

So what exactly do you mean by Global Thematic Investing?

REAL RETURN INVESTING AT VERITAS

*“The most successful men in the end are those whose success is the result of steady accretion. It is the man who carefully advances step by step, with his mind becoming wider and wider - and progressively better able to grasp any **theme**”*

Alexander Graham Bell, Scottish, inventor of the telephone 1876.

So what exactly do you mean by Global Thematic Investing?

In all walks of life, beyond business and finance, people understand what it means to get in front of themes and trends. It might mean 'fashion', it may mean 'innovation' and it could mean 'change'. Whatever these words mean to different people, they are certainly about understanding context or framework. No individual, company or indeed capital market operates in a vacuum: context is important. It helps to identify the fundamental economic drivers that are in your favour: both existing tailwinds and expected changes in the prevailing wind.

Twenty years ago, coming out of the major stock market falls of 1987, many of us now at Veritas were using themes as part of our investment approach. However, in using that sort of terminology you were asked to explain yourself. It was not part of the accepted lexicon of the asset management business. At that time, typically, many prospective clients or their advisors wanted to know about the four Ps (Philosophy, People, Process and Performance). They expected some peg to hang you on (value, growth, regional focus and so on) and they were being preached the religion of Passive Indexation (why bother with active fund managers when you can buy an index cheaply?). There were some clients who saw the wisdom in being less influenced by index driven thinking and more by themes in the business world: it made intuitive sense to them.

Fast forward to today and 'thematic' appears everywhere: common usage but not necessarily a common language or interpretation. Once again, one is obliged to explain oneself to clarify the fog of marketing-speak: and rightly so. What exactly do you mean by thematic investing? Like all strategies, it needs definition and the key is successful implementation.

To answer this from the perspective of the Veritas Global investment approach; it warrants a brief history, some examples of how different players use themes, a warning on common pitfalls and finally, a clarification of how we use themes.

Some History (and why use themes?)

For our part, the use of themes was born out of a desire to capture certain benefits to an investment approach as well as to escape from some 'conventional wisdom' that was highly questionable.

The benefits:

- ***The formulation of strategic context and getting behind future tailwinds.*** In selecting equity investments we were mindful we were buying the equity of businesses. These were not just tradable chips on the table. As Keynes pointed out, investment is an activity of forecasting the yield on assets over the life of the asset; speculation is the activity of forecasting the psychology of the market. In assessing the prospects for a company, understanding the essential economic, technical, regulatory and political characteristics of the industry within which the company operates is part of the judgment. Finding where the ball is going to and where there is likely to be consistent top line growth provides a strong framework within which to invest.
- ***Narrowing the universe and focusing further research.*** The use of indices encouraged investment decisions based upon momentum or the rear view mirror rather than assessments of who is best positioned for the future. A narrow regional or index-based approach was being increasingly undermined by globalisation and increasing correlations. The use of dogmatic value-based approaches, often with the increasing fire-power of quantitative techniques and better historic data, were too much of a blunt instrument and also often were about 'relative value relative to history'. We thought it better to adopt a global approach and then narrow the universe and focus research through identifying key trends and themes.
- ***Thinking as companies think.*** Companies were increasingly thinking about the impact on their business from technology, creation of common currency blocks, globalisation, the end of the Cold War, demographics and new business models (look where the banking

sector went in the US and the Europe over the last 15 years). Advisors to companies were pushing them along a path which took into account global themes. Academics on MBA courses were teaching corporate strategy weaving in themes. The respected writer and management consultant Peter Drucker (a man with real breadth of thought across boundaries) was early on the study of demographic trends and termed it “the future that has already happened”. The rise of middle class purchasing power in emerging countries is a key demographic trend. More recently the chief economist of Goldman Sachs described the explosion of the world’s middle class as: “one of the true structural themes shaping our era”. I saw this myself on a recent visit to China. We believed in the interdisciplinary, holistic and horizontal way of thinking- getting away from narrow indices; regions or artificial boundary lines.

As well as capturing the benefits we perceived, it was equally important to avoid the pitfalls of conventional wisdom at the time. We have always been attracted to think independently. The following were mindsets we sought to avoid:

- **Spot forecasting or market timing, which is a mug’s game.** Nobody can accurately predict what the economy will deliver; what interest rates will be or what level the stockmarket will attain in twelve months time. It is important to appreciate the difference between analysis of future; existing trends and themes and trying to predict the economy or market. In any case, equity markets are neither homogenous nor wholly efficient. Trying to beat Ben Graham’s Mr Market day in and day out in the short term is at best a ‘loser’s game’ and at worst a recipe to lose money. Better to use what Warren Buffet calls ‘patterns’ than listen to the spot forecasting economists and strategists.
- **Waterfront coverage.** The focus on indices and using them as the primary measure of a fund manager’s short term performance led to a desperation by fund managers to avoid getting the big constituent parts of the index wrong. Even worse, closet indexing and benchmark hugging followed. Armies of analysts were built up to cover the waterfront, often leaning heavily on the sell side analysts for their education and guidance. Scope was defined by indices. Valuation was always ‘relative to’ rather than based on intrinsic value. We avoided this, preferring to have more alert and flexible analysts thinking along the lines of how industries and companies work in a global universe. Focused by the

filtering of the themes, the analysts would devote time to the future winners not the past winners.

The ways in which themes are used today

No paper on this subject would be complete without some understanding of the different and contrasting ways themes are used in investing today. In itself, this contrast will help a greater understanding of how we use them in our global approach at Veritas.

- **Owners or strategic managers of capital:** It is common today for there to be some guiding principles within Family Offices; Foundations; Trusts or Pension Funds. These over-arching principles add significantly to the traditional thinking of asset allocation or matching of return objectives such as a long term real return. They can take the form of themes: Digitalisation; Knowledge Economy; Growth in Emerging Markets; Resources and Environment. Frequently they will seek exposure through out-sourcing to fund managers who think this way (like Veritas). These managers may include those who run a single focus type fund with themes such as the Environment and Alternative Energy. However, there are other ways of achieving this exposure such as Exchange Traded Funds (ETFs), Exchange traded Commodities (ETCs) and structured products. This can be to gain exposure which is not readily available in individual equity positions such as the focus on agricultural commodities.
- **Corporate managers of shareholders’ capital:** It remains the case that corporate managements think along these lines in establishing their corporate strategy. Consider the following from the 2008 interim results of HSBC in the statement by Stephen Green, Group Chairman: “Through this period of major uncertainty and beyond, we will continue to position HSBC for long-term growth. The major global long-term trends- the key drivers of change which underline our strategic thinking- remain intact. Emerging markets will grow faster than mature ones; world trade and investment will grow faster than world GDP; and the ageing of the world’s population continues. All of these trends have significant implications for financial services”. There will be no technology or telecommunications company that does not address the following themes in their thinking: broadband facilitating digitalisation; the mobile internet; growth in emerging markets; storage; CleanTech and

convergence of hardware, services and content. For retailers and advertisers, the impact of the internet is a fundamental theme.

- **Global Thematic fund of funds:** The identification of themes is used by some fund of funds strategies, formulating an allocation strategy based on themes. In this way highly focused funds can be employed to express the theme as opposed to individual equities. The exposures will ultimately be different. For example, water shortage and its implications is a fascinating existing and future theme. In itself, however, it is not enough from an implementation point of view. Do you seek companies that are water utilities? Do you seek skills and technology in desalination? Alternatively, do you buy a fund that has bought 95 year rights to three glaciers in northern Europe, all close to ports? Navigating this is the skill of the portfolio manager.
- **The purveyors of Indices:** There is a commercial interest in providing ever cheaper or liquid alternatives to thematic investing. This can be extremely broad brush, based on the rear view mirror and over-diversified but nonetheless gains 'exposure'. For example, in 2008 indices have been launched by investment banks to offer exposure to a large basket of stocks involved in Asian Infrastructure. Packaged and sold as 'an index providing exposure to Asian stocks which capture the Asian infrastructure theme', they demonstrate a desire to catch up with more forward looking and active fund managers by re-drafting the index boundaries.
- **The equity investment manager:** The use of themes has become fashionable to shape strategies of all kinds with stockpickers. Some have long lists of economic, industry or financial characteristics as themes (e.g. cash generation, corporate restructuring, pricing power). Some have long term 'buckets' that they place stocks into and then rarely change (e.g. growth in emerging markets, Intellectual Property and Innovation). Some use them primarily for marketing, some for research and others for guidance to buying baskets of stocks 'with momentum' (e.g. recent examples in the 'commodities super-cycle' theme). We would regard some of these thematic approaches as narrow and limited by not addressing appropriate valuation and conviction.
- **The Macro call:** There is a constituency of investor who is prepared and able to take what is genuinely the long view. They may well concentrate on only one or two major theme ideas over a ten year period. They are

the 'why don't we go fish-farming' types who will walk away from an asset class or enter one for long periods of time. These are the players who only want to see the wood and don't care about the trees. For example, in 1981 10 year US Treasuries yielded 15%. The last twenty years of the twentieth century became an era of disinflation with multiple consequences. At the time of writing this, the 10 year US Treasury yield is 3.8%: should you really be lending to the US at this rate for the next 10 years? Maybe time to sell and go fish farming.

Common mistakes (or what themes don't do)

We aim to avoid these pitfalls.

- **Themes don't pick stocks.** You cannot shoe-horn a complex company and its valuation into a theme. Don't even try and certainly don't believe those who over-rely on themes. There are those that see GE as well placed for the infrastructure theme both in emerging markets and developed markets: it has all kinds of exposure to this from power plants to water processing to wind turbines. There are others who see a financial company which has not yet addressed its impending credit losses. What price a conglomerate like GE?
- **Themes can encourage momentum investing.** Themes do not value a company's equity. Nor do they define quality. Themes are often long-lasting but very rarely original (hands up who hasn't heard of China's 'Urban Billion in 2025' or Indian urbanisation, what's new about outsourcing or offshoring?). There is a clear and present danger of being a momentum investor (fashion) rather than appropriately price sensitive, contrarian and concerned with quality. There must be a valuation element to investing.
- **Over-diversification.** Look carefully at how a theme is implemented. Watch out for 'catch all' fund managers with 10-15 themes and 80-100 stock portfolios that cover every base possible. Are you buying into clever implementers within the portfolio or an investor likely to have winners and losers cancelling each other out?
- **Marketing and Sales bias.** Today's asset management business expects clear and sometimes colourful articulation of what you do and how you do it. Watch out for the bandwagon jumpers and the good stories: is there substance behind the approach and does it

rely solely on themes or are there other aspects to the investment process that are as important?

How do we use themes at Veritas within the global investment approach?

Framework and context within which to invest.

In our strategy discussions, themes are a common language and part of the investment culture of the House. They can be long term plate shift themes of an economic or geopolitical nature. They can relate to industries and the key themes within an industry. Micro developments, such as corporate restructuring or technological innovation, often impact on the macro investment landscape. Some things change over time and are glacial; others have major sudden turning points. We are alert to both these enduring and fast changing themes. We are alert to change.

In 2007 an old order ended in the US where US credit growth had outpaced GDP growth massively for some time. A virtuous circle had been in place: rising asset values, reducing savings rates and a super-charged US consumer. Financial institutions changed their business models with securitisation; wholesale funding; development of complex derivative businesses and leverage in order to take maximum short term benefit. Then the credit bubble burst. Getting the themes right into this context was important to us: we avoided the car crash in financial stocks in 2007-08. We had established a theme from early 2006 of 'Resilience'. We identified the need to seek resilient characteristics such as oligopolies with pricing power; a strong balance sheet and sustainable cash flow; addressing the right consumer and within structurally growing markets. Equally, the contextual theme precluded us from investing in highly leveraged companies such as banks and other financial institutions. It led us away from consumer discretionary companies whose earnings were dependent on the sustained expenditure of over-borrowed households in Western economies.

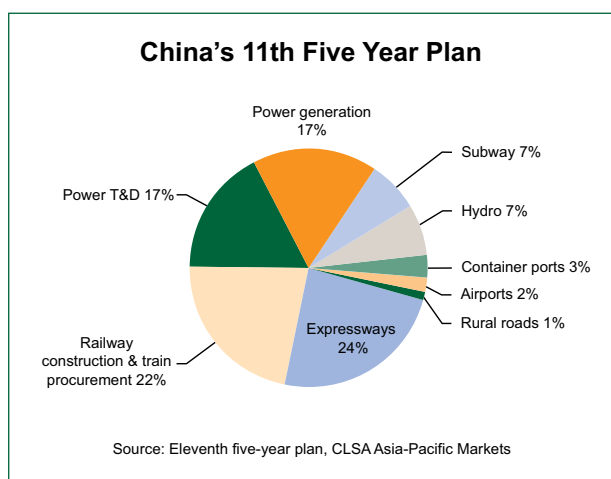
Filtering and Conviction.

We shall use our themes as one method of narrowing the universe to those companies we wish to analyse further and, crucially, place a valuation upon. For example: where can we find structural growth? We have been analysing global and regional expenditure on security and defence. We have been investing within our Connectivity theme with the growth of broadband and convergence. This filtering has two aspects. First, we shall aim towards concentrating

on the 3-6 high conviction themes we identify at any point in time with at least a 3-5 year time horizon. Second, it only is one aspect of our investment process as we then seek to place a fundamental valuation on high conviction specific company positions.

Identifying Tailwinds and Headwinds.

We seek to identify, as companies themselves do and as fundamental investors do, the future drivers of growth and performance. These we call Tailwinds. One example would be our theme of 'serving the national interest'. In the current environment, commitments by governments to support development through fiscal spending will become highly relevant. In this respect there is no better example than China with the fiscal firepower and policy intent to continue to drive growth forward. China's urbanisation programme and infrastructure spending may suffer short term challenges but is an established medium term trend. Infrastructure spending will account for around 25% of local government spending over the next 5 years in China. Nationally, the estimated infrastructure spending is \$920bn up to 2010.



This impacts on a number of areas: transport (toll roads, railways); energy (electricity transmission, distribution and generation) and water. We seek to get ahead of these tailwinds and have a number of companies we follow closely to gain entry points to their equity. It may also be the case that when analysing economic, capital market or industry context we identify serious Headwinds. These in themselves can help our filtering and investment focus by ruling out opportunities that face adverse change, creative destruction in their way, a disappearance of their 'moat like' characteristics or new competition.

CONCLUSION

In conclusion, well defined and implemented global thematic investing can generate outstanding performance. At Veritas, we understand the limitations of themes and we have extensive experience of the use of themes in our investment. Often a good theme is over-valued or not investable with sufficient quality of position. Themes are only one part of how we invest at Veritas. The use of our own research; our own network of consultants; our own quantitative screening for ideas and the fundamental analysis to arrive at an assessment of intrinsic value all play a role.

Simply put, themes are about framework, filtering for strong investment ideas and identifying headwinds and tailwinds. Simple is often best, however hard it is to implement successfully.

As we approach the US elections, it is interesting to remember the words of Woodrow Wilson, 28th President of the United States from 1913-21 including the First World War. He knew where to put the emphasis and keep it simple:

“Prosperity is the first theme of a political campaign”.



Charles Richardson

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For more information please contact Richard Meyrick – rmeyrick@veritas-asset.com, +44 (0) 20 7961 1443

VERITAS ASSET MANAGEMENT

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Sources: Veritas Asset Management (UK) Ltd.

Veritas Asset Management (UK) Ltd., Elizabeth House, 39 York Road, London SE1 7NQ

Phone: +44(0)20 7961 1600 Fax: +44(0)20 7961 1602

www.veritas-asset.com