nikko am
Nikko Asset Management

QUARTERLY INSIGHTS FROM THE NIKKO AM GLOBAL EQUITIES TEAM

July 2016

When selecting companies from around the world, our goal is to find investments that meet our criteria of 'Future Quality'. We believe that we should only invest in businesses that we understand and where our research gives us confidence that the management team will grow cash flows and consistently deliver returns that exceed the cost of capital. In addition, the future growth we forecast should be undervalued, or at least fairly valued in today's share price. We have noted that the growth backdrop for the world has changed little in recent years, but valuations for many companies have risen dramatically. As an example, our decisions over the last quarter to sell UGI Corp, a US utility company and purchase ICON Plc, a Clinical Research Organisation (CRO), merit further analysis.

UGI Corp is a holding company whose businesses distribute propane in the US, primarily Pennsylvania and liquid petroleum gas (LPG) in Europe, with France and the Nordic countries being its key markets. In addition, it operates a natural gas utility in Pennsylvania and a midstream and marketing business based in several key eastern US states. With limited analyst interest in this mid-sized utility and having spoken with management, we were of the view that the growth in free cash flow from this business was underestimated by the share price, whilst delivering a reasonable and growing dividend to shareholders.

This thesis has proved correct and we continue to believe that the business strategy being deployed by the management team is sound. Our dilemma, however, is that the share price has been an outstanding performer versus both the utilities sector and global markets. Closer analysis will reveal that the principal source of this excess return is not surprise growth but a significant uplift in valuation. Chart 1 highlights how the share price and rising P/E ratios are indeed highly correlated. This pattern is not untypical, indicating investor behaviours that are systematic in nature. Without a clear rationale as to why growth in this company should accelerate, the inescapable conclusion from our research was that the share price for UGI Corp now offered no alpha potential and so we sold our holdings to use the proceeds as a funding source for better ideas.

UGI Corp share price vs P/E ratio

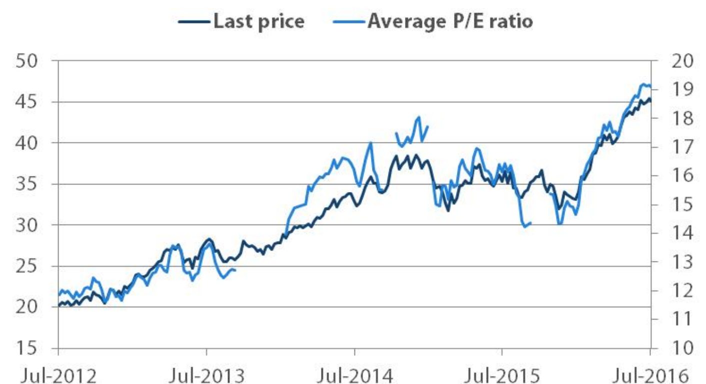


Chart 1: Source: Bloomberg as of July 2016

ICON plc was one of our new better ideas. We have been closely following ICON for some time and, after a period of lagging performance, we believed that the time to own this Clinical Research Organisation had arrived. We have already highlighted with UGI Corp how fairly indiscriminate buying of utilities has pushed valuations to levels that are no longer reasonable. Healthcare-related companies have experienced the opposite over the last six to nine months, with corrections in high-flying biotechnology companies and regulatory noises from the key candidates in the US presidential race resulting in sometimes indiscriminate selling across the sector. While we acknowledge the pressure on US healthcare given the share of GDP it now contributes, the desire for quality healthcare in an ageing society is unlikely to diminish—hence the importance of companies that enable the delivery of healthcare solutions in a more productive and cost-effective manner. This is precisely what CROs do and our research into ICON suggests that it is well placed to exploit this trend. With a mixture of organic growth and bolt-on acquisitions, we expect this company to deliver 15% growth per annum profits over the next five years, while remaining highly cash generative

throughout. With a FY2 P/E of 13x on our forecasts, we believe that any regulatory concerns are more than reflected in its valuation and this is now an ideal time to add a position in this company.

These examples aim to provide insight into the rationale behind changes in portfolio positioning. We do not desire to change holdings as this inevitably has a modest cost that we always endeavour to minimise. However, we never lose sight of the fact that delivering superior returns is dependent on the vagaries of share prices. These in turn are subject to the sentiment and psychology of investors, which may diverge considerably from reality at times.

Are you safe when you buy 'safe stocks' today?

The two main goals of central banks have been to re-price financial assets to encourage more risk taking and to encourage consumption and business investment through negative real rates. Market evidence would suggest that they have been fairly successful at the former but the latter is subject to significant debate. We have observed a rise in P/Es (note the example of UGI Corp above), a fall in bond yields, a fall in corporate debt spreads and indeed the escalation of property prices in the world's key financial centres. Before we discuss the efficacy of quantitative easing (QE) on economic growth, it's important to consider the behaviours that have been elicited by central bank policies and have become the accepted 'new normal'. Specifically, we would observe the following:

- Policy has ensured that safe yields (cash or sovereign bonds) are negligible, or indeed negative in some cases. This has forced savings institutions to seek safe yield in other markets, which has included equities that exhibit more bond-like characteristics.

- With income share of GDP (or average wages) being subdued, profit share as a percentage of GDP is reciprocally high (i.e. high profit margins). With low levels of corporate investment, the resulting free cash flows are being returned to investors. However, there is also an insidious loop in place where management has recognised that appearing to be a 'safe yielder' is generally advantageous for share price valuations. This has no doubt encouraged capital allocations, such as debt-funded share buy-backs or record dividend payout ratios, which may be more aimed at supporting share prices to benefit management incentive plans.

The outcome of this has been an increasing preference for companies that meet the desired low volatility and stable yield characteristics sought by investors. We do not debate the logic and indeed have embraced it in recent years, but our observation when conducting bottom-up research is that the valuations now being paid for companies that comprise this subset are becoming difficult to rationalise. Given the premium paid for this 'safety', further excess returns would appear to be dependent on dissipating growth and falling profitability in more volatile companies. Whilst this status quo could continue for some time, we would suggest that crowd-like behaviour such as this does not typically deliver sustainable excess returns, and stock picking in such sectors will require drivers for returns that are not correlated with the above 'safety' thematic.

MSCI World Index sector weights: Utilities & Staples vs Financials

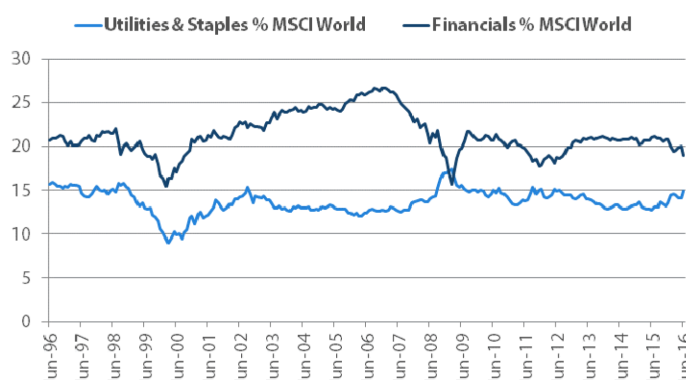


Chart 2: Source: MSCI as of June 2016

Inflection point for central bank policies beckons

We have highlighted that the price for safety may have moved clearly into expensive territory, which raises questions regarding what will change the status quo and investor behaviours. Any discussion regarding inflection points should be approached with caution, as many 'hedgehog' style commentators do this regularly and, like a broken clock, are eventually accurate. However, when we search for future quality companies, we attempt to be more 'fox-like' when appraising the broader forces that can significantly dictate the returns for individual companies. In this regard, we would observe the following:

- Negative interest rates in large swathes of the sovereign bond universe is unusual throughout financial history;

- Evidence of sustainable growth in economies where QE has been implemented for long periods is lacking. The propensity to save more as rates decline is overwhelming the propensity to spend;

- Populism and a backlash against wealth disparities are increasingly evident. The Brexit referendum outcome is an excellent example of such forces at play;

- Alternative monetary solutions such as 'helicopter' money are being trialled; and

- Profitability for financials is being significantly compromised and hence their ability to act as a mechanism for credit intermediation is under question.

All of this suggests to us that the current policies are eventually doomed to fail. Political expediency will ensure that further attempts are made to engender sufficient demand growth to ensure the current level of debt burdens (private and public) can confidently be serviced in the future. This will likely involve greater public sector involvement in attempts to

shift the money multiplier, given the clear lack of willingness by the private sector to do so. Indeed it could also involve more radical policies such as monetary financing (direct printing of government debt) or the write down of sovereign debt via conversion to perpetual zero-coupon bonds, with Japan being most able and in need of such solutions.

All of this raises a number of questions which we do not pretend to have answers to. More notable ones include the likely shape of yield curves (key for financials), the productivity of investment when led by governments, the possible shift to more protectionist policies, and the length of the honeymoon period for risk premiums as deflationary forces lessen before the corrosive nature of inflation erodes valuations. Given the number of variables involved, it would seem likely that policy events will have to be considered pragmatically as they emerge, and hence the focus remains firmly on assessing the best candidates for future quality without any assumption of radical policy implementation. However, ensuring that our investments are not exposed to excessive safety premiums will help the portfolio be prepared for a wider range of outcomes. We have also been considering where opportunities may vary across geographies and have reconsidered our prognosis for Asian markets.

Relative merits of Asia improving

We have consistently maintained a more cautious stance on most of the emerging world since 2012. Initially this was driven by the relative valuation merits, the dependence on high commodity prices and inefficient capital deployment. Cheap offshore US dollar debt financing was an additional concern, with the rise in the US dollar since 2014 leading to a de facto tightening of policy. We are clear that emerging markets are far from being a homogenous universe and hence such broad brush simplicity must be treated with caution. However, given that prior offshore capital flows into these markets were generally driven by generic buying of the asset class (e.g. the dubious marketing hype around BRIC funds), it is important to note that neither the hype nor the elevated valuations exist now as they did then. With increasing questions around the growth trajectory of QE-driven developed economies, the growth potential of these markets is now easier to compare.

MSCI AC Asia Pacific ex Japan – price relative to MSCI World Index

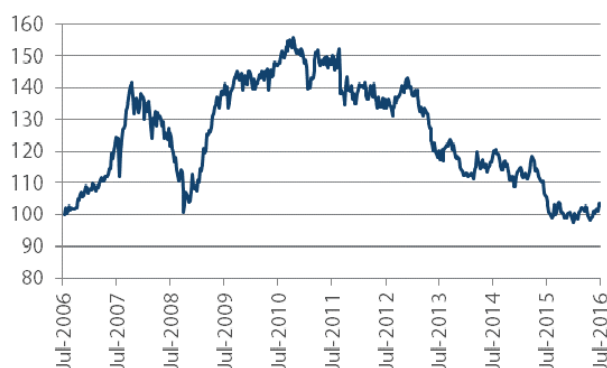


Chart 3: Source: FactSet and MSCI as of July 2016

Within emerging markets, the relative merits of Asia are clear. The region enjoys high savings rates, typically large current account surpluses, being a beneficiary of lower commodity prices and an increasing dependence on intra-regional trade in the most populous area of the world. Similar to the broad emerging asset class, Asia is heterogeneous, ranging from quasi-developed nations to those that are poorer, demographically younger and less indebted (India, Vietnam, Philippines, Indonesia). We are spending increasing time researching all of these markets for stock ideas.

Over the last quarter, our search in Asia has led us to Taiwan Semiconductor Manufacturing Company (TSMC), which is listed in the more mature Taiwanese market and is a clear global leader in semiconductor foundries. This industry is more mature in the context of the concentration of players and the adoption of the foundry model, but Moore's law has continued unabated to the benefit of technology leaders. TSMC is at the forefront of this evolution and is leading the development of scale manufacturing of 10 nanometer (nm) and 7nm nodes. Given the high asset intensity of this industry, the superior scale of TSMC as the largest player is allowing it the luxury of higher R&D spend versus peers whilst still generating free cash flow and a high dividend yield for shareholders. This company may not have high operating leverage given current strong profitability, but the barriers to entry are large for new entrants and we expect TSMC to fully participate in the on-going growth of global semiconductor usage in the coming years.

Portfolio positioning

The table below highlights our Global Equity Strategy holdings as of the end of June 2016. In aggregate, this indicates that we are currently finding more attractive stock picking ideas in the Healthcare sector in particular. On the other hand, there is a scarcity of ideas in areas such as the Energy sector, with the rally in stock prices in recent weeks making this unlikely to change.

Portfolio positioning

The table below highlights our Global Equity Strategy holdings as of the end of June 2016.

	Portfolio Weight
Energy	5.75
Caltex Australia Limited	2.13
Suncor Energy Inc.	1.62
Occidental Petroleum Corporation	2.00
Consumer Staples	11.04
Treasury Wine Estates Limited	2.03
Coca-Cola Company	2.34
Henkel AG & Co. KGaA Pref	2.00
Shiseido Company,Limited	2.24
Tyson Foods, Inc. Class A	2.42
Consumer Discretionary	7.06
Advance Auto Parts, Inc.	2.09
Geely Automobile Holdings Limited	1.37
Sony Corporation	2.19
Whitbread PLC	1.41
Financials	16.39
Affiliated Managers Group, Inc.	1.00
AvalonBay Communities, Inc.	2.17
Daiwa House Industry Co., Ltd.	1.57
Huntington Bancshares Inc.	2.07
Ichigo Inc.	1.53
American Tower Corporation	2.76
KeyCorp	1.44
Merlin Properties SOCIMI S.A	1.75
Intact Financial Corporation	2.10
Industrials	8.38
BAE Systems plc	2.05
C.H. Robinson Worldwide, Inc.	1.97
HD Supply Holdings, Inc.	1.34
Ryanair Holdings Plc	1.53
Travis Perkins Plc	1.49

	Portfolio Weight
Health Care	20.74
AbbVie, Inc.	3.00
ICON Plc	2.13
LivaNova Plc	2.35
Cardinal Health, Inc.	1.49
Cooper Companies, Inc.	2.22
Laboratory Corporation of America	2.54
MEDNAX, Inc.	2.43
Shire PLC	2.58
Sinopharm Group Co., Ltd. Class H	1.99
Information Technology	15.81
Microsoft Corporation	3.33
Facebook, Inc. Class A	3.38
SYNNEX Corporation	2.36
Tencent Holdings Ltd.	2.36
Nokia Oyj	2.01
Taiwan Semiconductor	2.38
Materials	6.13
CRH Plc	2.30
Johnson Matthey Plc	1.53
Scotts Miracle-Gro Company Class A	2.31
Utilities	1.78
Veolia Environnement SA	1.78
Telecommunication Services	5.15
AT&T Inc.	3.32
BT Group Plc	1.83
[Cash]	1.75
Total	**100.00**

*The holdings shown above are based on a representative account managed by the investment team. Reference to individual stocks does not guarantee their continued inclusion in the portfolios managed by the team

Source: Nikko AM, FactSet as at 30 June 2016

Any references to particular securities are for illustrative purposes only and are as at the date of publication of this material. This is not a recommendation in relation to any named securities and no warranty or guarantee is provided.

Global Equity Strategy Composite Performance to Q2 2016

Quarterly gross Returns % USD	**Q2 11**	**Q3 11**	**Q4 11**	**Q1 12**	**Q2 12**	**Q3 12**	**Q4 12**	**Q1 13**	**Q2 13**	**Q3 13**	**Q4 13**	**Q1 14**
SWIP Global Equity Portfolio	0.9	-19.4	9.4	14.2	-3.1	5.4	3.6	8.5	3.8	7.9	8.8	-0.1
MSCI World Index	0.5	-16.6	7.6	11.6	-5.1	6.7	2.5	7.7	0.6	8.2	8.0	1.3
MSCI AC World Index	0.2	-17.4	7.2	11.9	-5.6	6.8	2.9	6.5	-0.4	7.9	7.3	1.1
Alpha vs MSCI World Index	**0.5**	**-2.8**	**1.8**	**2.6**	**2.0**	**-1.3**	**1.1**	**0.8**	**3.2**	**-0.3**	**0.8**	**-1.3**
Alpha vs MSCI AC World Index	**0.7**	**-2.0**	**2.2**	**2.3**	**2.5**	**-1.4**	**0.7**	**2.0**	**4.2**	**0.0**	**1.5**	**-1.1**

Quarterly gross Returns % USD	**Q4 14**	**Q1 15**	**Q2 15**	**Q3 15**	**Q4 15**	**Q1 16**	**Q2 16**
Nikko AM Global Equity Portfolio	4.2	4.7	1.8	-5.5	3.7	-0.7	-0.2
MSCI ACWI ex AU Index	0.5	2.3	0.5	-9.3	4.9	0.2	1.0
MSCI AC World Index	0.4	2.3	0.3	-9.5	5.0	0.2	1.0
Alpha vs MSCI ACWI ex AU Index	**3.7**	**2.4**	**1.3**	**3.8**	**-1.3**	**-0.9**	**-1.2**
Alpha vs MSCI AC World Index	**3.8**	**2.4**	**1.4**	**3.9**	**-1.4**	**-0.9**	**-1.2**

	SWIP	Benchmark	Excess
Since inception ann (%)	12.38	10.23	2.15
3 Years ann (%)	12.38	10.23	2.15
1 Year (%)	21.81	19.07	2.74

	Nikko AM	Benchmark	Excess
Since inception ann (%)	4.38	-0.28	4.66
3 Years ann (%)	-	-	-
1 Year (%)	-2.91	-3.72	0.81

*The track record for SWIP is based on a composite portfolio managed by the investment team whilst at SWIP from 31 March 2011 to 31 March 2014. The team was subsequently acquired by Nikko AM in August 2014. The track record for Nikko AM portfolio is based on a composite portfolio from 01 October 2014 to 30 June 2016.

Source: Nikko AM, FactSet, Bloomberg

Nikko AM Global Equity: Strategy profile and available funds (as at 30 June 2016)

Key Features		
Investment Objective	+3% vs MSCI AC World	
Key Features	**30-Jun-16**	**Guidelines**
No. holdings	47	40-50
Active share	94%	90-95%
Cash	1.75%	0-3%
Available strategies	Global ACWI, Global EAFE, Global ex specific country, Sharia	
Available vehicles	UCITS-SICAV, Country domiciled mutual funds, unit trusts, investment trusts and segregated accounts	

This is provided as supplementary information to the performance reports prepared and presented in compliance with the Global Investment Performance Standards (GIPS®). Nikko AM Representative Global Equity account. Risk Data sourced from FactSet.

Nikko AM Global Equity Team

Nikko Asset Management's Global Equity team is based in Edinburgh, Scotland and comprises six portfolio managers/analysts, with an average 19 years' industry experience. The team's flat structure is designed to maximise their ability to capture the best ideas in client portfolios and to minimise any behavioural biases that may prevent them from achieving the best results for clients.

Experience

Significant diversity of background and combined breadth of experience through a variety of market cycles/crises across global investment markets enables the team to 'join the dots', applying their knowledge to think laterally and pragmatically to find the best available investment opportunities.

Free-thinking

The team does not believe there is a single pre-determined 'recipe for success' in idea generation. Experience and mutual trust allows them to keep an open mind about each investment case, often considering opportunities from different perspectives to the more rigid structures/cultures of other investment managers.

Execution

The team believes that effective execution of the process relies on a culture of focused collaboration to achieve one goal: high conviction portfolios that aim to achieve the best outcomes for clients.

It is this combination of extensive experience, flexible free-thinking and effective execution that offers a compelling and differentiated outcome for our clients.

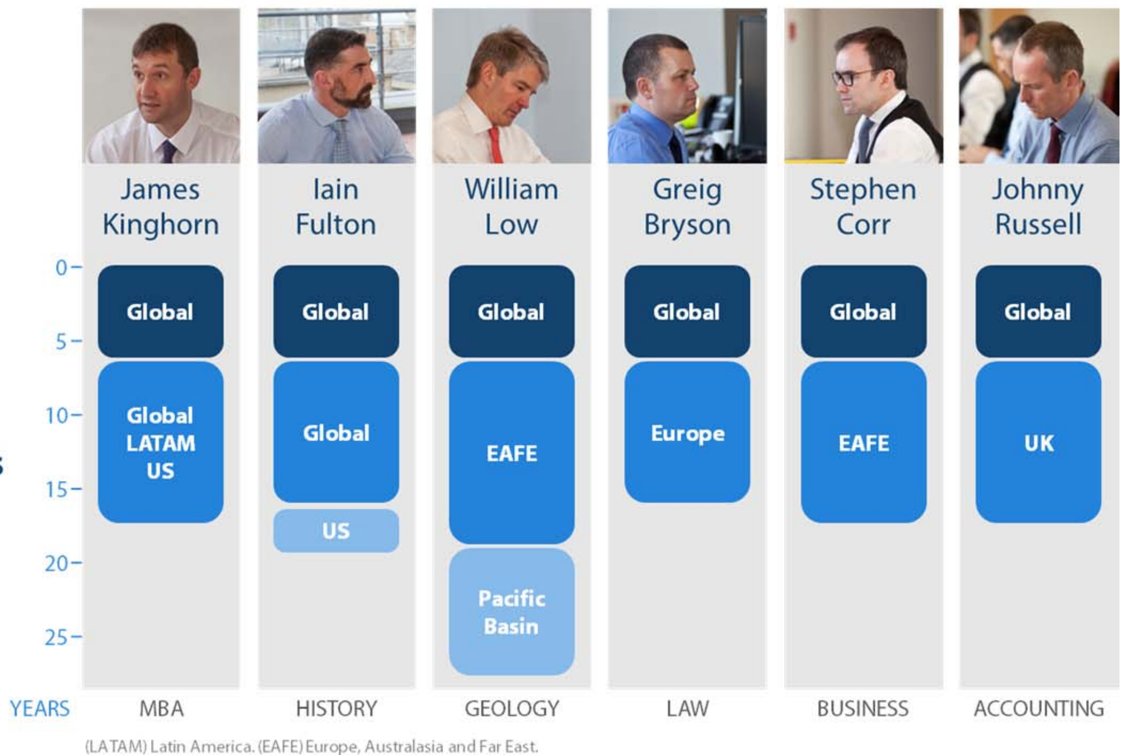
5+ YEARS Team Together

19+ YEARS Average Experience

6 PORTFOLIO MANAGERS in a Flat Structure

Mix of specialists + generalists

Cognitive diversity



(LATAM) Latin America. (EAFE) Europe, Australasia and Far East.

About Nikko Asset Management

Nikko Asset Management Co., Ltd. is one of the largest global asset management companies headquartered in Asia, offering world-class asset management solutions for global investors. With approximately USD 165 billion* in assets under management, our firm leverages its extensive global resources across 11 countries, representing over 30 nationalities.

*Consolidated assets under management and sub-advisory of Nikko Asset Management and its subsidiaries as of 30 June 2016.

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