MelvilleDouglas
A Member of Standard Bank Group

Melville Douglas

Global Equity Fund

"The past is a foreign country: they do things differently there"
First line of L.P. Hartley's novel "The Go-Between"

Who would have imaged at the start of 2020 that many of us would still be in varying types of lockdowns, confined to our country borders, and keeping Sunday afternoons free to Zoom call our friends and family? The thought of leaving home without your face mask or shaking hands are the new taboos.

Taking a glass half full perspective, the world is in a much better place than feared since the bottom of the market crash on the 23rd March 2020. Wall Street has soared over 80% as governments and central banks have thrown in the kitchen sink to support businesses and their citizens through the crisis. But everything comes at a cost – government debt has ballooned beyond levels seen outside world wars.

This quarter saw some unhealthy trends in market trading. Herd mentality has been whipped up by small-scale investors acting en masse, armed with plenty time on their hands and (for US citizens) $1,400 cheques posted from the White House. The enablers have been "get rich-quick" social media sites and the gamification of investing through new trading-as-entertainment platforms. Buying investments solely looking at the price (e.g. has-been video game store GameStop) rather than what cash flows the business generates is doomed to fail. We worry about the eventual fallout. Instead of chasing the price of a stock, we watch the earnings trajectory. At the end of the day, the intrinsic value of a stock is the cash it can pay back to investors in the form of profits. As Benjamin Graham taught us, "In the short run, the market is a voting machine but in the long run, it is a weighing machine." The most loved stocks often win the popularity contest over the short term, but it's those with substance that outperform over the longer term.

We take a long-term view when identifying quality compounders that are backed by structural tailwinds as opposed to taking short term tactical views. These long-term winners will continue to be disruption-proof franchises that can grow profits without needing a strong economy or higher inflation. As we emerge from a recession and in anticipation of life returning to normal, investors have chased bombed out re-opening trades and those geared to an uptick in economic activity. At some time in the future, as the global economy reverts to its low growth secular-norm, these longer-term winners will come back into favour despite having been side-lined more recently.

Going against the herd can be difficult at the best of times. Fear and greed are part of the human psyche. Rest assured, we are more than prepared to go hold our nerve. We remain committed to staying true to our investment philosophy in delivering superior risk-adjusted returns for our clients over the long run.

Quarterly Commentary as at March 2021

From our Fund Manager's Desk

We 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 Estée Lauder.

"I never dreamed about success, I worked for it" – *Estée Lauder*

Esty, as she was fondly known, was born and raised in Queens, New York in the early 1900s. It was her Hungarian uncle who introduced her to the world of velvety skin creams that were first created in their kitchen, and then in a make-shift laboratory in a stable in their garden. An exceptional saleswoman and marketer, she had an instinct for understanding what women wanted, and strongly believed in having to touch the consumer - show her the results on her face and explain the products to her. This was the essence to the brand's personal high-touch service.

After gaining traction by selling her products to women while they were sitting under the hair dryers at beauty salons, she and her husband launched the company in 1946. Their first major order was $800 worth of products from the ultra-prestige Saks Fifth Avenue department store a year later.

Estée providing a high-touch service to her customers at one of the US department stores

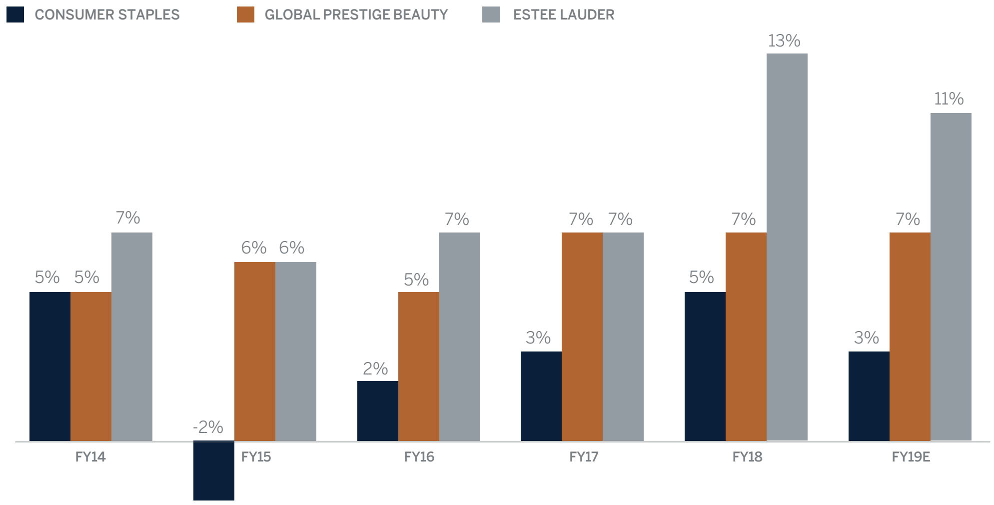
Source: www.elcompanies.com

Estée identified two traits in affluent women that she knew were key to her success – she knew they would be willing to spend more on the best products, and she knew they were very influential. She worked endlessly to get her products into only the finest of department stores, having to compete with established cosmetic powerhouses Elizabeth Arden, Coty and Rubenstein that had been around for years. But her determination, creativity and belief in her products eventually allowed her to breakthrough.

This focused strategy of servicing the needs of the high-end consumers is what sets the company apart. Not only does the beauty category grow much faster than the entire consumer staples sector, but prestige beauty (more aspirational, more profitable) grows faster than mass beauty (easily accessible, more of a necessity). Prestige beauty has much higher repeat purchase rates, is seen as an affordable luxury, and has aspirational brand's with strong pricing power. It is for these reasons that is has been one of the fastest growing categories in the consumer staples sector.

MelvilleDouglas
A Member of Standard Bank Group

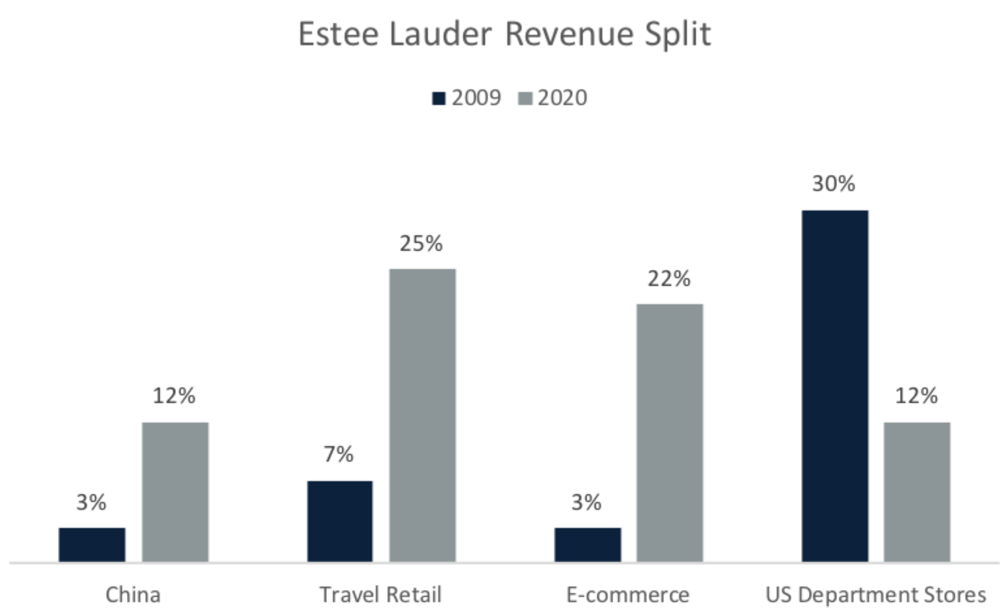
Global prestige beauty is one of the fastest growing categories within the consumer staples sector



Source: Company reports, Estée Lauder Investor Day 2019

But the impressive sales model that worked for decades has more recently faced one of its biggest challenges – the death of the department store. In the aftermath of the Global Financial Crisis, the US department store still accounted for around 30% of company sales. This is despite it being one of the costliest channels to operate. The steep costs of the luxurious, fancy looking counters combined with the cost of training and employing the best beauty advisors meant that profits from this channel were low. Fortunately, this successful family-run business had other strings to its bow. Online, travel retail (duty free shopping) and direct-to-consumer stores all became a much bigger and more profitable piece of the pie.

The company has pivoted towards faster growth areas



Source: Company reports, estimates, normalized

Travel Retail has fast become one of the most lucrative sales channels. Aspirational Asian tourists spend two to four times more than Estee's typical American or European customer. But in 2020 once again, their biggest and most successful channel was severely impacted. Sales ground to a halt due to the travel bans imposed as a result of the COVID 19 pandemic.

Quarterly Commentary as at March 2021

By pivoting towards additional avenues for growth, the company was able to mitigate the slump in Travel Retail that accounted for close to a quarter of group sales in 2019. Investors - including ourselves – were pleasantly surprised to witness how quickly consumers turned to alternative channels to purchase their most-loved brands. The likes of Estée Lauder, La Mer and Clinique – the company's hero brands – grew sales double-digits and defied the naysayers. Ecommerce sales grew from 3% of sales back in 2009 to more than 20% in 2020. The relatively high selling price of cosmetics combined with lightweight packaging, and the higher repurchase rates seen online resulted in profits that were much more lucrative than those earned in physical stores.

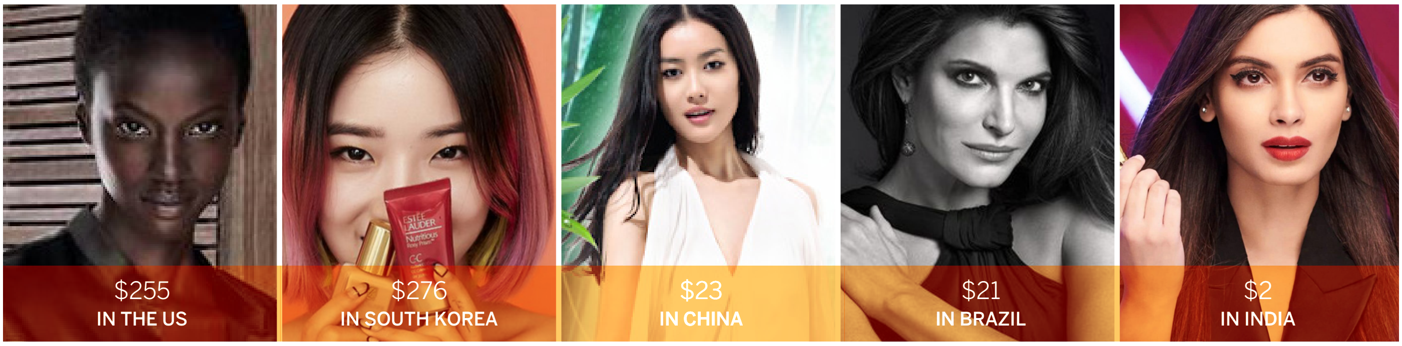
The unique and attractive part of the company lies in their diversification that expands beyond just sales channels - to product categories as well regions.

A few years back – when the selfie era took off – make-up sales boomed as consumers around the globe became more expressive and were willing to experiment in order to look good but to also stand out amoungst the billions online. But in a world of face masks and working-from-home, the desire to wear make-up is no longer there, nor is the need to. With sales down close to -30% at the height of the lockdowns, the category had taken a significant hit.

But with consumers spending more time at home and focusing on self-care, sales of their high-end skin care brands skyrocketed. A big contributor was the Asian consumers' affinity to beautiful, healthy skin - there can be up to 7 steps on average in a daily skincare routine. Sales in the skin care category – which is more than three times as profitable than the other categories – continued to grow more than +25% annually. No doubt make-up will recover as life returns to normal. Estée's balanced approach to high-end cosmetic categories - including fragrances and hair care - puts them in an advantageous position to consistently capture growth irrespective of the latest trends within the industry.

The opportunity and runway for growth is especially attractive in emerging markets where Estée Lauder is underpenetrated. Per capita spend on prestige beauty in China is less than 10% of that in the US. India's spend is less than 1% of that in the US.

Opportunity across emerging markets
Annual per Capita spend on Prestige Beauty

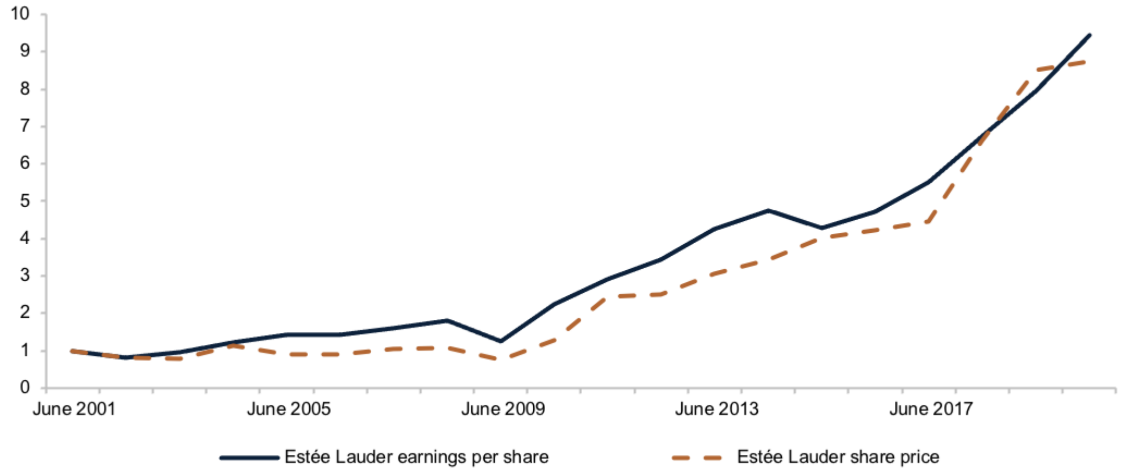


Source: Company reports, Estée Lauder Investor Day 2019

The multiple levers of growth across sales channels, product categories and regions is what we find attractive about the company. Management's efforts at tilting the business towards faster growth, more profitable segments have borne fruit. Combined with the high pricing power that prestige beauty brands – the likes of La Mer, Tom Ford, MAC and Jo Malone – command, the stage is set for the showstopping performance to continue.

Great investments tend to be businesses that can consistently and sustainably grow profits over time. As shown in the chart below, Estée Lauder has been a case in point. The company is responsive to change and has shown resilience in times of distress.

Estée Lauder's share price has followed earnings growth over the past 20 years



Source: www.bernsteinresearch.com

In building portfolios for the long term, we focus our time on ensuring we have high conviction around the longer-term growth drivers and eliminate any noise that we view as transitory. No doubt the near-term environment will remain challenging for the high-end beauty player. But we are encouraged by the strength of the company's drivers and their ability to increase earnings over the long term. Beauty lies in the eye of beholder. We view Estée Lauder as an attractive holding in the fund.

Quarterly Commentary as at March 2021

Patience is a Virtue

Spurred by the vaccine roll-out and hopes of returning to normality sooner than later, global economies are set to deliver rapid growth over the coming year. The IMF is expecting global growth of around 5.5% in 2021. Part of this is due to the low starting point. The other big contributor has been the generous $20 trillion plus of fiscal and monetary stimulus - equivalent to over 22% of global GDP – that central banks and governments have pumped into the system.

For those in employment the desire and willingness to spend is huge. This is understandable given the impact of the lockdowns on the ability to spend on 'go-out' activities such as travel, dining and entertainment. Once the floodgates are opened and societies feel safe to once again socialize, we expect to see a wave of spending to hit those industries most exposed.

Coming out of a recession, estimates err more on the conservative side as the investment community tends to be more guarded than usual. There are clearly behavioural factors, such as anchoring to the most recent (depressed) datapoint, the difficulty of changing a pessimistic mindset and the embarrassment of getting it very wrong. This phenomenon was observed coming out of the prior recessions in 2003 and 2010. Current global earnings forecasts are sitting at 25% for 2021 with the potential to surprise to the upside. We may therefore see share prices remain supported despite lofty valuations. As a result, we could well see another year of positive, albeit limited returns, from equities.

The profit recovery in 2021 will be faster for cyclical companies with high operating and financial leverage. Companies with less cyclical and more stable earnings (i.e. the ones we tend to bias) did not see their earnings collapse in 2020, and therefore there is less scope for a sharp rebound in 2021. We are not worried about owning the "Steady Eddies" – consistency trumps volatility when capturing compound returns. We maintain our disciplined approach. A balanced portfolio that invests in quality assets - at a reasonable price - will deliver superior risk-adjusted returns over the long term.