ASSET MANAGEMENT
COPENHAGEN

INSIGHTS LEARNED OVER THE LAST 25 YEARS

25 years OF TIMELESS PRINCIPLES

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Insights learned over the last 25 years: How the world changes – and then again stays the same

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Since 1990, when we initiated our global equity strategy, the world has changed in unpredictable ways.

Back in 1990, when we published our first investment letter, there was carnage in the global equity markets. War was about to break out in the Middle East, and few at the time probably thought this would still be with us 25 years later.

The area of optimism in the global economy was Europe then. As we wrote, "Development in Europe acts as a locomotive for the rest of the world. Structural change combined with more open markets assures continued growth." The Cold War had been won by the West, and the peace dividend was about to be collected. Europe was opening up, and there were great expectations for the expansion of the European Community. This was reflected in our investment portfolio, which held large positions in companies exposed to infrastructure developments across Europe. Telecommunications (SIP, formerly Telecom Italia, and Setemer, an Ericsson subsidiary in Italy) was one focus area, and the driver of growth in these businesses was not mobile nor internet communications but pure and simple fixed-line telephony.

Furthermore, our optimism regarding the structural but not cyclical growth of emerging markets was reflected in large positions in Greek stocks such as Titan Cement and the Commercial Bank of Greece. As we wrote, "It is our impression that Greece has significant potential, as the country modernises and moves closer to the new Europe." We grew wiser, but earned excellent profits in the Greek market in the 1990s. Greece was eventually elevated to developed-market status, but has since turned a full 180 degrees and gone back to emerging-market status and is probably not an area in which we will find structural growth anytime soon.

Over the past 25 years, economies and markets have changed markedly, and the professional investment community has seen profound change, with competition having increased tremendously. However, throughout this time, our focus has remained unchanged, on delivering superior returns from a concentrated portfolio of maximum 30 stocks. We believe our success is founded in the stability of our team and our ability to attract talent that supplement the organisation's burning desire for equity investments while staying true to our original investment philosophy.

Through this period, we have gained a number of insights that we believe will be important for us to know in the years ahead, as we continue our work trawling the world's equity markets for outstanding equity investments. These insights are:

INSIGHTS LEARNED OVER THE LAST 25 YEARS

- **Daring to be different – with conviction**
- **Mistakes made and lessons learnt: Think very carefully about political risk**
- **Earnings growth is the long-term driver of share prices**
- **Business model is more important than stock valuation**
- **Too much time is spent on temporary information at the expense of lasting knowledge**
- **Even in times of low economic growth, it is possible to find pockets of high growth: Thematic investments**

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Daring to be different – with conviction

All investors have to decide what type of investor they are. Passive investors and benchmark huggers have implicitly accepted index returns at best while having little risk of losing significantly, at least in a relative sense. Active investors disregard the false sense of security of a benchmark and aspire to returns that are better than average or even great. Going for greatness has its price, however: it is typically quite uncomfortable, because by definition disregarding the benchmark means taking radically different decisions than the market, and it is always uncomfortable not to be part of the crowd. Deviating from the crowd is a prerequisite for great results but no guarantee, as you could also be wrong. Are you willing to be different and are you willing to be wrong? If so, it means that you as an investor have a choice: you can go for safety and seek index returns, or you can aspire to great results but with significantly higher risk.

At Carnegie Asset Management, we have always firmly been in the camp of active managers. Our mantra has been maximum 30 stocks globally, a relatively high tracking error, a long-term investment horizon and an active share that most of the time has been around 90. At the same time, we have kept the standard deviation of returns at market levels. Our road to be different has always been centred on the willingness to take big positions in high-conviction stocks. And our conviction has always been based on our view of the long-term earnings base of the company.

All of our high-conviction positions throughout the life of our business as an asset manager have at times felt uncomfortable and looked wrong from a conventional point of view. Our major exposures in oil stocks in 2002-05 comes to mind. Like our zero weighting in oil and other energy companies since 2012. Today it seems obvious to be out of oil stocks at that time, but this was not conventional wisdom back then.

We used the panic to increase our position in September 2013, something that has since produced significant rewards for us.

Another example could be HDFC, which was our largest position in 2013, during the emerging market scare. The stock was heavily hit by selling pressure from investors fleeing EM stocks in general without differentiating India from Turkey or Brazil. We used the panic to increase our position in September 2013, something that has since produced significant rewards for us.

To be great, you have to do things differently and deviate from consensus. Our belief is that you get the best risk-return from a concentrated portfolio of growth stocks where you have high conviction in the sustainability of earnings growth.

Being an active and concentrated stock picker also requires the organisation to think long-term and your clients also to be focused on the longer-term returns. Even though you as an investor will eventually prove right in your thinking, the timing may go against you. Performance is not linear: actually, our experience is that it is very lumpy. As Keynes observed, "The market can remain irrational longer than you can remain solvent."

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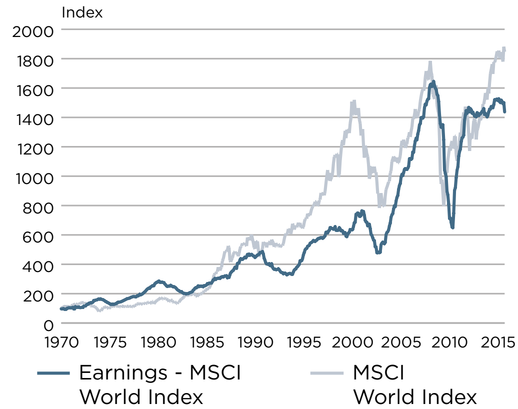
Earnings growth is the long-term driver of share prices

We firmly believe that the long-term trend in earnings determines the returns that investors receive from investing in equities. This belief is supported by historical facts, as can be seen in figure 1.

Figure 1

Earnings and returns



Source: MSCI

Since 1970, earnings have risen by 1,337% (USD), supporting equity returns of 1,747% (USD). Throughout this period, there have been time spans when equity markets have deviated from trend earnings growth creating shorter-term opportunities or risks. However, timing these events is difficult. Furthermore, we believe that the compounding of returns is a much less risky way of generating superior long-term returns than trading in and out of stocks and segments of the market in a desire to outperform the market.

To quote Wayne Gretzky, you "skate to where the puck is going to be, not where it has been", and so should you never ever invest in the present. It does not matter what a company has earned. You have to predict with a fair degree of certainty what the company will be earning in the future.

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One example could be Nestlé, a company we have invested in since our inception back in 1990. Over these past 25 years, Nestlé has delivered growth in earnings per share of approximately 10% per annum, and at times the share price has looked somewhat expensive. At the same time, our view has been that structural themes such as premiumisation and growth in emerging markets continue to support the company and that the growth outlook has not changed for the company, supporting the view that the company would "grow into its multiple." Over this period, Nestlé has delivered a total return of 2,200% (USD), or 13.5% per annum, versus the global equity market return over the same period of 420% (USD), or roughly 6.8% per annum. Nestlé today trades at 20 times 2016 earnings, which is expensive, versus its own history (because of low interest rates) but in two years' time the company will be trading just about 16-17 times 2018 earnings with an unchanged share price. As we do not see any change to Nestlé's growth outlook for the coming years, we think it is unrealistic to expect a de-rating of the valuation multiple for the company and thus believe that the stock will continue to deliver its past and present low double-digit return.

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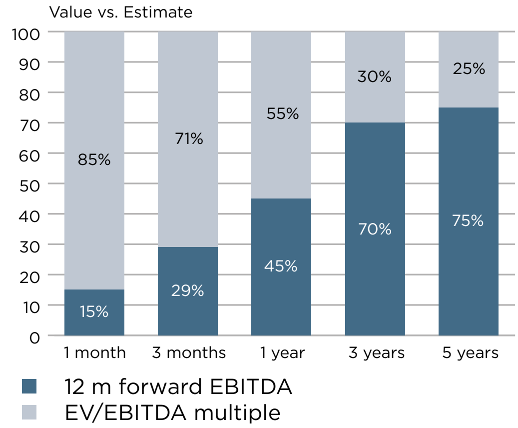
Business model is more important than stock valuation

Considering valuation is useful, especially if you have a shorter time horizon. However, for longer-term investment horizons, it is less useful. This is because over longer-term periods the earnings power of a superior business comes to the fore and directly drives the bulk of the performance. Timing and therefore valuation becomes less important, and the quality of the business becomes increasingly important for the long-term return, as can be seen in figure 2.

> **We do not want to pay exorbitant multiples for a stock, but we would rather pay a bit too much for the really excellent business than too little for the poor business.**

Figure 2

In the long term, returns are driven by earnings growth



Source: Goldman Sachs, Datastream

For this reason, our main focus when looking for new companies to invest in is to identify high-quality growth companies that will continue to deliver high returns on invested capital, thereby reducing the likelihood of multiple contraction. As Warren Buffett famously said, "Price is what you pay. Value is what you get." We do not want to pay exorbitant multiples for a stock, but we would rather pay a bit too much for the really excellent business than too little for the poor business.

Mistakes made and lessons learnt: Think very carefully about political risk

Being an active investment manager means taking active and at times controversial bets, which of course is not risk-free, as mistakes will be made. The importance in being wrong is, obviously, not to be wrong too often and, when you are wrong, trying to understand what made the investment a losing proposition.

Around the turn of the century, we were invested in two Nordic stocks, Tomra and Vestas, both of which were horrible investments and had a common problem. Tomra was the largest producer of reverse vending machines used for the recycling of beverage containers. Our conviction at the time of investment was that the company was exposed to strong secular growth as the recycling standards spread from the Nordic region, where the system had been very successful, to other parts of Europe and eventually to the Americas.

> **We learned a very important lesson, namely that you should be very careful with companies that depend on political decisions to realise their growth potential.**

Vestas probably needs no introduction. The investment case was, similarly, built on an idea of strong secular growth as wind turbines spread across the globe supported by countries' desire to increase self-sufficiency in power generation and reduce carbon emissions.

We sold both stocks after realising large losses on the investments. However, not everything was lost: we learned a very important lesson, namely that you should be very careful with companies that depend on political decisions to realise their growth potential. In the case of Tomra, things began to go wrong when the required legislation in Germany was not implemented and the large supermarket chains did not feel obliged to invest in new collection systems. Vestas' growth spur ended when expected orders from the US evaporated because the US subsidy schemes were not implemented as anticipated.

> **The lesson we learned was to be very careful when investing in companies whose growth outlook depends on favourable political decisions. We will always favour companies that are in control of their own destiny.**

In both cases, the companies' growth outlook was dependent on external and political factors. The lesson we learned was to be very careful when investing in companies whose growth outlook depends on favourable political decisions. Sometimes this is unavoidable when you want exposure to a high-growth market like China or other emerging markets, but we will always favour companies that are in control of their own destiny.

Too much time is spent on temporary information at the expense of lasting knowledge

We live in times of great uncertainty. Nevertheless, this has always been the case. Forecasting the future – even the near-term future – can be a daunting exercise. A case in point could be the ongoing Greek tragedy that has now been with us since the beginning of 2010. The media and Wall Street thrive on this kind of story, which is perfect for creating anxiety in order to sell the news or stimulate trading activity. However, we question how much performance one could generate from trading the news on Greece.

Too much time is spent on this kind of temporary news rather than focusing on creating lasting knowledge you can use to position your investments for long-term performance. Too much time is spent on thinking about whether it's "risk on" or "risk off" instead of focusing on factors about which you as an investor stand a decent chance of being correct – over the long term. A case in point could be our decade-long focus on the developing middle-income consumer base in India. When we initially invested in the Indian mortgage bank HDFC in 2005, India had an estimated middle-income population of about 50 million. Today that has increased to more than 250 million and is expected to be around 500-600 million by 2025, larger than the entire population of the European Union. When did you read in the newspaper that the middle-income population of India had just doubled?

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Since our initial purchase of HDFC in 2005, the stock has risen 460% (USD) versus a rise of the global equity market of only 90% (USD). We think it is much more important to recognise this unstoppable force than to spend your time evaluating the numerous possible outcomes of the Greek tragedy and the impact it could have on asset markets – something that is highly uncertain to forecast.

Even in times of low economic growth, it is possible to find pockets of high growth: Thematic investments

Investors usually expend significant resources trying to predict the general macroeconomic trend, since nominal economic growth over the long term determines the earnings growth of companies. However, history has also proved that there is no direct relationship between short-term economic cycles and stock market returns.

> **Over the past three years, we have seen unusually low economic growth in the Western world of approximately 2% on average and, despite this, we have identified pockets of strong secular growth.**

Even during periods of low economic growth, you can always find pockets of high growth in the world economy. Over the past three years, we have seen unusually low economic growth in the Western world of approximately 2% on average and, despite this, we have identified pockets of strong secular growth. One example could be Novo Nordisk and the obesity epidemic.

Other current focus areas for us are the expansion in middle-income groups in India and other emerging economies and robotics, where we continue to see strong growth from the large-scale industrial application of robots as well as from the new emerging theme of collaborative robots. Sensors are at the core of optimisation of industrial processes as well as for improved car safety and eventually fully autonomous cars and the build-out of the Internet of Things, where machines, appliances and humans are connected in one giant network. If you can afford to step away from conventional wisdom and the benchmark, you can always find pockets of secular growth.

Conclusion

Since 1990, when we initiated our global equity strategy, the world has changed in unpredictable ways. Themes have come and gone, companies have flourished and faltered, and countries have emerged and developed whilst others have lagged in development. The asset management industry has changed significantly, and the abundance of information and data has shortened investment horizons.

In the 25 years of actively managing global equities, we have steadily built our long tradition of stock picking, consistently identifying themes and trends that drive earnings growth and hence share prices. In the process, we have gained valuable lasting knowledge that also will guide us in the years ahead, as we diligently focus on continuing the journey we began back in 1990.

> **If you can afford to step away from conventional wisdom and the benchmark, you can always find pockets of secular growth.**

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