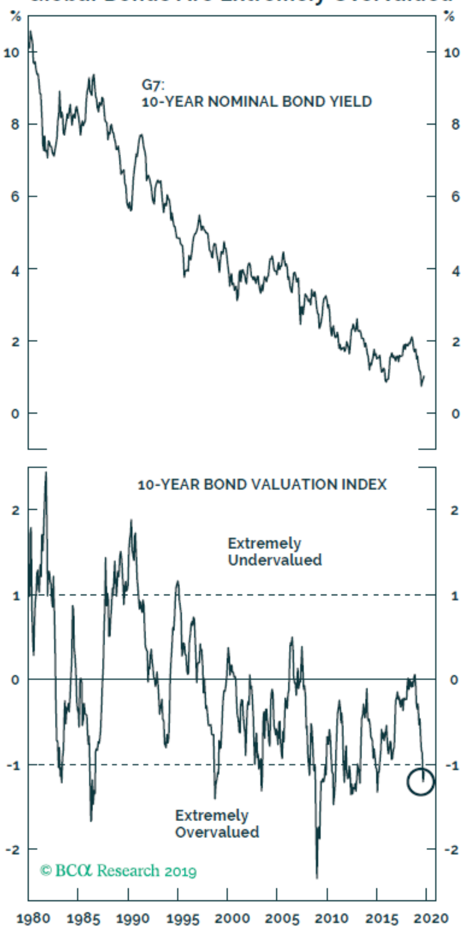
Exhibit 2: Returns across assets have been strong in 2019 after a very difficult 2018



Source: Datastream, iBoxx, Goldman Sachs Global Investment Research

However, we think that 2020 and the following years will require a much better selection of asset classes to be able to generate positive returns. For us, one of the major investment rule to remember is that every investment is risky, there is no ‘safe’ asset class. Unfortunately, there is a common misconception about risk and most investors associate it with short-term volatility, usually looking at the last five or ten years to assess what future volatility could be. This is how some investor might end up buying very risky investments, which generated good returns with low volatility in the past but are now in bubble territory.

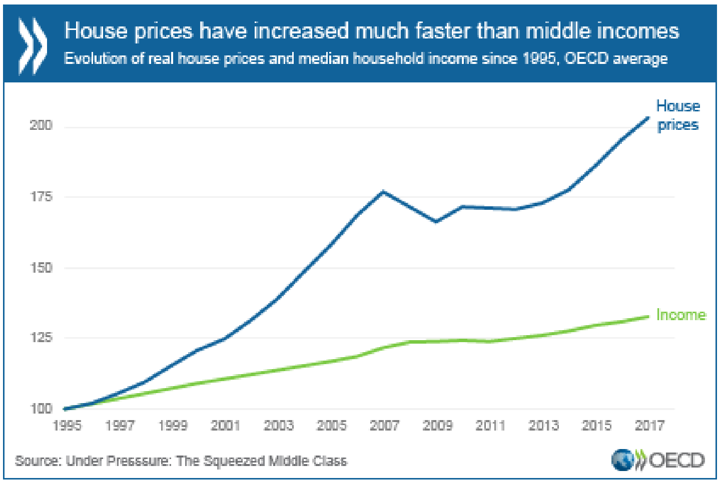
CHART 28
Global Bonds Are Extremely Overvalued

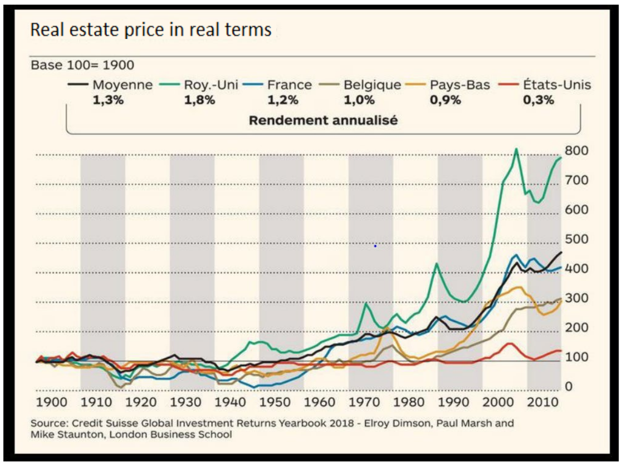


Instead, we think that a better way to invest is to first understand what potential return an asset class might generate and then analyse the risk profile. There are three broad categories available to the retail investor, **real estate, fixed income and equity investments.** By definition, fixed income assets (bonds, loans, money market instruments etc) generate a fixed return for the investor, which is absolute or fixed to a moving benchmark like LIBOR. Over the last three decades and especially since the crisis in 2009, the return on these fixed income instruments has collapsed, with most decent quality debt instruments yielding below, close to or just above 0%. Some readers might point out that investments in bonds have done very well in recent years, which is true, but it is mostly due to price appreciation and not yields. As overall rates declined, investors paid more and more for older & higher yielding debt instruments. Today, most fixed income instruments generate no yields and we are convinced that we have reached the end of this multi-year capital appreciation phenomenon in fixed income and potential return for this asset class is now close to 0%. We continue to strongly believe that most fixed income instruments should be avoided and the traditional 60/40 equity/bond portfolio sold by financial institutions over the last three decades is not an appropriate solution anymore.

"It is a terrible mistake for investors with long-term horizons -- among them pension funds, college endowments, and savings-minded individuals -- to measure their investment 'risk' by their portfolio's ratio of bonds to stocks."
WARREN BUFFETT

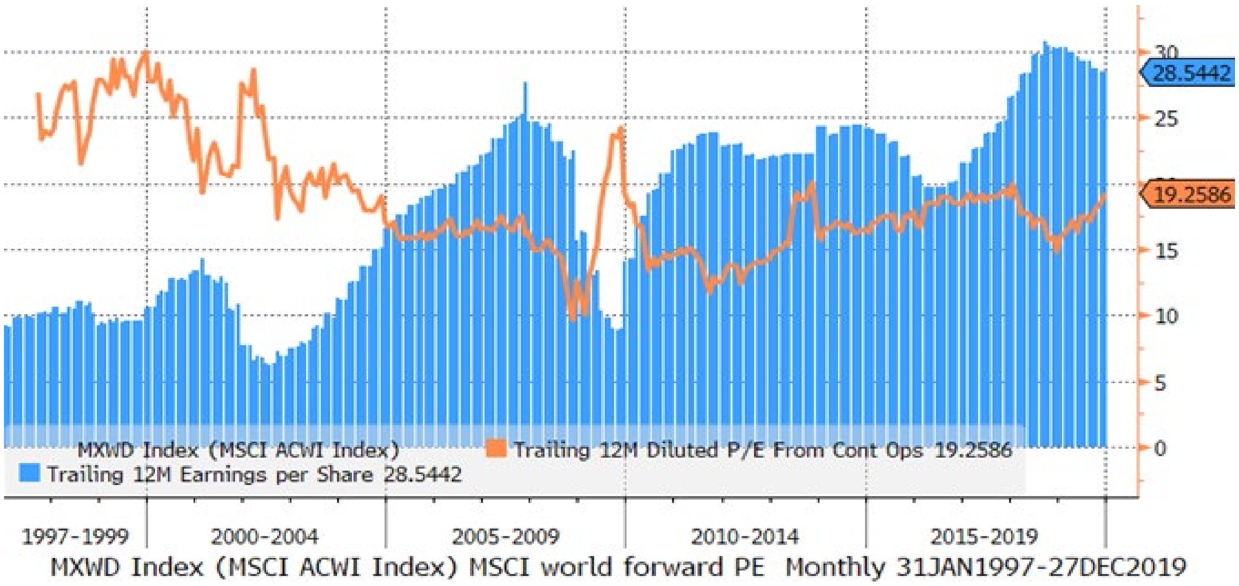
We are not experts in real estate and analysing the subject is beyond the scope of this newsletter. Nevertheless, it is important to point out that most Belgian households are over-invested in Belgian real estate. This asset class is also highly illiquid, generates significant transaction costs and is not diversified when investors buy buildings directly instead of real estate investment funds. Similar to fixed income investments, the source of return comes from price appreciation and rental yields. Europe, and Belgium in particular, saw a significant increase in real estate prices over the last few years (well in excess of the increase of the household income), made possible by the drop in financing costs.





At this point, mortgage rates are very likely close to the bottom making similar price appreciation unlikely and most of the return will depend on rental yields net of costs. Rents do tend to increase with inflation and therefore provide capital protection, but we would still recommend treading carefully and keeping in mind that the big increase in real estate prices is very likely behind us.

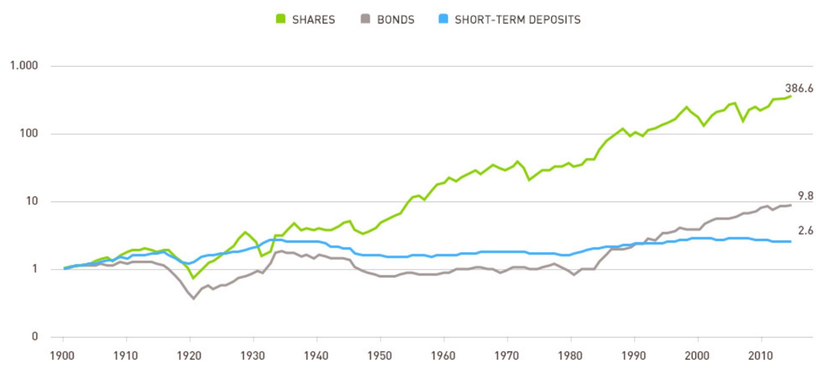
Now what about **equity investments** and in particular the **global stock market,** which we continue to think is a very interesting asset class for the long term investor? A first observation is that the world stock market trades in line with historic valuation multiples (orange line on the graph below) which tend to vary between 12x and 30x trailing PE.



Source: Bloomberg

The second major observation is that the earnings per share generated by companies does tend to grow consistently over long periods of time, being driven by economic growth, inflation and share buy-backs. Paul Marsh in his long term study of asset prices observed that over a hundred & twenty years period, stocks generated a nominal annual return of 8.2% and a real return (after inflation) of more than 5%, much better than any other asset class in the world.

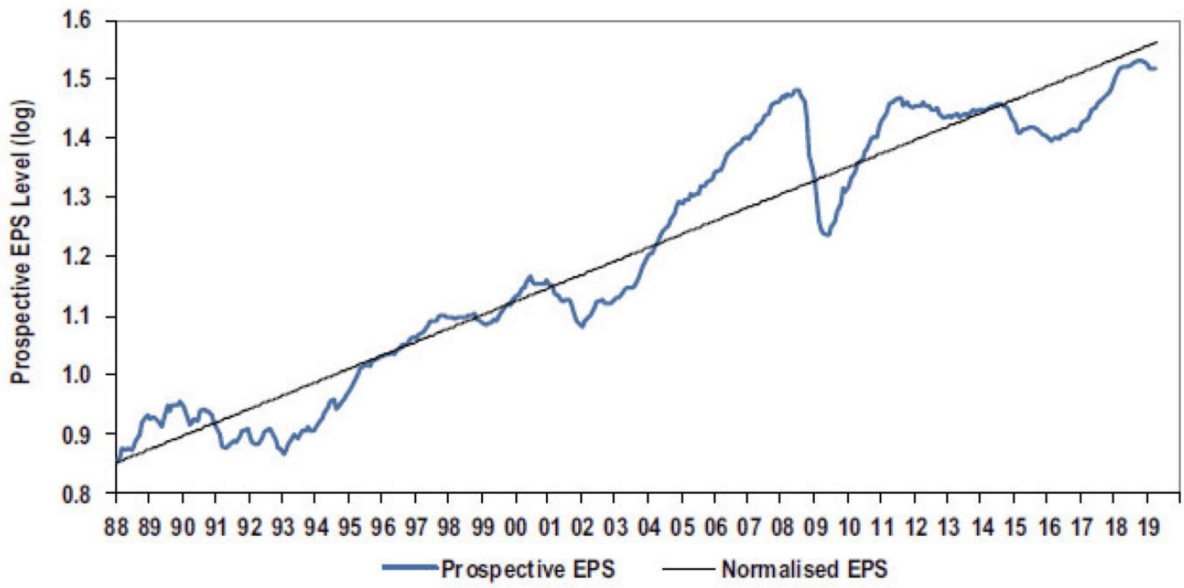
Real performance of different asset types (after inflation) - 1900-2017[1]



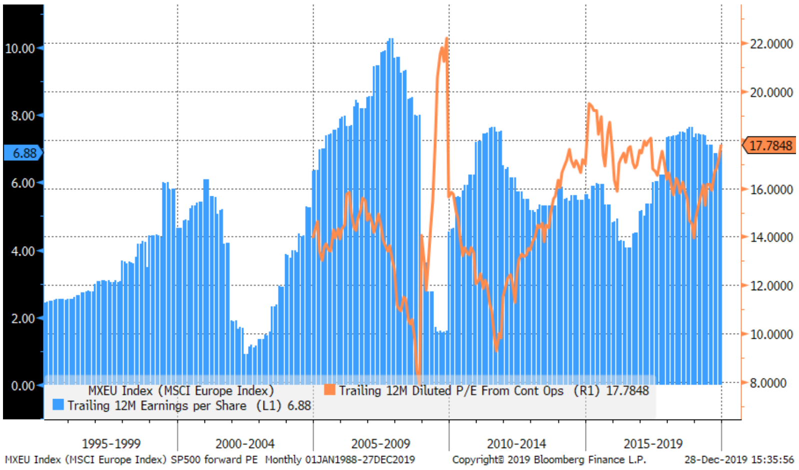
Annualized performance (before inflation)	
Equity	8.2%
Bonds	4.9%
Cash deposits	3.7%

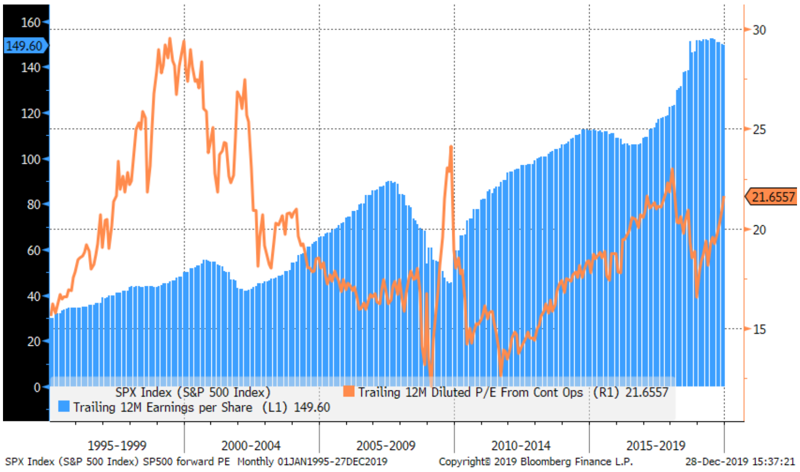
Annualized performance (after inflation)	
Equity	5.2%
Bonds	2.0%
Cash deposits	0.8%

[1] Source: Credit Suisse Global Investment Returns Yearbook 2018, Elroy Dimson, Paul Marsh and Mike Staunton, Triumph of the Optimists: 101 Years of Global Investment Returns, Princeton University Press, 2002.
* Past performance is no guarantee of future performance.



Source: BofA Merrill Lynch Global Quantitative Strategy, MSCI, IBES
Données à titre illustratif uniquement. Les comportements de marché passés ne préjugent en aucune manière de leurs comportements futurs.





Source: Bloomberg

Now the reason why we recommend investing in the **global stock market** and not regionally is that some regions of the world can underperform for a significant amount of time, Japan being the prime example with the TOPIX reaching an all-time high in 1988 and never coming close to this peak again. The world tends to progress relatively evenly over time, but most of the growth generally comes from a few regions and companies. The biggest contrast since the financial crisis in 2009 is the outperformance of the American market relative to European markets. As we can see on the graphs on the left, the S&P500 is actually not much more expensive than the MSCI Europe (22x trailing earnings compared to 18x trailing for the European market) but earnings per share are over 50% higher than in 2009 in the US when in Europe, earnings per share are more than 30% lower than in 2009! Despite the crisis starting in America, the region was much faster at taking the bitter pill, reforming its financial system and ultimately getting out of the recession a lot faster. Instead in Europe, the crisis crystallized some long-running structural problems like over-indebted Southern European governments and a lack of competitiveness. Ultimately, the continent is likely to get out of these issues but for European equity investors, we can already speak about a lost decade.

A final wish we would like to make for the next few years is the end of trying to time the market or trying to predict short-term market moves, which in most cases lead to value destruction for the final investor. In a recent study 'Mind the Gap', Morningstar calculates the average return achieved by investors compared to what the asset class has achieved. The good news is that the gap has tended to narrow over time, the bad news is that Europe is among the worst in-class and even more problematic, the gap tends to increase a lot in times of crisis like in 2009. Basically, the study confirms what we have observed empirically: investors tend to panic when they see losses increase and therefore miss most of the rally. The study also observes that in countries like the UK and Australia where most investors use automatic monthly investment plans irrespective of market moves and news, there is no such gap.

In conclusion, please don't try to time the market, don't panic in bad times but also don't invest beyond your means (a few years of expenditure in cash in the bank is generally prudent) and avoid 0% yielding fixed income. For more information about the risks of investing in the stock market, please refer to our article "8 golden rules about investing[1]" and "5 ways to reduce risks when investing"[2]. The TreeTop team wishes you all the best for 2020 and beyond and remains available for any questions you might have.

[1] https://www.treetoponline.be/fr/blog/article/8-regles-dor-pour-investir-en-bourse
[2] https://www.treetoponline.be/fr/blog/article/investir-en-bourse-5-facons-de-reduire-les-risques

2. Our convictions

After a difficult 2018 for our strategy, this year came as a relief but was probably not as good as we would have liked. On the positive side, a number of our long standing positions delivered excellent results, the major ones being **IWG** (leading global office sharing business with brands like SPACES & REGUS)**, VIPSHOP HOLDING** (leading discount e-commerce website in China)**, ASHTEAD** (leading equipment rental business in the United States) and **NORWEGIAN FINANS** (largest pure online consumer lender in the Nordic countries)**.** However, one single stock **INDIABULLS HOUSING FINANCE** (mortgage provider in India) detracted from our overall performance significantly, as a result of an unexpected crisis in real estate in India, which ended up dragging down the whole sector and then the whole Indian economy.

We dedicated our previous newsletter to why we continue to believe that India is a very interesting economy and stock market for the long term investor and why we remain confident in the long term potential for **INDIABULLS HOUSING FINANCE[3].** Over the last three months, most bonds of the Company have stabilized & re-rated and the stock is up 73% from the bottom in October, which sounds a lot but is still far from its peak. There are a few lessons to learn from the last eighteen months. First, bad practices in a sector can drag down everybody, including the best managed businesses. Despite being managed carefully, **INDIABULLS HOUSING FINANCE** like Goldman Sachs in 2009 got affected by the significant turmoil in the financial markets. Secondly, good long term structural reforms can create a negative domino effect in the short term. Part of the crisis was caused by the willingness of the Indian government to better regulate developers. While the new legal framework should be positive for the sector eventually, the bankruptcy of some bad players led to a freeze of wholesale financing in India and ultimately a collapse of most developers except the very best ones. The major difference between this crisis and other collapses, like the American real estate bubble in 2009 and the Greek debt tragedy, is that the long term demand picture is ultimately very sound. Indian households, unlike American ones in 2009, have very little debt and a strong need for better housing. The Indian government, unlike the Greek one in 2012 has little debt and much more headroom for macro-economic and fiscal stimuli. Because of the positive long term prospects for real estate financing in India as well as the prudent actions taken by the management of **INDIABULLS HOUSING FINANCE,** we have continued to hold the stock during this very difficult period. As we have seen with stocks like **VIPSHOP HOLDING and IWG,** stock performance can reverse very quickly as long as the fundamentals of a company continue to be strong and the long term potential intact.

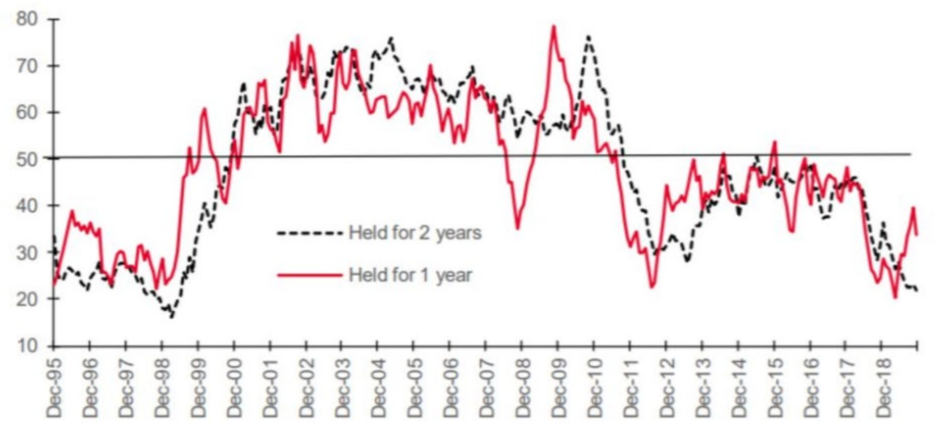
Both **IWG** and **VIPSHOP HOLDING** saw a strong positive reversal in performance in 2019. **IWG** executed on its long term plan to franchise some of its operations, selling down the franchise rights for its Japanese operations at much higher valuation multiples than market expectations. **VIPSHOP HOLDING** refocused its efforts on its core discount categories (apparel & cosmetics) and outsourced its last-mile delivery to improve margins. Tencent, the largest Chinese internet company and a long-term partner of **VIPSHOP HOLDING,** also recently increased its stake in the company, a sign of long term confidence in the business. Both stocks are good illustrations on how successful businesses sometimes face temporary hiccups leading to significant underperformance, before outperforming when a bad situation reverses.

In our three previous newsletters in 2019, we wrote extensively on how the under-performance of emerging markets compared to the United States might finally reverse and about the great long-term potential of India and China. We had reasonable success in China this year but India was not that positive for us. We also mentioned the massive outperformance of US large companies. Reaching the last few days of the decade, we have to admit that our timing on these predictions wasn't that great. The American stock market continued to outperform everything else in the last few weeks of December, boosted by the last minute trade agreement with China. A Bloomberg columnist recently analysed the performance of 16,000 actively traded stocks worldwide and benchmarked them against the performance of the S&P500. He found out that only 20% of stocks out-performed the S&P500 over the last two years,

[3] https://www.treetopam.com/documents/3Q19%20Manager's%20Letter%20JB.pdf

the lowest level since 1995. Basically, most stocks have done worse than large American companies making the life of active global stock pickers like us somewhat difficult.

The most depressing chart ever! Percentage of global stocks out of a universe of 16,000 world stocks outperforming the S&P 500 over a one and two-year basis.



Source: SG Cross Asset Research

We don't think switching to large American stocks at this point would be a good decision and we are staying with companies that continue to deliver excellent earnings growth, operate a quality business with high barriers to entry and trade at reasonable valuation. Changes tend to happen abruptly in the stock market and we hope to be well positioned when it happens.

Data & Information on the 31st December 2019

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