# Stock Selection Themes

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# A thematic approach to stock selection

- Diversification geographically and by sector and by stocks within sectors is the conventional way to construct a portfolio
- Alternatively, we can identify enduring global themes and screen for stocks that comply
- Seeking profitable exposure to structural growth together with a protective “moat”
- “Sleep at night” slow changing portfolio with about 20 “quality” stocks
- Available at reasonable valuations

# Themes to seek exposure to

- Favour branded exposure to emerging market consumer demand
- Favour exposure to German domestic demand
- Favour exposure to healthcare demands of an ageing Western population and to increasing incidence of Western lifestyle diseases in emerging economies
- Favour exposure to unconventional (shale) Oil and Gas
- Favour exposure to US Construction
- Maintain some exposure to secular commodity theme
- Maintain selective exposure to emerging markets Infrastructure theme
- Favour beneficiaries of ongoing automation and application of robotics
- Don't shun "quality" cyclical exposure
- Favour solid and consistent financial metrics
- Favour Anglo-Saxon governance

# Themes to avoid

- Avoid the victims of Chinese competition
- Avoid fiscal victims
- Avoid technology victims
- Avoid state-ridden sectors

# Favour branded exposure to emerging market consumer demand

- An increasingly consensus view over recent years….
- ….but this theme is still young relative to potential longevity
- Middle classes growing rapidly in emerging economies….
- ….as structural growth in GDP per capita looks set to persist
- Household & Personal Goods, Food & Beverage, Luxury Goods, Luxury Autos

# Favour exposure to German domestic demand

- It is crucial that the Eurozone should rebalance rather than retrench its way to equilibrium
- German domestic demand growth must be encouraged to balance retrenchment in PIIGS
- German unemployment and bond yields at record lows….
- As pay settlements and property prices move higher
- Euro weakness allows German exporters to maintain competitiveness globally….
- ….as competitiveness is conceded within Eurozone

# Favour exposure to healthcare demands of an ageing Western population

- ….and to increasing incidence of Western lifestyle diseases in emerging economies….
- Growing demand for diabetes treatments, dialysis equipment, orthopaedic devices, and various drugs
- Healthcare and Pharma sectors….
- ….but avoid those subject to government spending cutbacks in fiscally challenged developed economies

# Favour exposure to unconventional (shale) Oil & Gas

- Fast becoming a major global growth sector….
- ….led by aggressive application of new technologies in the US
- New and evolutionary technologies enhance the bargaining power of specialist operators in dealing with national governments

# Favour exposure to US Construction

- Residential sector is turning….
- ….with pent up demand from demographics
- US has infrastructure deficit
- Shale-related energy cost advantage can drive industrial investment in US

# Maintain some exposure to secular commodity theme

- This theme is about a decade old now and well established
- However, ongoing global population and GDP per capita growth amid finite commodity availability….
- ….suggests some exposure still justified
- Oil & Mining Services companies participate….
- ….while being more fiscally immune than the major Oil and Mining companies
- Providers of agricultural inputs and machinery would benefit from ongoing strength in agricultural commodity prices

# Maintain selective exposure to emerging markets infrastructure theme

- Also a very well established consensus theme….
- However, its long term structural nature warns against premature abandonment
- Some industrial engineering companies will continue to benefit from related demand growth if they can maintain pricing power….
- ….but care required to avoid victims of Chinese competition

# Favour beneficiaries of ongoing automation & application of robotics

- Investment in automation / robotics has been delayed by cheap Chinese labour
- ….but this is changing as cost divergence turns to convergence
- Smart machines spreading from information processing to manufacturing, assembly, distribution, clerical
- Robotics is an antidote to the problem of ageing populations
- Beneficiaries are companies that can identify and maintain benefits of labour cost savings (barriers to entry / pricing power)….
- ….and the leading providers of robotics and automation equipment

# Don’t shun ‘quality’ cyclical exposure

- ….where it offers profitable exposure to a structural growth theme
- Valuation can be at a discount
- A quality cyclical company is far superior to a mediocre defensive company

# Favour solid & consistent financial metrics

- Large cap
- Consistent cash dividend growth
- High marginal ROE….plus scalability
- Strong balance sheet
- No rights issues
- No reliance on big acquisitions

# Favour Anglo-Saxon governance

- Long run real total returns highest in US and UK
- Beware socialisation of ROE
- Cultural / governance issues are important over the long run

# Themes to avoid

- Avoid the victims of Chinese competition
- Avoid fiscal victims
- Avoid technology victims
- Avoid state-ridden sectors

# Avoid the victims of Chinese competition

- We have yet to see the impact on global competition from the ongoing development and maturation of the Chinese corporate sector
- China has, so far, contributed to a structural enhancement of profitability among Western companies through outsourcing etc
- However, as Chinese companies increasingly assert themselves on the world stage….
- ….they can become a major source of downward mean reversion in global profitability
- The impact (some decades ago) of the ascent of the Japanese and South Korean corporate sectors on global competition is a salutary lesson
- ….and concentration on maximisation of market share rather than profit would greatly increase the impact

# Avoid the victims of Chinese competition (cont’d)

- China 5-year plans increasingly looking for major global market share gains across a wide range of targeted sectors
- In a centrally controlled economy, development can be fast-tracked by donating dominant domestic market positions
- Sectors characterised by a “big ticket” high level ordering process seem most vulnerable
- Sectors characterised by “small ticket” low level buying decisions by individual consumers seem more immune

# Avoid fiscal victims

- Fiscally challenged governments are significantly incentivised to levy additional taxes on the corporate sector wherever and whenever possible
- The most vulnerable sectors are those not subject to the full forces of global competition….
- ….with a large and unmovable investment commitment in a specific national economy….
- ….and often enjoying some degree of regulated monopoly in the national domestic market
- Utilities, Telecoms and Financials are among the most vulnerable
- Major Oil and Mining companies can also be fiscal victims
- Truly multinational companies with discretion to geographically transfer operations and employment for optimisation of fiscal and other costs are least vulnerable

# Avoid technology victims

- Major ongoing advances in communications and information technologies have been enhancing corporate profitability in general
- ….but they have also been undermining the positions of incumbents in some industries by lowering financial and other barriers to entry and changing delivery channels
- Even when the incumbent adapts its business model to maintain market share, the sustainable market value of its existing capital base can nonetheless be significantly and permanently impaired
- Music publishing, books, newspapers, other media, telecoms, travel agencies, stock exchanges, traditional retail, some incumbent tech companies

# Avoid state-ridden sectors

- Risk of persistent excess capacity
- Competition not governed by profit motive
- Airlines, Steel, some Autos, sectors targeted by China

# The typical company

- Large cap, focused with global reach and dominating its market
- Barriers to entry
- Strong global consumer brands
- Not at risk of being undermined by changes in technology or fashion
- Profitable and scalable exposure to structural growth
- Proven success in penetrating emerging markets
- Global flexibility re optimisation of labour costs, taxation etc….
- ….but US or UK in origin and governance culture
- PE around 16 and dividend yield around 3.5%, solid balance sheet and record of consistent and growing cash returns to shareholders

# Stocks that fit the themes

ESN

adidas
BDF Beiersdorf
BMW
Colgate
CRH
Nestlé
Technip
John Deere
metso
DIAGEO
LVMH
MOËT HENNESSY. LOUIS VUITTON
gsk GlaxoSmithKline
Johnson & Johnson
K+S
P&G
Procter & Gamble
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