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Melville Douglas

Global Equity Fund

If you can keep your head

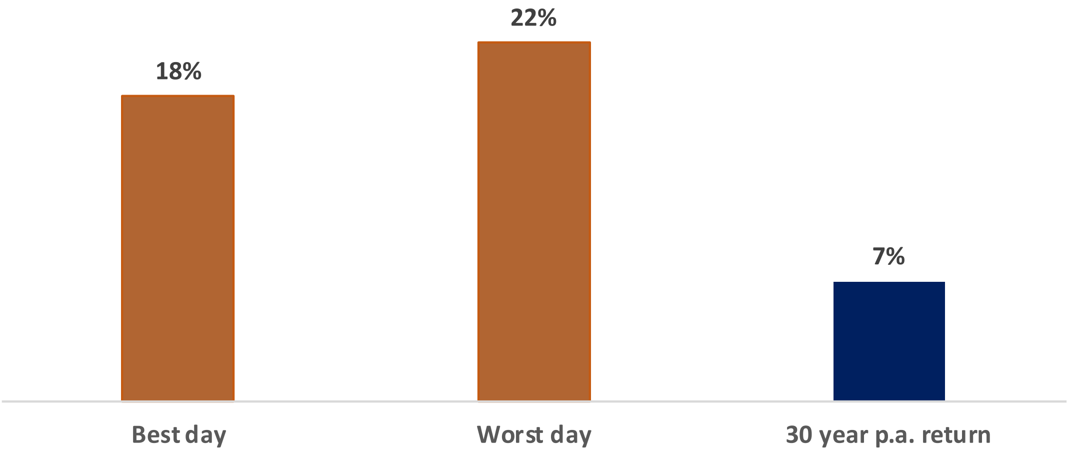
Dishearteningly for those of queasy disposition, Wall Street's recent roller coaster ride is the rule rather than the exception. The worst daily drop in 2018 of -3% was only the 50th worst day since the MSCI All Country World index started in 1998. The best day in 2018 of +3% was only the 49th best day.

Big daily moves in either direction often spur investors into action or decided inaction. Often these decisions are based on emotional greed-and-fear ingrained in the human psyche rather than cold logic. A big sell-off often stokes fears that it is an early warning sign of further losses ahead. A sharp jump up in share prices is not a happy experience for the uninvested. "Missing out", even on relatively modest near-term gains, often prompts investors to greedily hold back on implementing their long-term investment plan in the hope of buying on a dip.

Empirical evidence supports taking the contrary action to the emotional one. Over the past 30 years buying or staying invested in global equities after a particularly bad day (a drop of -3% or more) tends to be a winning strategy. Over the subsequent year, an investor would have generated a positive return 86% of the time and an average +22% return. The same is true for a great day (+3% or better gain) as 80% of the time this preceded a positive annual return, averaging +18%. Great days and terrible days herald around triple the return over the subsequent year compared to less extreme but psychologically more comforting days.

Resisting loss aversion pays dividends

Subsequent Global Equity 12-month US dollar average return afer a very strong or negative daily move



Source: Melville Douglas, Bloomberg data

"*If you can meet with triumph and disaster, and treat those two imposters just the same*". This line from Rudyard Kipling's poem "If-" is inscribed above the entrance to Wimbledon's Centre Court as a reminder of emotion management to the likes of Federer or Williams before they step into the arena. If an investor can follow this ethos and stoically stick to their long-term investment plan then theirs "*is the earth and everything that's in it*".

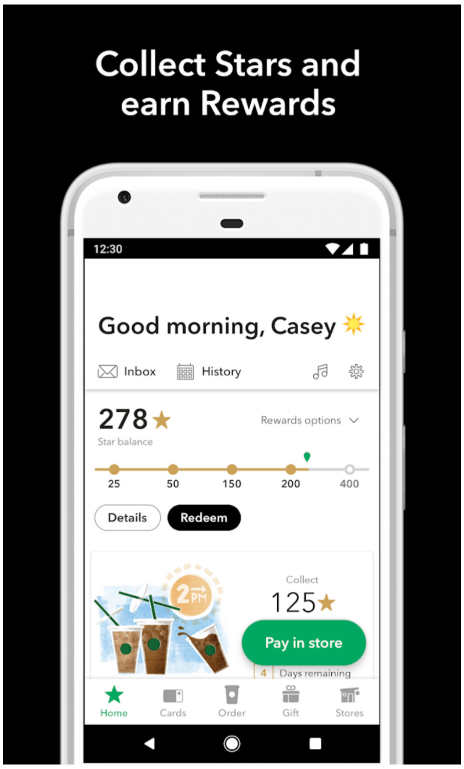
From our Fund Manager's Desk

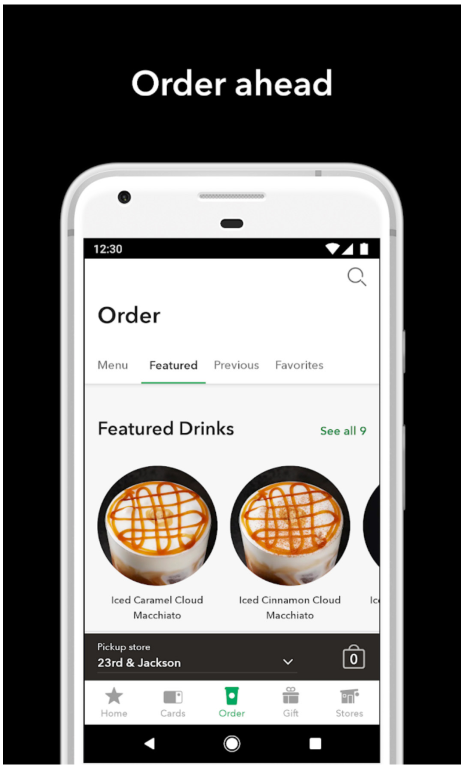
Our quarterly reports regularly explore the investment rationale of one of the companies we own in the Fund, to articulate what we find compelling. This time round we have chosen Starbucks.

Have you ever simply asked for a "coffee" at a Starbucks?

The world's largest specialist coffee chain has transformed an ordinary product into an indulgent, albeit affordable, luxury product and experience. Starbucks has not only created a market, but a whole new lingo. Mine's a "tall, half-caff, soy latte at 120 degrees". The upshot is that the Starbucks' multi-decade coffee revolution has caught the zeitgeist that places more value on ethical, emotional and aesthetic considerations. Consumers prefer to spend money on experiences than material things. To this extent, when he took charge of Starbucks, Howard Schultz created something people did not know they needed, but suddenly could not get enough of.

Unsurprisingly, selling coffees for $3 or more is a highly profitable business. There are also trade-up opportunities. "Would you like a blueberry muffin with that?". To boot, it is not only the attractive price points but also the regularity of purchase. It is routine for office workers to start their morning with a caffeine boost from their nearby café followed by a postprandial pick-me up later in the day. Starbucks locks in customer loyalty and drives higher spending through its innovative rewards programme. For example, you can earn extra points for free food or drink through "challenges" such as sampling their new range of Chai Tea Latte. The Starbucks app enables customers to order and pay in advance for their drinks and food, thereby skipping the queue when they arrive and encourage repeat ordering.





Source: Google Play

Costs are also lower compared to a traditional restaurant due to the absence of kitchens. As a result, Starbucks' US cafés generate a restaurant industry-leading pre-tax return on investment of 66%. This compares to a very healthy 38% return for Mexican fast-food chain Taco Bell, which we also happen to own in the fund via the holding in Yum! Brands. In other words, if a franchisee was to set up a Starbucks in the US, he or she would be paid back on their original cafés build cost within one and a half years. Hence, there is a continuing business case to roll-out more cafés in the relative underpenetrated Midwest.

The US is still the main market for Starbucks, contributing three quarters of sales. The café chain continues to drive growth through beverage and food innovations. For example, its most recent beverage launch was the Cloud Macchiato, a healthier alternative to a Frappuccino given the creamy head is achieved my mixing formed with egg whites. For those who view cafés as replacements for pubs, they can try Starbucks' Cold Brew Nitro, which is cold brew coffee charged with nitrogen to give it a rich creamy head like a draft Guinness. As part of the showmanship, a pint of it is even served from a beer-like tap.

Source: Starbucks China website

Another driver is China, which is Starbucks' fastest growing major market. This tea drinking nation is becoming increasingly hooked on the coffee experience. Starbucks is aiming to increase the number of its eponymous cafés in the country by 60% by 2022. Furthermore, the economics are even better than in the US. A Starbucks café in mainland China typically generates a return on investment of 86%, thereby paying back the set-up costs in just over a year.

Despite strong growth in coffee consumption, the Chinese market remains underpenetrated with only six cups of coffee drunk per person every year. In Taiwan and Hong Kong average consumption is over 200 cups a year and in the US it is close to 400. A report by market researcher Frost & Sullivan forecast freshly brewed coffee retail sales in excess of $23bn by 2023 versus nearly $6bn in 2018. This equates to +32% sales growth per annum. The underlying driver is rising urbanisation and disposable income to support increased coffee consumption. Attracted by this growth new home-grown, competitors are popping up. The largest of these is Luckin Coffee, which has a slightly different smaller store format focused on delivery and pick-up orders. At this stage of market development, new entrants are a net-positive as they act as promoters of the coffee drinking culture, driving overall consumption.

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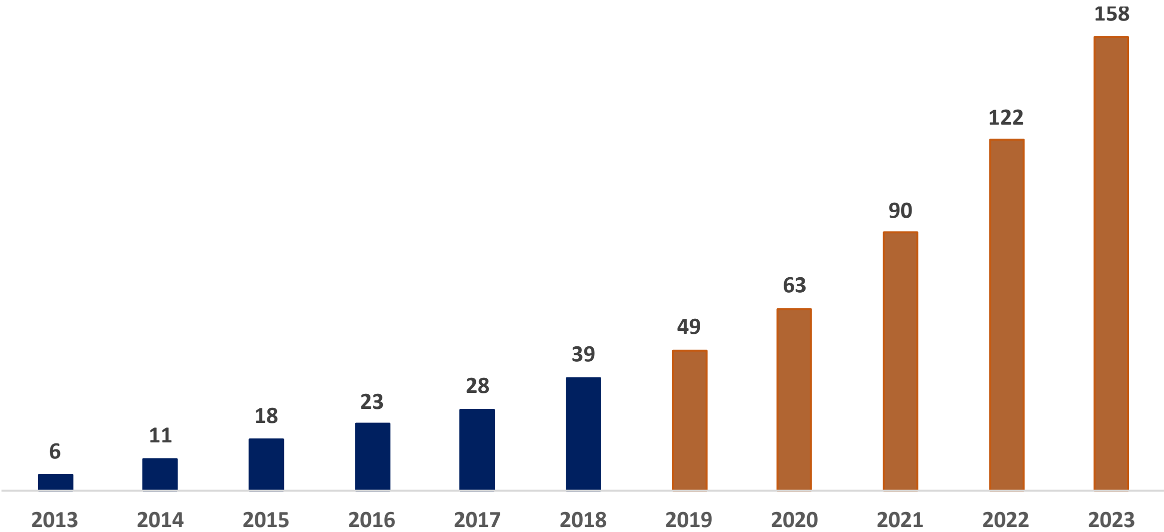
China – growth for all

Freshly Brewed Coffee Market Size (in billion RMB)



Source: Luckin F-1, Frost & Sullivan (estimate 2019+), Sanford Bernstein analysis

In an espresso shot…Starbucks is a highly cash generative business with significant potential to grow through new innovations and geographic expansion. Despite a recent rally, the shares remain reasonably priced at around the 10-year average price-to-earnings ratio. Still a tasty treat.

No smoking gun

July marks the longest US economic expansion on record, eclipsing decade-long growth in the 1990s. When will it end?

Expansions seldom die of old age but are killed by either overinvestment (e.g. US housing in the 2000s), external shocks (e.g. 1973 oil crisis) or the Federal Reserve. This cycle has been characterised by under- rather than overinvestment. The only exception has been the infrastructure spending boom in China. In mitigation the Chinese government still has plenty of levers to pull to avoid a sharp downturn that could break the Communist Party's implicit freedom-for-jobs pact with the comrade on the street. Destabilising external shocks are certainly possible given trade and geopolitical tensions but, by definition, are hard to forecast.

What about the Federal Reserve? Apart from a desire to "normalise" the level of interest rate, there is limited pressure for higher rates given the subdued inflation backdrop. Inflation has been rangebound for a decade. The lack of inflationary pressure is partly due to how consumer demand for credit in this cycle pales relative to disposable income. This is in marked contrast to prior cycles.

Without an acceleration in borrowing to buy or build, inflation is unlikely to pick up. This is supportive for equities given real rates have historically needed to be significantly higher before the onset of a recession. The chart shows that since 1957, real interest need to rise to or above 1.8% before monetary conditions are sufficiently tight to impact demand. Arguably, given public and corporate indebtedness the threshold may be lower before the next recession. Nonetheless, real rates currently at 0.5% look well adrift of being a problem.

Quarterly Commentary as at July 2019

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Interest rates - not a brake on the economy

Recession start	Real interest rate* before start
1960	1.9%
1970	2.8%
1973	5.5%
1980	1.8%
1981	7.9%
1990	3.2%
2001	2.6%
2007	1.8%
Median	2.7%
Current	0.5%

**Real interest rate = Fed Funds – Core CPI % YoY*
Source: Bloomberg data, JP Morgan analysis, Melville Douglas

A mutually destructive trade war of attrition could tip the world's economies and markets over the precipice. Investors have been conditioned into watching out for a few conciliatory tweets from the mercurial President that could defuse tensions and refocus attention back onto the positives, i.e. a healthy US consumer, improving earnings revisions and low interest rates.

But, for now, loose monetary conditions and stable and ongoing recovery in the domestic Chinese economy remain the overriding support and impetus for further stock market gains. Amidst the twists and turns of the market roller coaster, our process remains unwaveringly focused on selecting robust business models that can steadfastly deliver shareholder value over the long term.