NORTHERN TRUST

THOUGHTS AND THEMES FOR 2017

CONFIDENTIALITY STATEMENT

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INTRODUCTION

In one of his last diary entries for 1916, Tsar Nicholas the II noted "The year 1916 was cursed; 1917 will surely be better!" A few hedge fund managers might feel the same about 2016.

Whilst 1917 turned out worse for the Tsar, 2017 could be much better for portfolio managers. In fact, we believe active management generally is on the eve of multi-year renaissance. Following is our attempt to explain this assertion and to highlight where we see investment opportunities ahead. It's far from exhaustive and what we miss you can find on our website. Clearly these thoughts are yet to be stress-tested through argument and debate. For that I hope to visit you and discuss in person. Together we might get somewhere closer to the truth.

THE LESSONS OF 2016

Before looking ahead we look back on the year. We will not dwell on any success for this teaches little – we learn from our failures and 2016 was a great teacher. We learnt that with every investment we get wiser or richer but never both. We learnt valuation matters especially at inflexions. We learnt stocks can move dramatically when there is a change in accepted wisdom, that quality can be particularly punished when fortunes turn. We were reminded of the importance of price, that even bad companies can be good investments if the price is low enough. And good companies can be bad investments if the price is too high. We were reminded of surplus and scarcity and of positioning extremes. We were reminded of the need for balance, the importance of keeping an open mind and of acting when facts change. Finally, we were constantly reminded to avoid semantics and that there is little substitute for good stock picking. For those with such skills we see an extraordinary context for them to prosper at a time Alpha may trump Beta as dispersion rises, correlations break down and nominal growth picks up. Let's just hope it doesn't pick up too much however, for that, ironically, could be the very thing that topples markets.

THE UNINTENDED CONSEQUENCES OF AN ECONOMIC BOOM

Should President Trump get his way (which may be difficult once the cloak of office descends), we must consider this hypothetical scenario. For the outcome of an economic boom may not be what you would expect.

So, Trump seems to want to corporatise politics. He wants the Oval Office to become his board room with the cabinet his board. As a businessman he deplores inefficiency and bureaucracy and prefers pragmatism and profit. He has a plan, a manifesto (most of which can be found on @realDonaldTrump) and being an outsider to politics he seems to owe few favours to anyone, increasing his chances of getting what he wants (within the confines of office). He favours big spending, wants his name not just on planes but airports too. He plans to build roads, bridges and hospitals and according to economist Pippa Malmgren may even get the Chinese to pay for some of it. A strong economy means a strong currency. A strong currency means it's easier to attract the kindness of others when selling 100 year bonds. And if they don't he might impose a Debt Jubilee, reset private debts, reward savers with cash-injections and reignite a credit cycle the likes of which we haven't seen since the 1950s (see Prof. Steve Keen, Head of the School of Economics at London's Kingston University). He is results-oriented and will, we presume, judge himself by objective standards like GDP and cash flow. The more cash there is the more he can redistribute, which may in time mean he can even appeal to the Left's views on social welfare. He could usher in an economic boom, promote jobs, growth, make America truly Great and win in a land-slide in the next election.

This all sounds great except for one issue. It might topple markets.

The irony of the present situation is what Trump wants – an economic boom – could be the very thing that causes equities to fall (at least those not sensitive to the cycle). After all, if the logic is correct that QE, low rates and a depressed discount factor has attributed to a large part of equity performance, a removal of QE and higher rates could do the opposite. Indeed the Federal Reserve may be forced to become more aggressive. We must also consider the impact of higher rates on corporate buy-backs. Low rates induced corporates to lever up and do buybacks which was accretive to price (and pay-packets). But with corporate leverage now exceeding pre-crisis levels, higher servicing costs could reverse that trend. This is worth bearing in mind, for corporate buy-backs were a significant driver of price-performance last year, contributing over USD 500bn to stock purchases at a time most equity funds were seeing outflows. Even more concerning is what could happen to buy-backs if Trump's outlined tax plan is enacted in full. This requires careful consideration. As it does with reference to the US Dollar, which could undergo a revaluation, should he get his way. We discuss this further elsewhere but for now we turn to the point in his plan which removes, or at least caps, the ability for corporates to deduct interest expenses.

LESS INCENTIVE FOR CORPORATE BUY-BACKS

There has been a lot of discussion about tax cuts and the repatriation plan but there has been little about his proposal to disallow interest deductions on corporate debt. If rates go up, servicing costs will increase. However, if the Trump Administration introduces a cap on interest deductions, or removes them all-together, it could follow that buy-backs become less appealing use of cash. Corporates may instead decide to pay-down their debt or pay more in dividends which will attract lower taxes in time. The other option, one that seems most favoured by Trump is to promote business spending by allowing US-based manufacturers full relief on business investment if they forgo interest deductions. That will certainly motivate investment, especially for those with little debt. In other words, he hopes that cash, including the billions to be repatriated will be used for productive (investment) not for unproductive ends (buy-backs). This, we believe could revive the capex cycle and finally solve some of the productivity problem. Of everything we have considered with respect to Trump, this is perhaps the most significant. It forces us to question whether we are on the eve of a significant pick-up in capex, the dog that is yet to bark in this recovery.

A REVIVAL IN U.S. CAPEX

When central banks hold the cost of capital at zero, or at levels inconsistent with market forces, malinvestment occurs in the system. When combined with large output gaps and low wage pressure corporates can hide inefficiencies. They also have little incentive to invest. The outcome is sub-par growth, low-productivity and an ageing capital stock whose returns decrease over time – a vicious cycle. That could all be about to change with the removal of monetary stimulus (QE), the introduction of fiscal policy, a natural rise in rates and wage costs and the arrival of Trump. The U.S. Bureau of Economic Analysis points out the need to upgrade ageing manufacturing assets is particularly evident in the US where at 22.4 years, private sector fixed assets are the oldest they have been since 1955. Industrial equipment, including machines, turbines and electrical apparatus, at 10.2 years, is the oldest it has been since 1939, and public infrastructure has *never* been as aged as it now is!

Another factor to consider is wage costs. The US is already close to full employment and there is a labour shortage in construction. Given Trump stated he wants to add 25 million *new* jobs, labour could be about to regain its pricing power. Such cost pressure in the past has led US manufacturers to consider outsourcing to low-cost regions like Mexico or SE Asia. The problem with this strategy now is such regions are no longer as cheap as they were. Labour costs in China for example have increased nearly five-fold in a decade, which partly explains their drive towards robotics and automation. More importantly, Trump wants to impose a border tariff on outsourced manufacturing when imported back into the U.S. In other words, offshoring risks becoming a political headache, not to mention being less competitive than it was, as we saw with Ford's decision to shelve plans for a new plant in Mexico. Some Taiwanese companies have even made statements they are considering re-locating operations to the U.S. as a consequence. Now, with outsourcing seemingly less attractive the only other option to improve productivity and efficiency is to invest in labour-saving plant, robotics, more efficient equipment or software. In other words - capex. There may also be a tax incentive to do so. As we alluded to above, a critical part of the Trump plan could be to allow U.S.-based manufacturers to elect full expensing of plant and equipment in return for giving up the ability to deduct interest expense. For those with low debt then, this is an invitation for massive investment.

The final necessary ingredient for such spending decisions is confidence. That too is improving, with American CEO's more confident now than at any time since 2007 (but for a brief period in 2014, see *CEO Confidence Measure* on *Bloomberg*). The most recent Philly Fed Index showed CapEx expectations rose to the highest level since 2000.

Now, we last considered this theme back in 2013/14, a time absent full-employment, rising wage costs, much in the way of confidence (compared to now) and no President Trump. The names we cited then are probably worth considering again and they included: **ABB**, **Alfa Laval, Assa Abloy, Atlas Copco, Kuka, Duerr, GEA Group, Georg Fischer, IMI, Rexel, SAP, Schneider, Spirax-Sarco, Sulzer, Rotork, Volvo** and **Wartsila**.

We know several of these names well already, so our efforts will focus on those we know less well, like **Duerr**. On a cursory basis this looks interesting insofar it combines decent US CapEx exposure with secular growth in EVs, especially in China and US where they already provide the paint robotics for Tesla. A replacement cycle for the robots they implemented in the late '90's is also possible and their installed base is leading to higher margin service revenues. Good order growth, good balance sheet, pays a dividend and surplus cash will be used for value accretive bolt-ons, which on 13x Yr2 P/E sounds decent value. We plan to do more on this.

CORPORATE SPEND VS CONSUMPTION

A related theme is one that favours corporate spend over consumption. Whereas low rates have lowered the discount factor, improved the PV of long-term cash flows, reflated collateral values (people's homes and equities) and lowered debt servicing costs, higher rates could have the opposite effect, certainly on the latter. In other words, another consequence of rising rates (and the associated corporate spend which should accompany it) is it may reverse the era of favouring the Consumer over Corporate wallets, especially in the US. Who benefits most from corporate spend? Traditionally this would support Software, Employment Agencies, Premium Air-Travel, Hotels, Advertising and Investment Banks. We will discuss this more over the coming weeks.

CAPEX REVIVAL IN EUROPE?

As is the case in the U.S. the average age of assets in Europe is at record levels according to JPMorgan. This partly explains why European growth has been so anaemic. It has struggled to break a vicious cycle: the lower the rate of asset replacement the older the prevailing asset base becomes, the lower the return on those assets and the less cash available for new investment – exacerbated by the liability side of the balance sheet staying fixed. Until a virtuous cycle begins where European firms start spending more on Capex and/or governments on infrastructure then European growth is likely to remain sub-optimal. What then could break this cycle? We think self-interest could.

FISCAL SPENDING AS AN ANTIDOTE TO NATIONALISM.

We have long held the view that if Germany wants to keep the European Union together it will have to spend and allow others to do the same. Fiscal conservatism combined with low incentives for corporate Capex has obstructed lower unemployment in many countries. The jobless, who are often the younger demographic, have grown disenchanted with Brussels. The migrant crisis has disenfranchised them further. Even those with jobs have seen real wages fall over time, so rising wealth inequality has been another key factor in the surge in populism, not just in Europe but elsewhere (see Trump). With a heavy election calendar ahead of us in Europe, the issue of jobs and employment alongside rising in popularity for right-wing nationalists/populists, it seems possible to us the Germans could begin to ease fiscal restraint and spend. More spending should mean more jobs. More jobs should mean more votes and they can certainly afford it given the German current account surplus is the highest ever. What's interesting is they may have already embarked on it. A 5x CPI wage hike is implemented this month, they have already discussed tax cuts post the election and Merkel wants to increase the level of pensions for East Germans to match those in the West. Indeed last year was the first in seven that fiscal budgets were not a drag on growth. This year could well be the second. Finally demand for spending may come from the oldest legitimate excuse for creating employment by governmental expenditure: Military Keynesianism.

DEFENCE: MILITARY KEYNESIANISM

Defence spending has been a long standing theme for us, first discussed back in 2013 when we were very keen on **Safran**. We became more constructive on the outlook after Russia annexed Crimea, an act we thought at the time would stimulate NATO to reverse years of underspending (only a handful of countries have met their treaty obligations of spending 2% of GDP on defence). This environment has changed even more post the arrival of Trump. He wants to reverse years of underspending in the US and force his allies to do the same. (Even Japan is revising its pacifist constitution to make way for bigger defence budgets). They've pledged to increase the Army's active force by 65,000, increase the planned naval fleet by 70 ships and buy more fighter jets – all of which will cost hundreds of billions of dollars. And as Western spending goes up it seems fair to expect the same from adversaries too. Defence spend globally is heading higher, a fertile context for defence contractors and their suppliers.

One thing we note about the companies in this space is their large R&D platforms and significant intellectual property means they provide optionality not just to defence spend but to a multitude of exciting new secular trends that are hard to express elsewhere. For example, **Dassault Aviation** has been working on building ultra-fast jetliners which could kick off the next age of supersonic passenger flight which in turn could disrupt trans-Atlantic business travel. **Thales** is exposed to drone proliferation because their radar technology can detect, track and effectively neutralise drones. **BAE Systems** has been working on autonomous flight (not to be confused with auto-pilot) and believe they already have systems for military scenarios and in time could roll it out commercially. And both **BAE** and **Thales** provide exposure to what is the number one business risk cited by most CEOs: cyber security (NB: it is a small part of both, c5%, but growing incredibly fast). Only **Sophos** provides exposure to this in the UK. The sector is fairly uncorrelated to the market (refer Alpha comments below) and the European names trade at significant discounts to US peers.

Thales remains our top pick. Other names worth considering are **Meggitt, Safran, BAE Systems** and we think also **Finmeccanica**. Small cap **Fincantieri** may be worth a look as well (they build naval vessels).

COULD TRUMP CAUSE A SHORT SQUEEZE IN THE DOLLAR?

The direction of the US dollar touches many things; as such it's an important consideration for any portfolio manager. We don't profess to have any particular skill in FX although I have sympathy with my Head of Asian Research, Douglas Morton's idea that whenever the Fed has tightened in the past, the dollar strengthens ahead of that tightening and weakens thereafter. While that could play out in the very short-term, in the mid-to-longer term I fear the recent rise in the dollar might just be getting going. The reason for this is there is a structural dollar funding shortage which could be made worse through Trump's tax plan. Most are familiar with the idea capital will flow to where it's treated best. From the perspective of corporate tax, that could soon be America (Trump wants 15%). Equally powerful is the repatriation plan, a one-off 10% tax on foreign cash holdings whether it returns home to America or not. Now, the US did something similar with the Homeland Investment Act 2004. The vast majority of the repatriation occurred in Q1 of 2005. A 13% rally in the dollar index followed, this despite it being in a secular bear market. The total amount repatriated was USD 360B. This time, if you believe Trump, there is over USD 2T sitting off-shore that could be repatriated. And we could be in a secular bull market.

Returning to the more important issue of the potential dollar funding shortage, as the reserve currency provider the US runs a large current account deficit providing significant dollar reserves for the rest of the world to grow. The larger this deficit, the greater the supply of dollars and vice versa. To some degree, the rise of shale meant the US was less reliant on foreign oil, a large import. As a consequence the US current account deficit has been declining, meaning fewer dollars have been supplied to foreigners. Trump now wants more drilling in order that the U.S. becomes energy independent. This could impact the deficit further, so too could his proposal to 'border adjust' trade flows by not taxing income from exports, while disallowing deductions from imports. It's all part of 'Make America Great Again' as it plainly encourages making stuff in the U.S. rather than buying it from overseas. The Republicans believe this will be trade neutral as the dollar should *appreciate* to offset the border adjustment. In other words an Strong Dollar policy seems part and parcel of Trumpism. A parallel can be found with Robert Rubin when Treasury Secretary of the then Clinton Government from 1995 - he began promoting the dogma that a strong dollar is in the U.S.'s interest. Between 1995 and the end of Clinton's regime in 2001, the DXY rallied over 45%.

Could history rhyme?

If it does it would occur with an estimated USD 9T carry according to the BIS – the largest speculative trade in history. We doubt this is the last you hear on this point.

OIL'S VESTED INTERESTS FAVOUR HIGHER PRICES

Like China and Miners, the Oil market was another to humble investors this year with most expecting a lid would be kept on things through OPEC's policy of perusing market share combined with weak demand in China. Even our own views, which were bullish, turned out to be right but for the wrong reasons. Our thesis expressed the idea that the best cure for low prices was low prices. Last year was the first time in 40 years capex fell for two consecutive years. 2017 could be the third, which we believe to be unprecedented. In terms of regions, we focussed primarily on supply dynamics in US shale. Our expectation was the natural decline rates of existing shale wells would speed up, meaning a huge leap in rig counts was required just to keep production stable. We thought this unlikely save for a huge rally in oil prices, well above USD 55/b. Rig counts certainly went up, but so too did production and at prices sub USD 55/b. What we got wrong was production costs, which were well below what we had expected, certainly those in the Permian (NB: it remains to be seen how much of this was a result of suppliers offering negative margins to secure contracts; we would also expect some price pressure this year from raw materials and labour costs). The key driver for oil was instead China's recovery and in the latter period of 2016, OPEC. Whether or not OPEC adheres to their promises to cut, the move, if little else, signals that the irrational supplier is turning rational, a volte-face from pursuing market share at any cost. Saudi Arabia particularly wants higher oil prices and has the most ability to affect such. It's perhaps no coincidence the Saudi Aramco IPO is looming, one that would surely benefit were the oil price to rise from here. Such powerful vested interest is of itself enough to tip the balance in favour of expecting higher prices this year. Longer-term demand is surely challenged by renewables, EV and battery technology, but for now we remain constructive on the space. We have long flagged **Tullow** and **Saipem** as the higher risk/beta plays to rising oil prices. Tullow is an interesting deleveraging story, with huge equity value optionality but given its risk profile we stick to where we see value and self-help (**Amec Foster Wheeler**), acquisitive cash-compounding (**Hexpol**), under-valued synergies (**Technip**), safe dividend, sterling, and natural gas benefits (**BP**) and transformation (**Shell**). We were clearly too early getting off **Weir Group** which could continue to benefit thanks to Trump. **Tenaris** and **Vallourec** could as well. We would also highlight the testing and inspection names which could benefit from more drilling activity in the U.S. What's interesting about **Intertek**, **SGS** and **Bureau Veritas** is they have been materially de-rated recently, and are now trading at or below their recent trend PEs. The one with the most O&G exposure is **Applus**, although it's the one we know least about.

CHINA AND DISCRIMINATE REFLATION

It strikes us as odd that the No. 1 rated tail risk of most investors and commentators at the beginning of 2016 was China, yet little has been discussed on the topic since. We remember it well, for we were uncomfortably bullish at the time. It was a time when arranging meetings for Doug Morton was nigh on impossible - no one cared. The widely-held belief was China was about to fall under the weight of its own debt or devalue, or both. How things change. Fast forward a year and what's interesting is the debt issue has exploded further. And the enormous stimulus aimed at housing at the beginning of last year is now showing signs of reversal. Indeed Doug believes the government is now actively pursuing a policy of tightening to prevent over-heating and that it's working. Second-hand residential building prices have turned sequentially negative in Beijing - one of their largest markets. Year over year comparisons may follow this year, especially as the base levels are extremely elevated. **Vanke**'s President Yu Liang last month predicted that national home sales will drop 'significantly' in the coming year, while prices will fall in cities where gains were too fast. Now, it's worth highlighting this for no other reason than it runs counter to the current narrative of buying *anything* not nailed down exposed to Trump, fiscal stimulus or reflation. Another impact could come from the debt markets where the cost of Chinese debt across a number of different classes and durations has been rising rapidly. Such tightening of liquidity is not normally associated with rising commodity prices. Nor is a strong USD.

Despite optically cheap valuations, **Anglo American** is on less than 3x EBITDA if using spot prices (making it a risky short), we nevertheless think there are better ways of playing reflation, like Oil, Construction & Infrastructure, Banks and Capex beneficiaries.

China is the marginal buyer of most bulk commodities, but the idea that Chinese infrastructure can itself drive prices looks misplaced to us. Real estate accounts for around 20% of fixed-asset investment in China but nearly 40% of steel demand, according to Doug Morton. Although infrastructure accounts for a quarter of investment, it sucks up only 13% to 14% of Chinese steel output. In other words, infrastructure investment likely needs to rise a lot more to off-set a slowing property market. Something we view as unlikely.

THE DEATH OF ACTIVE MANAGEMENT?

"The reports of my death have been greatly exaggerated" - Mark Twain.

There has been a growing cacophony trumpeting the death of active management and especially that of hedge funds. There has been increasing confidence that passive strategies are the only valid ways to invest and investors have poured record amounts of money into Index Funds and ETFs, particularly into 'Smart Beta', which is a troubling term given that beta is, by definition, rules-based. Media negativity about hedge funds particularly has reached levels we haven't seen since early 2000. Back then growth was the style mantra - inspired by Fed-fuelled liquidity and the internet bubble. In April of the same year Vanguard had become the largest mutual fund by AUM, alongside record-busting inflows and Julian Robertson's liquidation of Tiger Funds. His bets on value stocks backfired as investors turned their attention to a 'factor' - high-octane technology shares - pressure felt also by the likes of Woodford and Buffett at the time. Fast forward to today. Growth is once again the mantra. The Fed-fuelled liquidity bubble is in bonds. Vanguard just smashed their record for inflows in a single year (USD305B) and a high profile hedge fund - Perry Capital - recently closed their doors. Sound familiar?

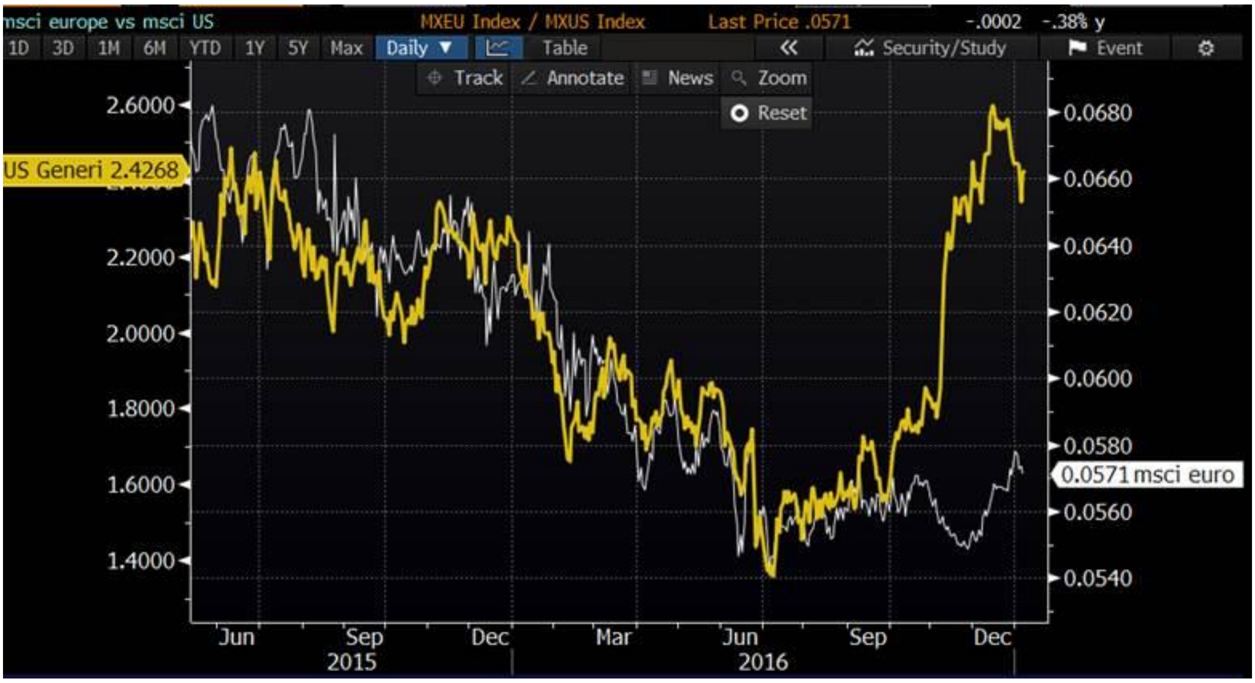
One of the issues faced in both periods was that forced buying from index trackers created market inefficiencies. In some respects the price mechanism malfunctioned as the market ignored whether an asset is good or bad, choosing instead to blindly chase the dominant factor, Technology in 2000 and bonds now. It's perhaps worth reflecting on what happened next. Following the astonishing rally from 1990 to 2000, the US stock market then compounded negative returns for the next 10 years. Yes, negative.

STARTING PRICE IS A KEY DETERMINANT OF FUTURE RETURNS

Should the bond bull market truly be over it's a pretty safe bet to assume the next 10 years in equities may not be like the last, especially so as bonds impact the discount factor and the market multiple. And as we all know one of the most powerful determinants of future returns is starting price. The starting price for US equities is not great. S&P profits are expected to hit a record this year and the multiple you pay for such is well above average. On Price/Sales (often preferred as sales figures are harder to manipulate), the S&P has only been more expensive once, in 2000. Granted, markets don't display any of the usual characteristics of a bubble, it's possible the discount factor could remain low indefinitely and stocks could travel much higher as a consequence, but they are, at least statistically speaking, expensive. Jeremy Grantham of GMO believes 2300 on the S&P represents a 2-Sigma event (two standard deviations above the mean). His best case scenario for stock returns over the next seven years is 2.8%. His worst case is -3%. Prof. Shiller's analysis of CAPE ratios probably concurs. This at a time the US currently accounts for c.40% of global equity value but produces less than 20% of its GDP. As Howard Marks once said, *"…when the future stops being like the past, extrapolation fails and large amounts of money are either lost or not made."* This could be one of those moments. Finally if Trump really does represent Reaganomics 2.0, we should look to the starting point of Reagan's time in government. Interest rates were over 20%, inflation was high and the starting PE on the S&P was 9x. Today interest rates are 75bps, inflation is low and the S&P trades on 18x. Not only that but the first two years of Reagan's term saw a significant recession, a decent bear market and an assassination attempt. Be careful what you wish for.

THERE IS AN ALTERNATIVE ("TIAA")

The idea of mean-reversion alone should have asset owners and fiduciaries dusting off a list of good Active Managers and true Alpha generators, especially so in Europe where the starting point is better as Europe is seldom this cheap versus the rest of the world. It's also worth bearing in mind that Europe is well positioned for reflation, if such continues, and is more value oriented than many other indices around the world. Its relative performance to the US shows clear correlation to rising bond yields although that relationship has completely broken down at present, no doubt to the uncertainty over the election calendar this year. See below: the yellow line is the US10Y, the white line is MSCI Europe vs USA.



Source: Bloomberg

A RETURN TOWARDS NORMAL IN EUROPE

While one must now consider politics more closely in assessing risk, as last year showed us not only was prediction fraught with failure but so too assessing likely outcomes. If you can't predict, it's better to prepare. A lot has already been written on the potential scenarios for France, Holland and Germany. We are not sure we can add to the topic save to observe that the significant discount Europe trades at to the rest of the world is largely due to this uncertainty. Until that clears the market multiple may remain depressed. That said, many European companies will continue to show good earnings growth, and if you can buy those cheaply we suggest you do. EPS momentum could be a rewarding factor this year and the latest PMI readings are consistent with this outcome. European earnings are going up. Europe generally has shown solid resistance in the face of a number of shocks. Credit growth is positive (the banking credit channel is very important as it represents most financing of SMEs/job creation). PMIs are more consistent with rate rises not NIRP or QE and it has quashed deflation. Central Bankers seem to have finally acknowledged the important role banks play in the transmission of money. By allowing the curve to steepen they help them *earn their way out*. Yes there are isolated pockets of risk, like Italy, but then valuations are low and a lot of these risks are discounted already, in our view. A weak Euro undoubtedly helps, acting like a safety valve and Europe's two biggest trading partners are both in recovery, with policies aimed at strengthening consumption. Should we now see a revival of fiscal stimulus like elsewhere in the world, corporate capex may follow which would have material impacts on the output gap, inflation expectations and of course unemployment. The Eurozone's unemployment rate has been gradually drifting lower and has finally fallen below 10%, currently at 9.8%. That is notfar from levels in 2004, nor indeed the average since 1989, of 9.6%. Should employment continue to grow, then the market may need a new narrative; one that includes 'normal' in the headline. Now, that's a word not common in investing parlance. It is a word not especially common when describing the valuations of things like banks which still trade below even their post crisis trends.

Should Europe regain favour, so too should its Fund managers

In the listed space we like **Jupiter AM** and even some of the banks have decent exposure, like **Natixis** (1/3 of profits) with plenty of USD exposure and a higher than average dividend. If Value continues to outperform **GAM's** purchase of THS last year might look very timely indeed, they being some of the better value managers we know. And if we are bullish on the prospects for active managers, we should be bullish on their value chain - the bourses and possibly the brokers. Maybe even ourselves? Finally, where I think real Alpha could be generated over the next 10 years could be in some of those well-known hedge funds who have just experienced their worst performance in years. Few things galvanise the spirit as much as reputation and self-interest.

TAKING THE BUFFETT BET, INVEST IN HEDGE FUNDS

Indeed it's often in times when a strategy is most loathed and reviled that it begins to outperform. Buffett made a bet in 2009 that an Index tracker would beat hedge-funds over the next 10 years. Short of a calamity, he's likely to win it. Were he to offer the same bet today, we would gladly accept it (if we could pick the managers). A number of hedge-funds have closed-end funds available to buy on the market, many of which trade at large (c.20%) discounts to NAV. **Man Group** in the UK (which owns GLG) is probably worth revisiting, and we think that if the market starts to reward good companies and punish poor ones, the ETF recently set up at Goldman Sachs to track hedge funds top positions could be worth looking at (**GVIP)**, especially versus the low-vol ETFs we mention below. Now may also be the time to pay more attention to the Event/Special Situation and Activist Funds, for many are hard-wired to identify value opportunities (spin-offs, M&A, restructuring) and then wait for, or create themselves, a catalyst. There are a number of these names probably worth further enquiry (e.g. **RWE, ThyssenKrupp, SCA, Volvo, Serco** and **ABB)** but we think the best expression of this in Europe is **Altice**. This could be one hedge-fund hotel worth staying at.

WHICH IS SMARTER ALPHA OR BETA?

Don't get us wrong, we think ETFs have a role to play. The Index ETFs provide a clean and easy way for investors to gain exposure to a particular market, sector or theme. Where problems occur is when they become so popular they begin to distort the investment merits of the securities they hold and concentrate risks in such a way that when they turn, they turn viciously. Take the low volatility ETFs in the US of which there are many. This strategy picks securities based on the volatility of their price and is the epitome of reflexivity; the more you buy it the lower the vol, the lower the vol the more you buy. For example, for 30 years **Exxon Mobil** never traded much below 10x or above 16x with an average around 11x. It's now on 38x. How can it be smart to buy things irrespective of their fundamentals or valuation? We don't believe it is. Smart Beta in this sense is oxymoronic in much the same was as 'clean diesel' or 'jumbo shrimp'. Only Alpha can be smart as it asks '*what if'*? What if rates go up and volatility rises? Indeed on our definition Exxon is not even 'quality' as its returns fell; on 38x we would sell it.

As an aside and in reference to what we discuss on buy-backs above, it's interesting to note that one of the best performing ETFs in the US last year was the S&P 500 Buyback Index (which measures the performance of the top 100 stocks with the highest buyback ratio). We wonder if that can repeat?

VALUE VS GROWTH - A REAL OR FALSE DICHOTOMY?

Our process usually starts with a theme or a driver and then works back to a stock. As such we don't consciously adopt any one investment style in our approach to stock selection but as others do it's important to be aware of the distinction.

Growth has been the predominant style for at least as long as QE has existed (arguably for longer as the discount factor has been falling for 35 years). *Lower for longer* has been the accepted mantra and the new-normal was for *sub-par growth into the foreseeable*. If growth stocks also generated consistent cash-flow they looked increasingly attractive vs. bond-yields. And of course, given low bond yields, the longer the duration their cash-flows were, the higher their PV.

Since the summer however we have been forced to consider an alternative narrative. As it's been a while, I spent most of December re-acquainting myself with the writings of Buffett, Howard Marks, Jeremy Grantham of GMO and Baupost's Seth Klarman. If I had to pick one who epitomises what I think is the true essence of value investing it's Klarman. But what they all share is that they don't buy stocks which are "cheap", but look for securities trading at low prices relative their intrinsic worth, the difference being the so called *margin of safety*. The idea is complicated however by different investors using different assumptions and time horizons when calculating value. One man's value stock can be another man's growth stock (Buffett and Coke is the classic example). Indeed, one often finds Lipper statistics with the same stocks appearing in mutual fund lists for both Value and Growth. It seems investment style labelling is a pursuit beloved of the consultants. Simplicity sells, although I question whether the complex nature of markets truly avail themselves to such distinctions. Things are never that simple which is why we prefer to avoid semantics, stay balanced and just pick stocks.

IS PRICE IS ALL THAT MATTERS?

Staying with Seth Klarman, **Baupost** has only had three down years in its 33 year history – mostly at or near market peaks. The last was 2015. In 1991 he wrote '*Margin of Safety'*, which developed a bit of a cult following and was considered the 'bible' of value investing at the time. Only a few copies were printed, making it hard to get your hands on and costing c.$800 on Amazon. (The British Library has a copy if you are interested). The essence of Klarman-style value investing is buying bargains ($1 for 50c), where value in relation to price, not price alone, determines investment decisions. At one price an asset is a buy, at another it's a hold and at another, it's a sell. Quality is irrelevant. Such a strategy requires patience whilst waiting for pricing dislocation to occur and cash to act when it does. For example, Klarman has returned $150 for every $1 invested over 33 years, and done so *because* he ran huge average cash levels (c.40%) not *despite* it. Cash provides optionality to *strike at the fat pitch.* But the near absence of bargains works as a reverse indicator as well. When they find there is little worth buying, there is probably much worth selling. For managers like Klarman and GMO's Jeremy Grantham, that's the position they find themselves today, at least it is in the U.S (refer to T.I.A.A., above). They were in a similar position just prior to 2000. Klarman compounded at over 16% from 2000 to 2010. The S&P compounded negative -1% over the same period.

For the vast majority of long only fund managers however it's hard if not impossible to be that patient. Quarterly redemptions see to that and investment mandates don't allow them to carry much cash. They are paid to invest. True value investing in that sense is hard to find in the mainstream. Instead most managers adopting this style are looking to be contrarian and swim in deeply out-of-favour areas, often in treacherous waters like low quality or deeply cyclical sectors in the hope that markets will mean revert. They want to buy from pessimists and sell to optimists. This can be powerful if combined with extreme pessimism and a lack of new negatives as for China and Miners in Q1, European Banks in Q4.

ARE THERE ANY 'BARGAINS'?

Howard Marks once said there is no investment so bad you can't fix it with the right price (and none good enough you can't ruin with the wrong one). George Soros believes the worse a situation gets, the less it takes to turn around and the greater the upside. In other words things don't have to get better, just less worse (this is akin to our own reference as to a *lack of new negatives*). Indeed one EM investor we know says she makes the most money when things go from truly awful to merely bad. They don't have to get 'good'. "*When everyone believes something is risky, their unwillingness to buy usually reduces the price to the point where it's not risky"* (Howard Marks). Now, we expect most will grow uncomfortable even at the thought of this approach. But those rare individuals with that sort of tolerance might be minded to look at Greek banks. They trade on about a third of their book values and many have cured their issues. UniCredit offers similar asymmetry notwithstanding the obvious risks to Italy and to Europe more generally (see aviatelive.com for more). Venezuelan property is another area we understand a few family offices are considering. Less risky perhaps are Brazilian bonds, if only compared to European equivalents. If you hold any Euro bonds with negative yields to maturity you are bound to lose money, and that's your best case. NIRP combined with rising inflation, not to mention a potential taper stands in contrast to Brazilian bonds with 11% yields with inflation falling. The Real would have to totally collapse for you to only break-even. If yields do compress the PVs of long-duration cash flows will improve which could support concession businesses, REITS and maybe even banks insofar credit growth should improve as rates fall and they have already taken enormous provisions over the past 12 months. Against this you would need to consider a lower carry, of course.

Within Europe, value in a broader sense can arguably still be found in a few sectors like Banks, Miners – if you mark to market - and Auto stocks. As most of you know, we think about Autos a lot (refer to our Peak Car thesis). Elsewhere, while we were bullish on China for all of last year, we now fear their attempts to tighten the property market, indeed tighten liquidity conditions generally, could impact commodities. Instead we prefer to express value and reflation characteristics through higher quality, more domestically exposed European banks. We were a buyer of several oil stocks for most of last year, remain buyers of a number of construction and infrastructure-related names (having first discussed the fiscal stimulus in April last year) and have a growing interest in Capex beneficiaries as discussed above.

THE LESSONS LEARNT FROM QUALITY COMPANIES

The concept of quality, as expressed in our Quality Cash Compounders idea and the associated baskets, is one of many themes that we have liked fora number of years. For us 'quality' transcends considerations as to the cycle, although this year taught us to be more aware of earnings inflections and to become ever more vigilant when assessing the durability of returns. The 2017 iteration will aim to learn from this and we plan to focus more on those names were valuations are lower and where earnings momentum is positive.

Our definition of quality captures not only growth businesses but also ones with some cyclicality. What's critical is they all have good cost control through the cycle and display an ability to grow their cash returns sustainably and compound those returns over time. It does not however identify bad nor deeply cyclical companies and so it is prone to periodic underperformance when the market's flirting with the latter. For those adhering to such a strategy, these episodes are simply an occupational hazard and can last for months if not years before regaining a premium. As Peter Lynch once said, *"In stocks as in romance, ease of divorce is not a sound basis for commitment."* Compounding requires *time* so we have always acknowledged these stocks would underperform periodically, warning of such in September. But over the very long term, and unless something changes with their ability to generate high cash returns, such companies should remain great long term investments.

And so, when the market misprices their odds of future success, it is an opportunity to buy more. In some instances that may be already occurring, especially so in franchises with large US business presence. They should benefit as much from Trump as their US counterparts, perhaps more so given the tailwind of a weaker currency. The fact that many have been de-rated, some even back to trend PE's, seems a decent re-entry point. After all 10 year yields have an awfully long way to go before they can be considered *at trend*. It could be years before they get there given the enormous and ever increasing debts of the U.S. government.

Another point we would make is these stocks are often misconstrued as classic Defensives when they're not. There are plenty that aren't your typical consumer/pharma 'quality' names, and some even express reflation characteristics. Quite simply, it's our attempt to identify 'great companies'. Over time, markets should reward great companies more than poor ones, assuming starting PEs are not overly inflated. In the same (in our view mistaken) way, the market, badges these as 'defensives' they also brand them 'bond proxies'. That's presumably on account of the reliable dividends many pay which are synonymous to the guaranteed income from a bond. But crucially over time dividends from these companies tend to rise, reflecting strong pricing power and the ability of these companies to pass on inflationary costs by raising prices. In this way the income stream from these companies is much more valuable than a bond because it offers protection from the ravages of inflation. So although it may make sense for equity yields in general to rise in reaction to rising inflationary expectations and falling bond prices, it seems irrational that the yields of quality companies should rise more as it is they that have the best chance of delivering inflation-proof returns over the long-term. Lest we forget that dividends account for the vast majority of investment returns over time.

It perhaps pays to remind oneself of the many secular themes that these companies express. The growth in emerging market consumption, to pick just one, is something we suspect is not lost on Brazilian billionaire Jorge Paulo Lemann who has been raising money recently. It would not surprise us to see his 3G Capital bid for any number of large consumer brands businesses, possibly together with Warren Buffett. If that occurred it might even highlight the comparative value opportunities in Europe. **Unilever** for instance is on 17x Y2 numbers and well positioned to benefit from a weaker currency. **Kraft-Heinz**, in contrast, trades on 20x and dollar strength should be a drag. While not a direct comp, **GSK** has a consumer business which if on a comparable multiple to these would mean you get the rest of **GSK** a lot cheaper than you currently do. And it's already pretty cheap on 13x Y2 with upgrades still likely. We remain buyers of **GSK.**

Finally**,** the era of Fed and central banks trying to influence the economy through lower rates is also unlikely to go away entirely, even over 20 years. Economic dogmas die hard, even in the face of evidence of failure. Think of all the unnecessary pain and misdirection from the idea of Rational Expectations and the Efficient Market Hypothesis. Accordingly, quality not only should work over the very long term, it provides a decent hedge to the idea the current enthusiasm for higher rates could be misplaced. Note a break of 3% is generally accepted to be the critical level on the 10yr by which it will be more accurate to say the bull market in bonds is truly over.

HOW OUR RESEARCH FARED IN 2016

On balance, our individual research ideas were very good last year, spread as they were across a broad range of styles, sectors and countries. We doubt much will change by virtue of a new calendar year, although our radar has a few new names in which we are interested. For more, we would suggest a meeting with our Head of Research, Paul 'Doc' Moran.

Our best performing Longs were **Melexis**, **Partners Group, ARM**, **Micro Focus** and **Ashtead**. Our worst, by far, was **Next**.

Of the Shorts **Ashtead** (a timely flip) and **Aryzta** were the standouts. The worst were **Elekta** and **Pearson** (although in fairness both are still significantly in the money as we have been short for some years).

Being China bulls, and having a few oil stocks and construction related names, we were somewhat insulated from the style rotation in the second half of the year, although we sold Staffers too early. In September we added some quality Banks and Dutch financials. We still very much like **NN Group** which we believe has failed to reflect the synergies of their recent deal. In early October we added yield steepeners such as **Generali** and we have been doing work on **Ageas** which also looks quite interesting.

We were reminded once again of how stocks masquerading as quality can get hit when there is an inflexion or change in fortune. We have developed tools that we think can help with this and we urge you to set up a meeting with Ameet Patel to discuss how they work. Currently **Coloplast** flags as one to watch. It would be a shame to see another great Danish company fall from grace after the year they have had (see **Novo Nordisk** and **Novozymes**).

Our Global TMT product lead by Neil Campling had an outstanding year in all three regions – European stock calls with **Logitech**, **Modern Times Group** and **Ubisoft (**all part of his eGaming thematic) worked very well. The Autonomous Vehicle primer, produced in October, outlined our views on a number of silicon and sensor plays, notably **Infineon** and **STM** none performing quite as well as **Nvidia** in the U.S which more than doubled. He called the consolidation in semiconductors early, which sadly meant he said goodbye to **ARM**, his longest standing buy call having liked it since £1/ share. He had great short calls on **Rocket Internet** and continues to provide balance for the many bulls on **Just Eat**, of which he remains a steadfast seller. For more from Neil, please contact us for his 2017 Themes piece and we would urge you to get onto the distribution list for his Global TMT Weekly.

THEMES WE REMAIN EXCITED ABOUT FOR 2017

There is a lot more we would like to discuss but have not the time to do so. Needless to say we remain excited by a number of themes, most you will find on AviateLive.com. We haven't mentioned Fiscal stimulus or construction much having turned bulls in April last year, but we remain positive, especially on **CRH.** We haven't mentioned the UK much either, our views seemly fairly consensual. We expect uncertainty until Brexit is negotiated. The consumer will face increasing pressure from a fall in real wages and so a spending hiatus on bigger ticket items could follow. Against that we still find opportunities in UK Homebuilders, especially **Persimmon**, and many of the exporters remain well placed in view of the fact sterling is likely to remain under pressure. Inversely linked to this, we expect more inbound travel - especially from China (Chinese Travel is an exciting theme on its own) which should benefit the likes of **Burberry, Ryanair** and **InterContinental Hotels**. Also inbound M&A is more probable given the improving terms of trade with the rest of the world, and the de-rating in many assets. **Imperial Brands** and **Imagination Technology** look vulnerable to us – the former is now quite cheap. Within Europe we find the liquidity withdrawal has created value opportunities in the mid-cap space and we are quite excited by the potential for a rebalancing in Germany, one that favours domestic consumption. So you can expect more from us this year on that space.

By way of more secular thematics we remain bullish on ***Vanity*** and remain focused on demographics. Other ***constants*** like ***Addiction*** generally and **BATS** in particular (*Heat not Burn* provides optionality). ***EGaming, eSports, AI, Robotics, The Need for Speed (Cable)*** and ***The Death of TV*** are still exciting Neil Campling. So too is the progression toward ***Autonomous Driving*** and ***EVs***, especially after **Ford's** recent plan to roll-out wireless charging facilities. We have discussed ***Peak Car*** since Nov 2014 so we don't feel it necessary to repeat again here. Needless to say we fear that some incumbent OEMs, especially those in Europe may face existential threats as time goes on. (Having cautioned on the **Fiat** short soon after Trump appointed a climate-change denier to the EPA we will be looking at that again quite closely over the coming weeks.) We want to remain structurally exposed to growth in emerging market consumption, especially aspirational purchases where ***Masstige*** (that being prestige but for the mass market) is a theme we have run for some years. One of the best plays on this is still **Pandora**. Linked to this is the huge growth in Chinese travel and we expect more M&A in that space, not least a continual re-rating of stocks exposed like **IHG, Ryanair** and **Amadeus**. More exciting themes include Super bugs (**GSK**) and Genomics (**Qiagen**) which we have discussed in the past and expect to again in future. In time we hope to look more into Autonomous Flight as well (**BAE Systems**).

FINAL COMMENT

So, as we reflect on 2016 and look ahead to the future we do so with some cautious optimism, if only to the state of our own industry. Ironically, what may be good for the economy could be bad for markets but nevertheless it should help to increase dispersion across asset classes, a context in which alpha-generators and especially hedge funds should flourish.

With that, I will close by thanking you for your custom in 2016. We wish you every success for the coming 12 months, thank you for reading this outlook and I hope to see you soon to discuss the ideas, themes and issues highlighted above.

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