WAVERTON
INVESTMENT MANAGEMENT

# Reflections on Style

## Waverton European Equity Team

### The Long Run Overview

Since 2001, when we started managing money together as co-portfolio managers, we have consistently applied the same investment philosophy and process to the management of our funds. By any measure, eighteen years is a long time to be managing money and hence we believe it is an opportune moment to provide clients and prospects with an overview on our investment style. Having a clearly defined investment style ensures investment discipline and has helped us navigate and generate alpha through the different market environments (TMT bubble, the bull market of the 2000s, the Financial Crisis, the Euro Crisis of 2011) we have experienced and invested through over the last 18 years.

### Buyer Beware

To state the obvious, but something that is often forgotten, we believe it is of the utmost importance for clients to know the type of fund or strategy they are buying, as this will provide insight into how the fund will perform during different market environments (e.g. up-markets, down-markets, sideways moving markets etc.). There should be few surprises for investors in a fund such as a material drawdown over and beyond expectations. Therefore, understanding an investment manager's style is a crucial element to setting the performance expectations of a strategy or fund.

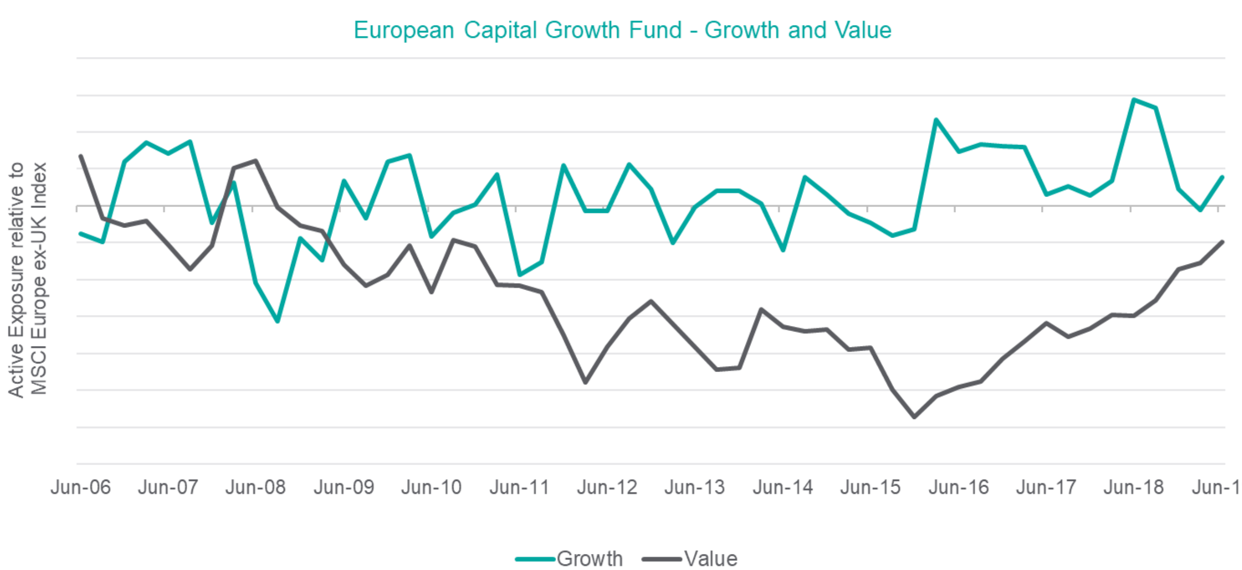
A manager's investment style is the anchor and lens through which they analyse companies. We view this as being a manager's investment DNA. Disciplined implementation of an investment style (which leads to the investment process) should, under specific market conditions, ensure that a strategy will be able to perform to expectations. It also ensures that a manager stays true to the investment process and *does what they say they do*. To use the jargon, there should be no style drift.

### The Value and Growth Straitjacket

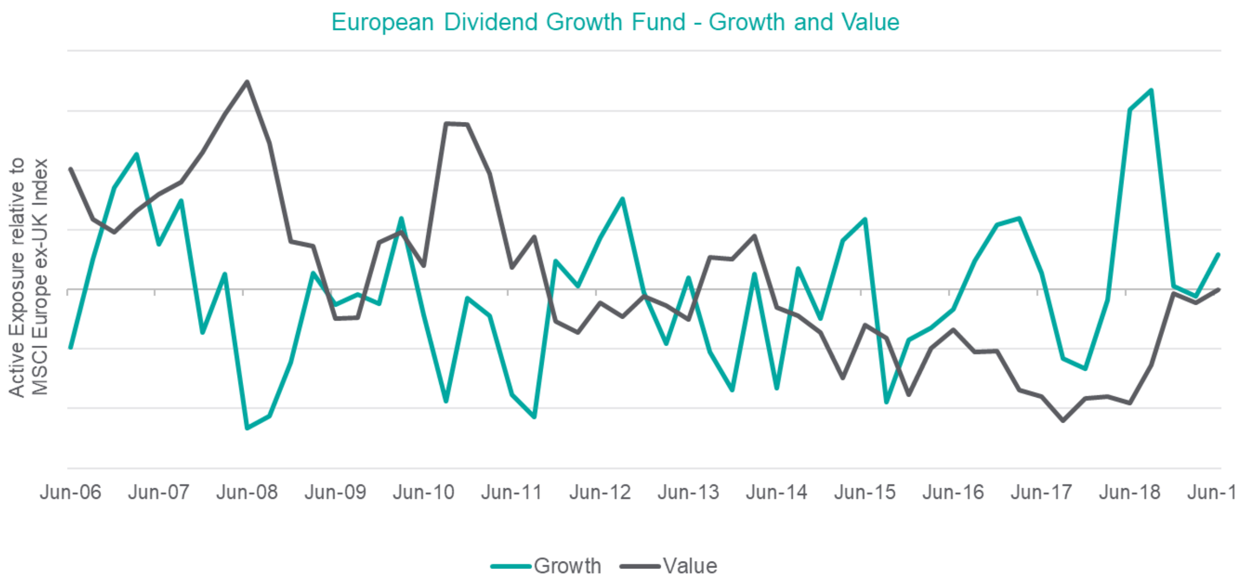
The most commonly used investment style categories are Value and Growth. Simplistically, Value is based on mean reversion with stocks trading on multiples (P/E, P/B, Price to cashflow etc.) less than the market or their sector peers. Growth stocks are generally considered businesses that we expect to grow earnings greater and for longer than the market. They will generally trade on higher multiples than the market. Both of these styles have investment merits and there exists managers who have proved successful over time by implementing either a Growth or Value style.

The alternative view is that these style buckets straitjacket managers, overly constrain them and are a naïve and simplistic approach to analysing managers. The manager selection industry has become, in many instances, a box-ticking exercise! Good stock pickers should have the flexibility to buy either Growth or Value stocks, irrespective of labels, based on the manager's assessment of a stock's fundamental attractiveness. As investors, we have sympathy for this perspective as our investment approach doesn't neatly fall into the commonly used style labels and is not constrained by the conventional definitions of Value and Growth. Our portfolios can and have included a combination of Value and Growth stocks. This is because our investment style is based upon the Capital Cycle investment philosophy. This is our investment anchor and the starting point for identifying fundamentally attractive stocks. There is not a lot that is unique left in the investment industry (commoditisation of information, the advance of quant, exponential proliferation of hedge funds has arbitraged away a lot of market inefficiencies). Nevertheless, we believe we are among a select few investment practitioners applying a capital cycle investment approach to stock selection. The focus on the capital cycle has helped the Capital Growth and Dividend Growth Funds to outperform during different style driven market environments, which will be addressed in subsequent newsletters. The following charts, using Factset data, shows the interaction between Growth and Value factors in both the Capital Growth Fund and the Dividend Growth Fund* since 2006:

**Capital Growth Fund**



**Dividend Growth Fund**




Source: Factset and Waverton Investment Management

*The charts show the active factor exposure of the funds relative to their benchmark. The factor exposures are the weighted average Z scores of the underlying positions in the fund to the Growth and Value factors. The Factor model used is the FactSet / Northfield Global Equity Model.

Neither Fund has had sustained structural exposure to either Growth or Value factors over time. This supports our view that our investment style and process is not restricted to a Value or Growth label, giving us the opportunity to generate alpha in any “style” driven market environment.

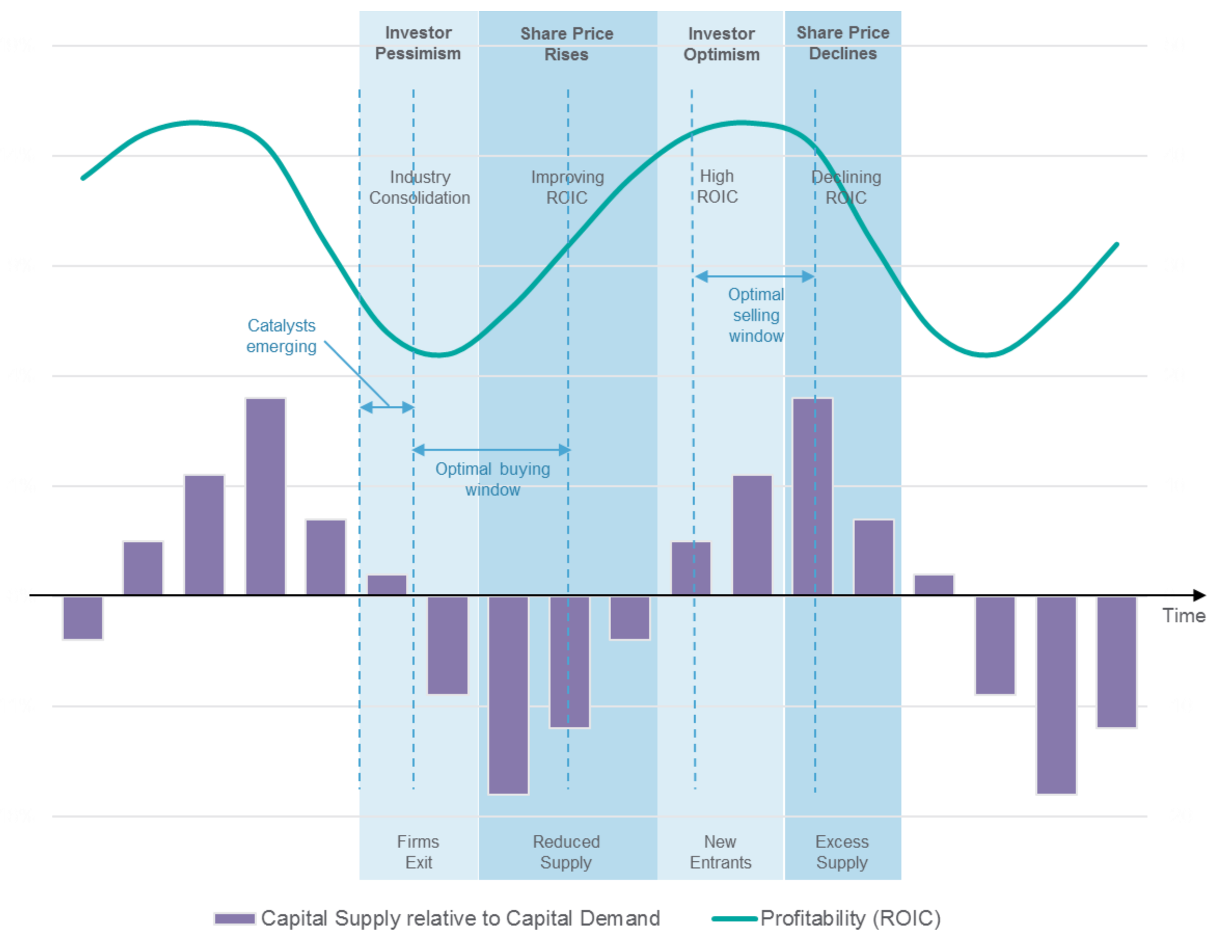
## Capital Cycle Investing in Practice

The capital cycle is mainly focused on understanding and quantifying the level of supply in an industry, rather than trying to forecast the – short-term - levels of demand (where most active fund managers apply their energies). We believe this focus gives us greater insight and a differentiated view in understanding the fundamental attractiveness of businesses and industries.

All industries go through a capital cycle, albeit to varying degrees. The duration and severity of each company and industry’s capital cycle is dependent on the barriers to entry for new entrants and the behaviour of existing competitors. There are industries (principally cyclicals) with lower barriers to entry that swing from excess optimism with new entrants attracted by high returns on capital, to excess pessimism due to a glut in supply and a resulting decline in returns. We are looking for companies in these industries that have experienced excess pessimism, but where consolidation and structural change is underway. Generally, these businesses trade at attractive valuations as the market is slow to identify and understand the changing industry dynamics. Consequently, excess supply is taken out, a number of competitors exit and the remaining, principally dominant players, become price setters (possess pricing power). Thus earnings visibility, cash flow, and profitability improve, resulting in a rerating of valuations.

The capital cycle approach also works for investing in less cyclical, long-term structural growth industries. These industries typically experience less severe swings in sentiment as they have higher barriers to entry. However, as the capital cycle's principal focus is on understanding supply, it can identify long-term structural growth businesses that dominate an industry i.e. possess a moat: being the lowest cost producer, benefiting from economies of scale, having a unique product offering or possessing proprietary technology. Given they are dominant market players, these businesses are generally, though not always, fully valued. Simply, there are fewer mispricing opportunities for us to exploit as investors. Nevertheless, we look to take advantage of the market's short-termism when these businesses are sold off and become attractively valued due to short-term issues, such as an earnings miss or temporary operational problems.

## Capital Cycle in Action



## The Salmon Farmers

An industry we have often talked to clients about, which illustrates how our capital cycle investment style works in practice, has been our selection of Norwegian salmon farming stocks starting in 2014. Our investment in the industry is a classic example of capital cycle investing in action.

The changes in the salmon farming industry were brought to our attention by one of our regional broker contacts - despite much criticism of brokers, we believe European regional brokers can be a fruitful source of ideas. Salmon farming is an industry that has historically been plagued with excess supply as companies continually increase production to meet global demand. While fundamentals had started to improve for Norwegian producers, the catalyst for buying into the industry was a meaningful reduction in the rate of growth in the supply of salmon, due to a new regulation to control sea lice. Salmon is produced in confined spaces, the result being a greater vulnerability to sea lice and disease in general. Therefore, controlling the parasite is a perennial problem for the industry and, if left uncontrolled, sea lice have the ability to wipe-out salmon stocks. There was icing on the cake of our investment thesis, as a disruption in Chilean supply of salmon - who account for 22% of global production - caused by a volcano in Chile, reduced worldwide production by 2.5%.

Marine Harvest (since rebranded Mowi - the dominant global salmon producer) was purchased in May of 2014 and Salmar, another Norwegian producer, was purchased in April 2015. At the time of purchase, Marine Harvest was trading on a P/E of 9x and a dividend yield of 10%, while Salmar was on a P/E of 11.9x with an 8% dividend yield. In April 2018, Salmar was sold as it had reached a P/E of 16x, while Marine Harvest was trading on a P/E of 13.5x when it was sold in February of this year (in the preceding 5 years, one year forward earnings had almost doubled). Our view was that both stocks had become fully valued for what is still a commoditised cyclical industry and the risk that company managements, who historically have been sub-par capital allocators, will always look for creative ways to increase supply. There is also the real additional risk of China growing its salmon farming industry, further adding to global supply.

Over the holding periods for the Capital Growth Fund, Marine Harvest returned 214% and contributed 4.7% to relative performance. Salmar returned 84% and contributed 2.5% to relative performance. For the Dividend Growth Fund, Marine Harvest and Salmar contributed 6.1% and 5.7% respectively to relative performance (the difference in the relative contributions for both funds was due to the timing of purchases and sales and the stock weightings in the respective funds).

## Conclusion

We believe that applying a capital cycle investment lens to the analysis of companies and industries ensures a differentiated perspective from the market in general and many of our competitors. This approach has made a significant contribution to our ability to generate alpha for our clients through different market cycles over the last 18 years, and our experiences have made us even better investors today.

As portfolio managers, we take seriously the fiduciary responsibility of managing clients' capital. Hence, we want to keep clients fully informed on all aspects of our investment philosophy and process and what it means for your portfolios. We appreciate any and all comments or questions on this inaugural newsletter.

By Christopher Garsten & Charles Glasse
July 2019

**Risk Warnings**

The information provided does not constitute investment advice and it should not be relied on as such. The stocks listed are for example purposes and should not be considered as advice or a solicitation to buy or an offer to sell a security. Past performance is no guarantee of future results and the value of such investments and their strategies and the income derived from them may fall as well as rise. Capital security is not guaranteed.

**Further Information**

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