PetersMacGregor
GLOBAL FUND



## Fund Facts

| | |
|---|---|
| Portfolio Managers | Wayne Peters<br>Michael Haddad |
| Structure | Global Equity Fund<br>$AUD unhedged |
| Inception Date | 10 September 2004 |
| Fund Size | A$103.7 million |
| Recommended Investment Timeframe | 5 years plus |
| Distributions | Annual, 30 June |
| Management Fee[1] | 1.35% p.a. |
| Performance Fee | Nil |
| Buy / Sell Spread | 0.10%/0.10% |
| Benchmark | Unaware |

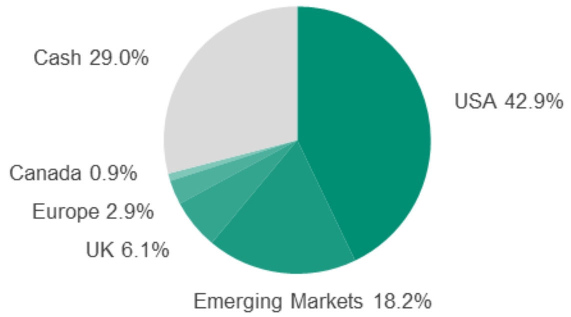
## Top Holdings

| Stock | Sectors |
|---|---|
| Amerco | Transportation |
| Berkshire Hathaway | Multi-sector Holdings |
| Fairfax Financial | Multi-line Insurance |
| Liberty Broadband | Cable |
| Liberty LiLAC | Cable |
| Liberty SiriusXM | Satellite |
| Lloyds Banking Group | Diversified Banks |
| PayPal | Information Technology |
| Twenty-First Century Fox | Movies and Entertainment |
| Wells Fargo | Diversified Banks |

## Fund Features

| | |
|---|---|
| Investment Style | Value |
| Portfolio Composition | 15-30 stocks, up to 30% cash |

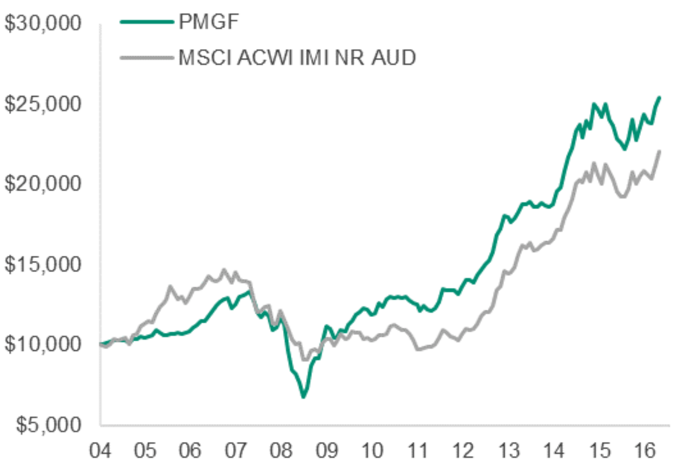
## Geographical Exposure by Revenue[2]




## Fund Performance[3]

| | Fund % | Index %[4] | Excess % |
|---|---|---|---|
| 1 month | 2.25 | 4.24 | -1.99 |
| 3 months | 6.46 | 7.02 | -0.56 |
| 1 year | 7.55 | 8.87 | -1.32 |
| 3 years (p.a.) | 10.64 | 10.78 | -0.14 |
| 5 years (p.a.) | 15.92 | 17.50 | -1.58 |
| 7 years (p.a.) | 12.83 | 10.95 | 1.88 |
| 10 years (p.a.) | 8.25 | 4.72 | 3.53 |
| Since inception (p.a.) | 7.87 | 6.64 | 1.23 |
| Total return since inception | 154.09 | 120.63 | 33.46 |

## Growth of $10,000 Since Inception




*[1] All fees are inclusive of the net effect of GST*

*[2] Peters MacGregor may on occasion, hedge against movements in the Australian dollar and other currency exchange rates, but the default position is to remain unhedged. Regional revenue breakdowns are approximations.*

*[3] Performance figures are calculated using exit unit price to exit unit price for the given period. Intra year performance figures are unaudited. The returns are net of management fees. They do not include franking credits.*

*[4] MSCI ACWI IMI NR AUD*

## Monthly Performance (%)

| Financial Year | Jul | Aug | Sep | Oct | Nov | Dec | Jan | Feb | Mar | Apr | May | Jun | FYTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2004-05** | | | 0.16 | 0.95 | 1.08 | 0.57 | -0.36 | 0.51 | 0.06 | -1.70 | 2.02 | 0.63 | **3.94** |
| **2005-06** | 1.02 | -0.26 | 0.33 | 0.93 | 3.08 | -1.76 | -1.17 | 0.12 | 0.14 | 0.14 | 0.83 | -0.32 | **3.02** |
| **2006-07** | 0.58 | 0.94 | 1.95 | 1.66 | 1.60 | 0.42 | 2.48 | 2.54 | 3.00 | 1.86 | 1.05 | 0.76 | **20.52** |
| **2007-08** | -4.98 | 1.82 | 3.93 | 0.89 | 0.29 | 1.71 | -5.42 | -4.54 | -2.49 | 2.70 | -2.01 | -8.03 | **-15.66** |
| **2008-09** | 1.55 | 5.28 | -2.89 | -14.76 | -12.58 | -2.26 | -7.60 | -11.11 | 8.79 | 17.70 | 6.27 | -0.41 | **-15.83** |
| **2009-10** | 11.63 | 9.30 | -1.28 | -5.05 | -0.18 | 4.37 | -0.32 | 3.42 | 2.31 | 2.97 | 1.64 | 2.08 | **34.26** |
| **2010-11** | -0.81 | -2.86 | 0.87 | 5.45 | -1.95 | 4.17 | 0.87 | -0.25 | 0.33 | -0.30 | 0.61 | -1.88 | **4.02** |
| **2011-12** | -1.50 | -0.39 | -3.66 | 2.59 | -1.32 | -0.83 | 1.11 | 3.07 | 6.64 | -0.95 | 0.22 | 0.01 | **4.67** |
| **2012-13** | -1.44 | 3.56 | 2.53 | -0.09 | -1.01 | 3.58 | 1.96 | 2.33 | 1.84 | 3.37 | 6.90 | 2.33 | **28.83** |
| **2013-14** | 4.41 | -0.49 | -1.71 | 1.38 | 2.26 | 2.74 | 0.02 | 0.86 | -1.83 | -0.05 | 1.27 | -0.69 | **8.28** |
| **2014-15** | -0.37 | 0.76 | 4.46 | 1.21 | 4.90 | 4.21 | 2.61 | 4.87 | 1.82 | -3.59 | 4.52 | -1.88 | **25.70** |
| **2015-16** | 6.53 | -1.39 | -2.03 | 3.38 | -3.75 | -1.70 | -3.25 | -1.29 | -1.65 | 3.01 | 4.95 | -5.20 | **-3.09** |
| **2016-17** | 3.69 | 3.37 | -2.09 | -0.44 | 4.59 | 2.25 | | | | | | | **11.73** |

## Introduction

The Peters MacGregor Global Fund returned 6.5% net for the December quarter, slightly underperforming the MSCI which increased 7.0%. But rather than focus on the quarter, let's review the unpredictable year that was 2016.

In May last year, journalist Barry Ritholtz explained that, 'In "Adventures in the Screen Trade," screenwriter William Goldman wrote that "nobody knows anything."'

'The book's first mention of that line, which is repeated throughout, referred to the many studios that passed on films that would go on to be blockbusters. Every studio in Hollywood but one (Paramount) turned down "Raiders of the Lost Ark." It became one of the highest-grossing films of all time, and was nominated for nine Academy Awards. "Star Wars" was passed on by the largest Hollywood studio at the time, Universal. It grossed $1 billion, and spawned a franchise with five films that are in the all-time top 100 in gross box office sales. Eventually, Walt Disney Co. purchased the Star Wars production company Lucasfilm, for more than $4 billion.'

## Here's looking at you 2016

Looking back, 2016 made it seem like nobody in financial markets knew much of anything.

It started with a flood of chilling headlines, including *'U.S. stocks post worst 10-day start to a year in history'*, and *'Markets suffer their worst start to the year since Great Depression'*. Things only got worse as the S&P500 index fell to 1,829 on 11 February, down 14% from the previous high in July and 11% for the calendar year.

The laundry list of worries was long. Stock valuations were high relative to both history and the low expected earnings growth of a range of industries beset by excess supply and pricing pressures. The low oil price toppled the shale boom, then rocked the finances of the world's big oil producers, including Russia and Saudi Arabia.

To repair its budget, the Saudi government announced plans to float 5% of its stake in state-owned Saudi Aramco, the world's biggest oil producer and potentially the world's most valuable company at over US$2tr. After predicting an oil price of US$150 per barrel just a few years back, Goldman Sachs's forecast collapsed to potentially as low as US$20.

China's gargantuan stockpile of foreign reserves was also forecast to be depleted in just a few years, as the country's bankers defended the Chinese yuan's currency peg to the US dollar while capital fled the country.

Chinese companies and citizens were desperate to get their money out of China before a major devaluation, as the government was determined to reduce its reliance on short-term measures to boost economic growth (such as debt-fuelled stimulus policies aimed at the housing sector) in favour of a more sustainable consumption-led economy. The iron ore price dropped by a third in sympathy to US$40.

It seems like ancient history now, but Armageddon never came. China quickly back flipped returning to its debt-fuelled stimulus policies, despite one yuan of economic growth now reportedly requiring six yuan of debt, compared to one yuan up until 2008 and two yuan between 2009 and 2010. House prices in some areas reportedly increased over 30% in 2016, despite the lack of current dwellers.

**S&P500 index up ~7% since Trump's election victory**
Image: Gage Skidmore

Trump defied the sceptics becoming America's 45th President. In contrast to the doomsayers that tipped the market would crumble if Trump was elected, the market liked his pro-American growth policies, and his dislike of regulation and the Fed's ultra-low interest rate policies.

The S&P500 index finished the year up 9.5%, and has increased ~7% since America voted in Trump. With the major oil producing countries working on plans to cut production, oil finished the year up 89% from its low and 32% for the year. The iron ore price virtually doubled to US$80 per ton.

We'll return to how the 'Trump Bump' has impacted the portfolio, but with so much happening in 2016 that seemed unimaginable not that long ago, it suggests William Goldman would've made a good investor.

The key point from this brief retrospective is that our edge as investors is not making bold forecasts about the highly unpredictable, but rather the comparatively mundane job of identifying undervalued businesses and holding firm until the market agrees with us. To the extent that negative headlines help create opportunities, all the better.

This may not seem particularly sophisticated in an age of quantitative funds, big data and robo-advice, but the stockmarket has never been captivated with old fashioned ideas like buying for the long-term. It simply isn't exciting enough.

## Finding your edge

In a 2007 speech, Seth Klarman neatly encapsulated why value investing works.

'Institutional constraints and market inefficiencies are the primary reasons that bargains develop. Investors prefer businesses and securities that are simple over those that are complex.'

'They fancy growth. They enjoy an exciting story. They avoid situations that involve the stigma of financial distress or the taint of litigation. They hate uncertain timing. They prefer liquidity to illiquidity. They prefer the illusion of perfect information that comes with large, successful companies to the limited information from companies embroiled in scandal, fraud, unexpected losses or management turmoil. Institutional selling of a low-priced small-capitalization spinoff, for example, can cause a temporary supply-demand imbalance. If a company fails to declare an expected dividend, institutions restricted to owning dividend-paying stocks may unload shares.'

'Market inefficiencies, like tax selling and window dressing, also create mindless selling, as can the deletion of a stock from an index. These causes of mispricing are deep-rooted in human behaviour and market structure, unlikely to be extinguished anytime soon.'

Provided humans govern markets, share prices will be far more volatile than the value of the businesses they represent. The following table shows the difference between the 52-week low and high for the 10 largest US stocks in 2016.

| Stock | Share price high | Share price low | Difference |
|---|---|---|---|
| Apple | $119 | $89 | 29% |
| Microsoft | $64 | $48 | 29% |
| Exxon Mobil | $95 | $72 | 29% |
| Johnson & Johnson | $126 | $94 | 29% |
| Berkshire Hathaway | $167 | $124 | 30% |
| JPMorgan Chase | $87 | $53 | 50% |
| Amazon.com | $847 | $474 | 57% |
| General Electric | $33 | $27 | 20% |
| Facebook | $134 | $89 | 40% |

**2016 lows and highs of the largest stocks in S&P500**
Source: Morningstar Direct

You may argue those stocks have simply gone from over-valued to extremely over-valued, but the crucial point is that regardless of the macro-economic environment, or which government is in power, the market is always producing opportunities for diligent investors alert to the difference between a company's share price and its intrinsic value.

As an aside, sitting alone in a room connecting the dots is a far more valuable use of time these days than searching for incremental information that's of little help. Where 20 years ago you could make decisions based on superior information, your edge today is more likely found in avoiding the distraction of useless information saturating markets. The cure is finding reliable indicators of superior returns, such as insider ownership, competitive advantages, low valuations, and shutting everything else out.

While hedge funds are using drones to count the cars driving over bridges or to measure crop yields, our edge has, and always will be, in controlling the behavioural aspects of investing. Put more simply, it means applying judgment to long-term scenarios, and preferring a higher lumpy return than a more consistent, but lower one.

## 2016's star: Passive investing

Despite the current popularity of passive strategies reflected in The Wall Street Journal's October obituary, 'The Dying Business of Picking Stocks', there are two reasons why this reflects a long bull market rather than a superior form of investing.

Chart 1 shows that not only has long-term investing not become more popular over time, short-term trading is as popular as ever. Holding periods were once measured in years, now the New York Stock Exchange puts it at eight months, while some estimates have shrunk to four months.

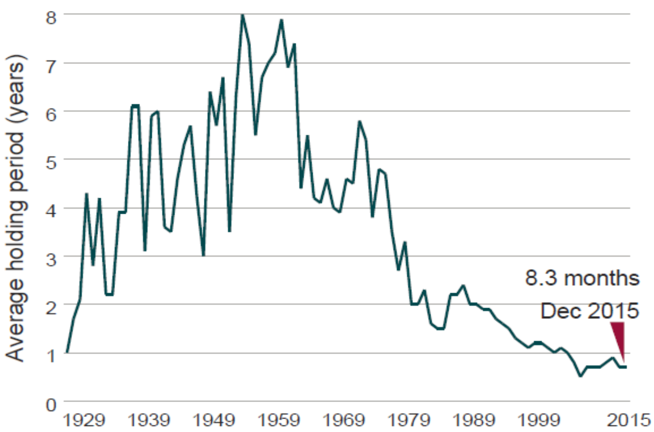



**Chart 1. Shrinking stock holding periods**
Source: MFS, Ned Davis Research

It flies in the face of legendary investor Jesse Livermore's wisdom, that 'It was never my thinking that made the big money for me, it always was sitting.'

Chart 2 shows how the flood of money into passive investment strategies continued in 2016. Morningstar estimates investors have withdrawn $303bn from actively managed funds over the past year and invested $437bn in passive funds (defined as index mutual funds and index ETFs).

In 2015, Citi also reported that passive funds were responsible for 31% of all trading in US stocks by dollar value, almost doubling since 2005. Remember this when you compare us, or any fund manager, to an index over a relatively short period.

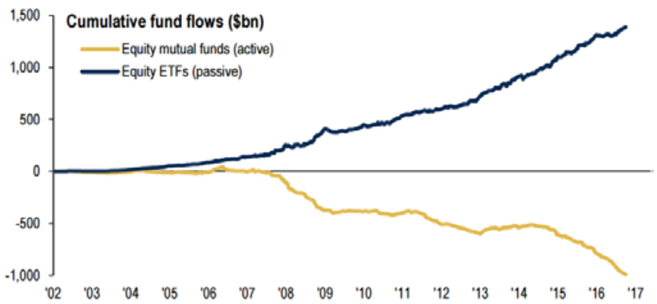



**Chart 2. Funds flows into active and passive funds**
Source: BofAML Global Investment Strategy, EPFR Global

ETFs alone are unlikely to cause a crisis, but they will accentuate volatility during the next major downturn as they race each other to sell stocks to rebalance.

More importantly, though, the combination of shorter holding periods and trillions of dollars trading on momentum via ETFs instead of intrinsic value will eventually provide wonderful opportunities for value investors to distinguish their returns vis-à-vis the major indexes. Patience in this regard should be measured in cycles, however long, rather than a few years.

Jim Grant, author of *Grant's Interest Rate Observer*, observes that 'Progress is cumulative in science and engineering, but cyclical in finance'. Long-term active management is currently out of favour but, unlike a pair of rainbow coloured happy pants my Mum once bought me, it will eventually come back into fashion when investors start putting risk before return.

## The Trump Bump

No one rings a bell at major turning points in markets, but Trump's election victory may have marked the end of the 30-year bull market in bonds. The US 10-year bond yield has increased from 1.5% to 2.5% in just five months, which is a huge move for this market. It's little wonder our financial holdings have finally broken out of their recent trading ranges.

Predicting how stock prices will react to Trump's proposed agenda of large infrastructure funding, less regulation and lower taxes, among other things that will face varying levels of resistance, is impossible.

A more inflationary and higher-growth environment has so far excited the market, but higher interest rates could reduce valuations for all manner of securities and investments. Of far more practical relevance is the impact it has had, and may have, on the businesses in our portfolio.

At the time of writing, since election day on 7 November, the share prices of our US financials, including **Bank of America**, **Wells Fargo** and **AIG**, and to a lesser extent **Berkshire Hathaway**, have increased 33%, 23%, 10% and 12%, respectively, as the market bakes in a 1-2% increase in interest rates. Trump has openly criticised Fed Governor Janet Yellen and the Fed's ultra-low interest rate policies, though he may yet want Yellen in charge to shoulder the blame if the economy turns down.

While it's nice to have near-term catalysts that can unlock the value of a stock, sometimes just being cheap is its own catalyst. We've owned this group of US financials for many years, as we believed their franchises were being undervalued by a market myopically focused on high growth stocks. We certainly didn't expect a Trump presidency to catalyse their value, but good things usually happen to cheap businesses. Eventually.

There may be good news to come for our holding in **Liberty Broadband**, too, through its major shareholding in America's second largest cable company, **Charter Communications**. While Trump's policies mentioned above require legislative action, most likely following long delays due to opposition, it will be much easier to appoint a new member or chairman at the Federal Communications Commission (FCC) after chairman Tom Wheeler recently resigned.

Wheeler was an ardent supporter of Net Neutrality laws, which prevents broadband providers from charging larger users more i.e. it ensures equal access to all, even if your next-door neighbour wants to binge watch Netflix for 24 hours and you only want to check the latest news headlines (54% of all internet traffic is allegedly used by Netflix and YouTube).

A change at the FCC may give Liberty Broadband, via Charter Communications, more pricing power that will fall straight to the bottom line.

## Portfolio changes

Over the past year and quarter the Fund has slightly lagged the index, but more importantly the past 18 months has been a period of rejuvenation for the portfolio. We've added 12 new names and reintroduced moving rental and storage business **Amerco**.

Normally three or four good ideas each year will suffice, so it's been an unusual period of opportunity. By comparison, the final quarter of 2016 was quiet. There were three major changes.

First, **Liberty Expedia** was spun out of **Liberty Ventures**. Liberty Ventures is a holding company that essentially boiled down to a two-thirds holding in America's second largest cable company, Charter Communications, and a one-third holding in online travel booking company, **Expedia**. We explained the investment case last October in *Making a reservation with Liberty Ventures*.

While Liberty Ventures' discount to the value of its underlying holdings hasn't closed since the spin of Liberty Expedia, eventually we expect CEO Greg Maffei will pull the necessary levers, such as buying back stock, to close it.

In the interim, we are excited about the opportunities Charter Communications CEO Tom Rutledge has to significantly increase the company's cashflow by combining the existing Charter Communications cable and broadband network with those of recent acquisitions Time Warner Cable and the much smaller Bright House Networks.

Second, we established a position in social media company **Twitter** (see *Stock in focus* below).

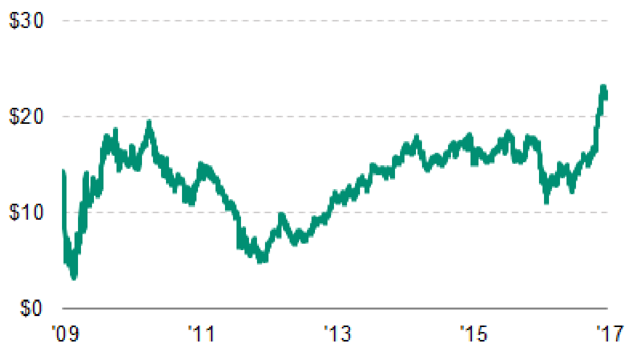
Lastly, we sold long-term holding Bank of America, which is worth reviewing in a little detail to understand why long-term investing still works.

## Lessons from a long-term holding

Bank of America

The ups and downs of Bank of America, particularly over the past three years, is a perfect example of how taking a long-term view can give you a huge edge over the market.

By 2016 it was easy to grow tired of this stock. It traded between $15 and $18 throughout 2014 and 2015, but then fell by a third to below $12 within two months, corresponding with the market-low for 2016 in mid-February. That might not seem like such a drastic fall, but it was equivalent to a loss in value of US$60bn.




**Bank of America share price, 1 Jan 2009 to 1 Jan 2017**
Source: Capital IQ

For the most part it seemed interest rate expectations were driving the share price. As the Fed waxed and waned about when interest rates would finally start their upward journey, so did the company's share price.

Banks are very profitable when the yield curve (i.e. the future expected path of interest rates) is upward sloping, as banks borrow at lower rates via deposits, and lend at higher rates for mortgages etc. over much longer periods. The spread is the bank's net interest margin, which has been squeezed by low interest rates and a flat yield curve. For context, Bank of America's pre-tax profit would increase by roughly 20%, or US$4.5bn, for every 1% parallel shift in the yield curve.

Business progress was also slow, as chief executive Brian Moynihan eventually dealt with the overhang of litigation from mis-sold mortgages prior to the GFC. By 2015 the big cost cutting programs were becoming more incremental, and the housing market is still only recovering at a glacial pace.

Even Moynihan was beginning to rely on interest rate increases to boost return on equity to the magic 10% figure, which would increase earnings per share to around two dollars and justify a $20 stock price based on a conservative 10 times earnings. If the economy picked up steam, interest rates increased by more than one percent, or the housing market improved, the company would be worth more.

The investment case was clear but few were willing to hold the stock as it was boring, progress was slow and many were unprepared to invest before interest rates started increasing. Despite the huge margin of safety the stock offered at various times, the problem of waiting to invest is that you missed the run from $12 in February to $22 today (we sold around $20).

Can the market always be considered efficient when, within the space of 10 short months, the market value of one of the world's most highly covered, largest and well known businesses fluctuated between US$120bn and US$230bn? Did this company's intrinsic value really vary in such a short window by such a huge amount?

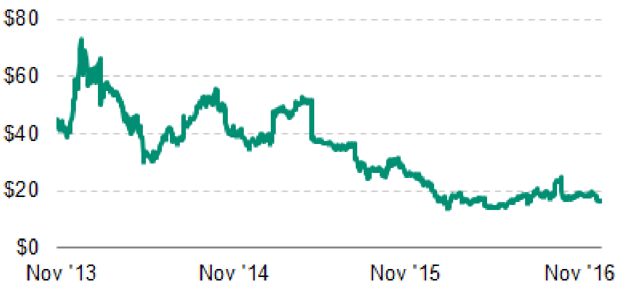
Any analyst worth their salt can analyse and build a model to value a company like Bank of America given the huge amount of information it publishes every quarter. But in Livermore's words, few are prepared to sit tight and buy when most others are selling. Whatever 2017 brings, this is how we will continue to manage your money.

## Summary

Summing up, during the December quarter the Peters MacGregor Global Fund achieved a strong 6.5% absolute return. If you, a friend or family member are considering diversifying overseas, please consult your financial adviser or feel free to call Alex Haynes, Head of Distribution, on +61 2 9332 2133.

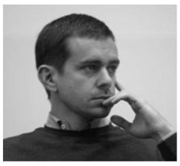
## Stock in focus: Twitter

Social media company Twitter has largely been left for dead, down 37% since its initial public offering at $26 on 7 November 2013, and 70% after reaching a high of $70 a month later. Discussions to sell the company in September amounted to nothing.




**Twitter share price since listing**
Source: Capital IQ

Twitter's problems are many. First, the CEO's office has been a revolving door starting with founder Jack Dorsey in 2007 and 2008, Ev Williams until 2010, Dick Costolo until 2015, and then back to Jack Dorsey. Further complicating matters, Dorsey remains the CEO of Square, which sells the funky modern equivalent of cash registers. Twitter has perhaps been best described by Facebook CEO Mark Zuckerberg, as 'a clown car that drove into a gold mine and fell in.'



**2007-2008**
Jack Dorsey

**2008-2010**
Ev Williams

**2010-2015**
Dick Costolo

**July 2015**
Jack Dorsey

**Twitter's revolving door of CEOs**
Source: Twitter

In 2007 and again in 2008, Facebook tried to buy Twitter but was turned down. Zuckerberg then replicated the best live features Twitter had, such as 'following' instead of 'friending', aggregating reactions to common stories and hyperlinking hashtags.

Despite management's best efforts, it seems Twitter cannot be killed. The resilience of a business despite mis-management is usually a clue that you've found a potentially great long-term investment.

Social media is considered a winner take all industry due to network effects i.e. the more people who join a social media platform, the more useful it becomes, in turn attracting more people.

As Facebook has become more ubiquitous, however, some users are limiting what they post publicly. This leaves the door open for others to create valuable niches, such as LinkedIn (used for professional relationships), Snapchat (which allows you to post a photo for 10 seconds before it disappears without a trace – particularly good for those regrettable Christmas party photos) and Twitter, which focuses on instant communication restricted to 140 characters.

### Should Dorsey remove the 140 character limit?

Twitter's self-imposed character limit has created an unrivalled ability for newsmakers and their followers to communicate. While it limits Twitter's potential and leaves the door open to competition, changing it risks what makes Twitter great: the speed of communication and its consumption by a wide audience.

The potential solution is second level tweets, which would supplement the 140-character limit with a link to longer form content. This could greatly improve the company's value to advertisers, as people spend more time on Twitter.

The company's recent belated moves to silence trolls (the name given to people posting hate speech and other degenerate material) should also make it more attractive to advertisers that will continue to switch their marketing budgets away from linear TV, for example. Twitter's recent experiment streaming live National Football League matches is also gaining momentum, quickly increasing its audience from around 2 million to 3 million for matches.

### Focus on the right metric

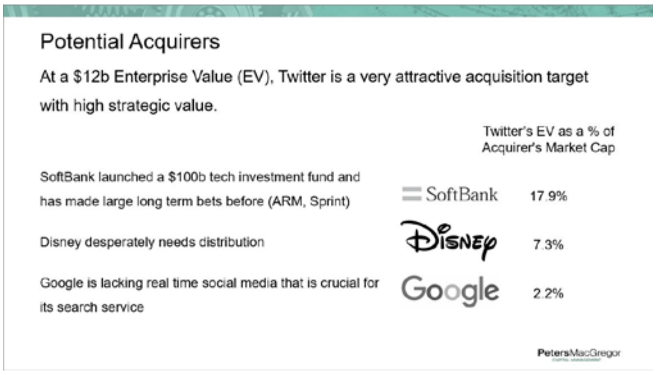
We also believe the flat total monthly user growth numbers belie the increasing value of Twitter to its most valuable contributors and followers, which is a far better guide to the company's value.

Unlike a closed system such as Facebook, Twitter's content is accessible without an account making comparable social media metrics less applicable. A more relevant metric is daily active user growth. Over the past three quarters this has increased from 3% to 5%, and most recently 7%.

Despite revenue growing at 27% over the past year and having multiple avenues for growth, the company must also cut costs. In 2015, $800m was spent on research and development, up from just $29m in 2010.

Yet the user experience has barely changed and is littered with easy fixes users are crying out for. If operating profit margins can approach 40% (still below Facebook's), the stock would be trading at under 13x pre-tax income, less than half of what Facebook currently trades on.

Should management botch things yet again, the company's cash-rich balance sheet, absence of dual class share structure with super voting rights, and miniscule market value compared to other social media companies should eventually make it a takeover target, potentially limiting our downside. A classic case of heads we win, tails we shouldn't lose too much.




**Potential candidates that could takeover Twitter**
Source: Peters MacGregor internal research slides

*Disclosure: Peters MacGregor Capital Management Limited holds a financial interest in Twitter through various mandates where it acts as investment manager.*

## Further reading

- *Investment update – November 2016 (video)*
  https://petersmacgregor.com/news-insights/videos/investment-update-webcast-november-2016/
- *Liberty Ventures*
  https://petersmacgregor.com/news-insights/investment-insights/making-reservation-liberty-ventures/