QUARTERLY UPDATE

GLOBAL HIGH CONVICTION FUND

December 2019

AITKEN INVESTMENT MANAGEMENT

As investors close the book on the final quarter of the decade, market sentiment has improved considerably since the tumult seen in August. While uncertainties remain – largely in the form of difficult-to-forecast geopolitical outcomes – improving economic data suggests that the US economy remains on reasonably solid footing, and green shoots in Europe and China suggest that 2020 should see the global economic cycle continue to chug along, albeit at a lower growth rate.

For several months, we have believed the downturn in economic data seen earlier in 2019 was caused by a lack of confidence from businesses to invest in the next capital project or to hire an additional employee, rather than a build-up of excess capacity in the real economy.

With the removal of some of this uncertainty in the light of the 'phase one' trade deal agreed on between the US and China, we believe manufacturing data should start to modestly improve. The fact that a worst-case Brexit scenario has also become less likely should do the same for business confidence in the UK and Europe.

As such, our outlook for global equities as an asset class is still reasonably constructive – particularly when compared to the return on offer from cash or fixed income – though we are more cautious on valuations, given the gains of 2019. Practically, this translates to a mid-to-high single digit return expectation for equity against the backdrop of global GDP growth slowing to ~2% during the first half of the calendar year, and then slowly picking up from there. Spikes of volatility will likely remain a feature of markets for some time to come, given the depressed levels of government bond yields and the impact this has on discount rates.

Assessing the Risks

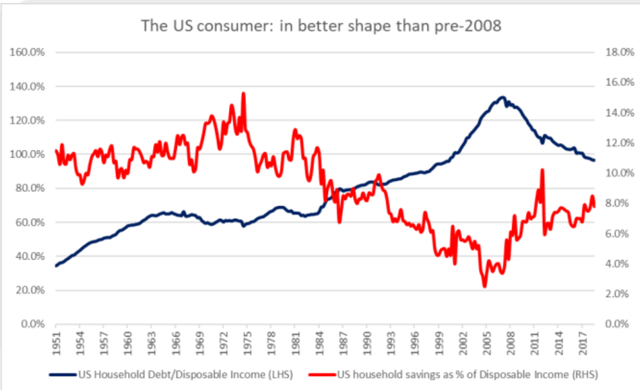
In formulating our 2020 outlook, we have tried to identify any specific build-up of over-investment or over-spending that could have a real economy impact, particularly in the United States.

At present, we don't see any material over-investment in capacity that is likely to lead to the classic 'late cycle' bust that precipitates a disorderly end to the economic expansion. The US fracking investment bust of 2015 may be a useful comparison: despite a substantial year-on-year decrease in capital expenditure after a period of elevated investment, it didn't hurt the overall trajectory of the US economy, which continued to grow despite the headwind. The ability of the US economy to withstand such an event is partly because manufacturing as a percentage of overall economic activity has continued to shrink relative to services, with the latter now representing roughly 70% of US GDP.

Investment in intangible assets (such as software, or research and development) is elevated relative to historical levels, but we believe this type of spending is of a more recurring nature. Additionally, this type of investment is benefitting from the dual tailwinds of businesses renewing their IT infrastructure to take advantage of lower-cost technological solutions that have matured over the last decade, and to position themselves to better compete in the digitally-connected marketplace.

Given that the current cycle has largely been driven by the resilience of the US consumer, it also provides us with some comfort to note that the average US household has seen its debt-to-disposable-income ratio decline from its pre-crisis peak, whilst the savings ratio has improved alongside it. Combined with robust hiring and stable participation rates, we think there is scope for modest wage growth to continue, further underpinning the ongoing expansion.

Given the current US unemployment rate (3.5% in November 2019), we expect the absolute number of new jobs created on a monthly basis to slow, but we believe it will remain in positive territory. As such, any material weakness in US labour markets would be quite concerning to us, and it is a metric we monitor closely.



Source: US Department of Commerce, Bureau of Economic Analysis

Beyond any real-economy imbalances, we also think the risk of near-term monetary policy error has subsided after the Fed's 'insurance' cuts in the latter half of 2019. As long as inflation remains subdued, we think the bar for rates tightening is fairly high, meaning financial conditions will continue to ease into the back half of 2020, given the 12 – 18 month lag between the Fed cutting rates and the positive impact being felt in the economy. (Conversely, if we had to flag a left-field, counter-consensus risk, it would be a sudden and sustained pick-up in inflation, which we discuss later).

The final pillar of risk (beyond real-economy over-investment and policy error) is of the financial nature: in short, is the financial system in good shape? After the spike in repo rates in September, the overnight funding market seems to have calmed down… on the surface, at least. The Fed continues to be active in providing liquidity as required and – per recent testimony to the Committee on Financial Services to the US House of Representatives – seems committed to a 'whatever it takes' approach to make sure this particular part of the plumbing doesn't cause ripples across markets. In the US, the banking system seems much better capitalised, though questions remain on European counterparts. Though financial risk can manifest itself in unexpected ways, we do not think the overall financial system seems unhealthy at present. Pockets of the equity and corporate credit markets look expensive, but to our thinking does not present a direct transmission effect into a real-economy impact during a sell-off.

Taken together, we think the internal risks to the economy (real-asset imbalances, policy error and financial system risk) seem to be reasonably contained at present.

Are there any external risks to be mindful of? Absolutely: a re-escalation of the trade war (between the US and Europe, for example) could undo much of the positive sentiment that has taken hold over the last three months, while any of a number of near-term political events (the next stage of the Brexit negotiations, the 2020 US election cycle, progress on North Korean or Middle Eastern peace talks, to name but a few) could drive volatility higher and roil markets. However, we believe that unless there is a strong transmission mechanism to slow growth in the real economy, such events are more likely to be opportunities for long term investors to add to quality assets (as August proved to be). We continually assess the risk of such draw-downs on a case-by-case basis.

It would be fair to say a global economy growing closer to 2% (as is expected in 2020) would find it more challenging to deal with any unexpected external shocks than an economy growing at 3%. All else being equal, the economy becomes more vulnerable to this kind of 'unforecastable' event risk as growth slows down.

In bringing all the above together, we think 2020 will see the global economic expansion continue, albeit at a lower growth rate. The conditions that underpinned the synchronised global economic acceleration of 2017 have certainly dissipated, but we do not buy into the view that this spells an imminent global recession. A lack of real-economy over-investment, a reasonably healthy financial system and accommodative monetary policy paints a constructive backdrop for the global economy – and should this be married with a burst of fiscal stimulus, economic data for 2020 may surprise to the upside.

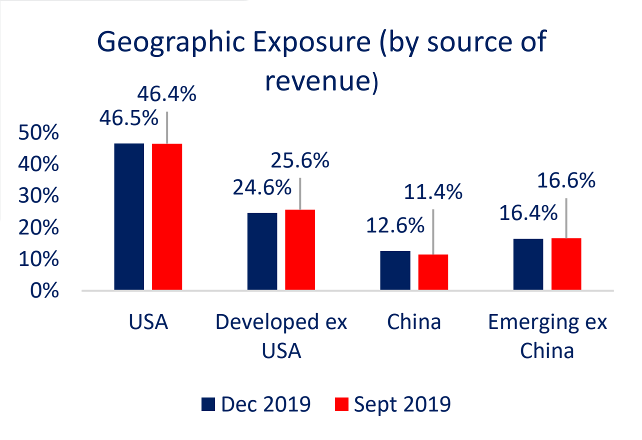
On the topic of fiscal stimulus, we are of the opinion that it would take a huge amount of coordinated and sustained government spending to create a global reflation that has staying power. It's not impossible, but we don't believe there is enough consensus at the political level around the world for this type of coordinated spending to play out.

Any rotation into deep cyclicals (such as materials, financial or energy stocks) could negatively impact our portfolio, given the investment philosophy we follow. We prefer to stick to our guns and buy businesses that can generate growth internally, rather than those dependent on government largesse to drive their ability to grow cash flows.

We close the section on our overall economic thinking by highlighting one contrarian risk: a sustained pickup in inflation. Most investors think this is unlikely, given the structurally disinflationary impacts of global supply chains and asset-light business models. However, we acknowledge that monetary policy is very accommodative against a backdrop of (arguably) full employment in the US. Should ongoing US labour market tightness result in inflation moving appreciably higher, policy error (i.e. the Fed remaining too accommodative for too long) could break the current inflation paradigm. There is already talk of letting inflation run above 2% for a 'catch-up period' to correct for the length of time US inflation has been below 2% in the current cycle, so the seeds of the idea are already planted. Clearly, this is not our base case, but it is something we keep an eye on.

Fund Positioning

The fund positioning did not change materially during the quarter from a top-down perspective. The cash weight has reduced from roughly 10% to 8%, as we selectively increased our exposure to US health care over the period by introducing Anthem, a US managed care organization.



Source: MSCI, FactSet, AIM

From a geographic revenue perspective, the exposure to the US remains virtually unchanged at 46.5% of the equity content, whilst the revenue exposure to other developed markets excluding the US declined by ~1.0% to 24.6%. The overall revenue exposure to emerging markets increased by ~1% to 29% of the equity, with the entire shift explained by an increase to our Chinese revenue exposure (now ~1.2% higher at 12.6% vs. 11.4% at 30 September 2019.)

At a more granular level, Microsoft, LVMH, Esteé Lauder and Facebook remain the top four holdings, whilst MasterCard has replaced Amazon as number five. The only position fully exited during the quarter was Union Pacific Corporation, as the stock had reached our estimate of fair value. In addition to introducing Anthem, the fund also increased its holding in Prosus, a Dutch listed holding company with substantial ownership in emerging market internet assets, amongst which a 31% holding in Tencent is the largest exposure. We also modestly increased our exposure to the Coca Cola Company over the quarter. Several positions saw minor rebalancing take place in December to remain aligned with our portfolio construction risk framework, given the ongoing rally in markets.

Fund Performance

For the quarter ending 31 December 2019, the fund delivered a return of +6.02%, bringing the return for the calendar year 2019 to +15.68% (net of all fees, in both cases).

Stock selection was positive for the quarter and underpinned relative outperformance over the period. Not having any exposure to certain underperforming sectors also aided the relative outcome.

- Several holdings materially outperformed the benchmark over the period, with Apple (+ 26.2% in AUD, +31.5% in USD), Netflix (+16.0% in AUD, +20.9% in USD), LVMH (+12.8% in AUD, +14.2% in EUR), Facebook (+10.6% in AUD, +15.3% in USD) and Tencent (+9.8% in AUD, +13.8% in HKD) making up the top five performing stocks.
- In terms of laggards, Starbucks (-4.3% in AUD, -0.1% in USD), new holding Prosus (-2.4% in AUD, -1.2% in EUR), Coca Cola (-1.7% in AUD, +2.4% in USD), Estee Lauder (-0.2% in +4.1% in USD) and Amazon.com (+2.1% in AUD, +6.5% in USD) were the five worst performing holdings.
  - Most of the fund's investments reported strong results over the October/November quarterly earnings season. A combination of better than expected company guidance, economic data and progress on a 'phase one' US/China trade settlement fuelled improving risk sentiment, which drove equity markets higher. Given this shift, it is not surprising that some of our more defensive holdings (such as Estee Lauder and Coca Cola) lagged for the quarter.
- From an absolute standpoint, the biggest headwind to performance in the quarter was the strengthening of the Australian dollar relative to the US dollar (+4.0%), Hong Kong dollar (+3.3%) and Euro (+1.0%). We estimate that the performance of the portfolio in USD was close to +10.0%.
- Given the positive absolute market performance, the ~7.2% average cash position produced a modest drag to performance.

Market Returns- 4th Quarter 2019	Total returns (%) in:		
Index	AUD	USD	Local
MSCI World Index (Developed Markets)	4.16%	8.56%	7.48%
MSCI Emerging Markets	7.30%	11.84%	9.54%
MSCI All Country World (Developed & Emerging Markets)	4.53%	8.95%	7.73%
MSCI USA	4.55%	8.97%	8.97%
MSCI Europe	4.43%	8.84%	4.49%
MSCI Japan	3.28%	7.64%	8.24%
MSCI United Kingdom	5.49%	9.95%	2.28%
MSCI Australia	0.06%	4.29%	0.06%
MSCI World excl. USA	3.48%	7.86%	4.96%
MSCI World excl. Europe	4.08%	8.48%	8.28%
MSCI World excl. Japan	4.24%	8.64%	7.41%
MSCI World excl. United Kingdom	4.08%	8.48%	7.78%
MSCI World excl. Australia	4.26%	8.66%	7.66%
S&P 500	4.49%	8.91%	8.91%
Nasdaq	7.91%	12.47%	12.47%
FTSE 100	6.64%	10.16%	2.68%
CAC 40	4.13%	8.53%	5.41%
DAX	5.61%	9.55%	6.61%
Euro STOXX	5.35%	8.47%	5.35%
Hang Seng Index	4.60%	9.02%	8.35%
Australian Dollar vs Currency			
US Dollar	3.95%		
Sterling	-3.71%		
Euro	1.02%		
Yen	4.47%		
Hong Kong Dollar	3.31%		
Yuan	1.26%		

Stock Insight

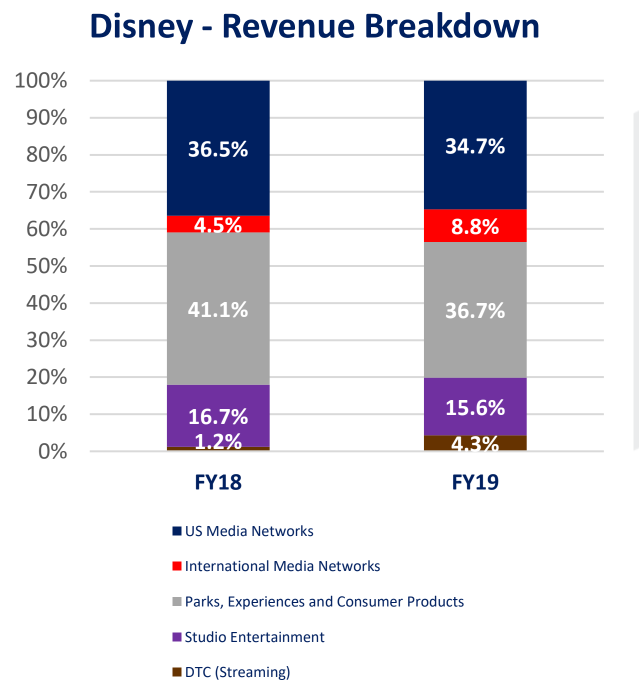
The Walt Disney Company

When constructing the fund, we always remind ourselves to remain true to first principles in identifying stocks for potential inclusion. Specifically, we consider the economics of a business – the existence of pricing power, returns on invested capital, cash flow conversion, investment intensity and profit margin profile – together with the management team's track record in capital allocation and responsible and ethical governance. We also do a lot of work to understand the future demand profile for a business' goods or services, as well as the competitive advantage a business enjoys, as we believe it is the only true source of any long-term ability to earn excess returns on capital.

In purchasing Disney for our portfolio earlier this year, we believe we own an outstanding business, composed of high-quality, differentiated and difficult-to-replicate assets, with a pathway to create economic value for investors for a long time to come.

Setting the scene

Disney is not a company that needs a lot of introduction; founded by brothers Walt and Roy Disney as an animation studio in 1923, it has been synonymous with family friendly entertainment for decades. However, most people associate Disney with box office success, and intuitively have a sense that they must also generate some portion of revenues from its theme parks and merchandising efforts. While true, it does not represent the full picture: the company generates most of its revenues and profits from linear cable and broadcast television networks, as can be seen from the chart below. (Some of the shift in weights in FY19 reflect the consolidation of the recently acquired 21st Century Fox assets for roughly half the financial year).



Source: Company data; adjusted to exclude intercompany eliminations for clarity

Thus, while the film studio and direct to consumer (DTC) streaming businesses garner most of the headlines, to build an investment case for Disney, it is critical to understand the other segments and place them in their proper context – particularly the Media Networks, given their relative contribution to revenues and profits.

A simplified recent history of Disney's Media Networks

The US Media Networks segment is comprised of the Disney, National Geographic, FX and ESPN cable channels, the ABC broadcast network and a 50% investment in the A&E Network. The segment earns revenues from selling airtime to advertisers and charging satellite and cable providers an affiliate fee for the right to show the content produced by Disney to their customers.

The jewel in the crown is undoubtedly the sports-focused ESPN network, which owns the distribution rights to a variety of widely followed sports in the US. Given its popularity and breadth of content, the ESPN family of channels has been able to consistently increase the affiliate fee it asks from the satellite and cable providers for many years. Why? Mainly, because sport remains the most valuable form of live entertainment: completely unscripted drama with an unknown outcome, and most valuable when experienced in the moment as opposed to later, when the result is known. (This contrasts with most scripted entertainment, which can be consumed as the viewers' schedule allows). As a happy coincidence, live sports are also incredibly well suited to selling advertising airtime, given the natural breaks in the on-field action.

Given the market structure of the US television landscape, ESPN has thus been an incredibly profitable venture for Disney over an extended period of time; of all the channels included in the traditional US cable bundle, ESPN enjoys some of the highest affiliate fees of any content provider.

Not surprisingly, the increasing number of consumers who choose to receive their in-home entertainment exclusively via a streaming service has hurt the traditional linear cable and broadcast companies. From a peak of roughly 102 million households with cable bundles in 2013, the current count stands somewhere between 86 and 87 million households – a steady year-over-year decline for an extended period.

The lower cost of internet-based streaming services has been a substantial driver of this shift in consumer behaviour, mainly enabled by the fact that these players (such as Netflix) can cut out a vast swathe of the distribution layer and go directly to the consumer. Some of the decline in cable households has been offset by consumers who choose cheaper digital bundles (featuring less channels) offered by certain distributors, but overall the trend seems clear: the traditional linear cable bundle will continue to see an erosion of subscribers over time in favour of streaming entertainment.

For Disney, this dynamic came to a head on 4 August 2015, during the company's 3rd financial quarter earnings call. CEO Bob Iger indicated to investors that ESPN had begun to experience 'modest sub losses', causing the firm to slightly lower the medium-term guidance for its affiliate revenue growth. Given that live sports was seen by investors as the final holdout to the threat of cord-cutting, it was not well received: most major US media companies sold off substantially on the following day, with Disney itself shedding nearly US$19bn in market value (roughly 9% from the previous closing price) on the news.

The market saw Disney as facing a near impossible-to-solve question: in a world increasingly shifting to streaming, how would the company respond to remain relevant? Any shift to aggressively move into the streaming business would likely come at a substantial cost and undermine its largest and most profitable business in linear television – a classic case of the innovator's dilemma.

Thankfully, Bob Iger seems like a man who likes a thorny problem and can take the long view.

Laying the Groundwork

Disney started off by purchasing a company called BAMTech – first a minority stake in 2016, then increased to a majority position in late 2017. The technology developed by BAMTech underpinned the streaming offering of Major League Baseball in the US. Disney acquired the company with the intent to use this technology to build its own streaming capability.

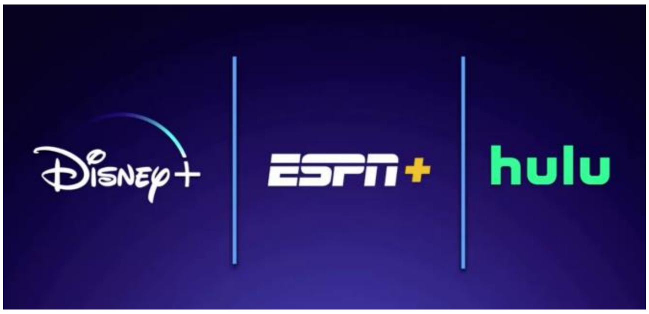
During an earnings call in November 2017, Iger announced the intention to launch a sports-focused streaming service called ESPN+ in 2018, and first mentioned the plans to launch a 'Disney-branded DTC' service in the latter part of 2019.

Shortly thereafter, in December 2017, Disney announced its intention to acquire the majority of the entertainment assets owned by 21st Century Fox. Given the size of the deal, it took more than a year to finally be completed, but as of 20 March 2019, Disney owns the film and television studios, certain cable networks and sizeable entertainment content library previously held by Fox, substantially expanding its intellectual property war chest for the upcoming launch of its own streaming efforts. As a result of the deal, Disney also owns a leading media asset in India, and now owns the majority of Hulu.

It's worth expanding modestly on the latter business. Hulu was originally established as a joint venture between various US television networks as an initial foray into the subscription video-on- demand landscape, with content being sourced from all partners to the venture (Disney, Fox, Comcast and Time Warner). Given the competitive nature of the relationship between its co-owners, the business was to some extent never free to fully pursue its full potential. Now under the effective control of Disney, it adds yet a third arrow to Disney's quiver of streaming offerings, offering a low- cost, ad-supported tier as well as a more expensive ad-free version.

ESPN+ launched in April 2018, giving Disney a foothold in the streaming landscape. It did not (and still does not) feature the most valuable sporting content the company owns – that is still offered through the traditional cable bundle – but gives Disney a destination to which we believe it can over time migrate this content to.

At an investor day in April 2019, Disney finally gave the market the complete roadmap for its future in streaming: a combined offering of family-friendly entertainment in Disney+, sporting content in ESPN+, and general entertainment content via Hulu, with properties from the Fox acquisition supplementing the shows already sourced from Disney's own studios. Available both individually and as a bundle, it finally gave the company a credible path to transition from the economics of traditional linear media to the streaming landscape, and it positioned Hulu as the venue for more 'edgy' content (think *The Handmaid's Tale*) relative to the family friendly venue of Disney+.



Investors responded with enthusiasm. The stock had never managed to breach its previous all-time high of nearly $122 set on the day of the August 2015 earnings call; following the investor day this year, it has finally surpassed this level.

Beyond the distribution channel

While this simplified history hopefully provides some context of the rationale behind the launch of Disney+ (and the roadmap going forward), it still does not address the most fundamental question: why invest in the business? What is the competitive advantage, and why do we think it can it be sustained?

Idle speculation is always fun, but as the adage goes, it's always difficult to make predictions, especially about the future. In that light, some of the most helpful investment insight can often be gained by flipping the question on its head – what will not change in the next ten years?

One thing we firmly believe will not change is that people will still want to fill an appreciable chunk of their leisure time by watching high-quality entertainment content. Admittedly, the mechanism for distributing this content may change, but we think the demand will still exist – and the players with the best library of content are well positioned to fulfil that need. For a variety of reasons, we think Disney is one of the players at the top of the field.

Firstly, it's worth taking a step back and briefly considering the other assets Disney owns outside of the Media Networks: the various studios, theme parks and related holiday offerings.

To our thinking, the core of Disney's ability to differentiate begins with its ability to generate world-class intellectual property within the Studio Entertainment segment. Whether this be animated (Walt Disney Animation, Pixar) or live action (Marvel, Lucasfilm, Walt Disney Studios), well embedded or recently acquired (Twentieth Century Fox, For Searchlight, Blue Sky Studios), the company has a long and storied track record of creating films and shows that delight viewers across the world. In fact, we think the library of characters stretching back many decades puts Disney in a fairly unique position, in that it has true cross-generational appeal. Parents are in the position to share the shows and films they grew up with, with their own children. Given the family-friendly nature of most of the content, this **cross-generational** appeal also underpins a second important differentiator: while kids love the content, parents **trust** the content. Given that the purse strings are largely controlled by the parents (well, in theory...) this matters a lot when it comes to allocating the family entertainment budget.

Disney has made a series of incredibly astute acquisitions under Bob Iger's tenure, buying Pixar, Marvel and Lucasfilm in 2006, 2009 and 2012 respectively. Between these three studios, Disney has produced a series of box-office breakouts, to the point of increasingly taking market share from other studios over the last decade. The Marvel Cinematic Universe has been an unparalleled success – doing what no one had attempted before in effectively telling a serialised story featuring the same characters over the course of 11 years spanning 23 films. The traditional Disney animation and live-action studios have also experienced a revitalisation under the firm leadership of Alan Horn, appointed by Iger in 2012.

While Disney makes more money than anyone else at the box office, it's not the primary generator of revenues or profits for the business. So why is it so important? In short, because Disney has many additional avenues through which to monetise the studio content that competitors generally lack. If Disney scores a hit at the box office, it's worth more to them than most of their competitors because they can then generate additional revenues through creating unique experiences at their theme parks or licensing the merchandising rights to 3rd party manufacturers (and taking a royalty fee for their efforts). Clearly, this doesn't happen with every film, but when a movie does resonate with audiences, Disney can generate revenues off the property for years to come.

Frozen is a great example. Released to popular acclaim in 2013, the film turned out to be a much bigger hit than anticipated by most. Over the next several years, Disney had no trouble selling the *Frozen* soundtrack and large volumes of branded merchandise. Disney also translated *Frozen* to a Broadway musical and introduced the ability to meet-and-greet the film's two main protagonists at Disneyland (with convenient merchandise stalls in very close proximity). It was a full-fledged assault on parents' wallets for a six-year period... and in 2019, Disney did it all again with the release of *Frozen II*, to critical and commercial success.

The key element here is not that the film itself is profitable – it is – but that Disney can monetise this property for many years and across many distribution channels, which now includes Disney+.

To that end, we think of the Parks, Experiences and Consumer Products segment as a true value-enhancer, giving Disney a differentiated ability to allow consumers to interact with its IP. On that note, the parks have been able to put up admission prices by above-inflation increases for many years without any materially negative impact to guest numbers – a true indication of pricing power, in our opinion. While we acknowledge it's a capital-intensive model, requiring ongoing innovation and investment, we think of it as a key part of the overall moat of the business.

This brings us to the Disney brand itself – another key pillar of our thesis.

When looking across the investment landscape, we think that one clearly emergent theme is that the strongest brands are taking control of their distribution channels and moving closer to their consumers. Nike is doing something similar, to the benefit of their long-term margin profile, and businesses like LVMH have done it for years. In the case of Disney, we think there is an additional benefit to building a more direct consumer relationship through Disney+, in that it will enable the company to build a far clearer picture of consumer preferences and interests than ever before, which in turn can inform the decision of which properties to emphasise at the theatre or its parks and resorts.

What about the media networks, though? ESPN is about to go through another cycle of renegotiating affiliate fees with cable and satellite providers in the US. In general, we think the business will push for a 'final' round of strong price increases, given that the next round (likely in the mid-2020s) will see the world in a far more streaming-oriented landscape, at which point we think the combined DTC streaming offering will have scaled to the point of being able to absorb the initial margin pressure from consumers switching to ESPN+. At the same time, we do think there's at least a possibility that not all content goes purely streaming-only, and that 'live' content – primarily sports and news – may actually work better in a non-streaming environment, where the 'in-the-moment' nature of the content is more valued than the ability to consume at a time and place of one's choosing. Regardless, we believe that there is path to managing the transition to a streaming future, acknowledging there could be some volatility along the way.

Futureproofing isn't free

As always, we think we should be intellectually rigorous when analysing any business for potential investment, and if there ever was a narrative-friendly stock, it's Disney. Where can we be wrong?

Firstly, it's important to acknowledge that Disney is a cyclically sensitive asset. Should the economic expansion slow (or end), revenue growth would likely go negative for a period of time as it did during the recessions of 2001 and 2009. In the latter case, revenues fell by 4.5%, whilst operating income fell by roughly 20%. This weakness was driven by a reduction in advertising and consumer spending, and magnified through the operating leverage introduced by the high fixed cost base of the various underlying business segments. Given our view of 2020 is that the US consumer remains in reasonably good shape, we do not think this is an imminent risk, but we account for the cyclicality in our discount rate and by modelling the valuation using several scenarios.

Secondly, there is execution risk to the Disney+ transition, particularly as it relates to the legacy Media Networks. The company itself has indicated it only expects to be breakeven on its DTC services by 2023/2024, indicating the level of investment in original streaming content required to build a full-fledged streaming bundle. Moreover, there is a second aspect to consider: if one believes that a part of the attraction of the DTC offerings are that it becomes the exclusive home of Disney content (any other approach would fundamentally undermine the attractiveness of the service, in our view), it follows that Disney will stop licensing this content to other networks, both in the US and abroad. This means Disney will forego a substantial chunk of high-margin licensing revenue whilst at the same time incurring losses as a result of investment in the DTC business. We think the management team is taking the strategically correct and brave decision to bite the bullet and start this transition, but the interplay of the above dynamics mean that 'success' may actually look like the company incurring deeper losses in the DTC segment at first. There's also the unknown cost of rolling out Hulu internationally – something management has indicated they will communicate to markets in early 2020. Given that outside the US, Hulu is a relatively unknown brand, it may require a decent amount of brand building alongside the investment in original content.

Thirdly, it's also worth noting that the Fox acquisition has substantially increased Disney's debt load – the company now has roughly US$47bn of gross debt on the balance sheet, and the future obligations for content rights amount to even more (though these latter would form part of the normal course of operations). Disney has stated that it is prioritising the reduction of the debt in its capital allocation plans and has gone so far as to suspend its share repurchase programme until its leverage ratios normalise. All else being equal, the company has more financial risk and less flexibility while the debt levels remain elevated.

Finally, there are a slew of risks around the offering itself: what if audiences tire of Disney's franchises? Are the studios at peak creative output? What happens if legislation regarding IP protections change? Can one of the tech majors – coming at the entertainment market with different objectives and substantial cash hoards – upset the streaming landscape? Can price increases at the Parks be maintained to the same extent as in the past? And – critically – what happens if cord cutting accelerates? While acknowledging all these risks, we also point out that they have been around for every year of the last decade. The most financially relevant is likely an acceleration of cord cutting, which would create an air-pocket of profitability right when spending at the DTC businesses ramp. This is a key risk, which we believe requires careful monitoring.

As always, it comes down to the price paid and the portfolio sizing. When buying Disney earlier in 2019, much of the good news around Disney+ was not yet reflected in the price. While it is tempting to value the business using a sum-of-the-parts approach (apply a 'normal' P/E multiple to the 'legacy' business, and add to that a price/sales or EV/EBITDA derived value for the DTC business), we believe the correct approach is to try and quantify the cash flows, given that Disney will ultimately be spending several billion dollars on growing the exclusive content library for the streaming venture while forgoing licensing profits elsewhere.

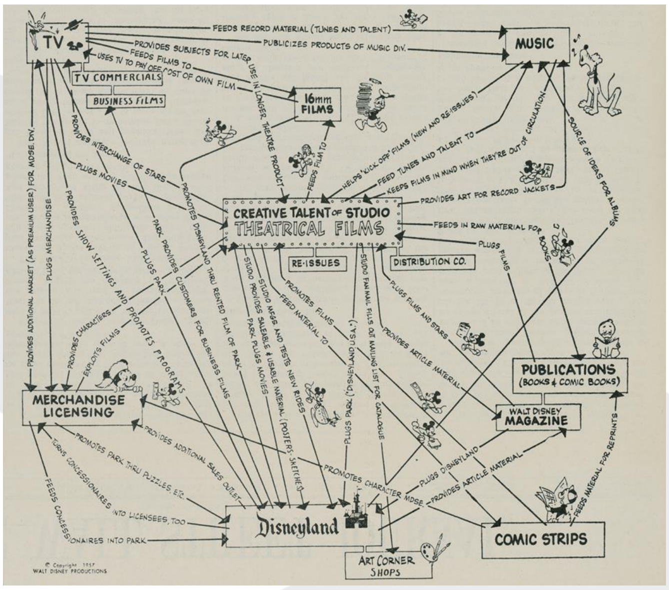
At present, Disney is a mid-size position in our fund; ongoing rapid appreciation may see us take some profits, whilst a pullback would hopefully provide opportunities to increase our holding at a reasonable margin of safety. While it's easy to build the bull case, we have a clear idea of the red flags that would make us re-evaluate our holding.

Conclusion

As stated upfront, we truly believe Disney is a collection of unique and difficult-to-replicate assets. Any competitor would literally have to spend years building the same brand affinity for its intellectual property, not to mention be willing to invest many billions of dollars in doing so.

By launching Disney+ and taking control of Hulu, the company has built a direct channel to connect with its audience better than ever before, whilst also hedging against the dominance of Netflix in the entertainment landscape. (We do not think Disney+ will necessarily only grow at the expense of Netflix, but that is likely the topic of a future note).

Disney is valuable because of the uniqueness and appeal of its intellectual properties and physical assets reinforce each other. Walt Disney himself realised this back in 1957 and laid out the foundations of the business model with this hand-drawn outline of how the various businesses under one roof serve to enhance the value and appeal of the others.



Source: The Walt Disney Company, Harvard Business Review

While much of the distribution landscape has changed and the business has expanded, the core principle remains as strong as ever, and underpins our belief in Disney being a long-term compounder.