fisher institutional

Snapshot

Market insights for investment professionals from Fisher Institutional — July 2018

Xero: wearing out the shoe leather

Sam Dickie
Portfolio Manager
— New Zealand

There are two pieces of art on the wall next to my desk at work — both are quotes by Peter Lynch, the former manager of the rockstar Magellan Fund. The first is *"There is absolutely no better investment technique than wearing out shoe leather and visiting companies"*. The second is *"Know what you own and know why you own it"*.

There are two potential reactions to those pieces of art — either we need to inject some flair into our taste in art or, given that as the manager of the Magellan Fund between 1977 and 1990, Lynch averaged a 29.2% annual return, consistently more than doubling the S&P 500 market index and making it the best performing mutual fund in the world, perhaps we should heed his advice.

While the former may be true, we decisively follow the latter and agree whole-heartedly with Lynch's advice. There is no substitute for looking in the eye of the managers at a business — it accelerates the knowledge process and gives us confidence that there are layers of quality management below the "C" suite. Given more than 50% of the revenue from the NZ Growth Fund is derived from offshore, we recently visited several of the offshore operations of the portfolio companies in the NZ Growth Fund as well as global competitors of these companies.

One of the highlights of the trip was an opportunity to spend some time with the head of Xero's UK operation, Gary Turner.

Xero is the market leading provider of cloud-based accounting software for small-to-medium businesses and their accountants in NZ, Australia and the UK, with growing presences in the USA and other markets such as SE Asia and EMEA. We assume Xero will continue to be the innovators of the industry, allowing it to retain its market leading positioning in Australia/NZ and the UK, grow its foothold in the US market, as well as overtime, grow its rest-of-world business. Combined with the huge market opportunity (global penetration less than 3%) and the wide MOAT Xero is building around its small business customers, we think Xero has material future earnings growth and the UK will be a key driver of that growth.

The UK: a lucrative opportunity

Gary is one of the longest standing executives at Xero and has presided over the UK operations of Xero since inception almost 10 years ago.

Not only has the UK gone from less than 25,000 subscribers and less than 15% of group revenue 5 years ago to more than 325,000 subscribers and more than 20% of group revenue today, importantly we see the UK as the strongest revenue growth driver for the next 5 years.

Xero has around 1.4m customers globally today and we agree with Gary that there is no reason Xero cannot reach over 1m customers in the UK alone and we forecast them reaching that milestone within the next 5 years.

A powerful tailwind for the business is the UK government's mandate requiring firms to lodge consumption tax (VAT) returns digitally from April next year. Given approximately only 1 in 7 of the 1.4m VAT registered companies in the UK currently use accounting or tax software, this will help ensure the impressive growth rates we have been witnessing continue.

The secret to Xero's success in the still relatively nascent cloud accounting software market in the UK will continue to be great product, great people, strong relationships with the accountant channel as a key route to market and the courage to continue to be the innovator of the industry.

It is face to face meetings like this that are invaluable in building our further understanding of portfolio companies like Xero.

fisher institutional

Believing in Brambles

Frank Jasper
Chief Investment Officer

Last month I was in Wellington where I had the chance to meet with some clients. As I am originally from the Hutt Valley I can say this; Wellington was on its very best Wellington behaviour. It was tempestuous, with that special horizontal rain that I am convinced blows straight in from Antarctica and has a gift for finding a way down the neck of your jacket and then chills you to the bone.

One of the things I covered in my presentation was the idea that building long-term wealth requires a little bravery — being brave enough to take positions that feel a little uncomfortable at the time or that may even seem counterintuitive. Ultimately, though, swimming against the popular tide has on many occasions resulted in our best long-term successes.

While the environment for one of the Australian companies in our portfolio **Brambles**, hasn't been quite as tempestuous as a Wellington southerly, it has been difficult. On this occasion though we think the storm has delivered us the opportunity to increase our investment at a very reasonable price. While it takes a little bravery to add to an investment when the news on the company isn't exactly great, this is precisely the right time to do it, given our belief that Brambles is a high quality company with sound long-term growth prospects.

Brambles is the leading global supplier of pooled pallet and reusable crate solutions to its customers, primarily in the fast moving consumer goods sector. The company has a long history of generating shareholder wealth and a track record of making smart strategic decisions.

At the moment, Brambles is facing transport and plant cost pressures in its key US pallets market. The list of challenges is long; higher fuel prices, driver shortages, some changes in customer behaviour in response to higher transport costs, higher lumber costs, inefficiencies due to capacity constraints, and changes in commercial relations with some retailers. These headwinds have pressured Brambles' profit margins in the US.

The company is working to relieve these pressures by implementing surcharges and adjusting contract terms as contracts roll over. It is also investing in a plant automation programme that will modernise its US service centre network to a standard similar to its more efficient European network. While these initiatives all make sense to us, these actions with the exception of surcharges, are not a short-term fix and we expect pressure to still be evident on the company's near-term earnings.

Brambles' balance sheet pressures are currently being reflected in its share price, and the valuation of the company, based on metrics like the price to earnings ratio, is sitting at five year lows. We believe this is the opportunity. Brambles is growing its revenues in mid-single digit levels, and we believe the company will continue to keep growing at such rates for years to come. As Brambles solves its short-term cost challenges, margins should improve turning forecast revenue growth into even healthier profit growth.

We love buying shares in high quality, growing companies on sale and have added to our investment in Brambles. We believe now is the time to be patient, ride out the storm and enjoy the good weather to come. We all know you can't beat Wellington on a good day. Fingers crossed out increased investment in Brambles gives us that same warm feeling.

A time for active management

Frank Jasper
Chief Investment Officer

Active management is at the core of everything we do at Fisher Funds. It's why we have New Zealand's biggest investment team and why we spend a lot of time out of the office getting deep into the nitty gritty of what makes one company better than another.

The reason for doing this is simple. If we can beat the market, by assembling a hand-picked portfolio of share or fixed income investments, this incremental return compounds over time to dramatically grow your wealth.

There is another reason we think active management is critical. It helps protect your money in more difficult environments.

The risk protection provided by active management is not well articulated or understood by many commentators. The academic evidence suggests active managers tend to do better when markets are performing poorly and do less well in very strong bull markets.

Protecting your capital in down markets is very important to long term wealth accumulation. This is for two reasons. First and foremost you build wealth through compounding returns over time. If active management can reduce losses in the tough times then you continue to compound off a higher base. If you suffer big reductions in wealth in down markets it takes a long time just to recover these losses before you begin making gains again.

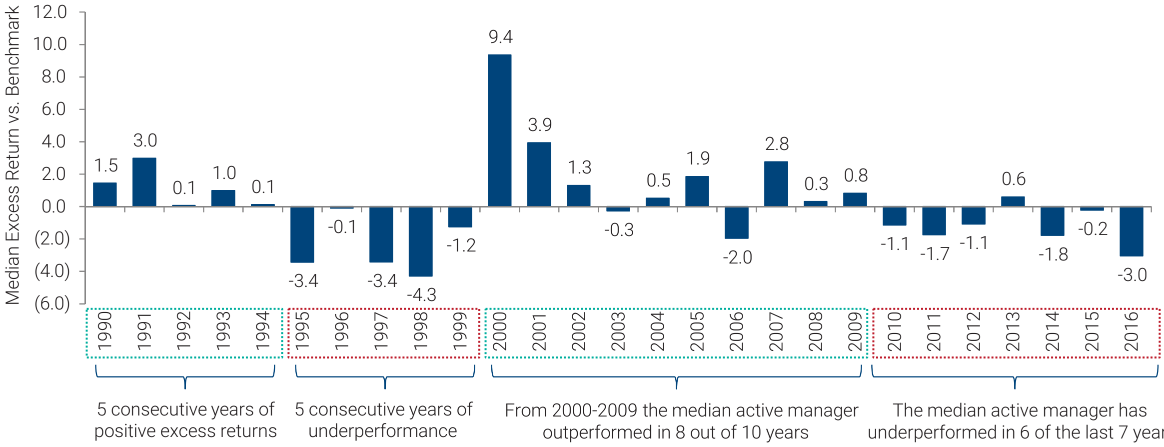
The second reason is around the timing of your need to access savings. If you need to access savings in a difficult environment the last thing you want is for a big reduction in portfolio value. Active management can hopefully mitigate some of that risk.

The implication from these observations is that outperformance is somewhat episodic. Some periods of time will be more fruitful for active managers, others less so. A chart from a Goldman Sachs study released a couple of years ago shows this well. The "alpha" they refer in the chart is the fund manager geek way of saying "beating the market", or outperformance.

On average the past few years have not been great for active managers. As noted this research is based on the averages and thankfully Fisher Funds has been able to add value over this time but it has been challenging.

There have been 4 distinct alpha cycles since 1990

Median Excess Return vs. Benchmark; Includes Actively Managed, Large Cap, Long-Only, US Funds



Source: eVestment, Goldman Sachs Global Investment Research.

While it has been tough for active managers in recent years I think the tide is turning for a number of reasons:

1. Long periods of active manager underperformance are typically followed by long periods of active manger outperformance — like day following night, periods of active manager underperformance are followed by periods of outperformance. History alone would suggest this switch in leadership is getting closer.

2. The growth of passive and quantitative management is opening up opportunities for active managers. There has been huge growth in passive and quantitative management of share market funds. This is at extreme levels. JP Morgan estimate that only 10% of market volume traded in the US is from fundamental, valuation aware investors like Fisher Funds. That means that prices are often set by investors who are buying regardless of the price or value that an investment represents. In our view this opens up opportunities. It means some companies may become ridiculously over valued. It means other companies may become increasingly attractive investments. This is a fertile environment for active managers. The only challenge is that while the outsized cash flows to passive funds persistent this mispricing can persist as well. But these things can, and invariably do, reverse.

3. The current economic environment we are in will undoubtedly change. Since the global financial crisis governments have become active in financial markets driving interest rates to very low levels and, in some cases, actively buying into share markets (the Japanese government reportedly owns over 70% of all exchange traded funds on the Japanese market). The upshot of this activity is very low economic and share market volatility. Environments with low volatility are typically not great for active investors. With the US Federal Reserve beginning to unwind the QE program and Europe likely to begin tapering its similar program governments are seeking to reduce market support. This is likely, in my view, to see a step up in market volatility and increased opportunities for active managers.

We believe the opportunities to add value to your investments will be better in future years than have they have been in the past few. That doesn't make it easy though. In my view there are three important elements that need to be in place to take advantage of the opportunities that will come our way:

1. A clear and consistent investment process — ours is the STEEPP framework that has been a bedrock of our approach since the firm started almost twenty years ago,

2. Good people — we have 19 people in the Fisher Funds investment team with over 286 years of experience. I believe this is the largest team in New Zealand and with varied expertise across a range of disciplines we are able to get multiple perspectives on the important investment questions.

3. The last key to success is hard work — wearing out shoe leather, asking questions and kissing a lot of frogs in the search for that rare prince of an investment. In depth, fundamental research with a long term focus adds value but it takes dedication.

Bruce McLachlan
Chief Executive

Debt up to our ears

My generation loves to remind today's younger generations that first mortgage rates were near 20% in the mid-1980's. This fact is often recalled within a statement of either "toughen up" or "be careful it could happen again", directed at today's younger generations buying exorbitantly priced houses. That though was over 30 years ago and the world has changed immeasurably since then. However, only 10 years ago the RBNZ Overnight Cash Rate (OCR) was 8.25%; today it is 1.75% and it has been at that level since November 2016. Having experienced very high interest rates in such recent history does dominate many investors thinking. This tends to create undue caution to their investment decisions today or creates undue expectations of what represents fair and sustainable medium term returns. So many investors are caught up in this old paradigm.

At the most recent RBNZ OCR review, Governor Orr signed off by saying that they would ensure the OCR is at the current expansionary level for a considerable period. That is, a sub 2% OCR is here for the foreseeable future unless something materially changes, which is not currently on the RBNZ radar.

Low interest rates are here to stay

So why are interest rates likely to stay so very low for an extended period, and why should we put aside such recent history? The answer is the world is awash with debt. To offset the depressing effect of the GFC, governments and households have taken on mountains of debt to maintain employment, sustain incomes and to take advantage of the very low interest rates to buy assets, particularly property. In New Zealand household debt was $14b in 1985, $135b in 2008 and $211b today. Increases in interest rates today, would apply to a far greater pool of household debt, and therefore affect consumer spending in a far greater way than it would have in earlier years. This significantly increases the power of the RBNZ (through the level of interest rates) to impact the wider economy. It also suggests that even modest lifts in interest rates could cripple many households, reducing the chances that this will be allowed to occur.

The situation is no better in many other western nations. In Australia for example, household debt in 2008 was $1.1 trillion whereas it is $2.5 trillion today. The Australian economy is now in effect held hostage by the mortgage market.

Shares will remain attractive to investors

It is very difficult for many of us to get high-interest rates out of our investing mindset. Yet when the level of global debt is analysed, it really does suggest that the upside risk to interest rates is limited, relative to our recent memories. That also suggests that we all have to re-engineer our businesses and lifestyle for this new paradigm. It also means that shares will ultimately remain a core part of investors portfolios long into retirement. Living entirely off interest from term deposits and government bonds is a strategy most likely destined for the distant memory just like 20% mortgage rates. You can all thank households' appetite for ever increasing mortgages for that.

Contact us

Frank Jasper
Chief Investment Officer
Phone 09 484 0344 | Email frank@fisherfunds.co.nz

Kate Meyers
Institutional Client Relationship Manager
Phone 09 487 2637 | Email kate@fisherfunds.co.nz

Market Movements

As at 30 June 2018

Stock Markets*	Closing Values	Changes over: 1 Mth %	3 Mths %	6 Mths %	12 Mths %
S&P Developed LargeMidCap - (Local Curr)	751	0.3	3.5	1.4	11.2
S&P Developed LargeMidCap ($NZ)	N/A	0.3	6.5	2.8	16.0
S&P Global LargeMidCap ($NZ)	N/A	3.1	7.2	4.8	20.3
USA - S & P 500	5351	0.6	3.4	2.6	14.4
USA - Nasdaq	8679	1.0	6.6	9.4	23.6
Japan - Topix	2549	-0.8	1.1	-3.7	9.7
UK - FTSE100	6629	-0.2	9.6	1.7	8.7
Germany - DAX	12306	-2.4	1.7	-4.7	-0.2
France - CAC40	13935	-1.0	5.6	3.0	7.4
HK - Hang Seng	79426	-4.5	-2.5	-1.6	16.3
Australia - S & P 300	62275	3.2	8.4	4.3	13.2
NZ-S&P/NZX 50 Gross Index (inc imp credits)	10720	3.4	7.7	7.0	18.9
NZ-S&P/NZX 50 Gross Index (excl imp credits)	8943	3.3	7.5	6.5	17.5
Market Volatility - VIX	16.1	4.3	-19.4	45.7	43.9

New Zealand Property		%	%	%	%
S&P/NZX All Real Estate (inc imp credits)	1320.8	1.7	6.3	2.3	9.9
S&P/NZX All Real Estate (exc imp credits)	1281.0	1.4	5.9	1.9	8.9

Ten Year Bonds	%	Yield Changes			
USA	2.85	0.02	0.11	0.45	0.66
Japan	0.03	0.00	-0.01	-0.01	-0.05
United Kingdom	1.27	0.04	-0.08	0.08	0.01
Australia	2.64	-0.01	0.06	0.00	0.04
New Zealand	2.85	-0.04	-0.07	0.13	-0.13

90 Day Interest Rates	%	Yield Changes			
USA	1.93	0.00	0.20	0.59	0.93
Japan	0.08	0.00	-0.02	0.02	0.02
United Kingdom	0.67	0.06	-0.04	0.15	0.37
Australia	2.12	0.14	0.08	0.33	0.41
New Zealand	2.00	-0.02	0.04	0.12	0.02

Bond Indices	Closing Values	Changes over: 1 Mth %	3 Mths %	6 Mths %	12 Mths %
S&P/NZX Bank Bills 90-Day	710.32	0.16	0.50	0.96	1.96
S&P/NZX NZ Government Bond Index	1697	0.58	1.06	1.54	4.23
Barclays Capital Global Aggregate Index (Hedged NZD)	N/A	0.19	0.19	0.21	2.20

Hedge Funds & Commodities		%	%	%	%
HFRX Global Hedge Fund Index (USD)	1265	-0.2	0.2	-0.8	2.5
DJ-UBS Commodity Index Total Return	180	-3.5	0.4	0.0	7.3
Gold (US$/ounce)	1251.30	-3.8	-5.4	-4.2	0.9
Oil (US$/barrel)	77.44	1.3	12.2	16.0	64.5

Currencies		%	%	%	%
NZD / USD	0.6771	-3.5	-6.1	-4.8	-7.5
NZD / EUR	0.5799	-3.5	-1.1	-2.1	-9.7
NZD / GBP	0.5128	-2.7	-0.3	-2.5	-9.0
NZD / AUD	0.9164	-1.2	-2.6	0.8	-4.0
NZD / YEN	74.99	-1.6	-2.3	-6.4	-8.8
Trade Weighted Index	73.50	0.7	-1.6	0.0	-5.7

**Total Return Indices. Indices are net of offshore tax.*
Source: Thomson Reuters Datastream