

Melville Douglas

Global Equity Fund

Diversify, not diworsify

“Don’t put all your eggs in one basket” is a wise adage. It is also the only free lunch in finance given there is no certainty about the future. By spreading risks an equity investor ensures their hard-earned capital survives the inevitable bumps in the road to deliver compound returns over the long term.

Equally, too many egg baskets can cloud your judgement, develop a false sense of security and dilute your chances of delivering a superior result. These foibles have played a role in many of history’s financial disasters. A case in point was the collapse of the \$126 billion hedge fund Long Term Capital Management (LTCM), which almost triggered a Lehman-like global financial crisis in the late 1990s. The fund, with no less than two Nobel Prize Laureates on its team sheet, appeared highly diversified across global markets through thousands of trades. The problem was that all these trades were simply the same bet, i.e. that volatility, credit and liquidity spreads would narrow from historically high levels. Instead, these spreads blew out after the Russian bond default in August 1998, resulting in catastrophic losses for LTCM. As the old Wall Street saying goes, the only thing that goes up in a bear market is correlation.

As a stock picker, too many holdings can also crimp your chances of beating the market. This point was succinctly made by none other than John Maynard Keynes over 70 years ago. He was not only one of the 20th century’s greatest economists, but also a very successful professional investor. He wrote in the 1940s that “to suppose that safety-first consists in having a small gamble in a large number of different companies where I have no information to reach a good judgement, as compared to a substantial stake in a company where one’s information is adequate, strikes me as travesty of investment policy”.

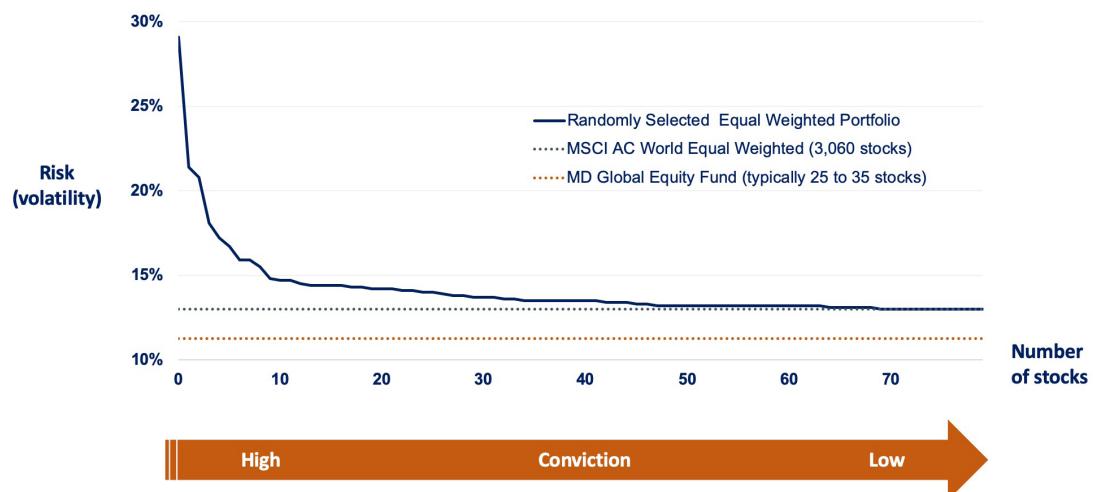
Keynes’ portfolio construction philosophy resonates with ours. Truly wonderful investment ideas are not dime a dozen and therefore investors should hold meaningful positions when these rarities are uncovered. By contrast, holding increasingly lower conviction ideas for the sake of diversification is “diworsefication”. Peter Lynch, the legendary former manager of the Magellan global equity fund, made up this term in his 1980s investment book ‘One Up on Wall Street’ to describe management teams who spread their time and resources across too many businesses. In his book he highlighted Gillette’s ill-fated and short foray into digital watches in the 1970s. Diworsefication eventually entered the lexicon to describe how the benefits of diversification can tip into a disadvantage beyond a certain point.

What then is the ideal number of stocks to hold in a portfolio? The investment industry, given our physics envy, tries to distil everything into a single number. Clearly this is spurious accuracy. We prefer to think in ranges, which will vary depending on the investment approach. For the Melville Douglas Global Equity fund we would typically aim for around 25 to 35 holdings.

The minimum number of stocks to hold in global equity portfolios is not as high as many would imagine. One measure of risk is price volatility. According to modern portfolio theory, diversification can lower portfolio volatility because share prices do not move exactly in tandem with each other. As more stocks are added the overall volatility of a portfolio’s value declines. As shown in the chart, you can halve the average volatility of holding one stock by simply adding a random sample of nine more names to the portfolio. Beyond this point, the volatility-lowering benefit of diversification is nothing to write home about. A ten-stock portfolio is only 20% more volatile compared to holding over 3,000 stocks in the MSCI All Country World equity index.

Quarterly Commentary as at 31 December 2019

Not too many, not too few



Source: Melville Douglas, Bloomberg. Risk is the annualised standard deviation based on 5-year monthly US dollar returns to 20/11/19

A ten-stock portfolio is a touch aggressive because it would only take bad news in one or two stocks to torpedo portfolio performance. Our aim is to make money for our clients through the compounding effect of sustainable returns over time. For this to work we need to be able to ride out those inevitable “known unknowns” and “unknown unknowns” (to paraphrase former US Secretary of Defense Donald Rumsfeld’s famous quote). To do so, around 25 to 35 holdings spread across different sectors, regions, themes and macro sensitivities (e.g. rates, oil price and business cycles) sufficiently covers most eventualities.

Maintaining balance is key to how we invest at Melville Douglas. Every stock held in the Melville Douglas Global Equity fund is a high conviction idea, but we construct the portfolio to ensure there is a sufficiently robust spread of ideas to withstand a few cracked eggs.

From our Fund Manager's Desk

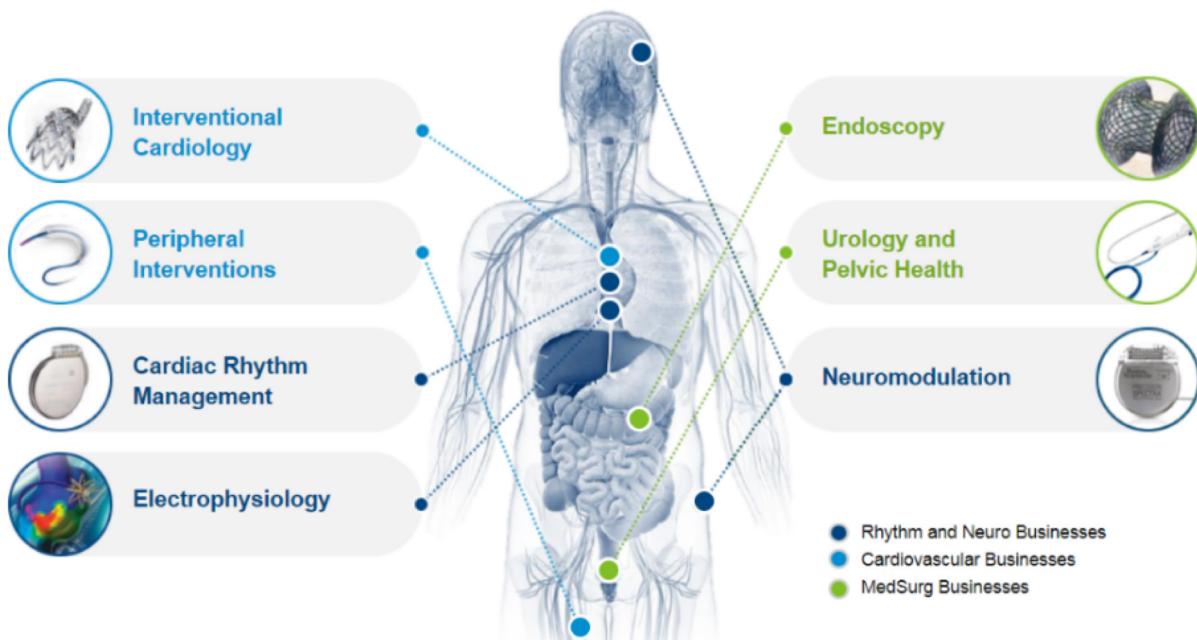
Our quarterly reports regularly explore the investment rationale of one of the companies we own in the Fund to articulate what we find compelling. This time round we have chosen Boston Scientific.

Rather like investing, maintaining a sustainable edge in medical innovation requires staying within your realm of expertise whilst maintaining a diversified portfolio of attractive opportunities. Boston Scientific has transformed itself into one of the best proponents of this strategy within the MedTech industry. We elaborate why we hold the shares.

Boston Scientific develops and sells global medical devices. It is well regarded in the industry for its long-held cardiovascular franchise, which includes pacemakers, defibrillators and stents. These legacy products are still growing steadily in demand but the pace is limited given competition from the likes of Medtronic and Abbott. Ongoing innovation has helped. For example, Boston Scientific's Resonate™ family of implantable defibrillators and Eluvia™ drug-eluting stents to keep arteries unblocked has helped to bolster growth in its cardiovascular franchise. However, the nub of the investment case is the company's diversification into adjacent fields of expertise. Through a mixture of in-house innovations and bolt-on acquisitions, Boston Scientific has branched out into faster growing areas, such as neuromodulation and endoscopy.

Quarterly Commentary as at 31 December 2019

Focused diversification with product depth - Boston Scientific's seven specialty areas



Source: Boston Scientific

Within neuromodulation Boston Scientific provides spinal cord and deep brain stimulator systems used for the management of chronic pain and the treatment of Parkinson's disease respectively. The company's Spectra WaveWriter™ Spinal cord stimulator system is a drug-free treatment that can mask pain messages travelling to the brain by sending electrical impulses to the spinal cord that can vary with frequency, pulse width and amplitude. Patients are also able to provide real-time feedback, using a remote control which is designed to enable adjustments because everyone experiences pain differently and pain changes over time. One in five adults in Europe are affected by chronic pain and therefore this innovative treatment can help to reduce the growing dependence on opioid drugs by high-risk users.

Drug-free pain relief – Boston Scientific's Spectra WaveWriter™ Spinal cord stimulator system



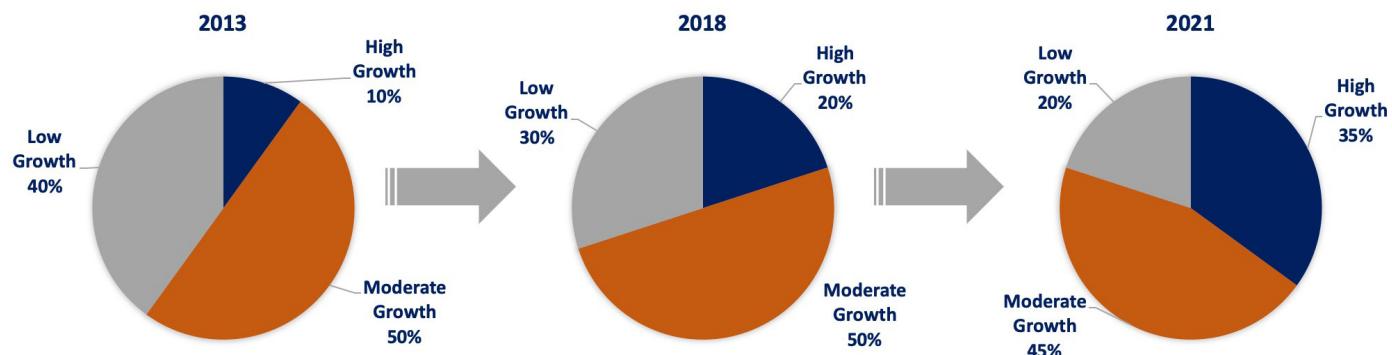
Source: Boston Scientific

Quarterly Commentary as at 31 December 2019

Another exciting growth opportunity is endoscopy. This is a procedure where the inside of your body is examined using an endoscope, which is a long thin flexible tube with a light source and camera at one end. The worldwide endoscopy devices market is expected to grow over +6% annually and exceed \$35bn by 2022. A driver has been the consistent increase in the incidence of cancer, gastrointestinal diseases and other chronic diseases, which can be attributed to the ageing population, growing incidence of obesity and lifestyle related factors. Additionally, the improvement in visualisation and diagnostic technology, accompanied by higher awareness of advantages among medical professionals, is driving the demand. The market is dominated by flexible endoscopes, of which Boston Scientific has several products in this category.

Boston Scientific's diversification strategy is starting to pay dividends. Revenue is projected to grow +8% to +10% per annum, an acceleration from several years ago due to management's decision, led by chief executive Mike Mahoney, to undertake this transformative shift in the business mix to higher growth devices categories. As a result, the revenue mix to the flattish growing (0% to +3% per annum) pacemakers, defibrillators and stents businesses declined from 40% of group revenue in 2013 to 30% in 2018, and management are targeting 20% by 2021. The flipside is an increase in the revenue mix in high (greater than +10% per annum) and moderate (+4% to +9% per annum) growth markets to 80% by 2021.

Transitioning revenue mix from low to high growth



Source: Boston Scientific, Melville Douglas

In addition, Boston Scientific has a track record of driving operating profit margin expansion since 2012 through productivity improvements and cost savings. The company expects operating margins to exceed 30% over the long term from about 26% today. The combination of accelerating revenue growth and expanding profit margins is expected to drive +12% to +15% per annum earnings growth over the medium term. A strong platform to deliver compound investment returns to shareholders. The shares are valued approximately in line with the medical devices sector, although a premium is warranted given the potential to deliver earnings per share growth above their peer group.

In summary, an investment in Boston Scientific directly benefits from the increasing demand for healthcare as populations age and from rising patients' expectations for high quality care. Unlike prescription drugs, where pricing will likely remain a political football during and beyond the Presidential election campaigns, MedTech is viewed favourably as "part of the solution" to improve healthcare outcomes and lower medical costs. Boston Scientific's ongoing strategy of targeting a spread of high growth speciality niches ensures it retains leadership at the cutting edge of innovative therapies. Focused diversification makes sense in MedTech as well as in global equity fund management.

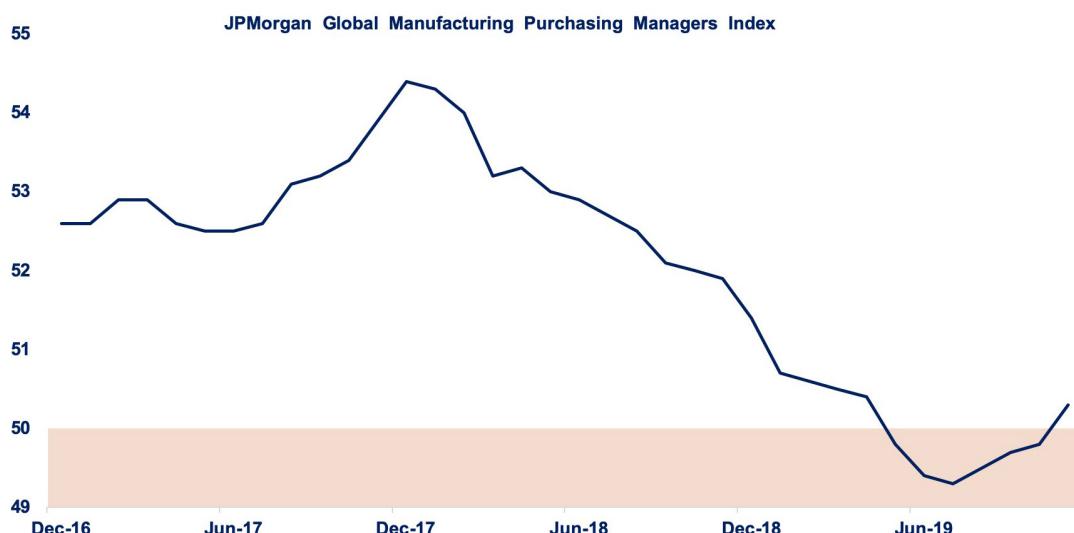
Quarterly Commentary as at 31 December 2019

Three and done, all said and done?

Central banks had a key role in spurring the powerful equity and bond markets rally of 2019. What they do next will be just as crucial this year.

Last year both the Federal Reserve and the European Central Bank sought to pre-empt the impact of escalating trade wars by cutting rates and restarting quantitative easing. Although economic growth slowed, their campaign stemmed the risk of a harder landing. As shown below the global purchasing index - a closely followed measure of business sentiment - is quietly ticking up. Last month it moved above the 50 level, indicating economic expansion rather than contraction. This improvement is consistent with a global growth recovery in early 2020.

Bottoming business sentiment



Source: Bloomberg, Melville Douglas

Investor nerves have also been settled by cooler political heads. As the year drew to a close, there was a temporary Sino-US détente over trade and the UK avoided a cliff-edge no deal Brexit. Although dissipating geopolitics and business cycle risks bode well, a fickle US President could yet upset the apple cart.

Given it is less than a year until the US presidential election, Donald Trump has a clear incentive to keep the economy on track. No doubt, Donald Trump will recall Bill Clinton's successful "The economy, stupid" 1992 presidential campaign against the incumbent George H Bush. Despite Bush's sky-high poll ratings in 1991 after the winning a war to liberate Kuwait from Iraqi occupation, US voters were subsequently more concerned about the economic recession that prevailed in the lead up to the election.

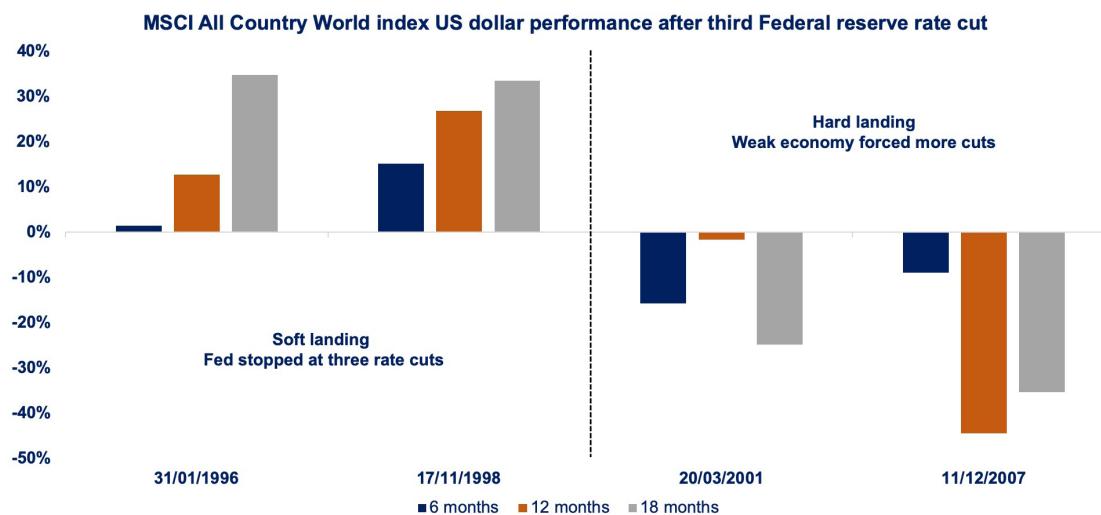
It is not a coincidence that US stock markets rarely decline the year preceding a presidential election. Over the last 20 US election cycles, there have been only two instances of the market down a year ahead of the poll. During both of those occasions there was a recession (1960 and 2008). The average return for the S&P 500 index for the year leading up to the US election was +13% when there was no recession.

What central banks do next, particularly the US Federal Reserve, will give a good indication of where markets go from here. We have already had three cuts by the Federal Reserve. The third cut was on 30th October 2019. Although recent statements by Fed chairman Jerome Powell indicated little urge to tighten policy, more rate cuts would indicate fears of an economic hard landing into a recession. No further cuts would imply the Fed was successful in softening the slowdown in 2019 and a potential recovery

Quarterly Commentary as at 31 December 2019

ahead. This would be a positive outcome for markets. As shown below, three-and-done rate cuts in 1996 and 1998 resulted in higher markets over the subsequent 12 months. By contrast, more than three cuts in 2001 and 2007 led to an uncomfortable ride for global equity investors.

Rule of three



Source: Bloomberg, Melville Douglas

Our base case is a soft rather than hard landing, but we closely watch economic data for any change in trend and for the concomitant central bank response. So far investors have responded well to monetary easing during this cycle but, as we all know, you can have too much of a good thing.

In summary, a dissipation of political and business cycle risk has re-invigorated the outlook for equities. We continue to expect positive returns from global equities, although the risk/reward trade-off is tempered by the record length of the decade-old US economic upcycle, modest corporate earnings growth, full-but-fair valuations and more volatile than usual geopolitical backdrop.

Melville Douglas

Melville Douglas Investment Management (Pty) Ltd is a subsidiary of Standard Bank Group Limited.
Melville Douglas Investment Management (Pty) Ltd (Reg. No. 1962/000738/06) is an Authorised Financial Services Provider. (FSP number 595)

Disclaimer

This summary brochure has been prepared for information purposes only and is not an offer (or solicitation of an offer) to buy or sell the product.

This document and the information in it may not be reproduced in whole or in part for any purpose without the express consent of Melville Douglas.

All information in this document is subject to change after publication without notice. While every care has been taken in preparing this document, no representation, warranty or undertaking, express or implied, is given and no responsibility or liability is accepted by Melville Douglas as to the accuracy or completeness of the information or representations in this document. Melville Douglas is not liable for any claims, liability, damages (whether direct or indirect, actual or consequential), loss, penalty, expense or cost of any nature, which you may incur as a result of your entering into any proposed transaction/s or acting on any information set out in this document.

Some transactions described in this document may give rise to substantial risk and are not suitable for all investors and may not be suitable in jurisdictions outside the Republic of South Africa. You should contact Melville Douglas before acting on any information in this document, as Melville Douglas makes no representation or warranty about the suitability of a product for a particular client or circumstance. You should take particular care to consider the implications of entering into any transaction, including tax implications, either on your own or with the assistance of an investment professional and should consider having a financial needs analysis done to assess the appropriateness of the product, investment or structure to your particular circumstances. Past performance is not an indicator of future performance.