8 January 2022

Dear Equity Client

GLOBAL BEST IDEAS EQUITIES – 2022 Annual Letter

2021 PERFORMANCE

Many global equity investors enjoyed another pleasing year of double-digit returns in 2021, despite the high base of the previous year and the stop-start global economic backdrop. The MSCI World Index (including Emerging Markets and dividends) delivered a +18.5% return over the year (in US$ terms; +19.6% in UK£ terms).

Following a deep and shortest ever recession during the Pandemic, the US economy experienced a sharp V-curve recovery with the GDP recovering to its previous peak level within less than six quarters. Consensus S&P 500 earnings expectations regained their pre-Pandemic peak level within just over a year, and at the end of the year already exceeded that peak level by almost a quarter. This constructive fundamental backdrop was supportive of Equities.

We should highlight the enormous impact of the successful virus vaccine treatments, and all the credit is due to modern science in this context. The global economic recovery was, though, not a smooth process with varying degrees of economic lockdowns at different stages in different countries following the appearance of more virus variants. Further to this, the Chinese economy was also hampered by their property market collapse, uncertainties around the reorientation of their economic agenda towards a 'common prosperity' social programme, and their aggressive regulatory interventions, particularly in their technology sector.

Supply chain constraints and their effect on inflation, particularly in the context of rising demand levels, has been another main feature especially in the second half of 2021 (and continues to be so). Central banks have remained accommodative despite this surge in inflation. Their general stance has been that normalising economic conditions should be able to resolve most supply backlogs over time. The year ended with uncomfortable inflation levels worldwide.

Whilst new virus infection issues continue to cause a stop-start economic backdrop, we believe the recovery phase of the new US economic cycle is complete. Equity investors can be grateful for the strong administrative management under unique economic circumstances following a similar experience through the Financial Crisis.

ECONOMIC OUTLOOK

Major US leading economic indices remain constructive in their immediate outlook. Omicron has damaged US Consumer Confidence somewhat, but with an improving virus outlook and strong US consumer balance sheets, we believe confidence levels can improve through the year.

The Biden administration has a large stimulatory programme for the US economy, but has struggled to obtain some of the necessary approvals to proceed and now faces a difficult build-up to the mid-term elections. This year, the US economy faces rising fiscal drag along with the shrinking consumer savings.

Globally, improving economic conditions can follow from better than feared Omicron news. World trade is close to record levels despite the previously mentioned continued major logistical constraints – which should also improve through the year. The Chinese government has little choice other than to stimulate their economy more effectively.

We believe the world economy is already in a typical mid-cycle phase of normal economic growth, decelerating this year from last year's high growth level. We expect continued growth for some time, but at sub-par levels in most of the world's largest economies following the damage from the two successive major economic crises and high government debt levels.

INVESTMENT OUTLOOK

The following are the main fundamental issues framing our investment outlook:

1. Covid-19
   It seems the most severe economic risks in this context are behind us, that science has enabled us to live a 'new-normal' life with the virus and that it is no longer prudent anymore to withhold investments purely because of the virus threat.

2. Inflation
   We believe a more normalised economy that is rid of the most severe supply chain complications may be slowly on its way in the second half of this year. This view is supported by the fact that new US job openings, key commodity prices, shipping costs and backlogs are in process of rolling over from their peak levels. Seeing continued virus uncertainties, we put a 60% probability on a good outcome of US inflation at a comfortable level of around 3% at the year-end, a 15% probability for an even better outcome of around 2% and a 25% probability of a bad outcome with inflation remaining at uncomfortably high levels.

3. Policy Errors
   The market fears central banks may react either too early or too late, or too heavily or too mildly, in restricting inflation risks. Whilst we have more confidence for responsible central bank actions, risk remains that market nervousness in this context may lead to misinterpretations of central bank abilities to 'get it right' and cause market volatility in the process and at the different tightening steps.

4. New tightening cycle
   It is clear that the next US tightening cycle is closer than what many perceptions have been. Many market participants fear an outlook of rising interest rates. We are not complacent in this context, but recognise the facts that rising rates at this stage of an economic cycle more than often reflect normalising circumstances, that rates currently are only back at end 2019 levels and that they may remain in negative real territory for a while. Furthermore, historically, despite the triggering of an equity de-rating process, subsequent equity returns have on average compounded at around +8.5% p.a.[1] over the tightening cycles because of good earnings growth.

5. High Valuations
   We are very conscious of high equity valuations on many fronts. S&P 500 valuation multiples are, however, not on overly excessive levels relative to bonds. With rising rates, though, the critical issue in this context is the certainty of good earnings growth coming through for each of one's portfolio holdings to absorb the high valuations. Earnings disappointments can clearly now lead to weak portfolio performance.

[1] *S&P 500 index*

In this context, we highlight the risk of high valuations in the case of many no- or low-profit franchises. They offer little buffer against the rising interest rate alternatives and investors may potentially risk severe capital losses. Investors should, in particular, guard against businesses that last year attracted disproportionate amounts of investments despite their low profitability.

6. Growth vs Value Investing
   Some investors switch tactically between Growth and Value investment opportunities. The latter tend to come more in play during the recovery process following a recession or with a strongly growing economy.

   We believe the main reason for equity investing is to participate in the sustainable growing value creation of a quality business. Furthermore, Growth has historically outperformed Value by around +2.5% p.a. over an economic cycle, with outperformance increasing during the maturing phases. We, therefore, would rather consider Growth investing in a strategic compounding sense with fewer opportunities for bad timing, and Value investing for more tactically minded traders.

7. Socio-Political Risks
   There are numerous risks in this context, including issues around Taiwan, Ukraine, Belarus and the Middle East. We have learned that, in the absence of concrete military invasions, it is usually not productive to withhold normal investments awaiting absolute certainty. We have, though, more reservations about China's new social programmes, aggressive regulatory interventions and hidden taxes. It has materially raised the risk premium on investing directly in the region. We hope for more clarity in this context to reconsider investment opportunities.

We believe we are about halfway through a structural equity bull market and that we can look forward to more buying opportunities in sustainably growing businesses rather than looking for selling opportunities of our quality holdings.

INVESTMENT THEMES

We relentlessly adhere to our investment philosophy of only owning high quality sustainable growth businesses to hold for the long term, and remain very valuation conscious. The strategy's holdings are not adjusted for short-term tactical economic issues or ever-evolving investor preferences that usually last for short spells only.

Our Global Best Ideas Equity strategy is well exposed to the following structural investment themes and companies:

A. Health Care
   Along with the already long elective procedure waiting lists (further extended by the Delta and Omicron virus variants), the global focus on science and health care supports this structurally growing industry over the longer term. We focus more on the MedTech and equipment side of the industry in specialist operators with strong competitive edges and barriers of entry. We have over the past year further increased our investments in **Intuitive Surgical** (surgical robotics), **Edwards Lifesciences** (cardiovascular treatments), **Stryker** (orthopaedics and surgical equipment) and **Thermo Fisher** (scientific laboratory equipment). We are not invested in human pharmaceutical businesses. Our animal pharmaceutical business (**Zoetis**) continues to experience strong organic growth.

B. Fourth Industrial Revolution (4IR)

We are still in the early phases of the fourth industrial revolution of mass digitisation and believe it can compound in excess of a fifth each year over the next five years. Developments around big data, cloud computing, artificial intelligence, advanced robotics, internet of things and 5G, cyber security, 3D manufacturing and virtual reality, along with the inter-connectivity benefits, have a very long runway. Apart from the excellent business opportunities this is already creating, it is worth emphasizing also the overall productivity and cost control benefits from these key technologies.

A particular feature to highlight is that many large businesses that drive these material technological advances are already very profitable and generating strong cash flows. This aspect is changing investor perceptions for the better around the risk and volatility of many technology shares. An exercise of 32 companies directly involved in some of these technologies illustrates that they have, on average, outperformed the MSCI World AC index by a ratio of over 2.5 times over the past five years, and with a ratio of over 5 times over the past ten years. We see little reason to expect a reverse of this trend going forward.

We are well invested for this profitable revolution. Those businesses with the highest direct exposures to 4IR are **Accenture, Alphabet, Amazon, ASML, Cadence Design Systems and Microsoft.** In terms of the direct utilisation of 4IR in their business, we would also highlight **Intuitive Surgical** (robotics surgery) and **Nike** (speed of implementation and direct connections with consumers).

C. Lifestyle

Covid-19 has further accelerated trends of healthier living and making more time for one's self and family and friends. **Nike** is by far the world leader in providing sporting attire, whether for the professionally competitive or more informal market. Owning or gifting a luxury item now has more of a 'touching of one's soul' factor. **LVMH,** with a widely diversified portfolio of luxury items, benefits hugely from this structural growth theme.

We continue to make sure our core universe of candidates and our portfolio remain fresh and include the future structural winners complying with our four-pillar investment strategy of:

a) above average sustainable organic growth,
b) quality management and business culture,
c) highly profitable with good reinvestment opportunities, and
d) strong and growing cash generation.

ESG AND STEWARDSHIP

With our investment philosophy designed for sustainable long-term growth, Environmental, Social and Governance (ESG) considerations are integral to our investment process. Our additional research work in this context fully incorporates the fundamental issues, considering also inputs from external ESG specialists. We vote on all the holdings in our Global Best Ideas Equity Fund, prioritising sustainability and best-in-class governance in all our voting decisions. We also engage with numerous businesses on important stewardship issues (for both our portfolio holdings and other candidates). Details of our votes and engagements are published on our Fund's website.

Stonehage Fleming is a signatory to the United Nations' Principles for Responsible Investment.

IN SUMMARY

Our strategic approach to investing remains intact. We are not considering short-term tactical trading opportunities, but rather believe quality businesses will continue to have odds on their side for sustainable value-add performance over time.

We are grateful for all your support.

With kind regards

Gerrit Smit
Partner – Head of Equity Management

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