MelvilleDouglas
A Member of Standard Bank Group

# Melville Douglas

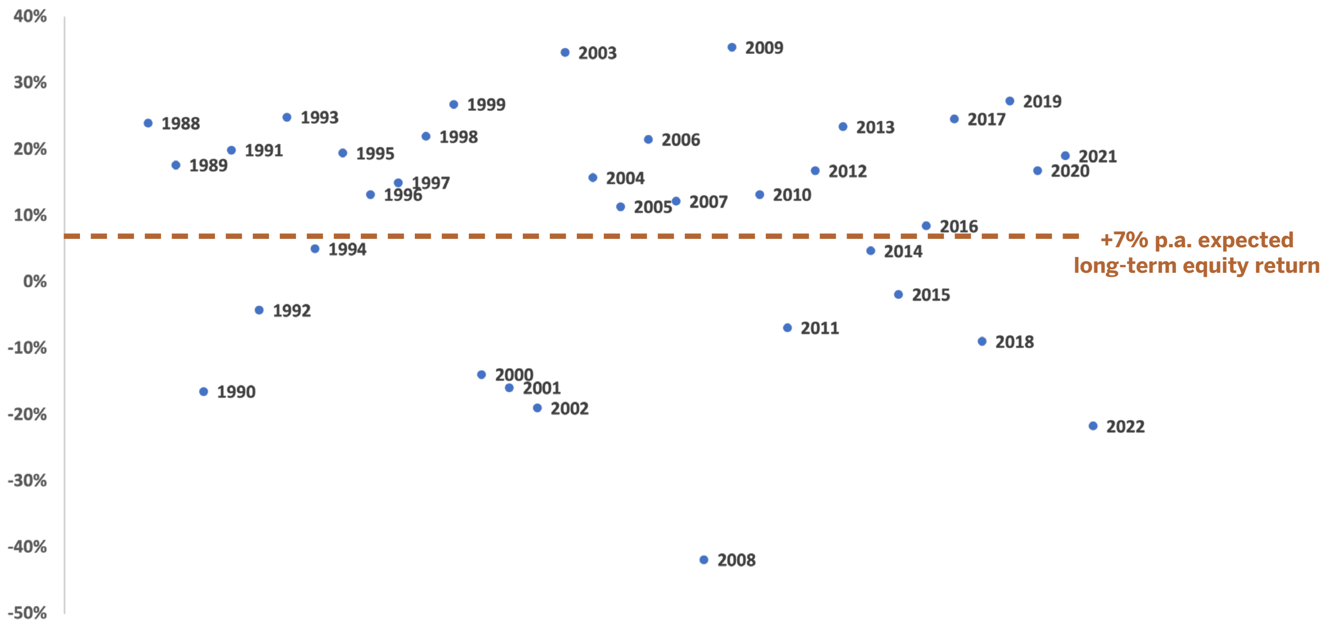
Global Equity Fund

## A random walk down Wall Street

The rally in everything came to an abrupt halt this year as an increasingly hawkish Federal Reserve drained the monetary punchbowl. Apart from President Putin-plays, such as commodities and arms manufacturers, there were few hiding places. Bonds and equities both fell double-digits. Even cash was not much of a safe-haven in real terms whilst inflation soared to its highest level in four decades.

As illustrated in the scatter chart, huge swings in stock markets are par for the course. In any one calendar year, global equity returns since 1988 have broadly ranged between -40% to +40%. In hindsight, it would have been wonderful to have avoided the big down years. In reality, few traders consistently succeed in timing the peaks and troughs. Most end up buying high and selling low.

**A random walk – MSCI All Country World index calendar year returns**




Source: FactSet

As investors of companies, rather than renters of stocks, our default strategy is to buy-and-hold. So long as we don't excessively overpay, the long-term return on the shares will broadly equate to their earnings growth. We have high confidence our companies will deliver attractive profits as they all have a sustainable competitive edge and operate in growing addressable markets. By latching onto their coat-tails, we have a repeatable way to grow and protect the real-value of our clients' savings.

What long-term return should we expect?

# Quarterly Commentary as at 30 June 2022

The average calendar year total return for global equities since 1988 was approximately +8%. When we have investment planning discussions with our clients, we would tend to guide for slightly less than that, i.e. circa +7% per annum over the long term. Headwinds include slower global economic growth as a result of ageing demographics, higher government debt levels and less emerging markets catch-up potential. Nonetheless, a +7% annual return is still a decent batting average. It would result in an investor doubling the value of their blue-chip portfolio every 10-years through the power of compound growth.

The road has always been long and winding. The first half of 2022 has proven to be one of those uncomfortable counterbalancing declines to the higher than average returns of recent years. The price investors are willing to buy for high quality businesses will oscillate according to the prevailing greed and fear. Animal spirits are further stoked by macro factors such as wars, pandemics or economic uncertainty. But a company's underlying earnings power and intrinsic value will continue to build over time.

Benjamin Graham (Warren Buffett's mentor) noted the market is a voting machine in the short run but a weighing machine long term. This is also our view. We maintain a steady course through the ebbs and flows.

# Quarterly Commentary as at 30 June 2022

## 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 Amphenol.**

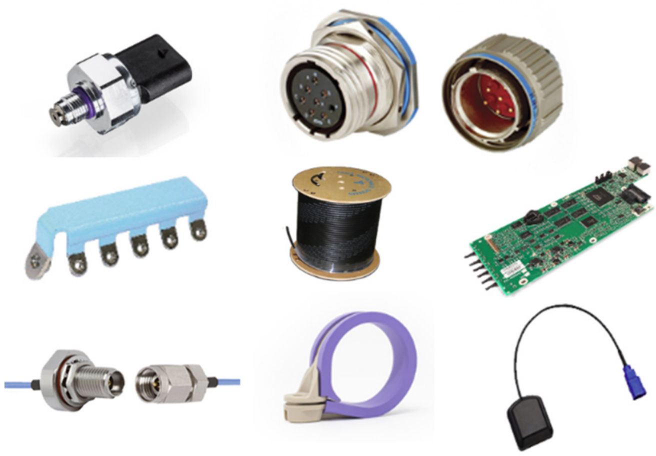
Amphenol is a "mini-me" of the Global Equity Fund. The company is composed of hundreds highly profitable businesses (autonomously run by entrepreneurs) that supply to a broad range of industries around the globe. Within technology it is a reassuringly unglamorous but resilient company with a highly lucrative business model that can be locked away in your top drawer. It is the dull but reliable tortoise to the racier but ephemeral hares.

## What does Amphenol do?

Most people would not have heard of Amphenol. But they are daily users of its clients' products, which include Apple iPhones, BMW cars or Samsung smart TVs. Amphenol designs and manufactures the mission critical "back-of-the-scenes" components that make these items work.

Amphenol is an electronics components company. Its products include electric wiring interconnect systems, sensors, antennas and fibre optic cables for a multitude of uses and end-markets. For example, its connectors are critical in ensuring that power and data is reliably and effectively transmitted through an electronic circuit. The electronification of everything means that more applications contain electronic circuits with increasing complexity and capabilities. Amphenol is an enabler of this electronics revolution.

**Unglamorous but mission-critical tech - What Amphenol's products look like**



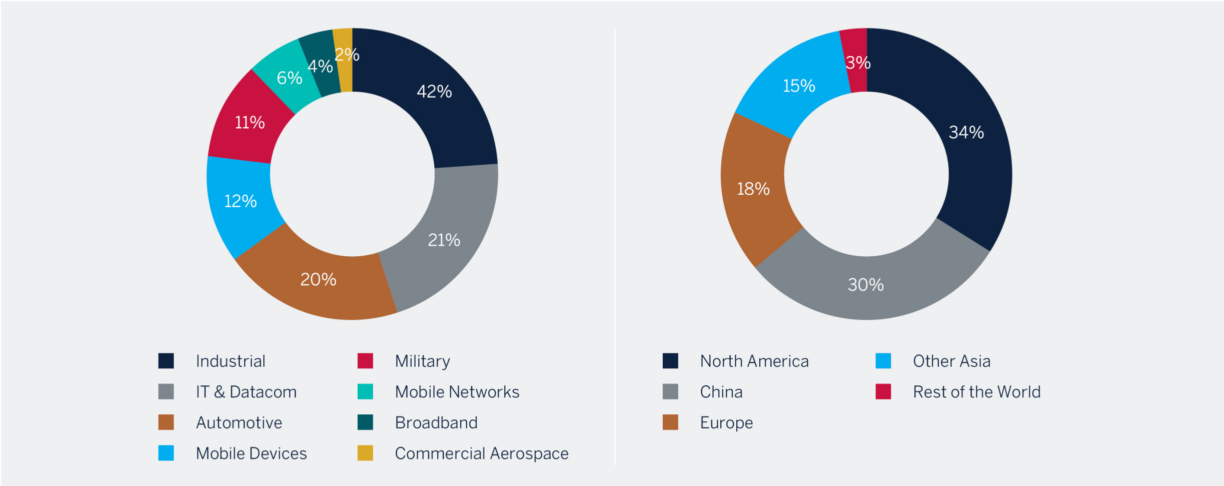
Source: www.amphenol.com

## Buying the haystack rather than searching for the next needle

For every Microsoft or Google there have been thousands of tech also-rans that have been poor investments. We know we do not have an edge over our peers in discovering the next Big Tech name in its infancy. Instead, we either own an established winner and take a view their competitive advantage will persist, or we buy a company that sells mission-critical equipment to the entire field. Amphenol is in both camps. As the picks-and-shovel supplier in the tech goldrush it has always made a nice turn on the hopes and dreams of the next get-rich-quick prospector.

It is easy to see the electronification of everything under the sun continuing for many years and decades to come, driven by increased connectivity and automation. The proliferation of electronics has helped to increasingly diversify Amphenol over the past two decades across a wide breadth of end markets and 1,000s of products (albeit all within its sphere of expertise). Its core communications-related sales (i.e. IT & datacom, mobile networks, mobile devices and broadband) has declined from 65% of revenue in 2000 to 43% in 2021 as the automotive and industrial markets contributed to a growing pie.

**A bit of everything, everywhere - 2021 revenue split by end-market and geography**




Source: Company reports, Atlantic Equities estimates. Geography is customer location.

New avenues for growth include vehicle electronification, manufacturing automation, next-generation 5G technology and cloud computing. For example, robotics and automation in factories are expected to grow around twice the rate of GDP. This diversification also makes the company less obviously prone to losing out to technological disruption.

## An entrepreneurial culture

As well as growing organically, Amphenol has a long and successful track record of bolt-on acquisitions to secure new products and customers that plug into its existing business model. Importantly, Amphenol adds companies with strong and entrepreneurial management that do not need to be "fixed". As well as boosting sales and saving costs through accessing its supply chain, these acquisitions have relatively low integration risk given Amphenol's hands-off approach.

Amphenol's entrepreneurial culture is a key strength. The company empowers its 130 General Managers to run their businesses as if they were the owners. Indeed, many are former owners of companies that Amphenol had acquired. They are given full authority and responsibility over their unit's profit & loss, and their incentives are structured in a similar way to an independent business. Innovation begins with the locally based General Managers, who can quickly respond to evolving technology trends rather than wait for direction from the top.

Equally important are its close customer relationships. Working with customers at the design stage generally leads to products with higher value-added content. Simultaneously, Amphenol is also able to leverage the benefits of scale to drive innovation as its seven Group General Managers have direct oversight over the company's 130 General Managers. These Group General Managers help to foster shared best practices, align General Managers who have significant overlap within their group, and tap into knowledge from other parts of the company. The company's auto antenna business is a good example of this dynamic as it was built on the company's core competency in antennas for mobile devices.

# Quarterly Commentary as at 30 June 2022

## Wide economic moat = high return on invested capital

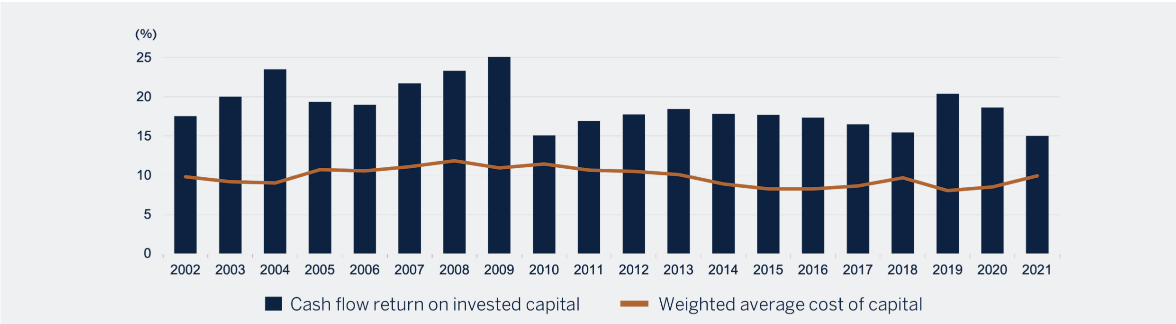
As well as the electronification trend, there remains plenty of scope for share gains in fragmented markets. According to Atlantic Equities, Amphenol has 14% share of the $70bn connector market but only 1% share of the $110bn sensor market. Only rival TE Connectivity matches Amphenol's scale and market diversity in the connector market.

The company's competitive advantage (or what Warren Buffett terms economic moat) is its manufacturing scale, reputation as a technology leader and sticky customer relationships. It is nigh impossible to displace sales of its mission-critical components because customers are more interested in dependability rather than price.

A connector is typically only 1% to 3% of an end-product's cost of goods sold. As a highly engineered Amphenol connector is specifically tailored for and embedded in a customer product, the disruptive switching costs of using a cheaper rival connector are far higher than the miniscule potential savings. Financial strength is also a critical advantage over smaller competitors as customers will want to deal with a supplier that will still be a going concern during an economic downturn.

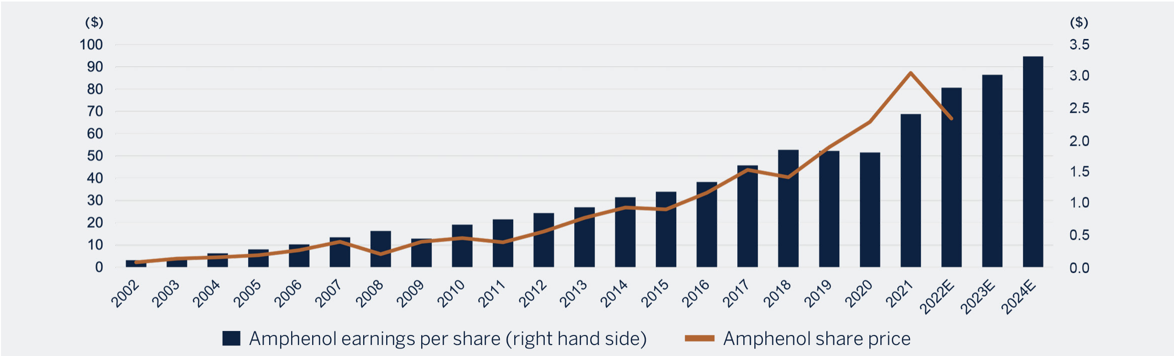
Proof is in the pudding. By reinvesting in high return growth opportunities, the earnings base has seen attractive compound growth which begets a higher share price. This money-making machine's moat and compelling opportunity set remains in place today.

**A quality business that delivers cash returns above the cost of capital...**




Source: FactSet, Atlantic Equities, Bloomberg

**...leads to earnings per share growth, which begets attractive investor returns**




Source: FactSet

## A classic compounder

Amphenol was founded in 1932 to provide tube sockets for radios. 90 years later the company continues to thrive. The secret sauce is an entrepreneurial bottom-up culture. An investor is buying over a hundred well-run businesses, not just one, that are broad beneficiaries of digitisation everywhere. Amphenol shares will not make overnight lottery-type winnings. But being exposed to the entire tech haystack, rather than vainly finding the needle within it, is the reason for its slow burn and enduring success.

# Quarterly Commentary as at 30 June 2022

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## When Growth becomes Value

What is cheap and expensive is not just a matter of price. When buying a car there is a reason you can buy a clapped-out banger for what looks like a bargain. The inevitable repairs and spare parts will rapidly exceed your purchase price.

The same principle applies to stocks. The table below shows two portfolios comprising of three companies. One is a selection of stocks at giveaway prices in 2017: a high-street retailer (The Gap), a tobacco company (Altria) and a big tech company (IBM). Their price-to-earnings ratios ranged from 10x to 13x, i.e. comfortably below the 20-year historical average for global equities of circa 15x. Let's call it a deep-value portfolio.

The other portfolio contains good quality companies trading at seemingly exorbitant prices in 2017. At the time they were over double the valuation you would normally pay for the average stock and triple the deep-value portfolio. They also happened to be the top three stocks held in the Melville Douglas Global Equity fund in June 2017. They are still amongst the top 10 holdings in the fund.

**When Growth becomes Value, and Value becomes expensive**

| | | P/E in 2017[1] | "Hindsight" P/E (2017 price / 2022 EPS)[2] | 5-year shareholder return (share price + dividends)[3] |
|---|---|---|---|---|
| | The Gap | 13x | 33x | -54% |
| | Altria | 10x | 47x | -24% |
| | IBM | 13x | 24x | +18% |
| MD Global Equity | Visa | 49x | 15x | +110% |
| MD Global Equity | Microsoft | 32x | 7x | +285% |
| MD Global Equity | Alphabet | 33x | 9x | +127% |

Source: Melville Douglas, FactSet

Notes: 1. Share price on 23rd June 2017 divided by last 12 months earnings to 23rd June 2017, 2. Share price on 23rd June 2017 dividend by last 12 months earnings to 23rd June 2022, 3. Total return for shareholders for the 5 years to 23rd June 2022, including share price appreciation and dividends reinvested.

As you can see, selecting stocks simply on the price-to-earnings ratio (P/E) ignores the "E" in the equation. It does not tell you how much profit the company will make for its shareholders in the future. Over the subsequent five years, the expensive-looking stocks massively outperformed.

The telling factor is that earnings growth was far stronger. If its share price had been flat over five years, Microsoft would have been trading on a measly 7x P/E ratio today as its cloud computing division (growing revenues at a 50% per annum clip) powered the earnings base. By contrast, cheap-tech IBM saw its profits halve as it continued to miss out on new opportunities.

Of course, there are many deep-value ideas that work out. However, you need a catalyst (such as a successful turnaround in the business, the right macroeconomic conditions, a takeover, etc...) to change investors' minds about the stock. If there is no catalyst, then a shrinking business will simply be worth less over time.

By contrast, a successful quality-growth stock tends to have durable competitive advantages and enough opportunities to reinvest at high returns on capital. Shareholder value builds over time rather than in an instant. In short, there is more mileage in paying a little bit more for quality.