

Melville Douglas Global Equity Fund

Comparing apples and pears

Sir Isaac Newton credited an apple falling from a tree as the inspiration for his law of gravity. What goes up must come down is a property of the physical world.

Based on Newtonian-type laws, share prices should be gravitationally pulled to a predetermined fair value. It seems logical to buy an attractive business when its share price has plummeted the depths and take profits in another that appears egregious overvalued.

However, in the investing world there is persistence in winning and losing streaks. Mean reversion often does not occur. The following elements come into play:

1) The goalposts can move

What is expensively or cheaply valued today might not be tomorrow as a company's prospects wax and wane.

This is especially case today where innovation has permanently disrupted and bifurcated a wide range of industries. Many low price-to-earnings multiple stocks have stayed cheap. Disintermediated and disrupted business models such as department stores, legacy car companies and tobacco are recent examples.

Equally, seemingly high price-to-earnings multiple winners, such as Big Tech, have not succumbed to the normal laws of competitive erosion as a result of free-market economics. Their network effects and scale advantages have enabled high levels for profitability to persist far longer than thought possible. Alphabet, Google's parent company, is one such example. We will elaborate on its wide economic moat later in this report.

2) The theory of reflexivity

This concept, championed by hedge fund manager George Soros, describes a feedback loop in which investor perceptions impact company and economic fundamentals that in turn changes investor perceptions, and so on. The resulting vicious or virtuous circle can cause prices to persistently deviate from the current fair value as poses an ongoing challenge to the price equilibrium.

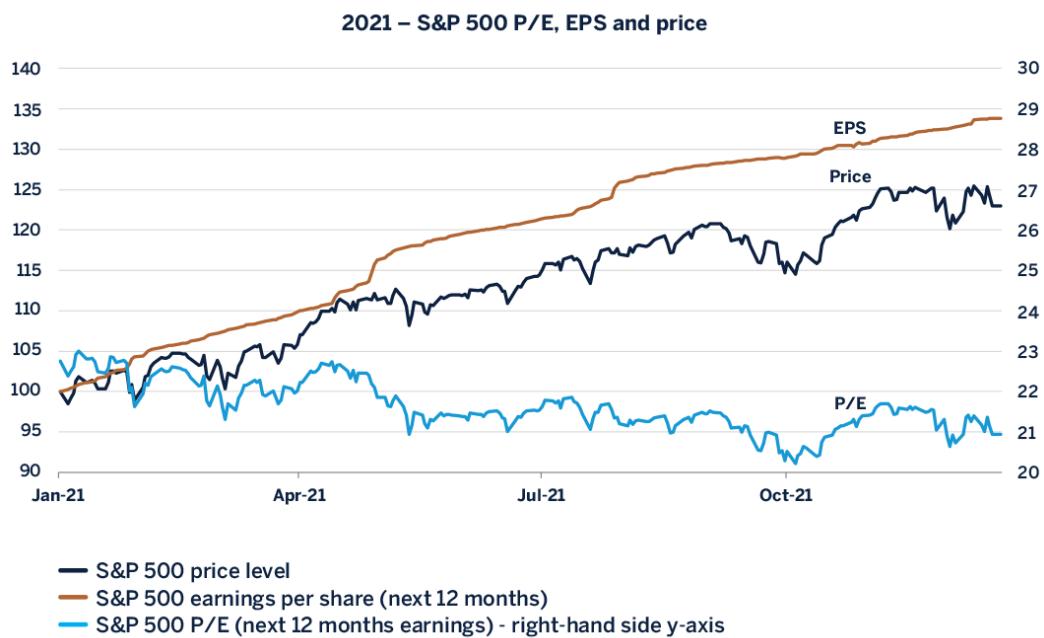
3) "In the long run we are all dead", as economist Maynard Keynes famously observed.

The market price of an asset may eventually align with its fair value, but it could take months, quarter or even years. By then point 1) may have changed the fair value.

Last year's market performance is a case in point. The S&P 500 started in the year looking expensively valued on 23x price-to-earnings (versus 10-year average of 17x), having risen +16% in 2020 and doubled over the prior five years. It ended 2021 up +27% but the price-to-earnings ratio was lower at 21x. The reason was that the goalposts moved: corporate earnings grew even faster than the rise in share prices.

Quarterly Commentary as at 31 December 2021

Earnings' gravitational pull



Source: FactSet, Melville Douglas

In his book “One Up on Wall Street”, legendary investor Peter Lynch said, “Selling your winners and holding your losers is like cutting the flowers and watering the weeds.”. It is good advice. Avoid overtrading and allow your winners to run if the fundamental case remains intact.

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 Alphabet.

A rare accolade and sign of widespread acceptance is when a brand becomes a verb. Classic examples include Sellotape and Frisbee. To “Google” something is also in the lexicon. It is synonymous with searching for answers on the internet.

Google's parent company Alphabet has successfully capitalised on its dominance in internet search to become one of the best businesses in the world, delivering ten-bagger share price returns over the past decade. We explain why the investment case has plenty of mileage in the tank. It's as simple as ABC.

A is for Advertising

On the face of it Alphabet is a sprawling conglomerate owning a myriad of leading internet platforms and applications. As well as the Google search engine and YouTube video sharing website, the company is behind Google Maps, Chrome web browser, Gmail, Android mobile operating system, the Google Play online store and the Google Cloud Platform. The list goes on.

What brings these websites, apps and services together is a highly profitable business model primarily based on online advertising. In 2020 over 80% of Alphabet revenues were derived from selling and placing ads. It is the market leader. According to eMarketer, Alphabet had 29% global market share of digital ad spending. Facebook is number two with 24% and Alibaba is third with 9%.

The next few paragraphs will elaborate on the attractive outlook for online advertising, Google's enduring dominance and YouTube's potential in TV.

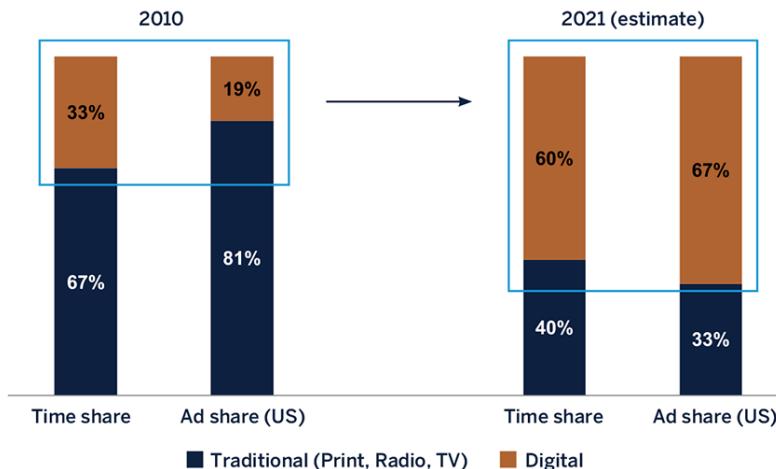
Online advertising's growth runway

Advertising is a growth industry. US advertising spend has stayed at around 1% of GDP over the past fifty years because it is a relative expenditure. Businesses need to keep pace with their competitors, or they run the risk of losing mindshare. This contrasts with some absolute expenditures, such as food and energy, that have become a smaller part of the economy as usage and production became more efficient. There is a limit to how much you can eat, but there does not seem to be a limit to which companies will vie for your attention.

Over the past decade, digital (or online) advertising spend has been taking a larger slice of this growing pie. Advertising dollars have followed the money, i.e. their customers. The share of time spent on digital media has almost doubled over the past decade. As time spent online continues to grow, advertising dollars will follow.

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Ads spent = time spent



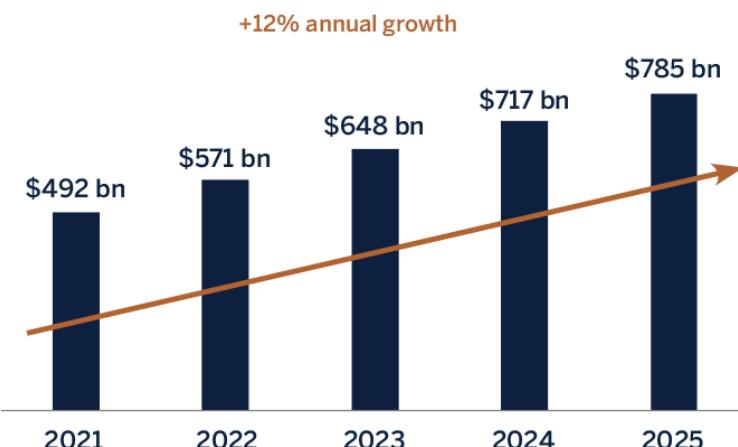
Sources: Bond Capital, eMarketer, Insider Intelligence, Sanford Bernstein and Melville Douglas analysis. The data relates to US advertising spending and time spent on media by US consumers.

In addition, digital advertising has a higher return on investment than traditional formats such as TV, newspapers, magazines and radio. Online activities offer a more engaged and accessible user experience which enables digital advertisers to undertake personalised targeted campaigns. For example, if you are googling city breaks to Italy, sooner or later you will receive a tailored booking.com advert in your search results that will likely resonate with you at that precise moment in time. As click-throughs are measurable, booking.com can rapidly scale and adjust its campaigns accordingly to optimise effectiveness.

Arguably digital media's two-thirds share of total US advertising spend, as shown in the chart, overstates the share of corporate budgets. We are nowhere near full penetration. As more businesses move their operations online, digital advertising can unlock new budgets that were previously never accessible to the marketing departments. In the online world advertising spend can also encompass promotion budgets, product placements, rent and even some labour costs given its automated nature. A prime position on a newsfeed or search result is the online equivalent to owning a flagship store on Bond Street in London or 5th Avenue in New York.

All of this adds up to an expanding and scalable addressable market for digital media winners such as Alphabet. Based on eMarketer estimates, worldwide digital advertising is expected to grow over +12% per annum over the next four years. A meaningful pace.

Growth engine - Worldwide digital advertising spending



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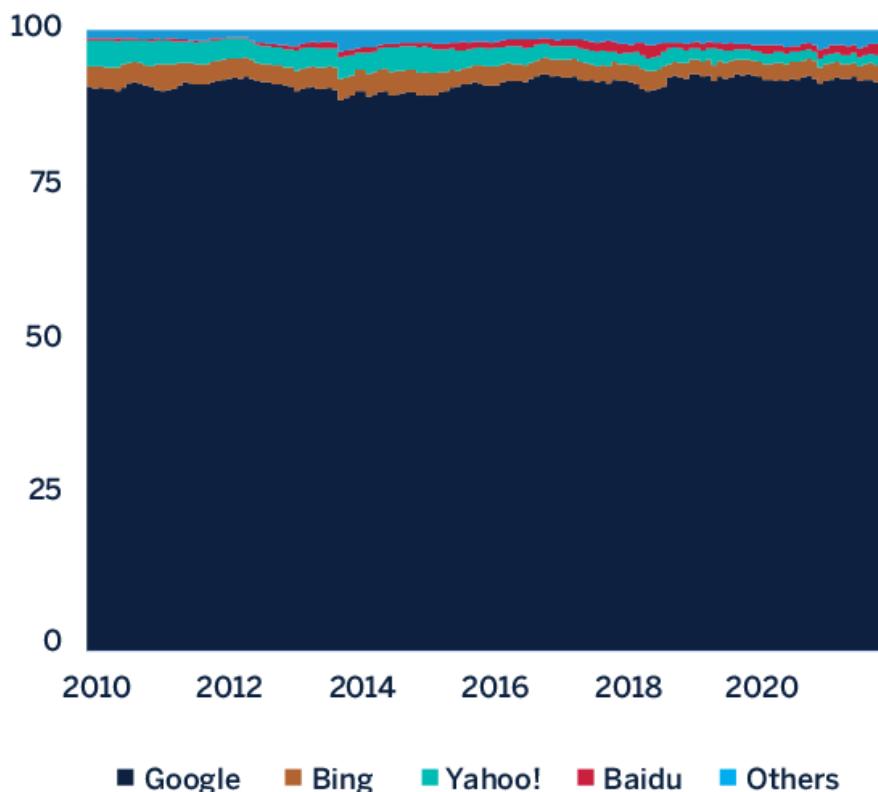
Google Search – Winner takes all

Approximately 90% of the world's data has been created in the last two years alone. According to Dihuni (2020), every day we create enough data to fill 10 million Blu-ray discs that would be the height of four Eiffel Towers when stacked.

Search engines provide a critical valued filtering device for internet users that efficiently sifts through this mind-boggling quantum of data. This recurring and interactive service is highly valued by advertisers. According to Statista, over 35% of worldwide digital advertising spend was directed to internet search in 2021. Google Search monopolises this category.

Google's dominance is a case study in scale advantage and network effects. Because Google handles far more searches than rivals Bing or Yahoo, it has more data to refine its results. Internet users see no need to use another (inferior) service. These dynamics create a virtuous circle for Google. Its accumulated learning and computer code acts as a massive economic moat. As a result, Google has cornered the internet search market for two decades with over 90% of global market share.

Winner takes all – Search engine worldwide market share



Source: eMarketer estimates, October 2021

The combination of billions of “eyeballs” and the personal preferences signalled by their searches is gold dust for advertisers. Google provides advertisers with highly relevant leads and personalised targeted campaign placements. This enables them to gain the greatest bang for their advertising buck.

Google has a monetisation model that is based on being paid for successfully connecting customers with merchants. For example, a search for “mobile phone” in Google, will not only flag a Wikipedia page weblink on the topic but also links directing you to mobile

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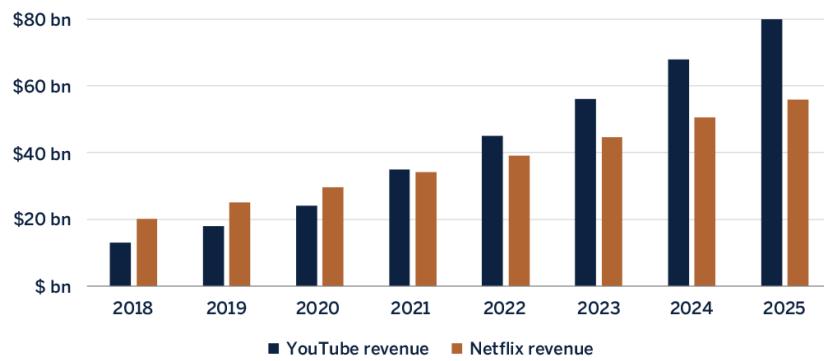
device sellers in your area. To gain the top spot on your search (i.e. page one), the mobile phone advertisers must outbid each other through an automated auction. Advertisers then pay Google each time you click on their advert.

In short, Google Search is a wonderful business. There are few companies across the globe that can match its near unassailable competitive advantage coupled with its highly profitable revenue and recurring revenue model.

YouTube – The hidden “Y” in FAANG

As it is part of a larger group, YouTube is often underestimated as a standalone business despite having 2 billion monthly average users and over 1 billion hours of video watched daily. Google's video sharing and in-house content streaming business generates about the same level of sales as Netflix through advertising and subscriptions. Furthermore, YouTube is growing at a much faster rate. As shown in the chart, YouTube revenue has likely already surpassed Netflix in 2021.

YouTube - #1 streaming giant



Sources: UBS estimates (YouTube subscription and advertising) and FactSet consensus (Netflix revenue)

The big opportunity for both video streaming services is the ongoing viewership share shift from legacy Linear TV (take-it or leave-it programmes broadcast at a specific time) to Connected TV (a vast array of programmes delivered on-demand to a television connected to the internet). As the largest Connected TV (CTV) player, YouTube is in pole position for this share shift. 100 million US users are already watching YouTube content on their TV sets.

Despite continuing declining viewership, US television advertising spend remains high at around \$70bn. This is due to live sports (about 40% of spending) and inertia. But CTV's digital targeting and measurement capabilities and audience-size are simply too good for ad buyers to ignore. In the US, the most watched TV show is Sunday Night Football on NBC with 16.7 million views a week. This contrasts with MrBeast (a YouTube personality) with 64 million subscribers and averaging 20-30 million weekly views of his shows. The money will follow. According to eMarketer CTV's market share of total TV advertising is expected to increase from 13% in 2020 to 29% in 2025.

B is for (Other) Bets

There are certain species of shark that die if they stop swimming. In today's fast changing world, business models are threatened by revolutionary rather than evolutionary change. You need to keep swimming rather than sit on your laurels. Alphabet is a past master.

To safe-guard its future the company has taken advantage of its highly cash generative advertising business, to invest high risk-high reward moonshot opportunities. These businesses are housed under its "Other Bets" division. Examples include Calico (anti-ageing research), Weymo (autonomous vehicles), Verily (medical devices) and Deep Mind (artificial intelligence).

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Akin to venture capital, there is a high failure rate. According to killedbygoogle.com 244 of its projects have been launched and then shut down. But, by taking calculated risks, Alphabet has maintained its relevance and added meaningful growth drivers. The acquisition of YouTube in 2006 is a case in point. The \$1.65 billion price paid was widely criticised at the time. Alphabet has had the last laugh. The business now generates annual revenue of over \$18 billion (over ten times the price paid), contributing to over 10% of group revenue.

Another moonshot was Android. It was acquired for the measly (in hindsight) sum of \$50 million in 2005. By making it freely available and open sourcing it, Android has become the world's largest mobile device operating system. Importantly, it has been a key element in securing Google Search's dominance in the mobile as well as desktop world.

C is for Cloud Computing

Outside advertising Alphabet's largest business is its Google Cloud Platform. The company leveraged off its expertise in running massive data centres for its internet search business to launch a cloud computing service in 2008. This internet-based service enables companies to rent computing capacity without having to incur the inflexibility, lack of scale and cost of building it in-house.

Google Cloud Platform is the third-largest of the “big three” public cloud vendors, behind Amazon Web Services and Microsoft Azure (both of which are also held in the fund). While its larger competitors provide a broader array of services, Google's cloud offering plays to its strengths in artificial intelligence, machine learning and in its deep expertise around open source technologies.

The pandemic has brought to light the disaster recovery benefits of the cloud computing model as employees were able to securely and effectively work from their kitchen table or spare bedroom. Nonetheless, the transition from on-premise computing infrastructure to a cloud model is still at a relatively early stage for most companies. It represents a rapidly growing trillion-dollar addressable market for Google Cloud Platform. Once again Alphabet has struck gold.

C is also for Compound Growth

Our investment philosophy is based around capturing the power of compound growth by investing in highly profitable, growing businesses with sustainable competitive advantages. Alphabet ticks the box. Its leading positions in digital advertising and cloud computing could drive significant growth. Furthermore, the Other Bets division goes towards future-proofing the business in a rapidly changing and disruptive world.

What are the risks?

Big Tech is a victim of its own success. Google's dominance has put itself in the sights of regulators looking to crack down on anti-competitive behaviour. We are reassured by our discussions with legal experts, who note the remedies that could be pursued would not leave the company in a substantially worse position. We will however watch this space.

The other big risks are technology change and competition. We do not see an existential threat over the horizon but that will not stop us from following it closely.. Alphabet could miss a trick on the new big platform transition. Meta Platforms (the parent of Facebook, Instagram and WhatsApp) and Amazon remain big competitors. There are also new media platforms, such as video-sharing app TikTok. At present the pie remains large enough for more than one winner.

In summary Alphabet is a rare find. It has one of the world's best business models, a rock-solid competitive position and multiple growth runways for many years to come. It remains a core holding in the fund.

Draining the punchbowl

During the first COVID wave in early 2020, central banks and governments threw in the kitchen sink. They undertook huge bond buying programmes and furlough schemes to ensure voters made it through a self-imposed recession. By-and-large their gambit worked.

Today the challenge is too much growth, not too little. Price inflation is tracking well above central bank targets. Much of this can be attributed to COVID-related disruptions, but the longer it persists the more likely higher inflation expectations will be imbedded in the collective psyche. Central banks have responded by slowly withdrawing the monetary punchbowl from the party before they risk losing their greatest asset - their credibility.

History suggests monetary tightening is not usually a problem for stock markets. The most recent example was when the Federal Reserve sought to normalise policy after the Global Financial Crisis of 2007-09. The US central bank announced it would reduce (or "taper") its bond buying programme in late 2013 and then started it in early 2014. As shown in the chart below, the MSCI All Country World index wobbled -5% to -10% around those events but was comfortable up over 2013 and 2014. The economy (and by extension corporate earnings growth) had enough strength to offset the policy change.

Withdrawning the monetary punch bowl did not stop the 2013 to 2014 party



Source: FactSet, Melville Douglas

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We expect the same pattern this year. At the tail end of last year, the Federal Reserve started tapering. Using history as a guide, we should be braced for a spot of near-term choppiness (particularly if the inflation data remains elevated) but we should also expect positive returns over a 12 to 18-month time horizon. There are already signs of easing supply bottlenecks and a levelling off energy prices. Once COVID-related uncertainty subsides, we expect a pent-up demand boost from "going out" consumer spending and from businesses deploying their contingency cash reserves into long term projects.

The free drinks are coming to an end, but the party is still going.

Melville Douglas

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