Melville Douglas

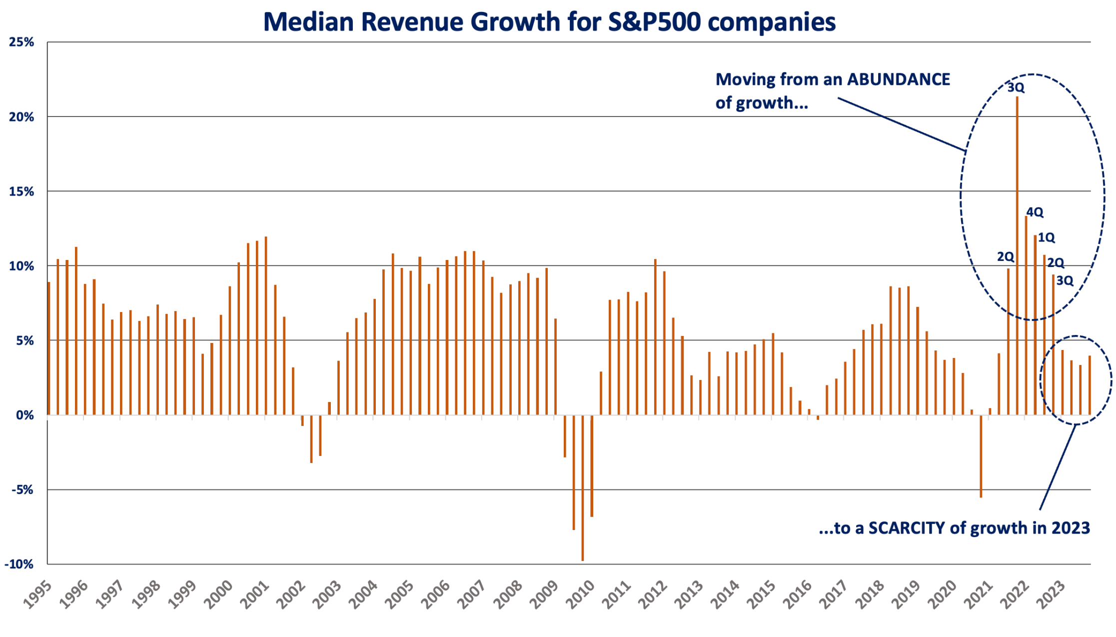
Global Equity Fund

Style is temporary, philosophy & process is permanent

2023 beckons for quality-growth stocks (to which the fund has an intended bias).

The prior two years had not been conducive. As shown in the below chart, the sharp rebound from draconian COVID lockdowns in early 2020 resulted in the highest median revenue growth for S&P 500 companies in over 30 years. A myopic investor may question why pay 24x price-to-earnings for Microsoft's metronomic +15% per annum revenue growth when the average S&P 500 company trading at 18x price-to-earnings will produce the same or better growth in the calendar year. More attractive interest rates on cash in 2022 further compressed the premium investors were willing to pay for higher, but more volatile, compound earnings growth.

From feast to famine – growth becomes more scarce



Source: Robert Baird, Bloomberg data

Today's backdrop is very different. Higher borrowing rates are starting to bite into demand, albeit mitigated by healthy consumer savings and solid corporate balance sheets. There will be far fewer companies that can grow revenue and cash flows at a robust clip. It makes sense to pay a premium for growth when it is scarce. It doubly makes sense when the same stocks have devalued over the past year.

More importantly, beyond the business cycle perspective, quality-growth companies have historically provided better risk-adjusted returns than more speculative investments. This anomaly is due to persistent demand for high-risk stocks that offer embedded leverage (i.e. similar returns to buying on margin) and lottery characteristics. Retail investors are drawn to moon-shots that will be the next Apple or Tesla. This persistent over-bidding of high-risk investments is well underpinned by human nature (i.e. greed) and, unfortunately, as investors seek to gamble insufficient savings to meet future retirement needs amidst a low return world. The meme stock boom-and-bust is the most recent example. The upshot is that "boring" quality-growth shares should continue to deliver better outcomes for patient investors.

Quarterly Commentary as at 31 December 2022

MelvilleDouglas
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From our Fund Manager's Desk

Our quarterly reports regularly explore the investment rationale of one of the companies we own in the Fund to articulate what we find compelling. This time round we have chosen Amazon.

It's always "Day One" at Amazon. This mantra was espoused by Amazon founder and long serving CEO, Jeff Bezos. First mentioned in his now famous 1997 shareholder's letter, Bezos outlined the fundamental measures of Amazon's potential success — relentlessly focusing on customers, creating long term value over short term corporate profit, and making many bold bets.

Considered one of the more insightful and visionary corporate leaders of the last three decades, his retirement in 2021 left investors questioning if his departure would mean it was now Day Two. Amazon represents the best of innovation and corporate strategy within the Global Equity Fund. At the same time, it is also one of the best executors at scale in any industry globally. We see tremendous opportunity ahead for Amazon, and value in its stock. This is the fascinating story of its success.

The enormous size of Amazon's fulfilment centres is difficult to imagine. The largest, at more than 370,000 square metres would cover 40 football pitches.

In the business of scale

From its modest beginnings as an online bookstore in 1994 to becoming the world's largest ecommerce platform outside of China, Amazon has continued to defy sceptics over the last 25 years. Today, more than $600bn of goods are sold through its online platforms and brick-and-mortar stores. By comparison Walmart, America's number one retailer, is the same size but growing at less than half the pace of Amazon.

A large part of Amazon's success has been its industry leading distribution and fulfilment capabilities. In the early 2000's, the company strategically chose to open its online e-commerce platform to outside sellers (third party merchants) – today they make up about 60% of sales. Fulfilment by Amazon (FBA) is a service that allows businesses to outsource order fulfilment. Amazon will handle the logistics of receiving, warehousing and delivering stock – leaving the nearly two million Amazon sellers to focus on finding products that customers will love.

Robots are increasingly more common in Amazon warehouses, moving and sorting goods from inventory to shipping. Amazon's investments in robotics should result in industry leading fulfilment costs and a long-term advantage over competitors. Source: Amazon

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Today, Amazon Prime members get free same day delivery through a sprawling and complex logistics network. Countless employees, thousands of vehicles, and nearly 100 aircraft work in concert to deliver a package to a customer's door only hours after clicking the buy button. Building out this level of service has come at huge expense and to replicate it would be a task beyond almost any new entrant.

Amazon's scale advantage over any would be competitors benefits them in two ways. The first is a cost advantage – by moving greater volumes through their warehouses, the cost per delivery is lower. This allows Amazon to take a higher margin off third party sellers and offer their own products at a lower price.

The second benefit is the intangible value derived from the massive network of buyers and sellers. Customers will keep returning for the selection and value that Amazon is known for. On the other hand, merchants know that to reach the largest audience they must sell on Amazon.com. This network is very profitable for Amazon. With 200m customer subscriptions, Amazon Prime is estimated to be a $25bn per annum business, while the ecommerce platform takes in almost $40bn annually through merchant advertising.

Software is eating the world

In 2011, Marc Andreessen, one of Silicon Valley's foremost thinkers, famously wrote that "software is eating the world." His prediction was that software companies would disrupt traditional industries and gradually take-over a large part of the economy. His image of the future was prescient. More than ever before we live in a data driven world where software is an increasingly important part of every business.

Cloud hyperscalers provide the IT infrastructure needed to allow entire businesses like Netflix to exist in the cloud. Traditional industries like financial services are moving into the cloud at an accelerating pace. The cloud allows organisations to store, retrieve and usefully deploy data and software applications. Offering cost efficiency, flexibility and huge, huge scalability – everything an IT department is looking for.

Data Centres form the critical infrastructure backbone of Amazon Web Services. These vast storage and computing centres are responsible for generating more than $80bn of revenue annually for Amazon and only a handful of companies are able to deploy globally at the scale that AWS does.

Starting in 2007, Amazon Web Services (AWS), found a loyal customer in Amazon.com – its first and best customer. Soon thereafter, realising that like e-commerce fulfilment, by opening its infrastructure to third parties and offering its expertise to them, it could scale faster and lower the cost of doing business for Amazon's own operations.

AWS is the largest cloud computing business globally with $80bn in sales, and data centres across more than 200 global locations. Within Amazon, AWS is now the core of its profitability and largest single source of cash flow. With large barriers to entry, sticky customers, high margins and a long growth runway – AWS exhibits many of the quality attributes that we look for in a company. If AWS were a standalone business, we would likely own it in the Global Equity Fund.

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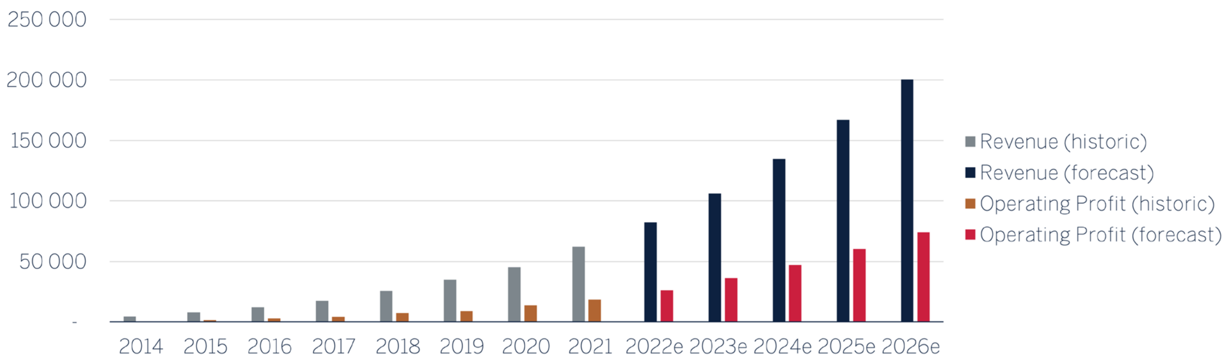
AMAZON WEB SERVICES REVENUE & OPERATING PROFIT (USD BN'S)

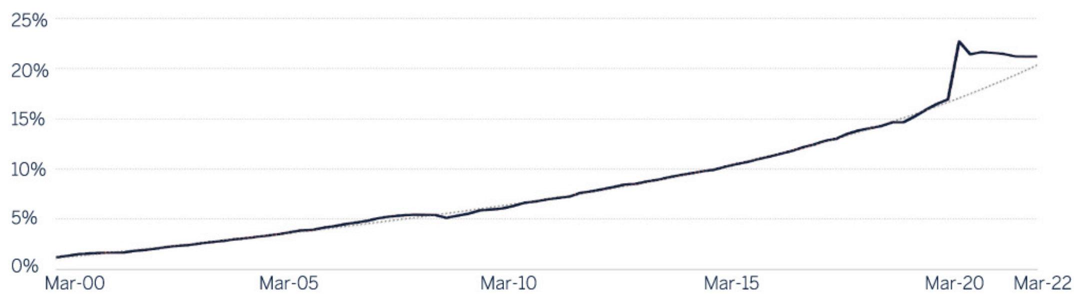


Amazon Web Services has grown revenue and operating profit at an annual rate of 45% and 69% over the preceding 7-years. It is forecast to continue growing, albeit at a much slower pace, reflecting the sheer size of the business unit today. Source: Melville Douglas, Canalyst

The great pull forward

The COVID-19 pandemic forced change to the way we live and to how companies manage their operations. Practically overnight, lock-ins begun and work-from-home became the normal operating procedure. This advanced already in place trends as the demand for online services, ecommerce shopping and remote working tools exploded. Being the world's pre-eminent ecommerce platform and having a large base of customers in the internet economy, Amazon's business surged during this time.

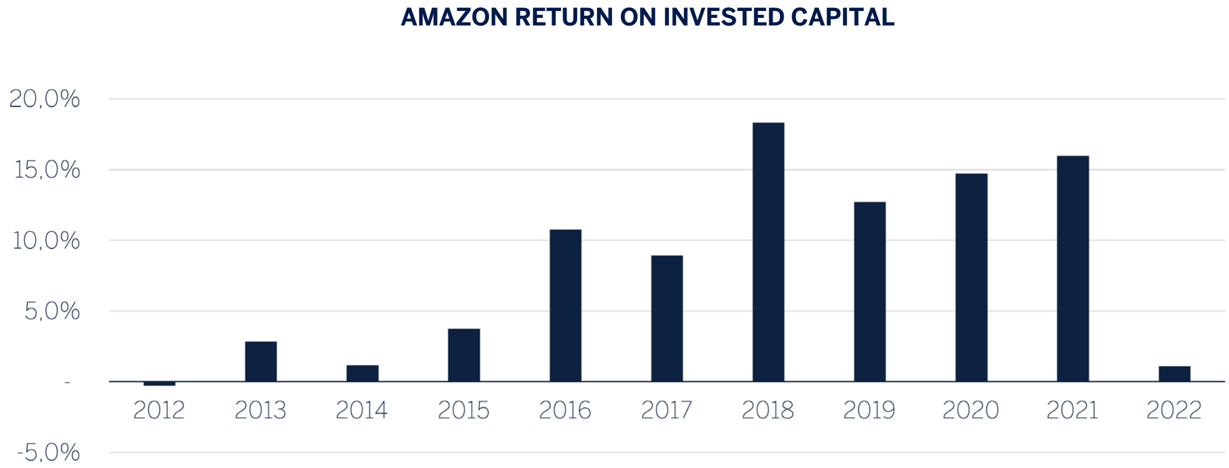
US ECOMMERCE AS % ADDRESSABLE RETAIL



Ecommerce as a percentage of US retail exploded from 17% to 23% almost immediately during the pandemic. This number has remained flat over the last two years, surprising investors and companies that expected growth to continue off the new, higher base. Source: Benedict Evans

In response to this, Amazon moved into an accelerated build out phase – over 2 years Amazon doubled its warehouse capacity which it had taken 25-years to build. These new facilities would be staffed by hundreds of thousands of new workers bringing Amazon's headcount to more than 1.6 million – making it the one of the largest private employers in the world.

This exuberance wasn't to last. The reopening has seen shoppers, still flush with funds from stimulus cheques, shift spending to travel and experiences. The accelerated growth experienced during COVID-19 has not been sustained and we have seen a significant slowdown. Excess capacity and increased overheads have swung the ecommerce business from its most profitable year ever to making a loss. This has resulted in what we believe are temporarily depressed profits and a break in the long-term trend of an improving measure of Return on Invested Capital.



Amazon Return on Invested Capital - steady improvement over the last 10-years. Large investments in ecommerce over 2020-2021 and a decline in profitability have resulted in reduced returns. Source: Melville Douglas, Canalyst

With the countermeasures taken by Amazon it should take approximately 18 months to grow into the capacity that has been built. At that point, increased utilisation should result in efficiencies driving higher margins and a return to pre-pandemic profitability growth trends. When companies invest money to expand their business you don't typically get an early return. Amazon's focus on long term value creation serves us as investors. We would be concerned if the business didn't invest for future growth in order to optimise short term profitability.

Amazon defines customer value at its core

Amazon made buying on the internet safe and reliable. Removing the frictions of online payments and returns while resolving customer worries about counterfeits and delivery issues. The relentless focus on customer value over the last 25 years has seen Amazon grow to become synonymous with ecommerce in the US. The core principles behind its success are saving customers money, saving them time and offering a vast selection.

Figure 7 The Amazon Flywheel - purportedly sketched by Jeff Bezos on a napkin in 2001. It illustrates the cycle of value creation created by growing the number of sellers and customers on Amazon. Source: Visual Capitalist, Amazon

Today AWS does the same for a very different set of customers, but it is the same principle of driving customer value that allows it to succeed.

And remains a long-term winner

Jeff Bezos was once asked by an employee what Day Two looked like at Amazon, he responded “Day Two is stasis. Followed by irrelevance. Followed by excruciating, painful decline. Followed by death.” Our view is that Amazon remains a Day One organisation. The company has time and again demonstrated a long-term mindset, focus on its customers and a proven ability to adapt and rapidly innovate. Importantly, it has maintained this while growing to become one of the largest businesses in the world. By every account we see Amazon continuing to create long term value for shareholders.

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Market timing – take your pick or play the long game

"Are we there yet?" is a phrase often heard on long car journeys or during market selloffs.

A trough can only be pinpointed with accuracy in hindsight because bear markets come in all shapes and sizes. As history often rhymes, it can provide a guide.

There have been three main types of bear markets:

1) Event-driven

This is typically a sharp short shock in response to an unexpected outcome, such as a war (First Gulf war in 1990) or health issue (COVID in 2020). Their bark tends to be worse than the bite, and the market swiftly recovers once the initial period of uncertainty has subsided.

2) Cyclical

As night follows day, economies slide from boom to bust to purge the excesses built up during the good years. Equity investors tend to over-extrapolate the corporate earnings trajectory on the way up and on the way down. A business cycle recession acts as an overhang on stock markets, resulting in a bear market that typically lasts one to two years.

3) Secular

This is the most damaging as it is associated with a drawn out and deep sell-off as a result of an irreversible downward shift in the economy, a huge asset bubble (e.g. Japan in the 1980s) or a systemic problem such as a banking crisis. These bear markets can last years or even decades, depending on circumstances and the policy response (correct in 2008/9, incorrect in the 1930s).

The current bear market, which started in January 2022, looks cyclical in nature. Today's central bank rate hikes are an attempt to cool overheating economies to keep long-term inflation expectations in check. They are likely to succeed, albeit not without pain. Given the average length of a cyclical bear market is one to two years, we are either halfway or fully through the worst.

Should you make big portfolio changes based on your view of where we are on the cycle?

Yes, if you are a trader. No, if you are an investor. The chart below shows the average return on the MSCI AC World index two years before and two years after the past five major troughs (1990, 2002, 2009, 2011 and 2020). The seven months spanning the trough are highly volatile – an opportunity to make big gains or losses. Good luck to you if you are attempting to sell and then buy at the right moment. There are thousands of professional traders looking to do the same.

Do we have a special insight? We worry about corporate earnings downgrades ahead amidst economic recessions in 2023. But so does almost everyone else. It could already be priced into expectations. There is wisdom in crowds outside the extremes.

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To time or not to time, that is the question. Unless you have high conviction, best to be invested

Source: Melville Douglas, FactSet data. MSCI All Country World index performance around major troughs: September 1990, September 2002, March 2009, October 2011 and March 2020.

The alternative is to grin and bear the ups and down, or (even better for your well-being) switch off the Bloomberg screen. On average, you are back to where you started (after the initial mid-teens slide) in seven months' time, and then the market continues trend higher. If you had sold out of the market to avoid paper losses, you might find it difficult to get back in at a higher level.

More often than not, it is best to stay invested.