

September 2019

## Volatility: The New Normal

As the wisdom goes, there are decades where nothing happens, and weeks wherein decades happen.

In looking back on the 3rd quarter of 2019, investors should have sympathy with this sentiment, having endured an extremely volatile quarter that saw another escalation of the US/China trade war, a synchronised collapse in global bond yields, sustained public disorder in Hong Kong, the biggest intra-day surge in oil prices on record, an equity market factor rotation and never-ending political drama in both Washington and London. The table below gives some context by providing the trading ranges – peak to trough – for several major global indices over the quarter.

Index	Trading Range
MSCI World	6.2%
MSCI Emerging Markets	7.3%
MSCI All Country World	6.2%
S&P 500	6.4%
Nasdaq	7.8%
Dow Jones	7.4%
CAC 40 (France)	8.7%
DAX (Germany)	10.7%
ASX 200 (Australia)	6.5%
Hang Seng (Hong Kong)	14.1%

Source: FactSet

Against this backdrop, the actual outcome – global markets ending marginally higher in USD, barring some substantial currency moves – underlines the extent to which noise and volatility dominates the market news cycle between reporting seasons. There's not much to be done about the noise, unfortunately – the 24-hour news cycle needs headlines, and there is currently no shortage of supply.

We've elected to stick to our knitting and focus on the stocks we own, ensuring they still meet our quality criteria. When companies do put numbers out – such as Nike, in September, or Estee Lauder in late August – the market tends to refocus on the fundamentals. With another round of quarterly earnings coming up in October, we believe the macro-economics will take a backseat to businesses actually reporting the outcomes on the ground.

## The US Yield Curve Inversion

Of all the headlines, none caused more consternation to investors than the US yield curve inverting. Inversion – the term used to describe the phenomenon when bonds with longer maturities yield less than those with shorter maturities – normally signals that investors are concerned about a material slowdown in future economic growth, and are willing to accept a lower yield for the certainty of a future return. A yield curve inversion has preceded every US recession since 1950 – though a recession has not followed every instance of an inversion. In the cases where a recession did occur, it usually took longer than a year – and in some instances, closer to two years – to materialise.

The flattening of the US yield curve should be viewed against the backdrop of the ongoing extraordinary monetary policy settings in place around the world. Research done by the Federal Reserve itself suggests that the last decade of quantitative easing has likely depressed the long end of the yield curve by approximately 1%.

With central banks still actively buying bonds and policy rates at or below zero in Japan and large parts of Europe, the relative appeal of earning a positive coupon on a 10-year US treasury bond fuelled the extraordinary buying seen August. Even the US 30-year yield briefly traded below 2% – not that outlandish a notion when the alternative is to own a negative-yielding 20-year German government bond and pay 0.40% every year for the privilege of lending the government money.

As we have said before, we do not think owning fixed income assets at these levels are likely to provide attractive real returns to investors over time, particularly given the risk of capital loss far outpacing the interest earned if rates move even modestly higher.

**US Real Interest Rates – past three US recessions**

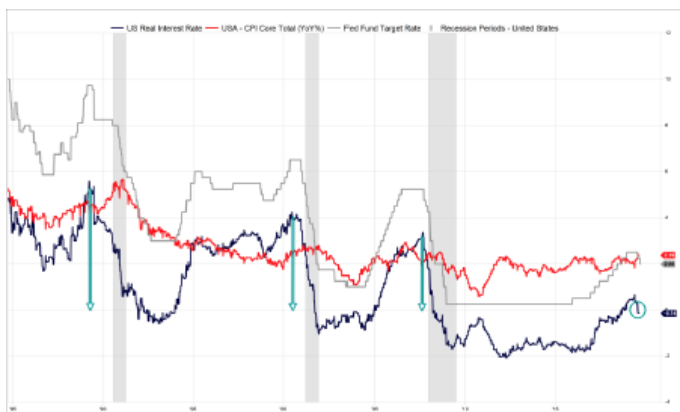


Source: FactSet

However, a yield curve inversion against a backdrop of slowing global growth is a shot across the bow of US central bankers, politicians and investors alike. Unlike during past yield curve inversions, the Fed has already reversed course and cut rates. Whether this is enough to extend the economic expansion remains to be seen, but is certainly preferable to the alternative of continuing on the path of rate increases.

Perhaps more instructive than only watching for a yield curve inversion is to consider the real interest rate. Defined as the difference between the Fed Funds rate and core CPI, real rates have peaked at substantially higher levels prior to past recessions.

**US Real Interest Rates – past three US recessions**



Source: FactSet

It can be argued – likely with some merit – that the Fed shrinking its balance sheet has imposed additional monetary tightening not fully captured by the real interest rate. Given a higher public and corporate quantum of debt, it also stands to reason the threshold for real rates to negatively impact demand will be lower than in the past. However, with the real rate close to zero at present, it does not yet seem like a problem, and to our minds does not imply the certainty of a US recession as a foregone conclusion within the next twelve months. The big unknown is the confidence-sapping impact of the trade war: were that to materially escalate, the likelihood of a US slowdown would increase substantially.

**A Question of Confidence**

With central banks pursuing further monetary stimulus, it is worth considering whether it will have any effect on the real economy. Given that developed market interest rates already at very low levels, we are not convinced further rate cuts alone will translate into improved economic performance. In fact, the case that policy rates are close to the reversal rate – where accommodative policy actually starts negatively impacting lending – is becoming more compelling.

In looking at the current sources of economic drag, the aforementioned manufacturing slowdown is evident around the world, with Manufacturing PMI's trending down from late 2017/early 2018 peaks.

This slowdown has more recently been exacerbated by the increasingly volatile global trade landscape, which has had the effect of negatively impacting business confidence and the willingness of management teams to invest.

However, in the US, manufacturing accounts for only ~11% of GDP, while consumer spending is much more meaningful at ~70% of GDP. US consumers – possibly remembering the extraordinary pain experienced during the global financial crisis – have chosen to deleverage their balance sheet over the last decade, with household debt now at ~85% of GDP compared to a peak of ~94% in 2008/2009. This combination of lower leverage, ongoing jobs growth (translating to lower unemployment) and steadily growing hourly wages over the last few years has seen consumer spending hold up well, even in the face of worsening corporate sentiment.

**US Business Confidence vs. US Consumer Confidence**



Source: FactSet, Conference Board, Chief Executive Group

The salient question now is whether a further weakening of business confidence starts to materially impact hiring and wages. If this were to occur, the transmission to weaker consumer confidence would likely be swift.

We believe business confidence is the missing ingredient, and any positive developments leading to more visibility on the business landscape will likely underpin a sharp restoration in capital investment, both in the US and elsewhere.

## Fund Positioning

During the quarter, we have endeavoured to use market weakness to allocate cash to our high conviction names, and even introduced a new holding (Nike) during the multiple rounds of selling in August. At the same time, we have done further work to ensure that our names are well capitalised – even in a tougher environment - and well positioned to benefit from the secular trends we identified when including them in the fund.

As such, we remain favourably disposed to payment networks, high quality software names, and global internet platforms, with select consumer-facing holdings where we think the businesses in question have a strong element of pricing power. We also have some health care exposure, which should provide a defensive quality in the event of a slowdown. Finally, given our recognition of the risks outlined above, we hold around 10% in cash, with a view to deploy where we think we can invest in high-quality businesses with a reasonable margin of safety.

As we have written in our recent updates, we tend to think of the regional exposures of the fund on a look-through basis, given that this is ultimately where the economic returns are generated. At present, we have a bias to US-listed names, but the revenue split of the equity component is much more balanced. Around ~46% of portfolio revenues are earned in the USA, with the balance being allocated to other developed markets (~26%) and emerging markets (~28%, of which China is ~11.5%).

Lastly, it is worth addressing the currency exposure of the fund. Given the relative strength of the US economy, and the Fed's 'wait-and-see' approach to further rate cuts, we believe further US dollar strength is likely, particularly given that other central banks are already aggressively cutting rates. Even on our own shores, Governor Lowe has stated that an appreciating currency would be 'unhelpful' in achieving full employment and the inflation target of the RBA. The 25bps policy rate cut in October underpins our view that rates in Australia will continue to trend down, at least in the near term, and implies further weakness for the Australian dollar.

This view, combined with the changes made to the structure of the fund in July (specifically, the change to an Australian dollar-denominated global benchmark), has resulted in the fund stepping down its hedge to foreign currency exposures systematically over the quarter. At present, the fund is no longer hedging its foreign currency exposures, and does not intend to do so in future.

## Fund Performance

For the quarter, the fund delivered a return of -0.32%.

- The underlying stock selection delivered a positive outcome, with several names (Nike, +19.8% in AUD, +19.2% in USD; Apple, +18.2% in AUD, +13.6% in USD; Alphabet, +17.3% in AUD, +12.8% in USD; Estee Lauder, +13.3% in AUD, +8.9% in USD) materially outperforming on solid results.

- A2 Milk was sold on valuation grounds for a return of +14.4% in AUD in the quarter, prior to a substantial sell-off on weaker than anticipated guidance.
- Portfolio stalwarts such as Microsoft (+8.4% in AUD, +4.1% in USD) and MasterCard (+6.9% in AUD, +2.8% in USD) held up well, with Microsoft benefitting from strong results and the announcement of a new USD40bn share repurchase programme alongside a 10% increase in the dividend.
- In terms of underperformers, Amazon.com (-4.6% in AUD, -8.3% in USD) and Facebook (-4.0% in AUD, -7.7% in USD) were weak, whilst Netflix (-24.2% in AUD, -27.1% in USD) was the biggest laggard.
  - Amazon and Facebook both suffered in September, when markets favoured cheaper cyclicals over secular growth names. Additional focus on regulatory scrutiny in the US also dampened sentiment.
  - We have done a material amount of work on Netflix during the quarter to test our investment thesis. The stock reported disappointing results in July, and concerns around an increasingly competitive streaming landscape combined with fears on content cost inflation saw the stock continue to lag as the quarter wore on.
- We believe the long-term outlook for Netflix remains fundamentally unchanged: the shift from linear to streaming television is a once-in-a-generation business transformation affecting the entire media industry. We do not believe that legacy media competitors launching their own streaming services are armed with the balance sheet firepower to get into a long, protracted content battle with Netflix, particularly given that the latter has the benefit of global reach. Even if near-term subscriber numbers are weak, we think the bigger multi-year trend remains intact. We have used the weakness to increase our position after trimming it on valuation concerns in early July, but will closely monitor the stock for further developments.
- The largest driver of near-flat absolute performance for the quarter was the impact of the weakening Australian dollar. As alluded to above, we took the decision to systematically remove the hedge to all foreign currency exposures given the change to the structure of the fund. This was done in several tranches over the quarter. However, the practical impact of this meant that the fund did not materially benefit from the sharp drop in the Australian dollar during July and August. We estimate the the cumulative impact of being hedged to foreign currencies over the quarter was roughly -2.9%.
- After the broad market sell-off in August, September saw investors favour cyclical stocks – notably financials, banks, mining and energy businesses – over consumer-facing names and technology companies. Many of the more cyclical businesses do not meet our quality criteria – particularly from a balance sheet perspective – and thus we did not participate in the rally. Given our investment philosophy, we are unlikely to ever have large exposure to these sectors. Should a value rally persist, we might lag broader markets over the short-term.

Market Returns- 3 <sup>rd</sup> Quarter 2019	Total returns (%) in:		
	AUD	USD	Local
Index			
MSCI World Index (Developed Markets)	4.45%	0.53%	1.53%
MSCI Emerging Markets	-0.51%	-4.25%	-2.07%
MSCI All Country World (Developed & Emerging Markets)	3.87%	-0.03%	1.11%
<b>MSCI Regional</b>			
MSCI USA	5.36%	1.41%	1.41%
MSCI Europe	2.35%	-1.49%	2.63%
MSCI Japan	7.24%	3.21%	3.47%
MSCI United Kingdom	1.25%	-2.55%	0.66%
MSCI Australia	3.15%	-0.72%	3.15%
<b>MSCI World excl.</b>			
MSCI World excl. USA	2.93%	-0.93%	1.75%
MSCI World excl. Europe	5.39%	1.44%	1.40%
MSCI World excl. Japan	4.35%	44.00%	1.36%
MSCI World excl. United Kingdom	4.21%	0.30%	1.58%
MSCI World excl. Australia	4.50%	0.58%	1.50%
<b>Other Indices</b>			
S&P 500	5.66%	1.70%	1.70%
Nasdaq	4.09%	0.18%	0.18%
FTSE 100	1.52%	-2.29%	0.93%
CAC 40	2.45%	-1.39%	2.73%
DAX	-0.04%	-3.79%	0.24%
Euro STOXX	2.28%	-1.55%	2.57%
Hang Seng Index	-4.23%	-7.82%	-7.49%
Shanghai Composite	-1.55%	-5.24%	-1.36%
<b>Australian Dollar vs Currency</b>			
US Dollar	-3.88%		
Sterling	-0.64%		
Euro	0.33%		
Yen	-3.68%		
Hong Kong Dollar	-3.53%		
Yuan	0.07%		

## Stock Insight: Nike

When considering companies for potential inclusion in the fund, we are clear about the characteristics we look for: a proven track record of generating excess returns on capital and equity throughout a business cycle, superior cash conversion relative to accounting profits, a well-capitalised balance sheet, and modest to low volatility of sales growth.

From a non-financial perspective, we also investigate the industry structure to better understand the competitive landscape and intensity of competition, and explore the enablers of the competitive advantage that drives customer loyalty or pricing power.

Lastly, we try to find businesses that have exposure to a secular change taking place in the world, underpinning their ability to grow revenues.

In buying Nike during the periods of volatility in August, we believe we have found a business that meets our criteria for a quality long-term investment. Happily, Nike reported a very strong set of numbers to the market during the month of September, and the stock rallied strongly on the result. Management commented on the near-term outlook remaining positive, despite the increased macro-economic noise, and modestly raised their full-year profit guidance on improved margin expectations.



## Building the investment thesis

At its most fundamental level, we own Nike because we think it gives us exposure to three important secular shifts: the growing global focus on health and wellness, the increasing preference towards more casual dress styles among younger consumers, and the rapid transformation of the manufacturing and sales processes enabled by changes in technology.

Globally, the thinking on encouraging healthier lifestyles is gaining traction: partly because of the social and community aspects, but also because educators and health care policymakers have come to the realisation that a population encouraged to have healthy and active lives are less likely to be as big of a burden on the public medical system. Beyond the purely practical, evidence suggests that as disposable incomes grow, the desire – and ability – to live a healthier life converge, leading to greater sports participation, whether formal (such as joining a club or league) or informal. Professional sporting bodies are also contributing to this shift, as they have become far more adept at growing participation at grassroot-level among younger age groups.

This more active lifestyle is also impacting general dress styles, with the trends towards so-called ‘athleisure’ wear seeing the athletic apparel and footwear category outpace the growth of the overall apparel and footwear categories over the last several years. To put some numbers to that, athletic apparel and footwear grew from ~22% of all US apparel and footwear sales in 2008, to roughly 30% by 2017. Globally, athletic apparel and footwear make up ~18% of the overall category as of 2018. Given that this number includes the USA, it would suggest that the category has much lower penetration in markets such as Europe and Asia Pacific, and therefore substantial scope for growth. A large part of this shift is driven by millennial consumption patterns, which we would expect to continue to play out.

Given the constructive outlook for increased sports participation, a trend towards more casual dressing, and a shift towards more healthy lifestyles, what makes us like Nike more than its competitors?

Firstly, we believe Nike has among the best brands in the athletic apparel and footwear category across all regions, consistently scoring exceptionally highly for brand awareness, perception and purchase intent. Nike – being several orders of magnitude larger than most of its competitors – have been excellent stewards of their brand, and have a storied history of partnering with and growing alongside some of the most famous sports personalities of the last several decades. (There’s a reason why the Jordan brand of basketball shoes often command a multiple of the official selling price in the sneaker resale market.)

In mid-2017, the company launched a focused campaign centred on 12 key cities around the globe, with the idea that serving these markets incredibly robustly will do more to enhance word of mouth and viral online marketing than only a traditional brand marketing campaign. The decision has handsomely paid off, as the robust upwards inflection in online engagement and sales growth since has proven.

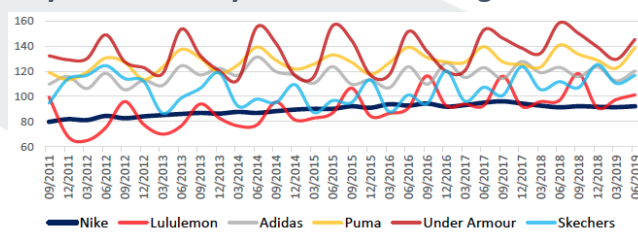
Secondly, Nike has made substantial investments in product development and manufacturing techniques that we believe put them at a competitive advantage to their rivals, embracing the changes enabled by new technologies to enhance their manufacturing efficiency and increase speed-to-market. These changes largely focus on automation, using new materials, reducing wastage (and designing new products to be more

efficient in terms of having less off-cuts or other wastage than was previously possible), and improved near-market sourcing. This latter point is especially relevant, given the impact of global tariffs. Nike management has actively worked to introduce flexibility into its supply chain ever since the threat of tariffs was raised several years ago, and we believe they have done more than most in terms of being able to reallocate manufacturing and supply to regions with less direct tariff risk.

Nike is also spending a substantial amount of money to introduce RFID –or Radio Frequency Identification – technology into its entire supply chain. This will not only allow the company to more accurately track and allocate supply, but also serve the purpose of more efficiently managing overall inventory levels.

Relative to competitors, Nike already has incredibly stable inventory levels throughout the year – reflecting, in our opinion, the less seasonal nature of demand for and more diversified range of Nike products. However, we believe the investment in further supply chain optimization will allow for even more efficiency, ultimately freeing up more cash flow from being tied up in working capital.

## Days of Inventory on Hand – Trailing 12m



Source: FactSet, Company Reports

Thirdly, Nike is embracing new technologies to build a more robust direct-to-consumer (DTC) sales channel. A few years ago, this largely comprised of sales through Nike-operated flagship stores around the world, but the company has aggressively expanded into building an e-commerce offering.

Increasing the DTC channel relative to the wholesale channel in the sales mix is beneficial at several levels, not least of which is that it allows Nike to better control the average selling price, avoid unnecessary discounting to clear inventory, and improves the realised retail price by avoiding the discount given to wholesalers. This price uplift supports gross margins.

Nike is leveraging digital channels to build a community of likeminded fitness enthusiasts, as well as improving ease of purchase while gathering deeper data insights, which in turn informs new design and inventory decisions. These three factors should continue to support the growth of the e-commerce DTC channel, and underpins our belief that there is substantial scope for further overall margin expansion as the channel matures.

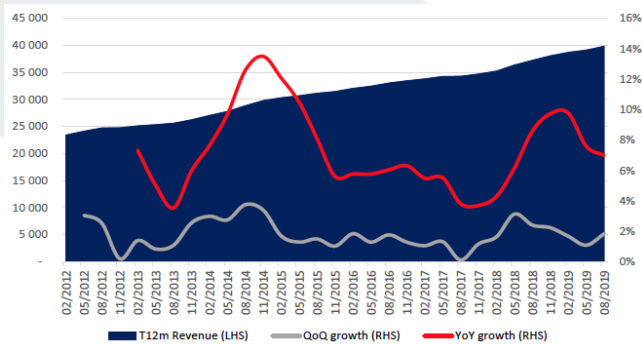
Finally, Nike has been aggressive in building out its ability to appeal to consumers outside the US. With investments going back several decades, Nike has carefully stewarded its reputation as a brand that supports and understands local consumers, signing up local sports stars and building sponsorship relationships with local teams.

Nowhere is this more relevant than China which is Nike’s fastest growing region. There is ample government support for endorsing health, wellness and increased physical activity, and the number of sporting events in China has increased

substantially. Running – an activity with low barriers to participation – is seeing a huge surge in popularity. Given the strong demand in China, Nike plans to launch its NIKE app in China by the holidays, which should provide further scope for revenue growth to accelerate in the near-term.

The combination of all these factors has seen Nike deliver incredibly steady revenue growth for an extended period of time.

### Nike – Trailing 12 month Revenues with YoY/OpO growth



Source: FactSet, Company Reports

The chart above illustrates the year-over-year and quarter-over-quarter trailing twelve month revenue growth rates over the past seven years, alongside the actual dollar value of revenues for the trailing twelve months for every period.

Despite a substantial channel oversupply issue in the US during 2017 – largely caused by wholesale distributors facing increasing disruption from e-commerce – Nike has enjoyed a period of remarkably stable revenue growth, averaging around 7% year-over-year. (Were it not for the ongoing strength of the US dollar over the period, the reported number would have been even higher).

In digging into the numbers, there's certainly an aspect purely related to increased volumes and expanding distribution, but the real magic is the ongoing ability to modestly increase prices. To us, this pricing power is incredibly important, as it suggests Nike has truly differentiated its offering in consumers' eyes.

### Putting the pieces together

The convergence of a secular trend, combined with Nike's unique brand and investments in design, manufacturing and distribution all translate to the company being a high-quality compounder, in our opinion. The balance sheet is amply capitalised, and even in the event of an economic slowdown, we think the company is well positioned to weather any near-term disruption.

What are the main risks to our investment case? We acknowledge there is always the near-term issue of a fashion miss, or a sports star (or team) signed with a rival performing better in any given season, leading to a sales shortfall. These risks are part and parcel of investing in the athletic apparel and footwear sector, and generally are buying opportunities for patient investors.

A more material risk to our thesis is a weakening of the secular shift towards healthier lifestyles. As a trend, it seems well embedded in younger consumers, but we acknowledge that any change to this outlook might impact the outlook for the business. We will continue to monitor this metric closely.

We also acknowledge that Nike ultimately sells a discretionary product to consumers. If a substantial global economic slowdown were to play out, growth would certainly be impacted in the near-term. However, we prefer to take the three-to-five year view, and given that we were fortunate enough to introduce the business into the fund with a reasonable margin of safety, we hope to protect the downside by being selective on the entry price we have paid.

### Outlook

We do not think volatility will abate soon. Given the multiple hurdles to navigate in October – the next round of US/Chinese trade negotiations, a fast-approaching Brexit deadline, and possible impeachment proceedings in the US gaining traction – there are ample reasons for markets to continue reacting violently to every headline.

As we have written before, we do not think trying to position the portfolio to capture every near-term market gyrations is a sustainable way to invest on clients' behalf. We continue to favour businesses with secular growth prospects and a proven ability to compound their cash flows. Given the heightened levels of uncertainty – particularly around the range of potential outcomes for the US/China trade war – we have diversified our holdings and hold some cash, but stand ready to deploy in the face of further volatility. If anything, we believe the case for owning very high-quality global businesses have only strengthened. Stretched balance sheets don't matter right up until the moment they do – and then the market tends to decide they matter quite a lot in a very short space of time.

As always, we sign off with our mission statement: the AIM Investment Team remains focused on generating superior risk-adjusted returns through owning a concentrated portfolio of high-quality businesses that can compound in value over the long term.

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