Introduction

Your portfolio was down 10.4% for the month of December compared to a 10.3% fall by the index. During the quarter ending 31 December 2018, over the past year your portfolio decreased 9.9% versus the MSCI's 0.6% increase.

General Commentary

The top-heavy MSCI finally caught up to many of its broad components this quarter registering a 10.3% decline while many component markets and sectors are now in bear market territory (down greater than 20%). Market participants are discounting greater concerns around the health and risk profile of the global economy. And – we believe – rightly so.

A number of factors are coming together in a way that we believe will present continued challenges to valuations into 2019. Specifically, the US has a Fed Chairman now whom we believe to be independent, conservative and prudent. Jerome Powell has adopted a generally hawkish position and seems intent on re-setting expectations around both interest rates and quantitative easing. Having taken a hard-line in December, he's subsequently softened his stance with regards to interest rates and Quantitative Tightening, and we feel this is a fair reflection of what the 'market' has been telling us in terms of economic activity and risks.

The Fed with its cheap and easy money may have contributed to asset price bubbles, but when markets eventually roll over, an accommodative Fed really does little to soften the blow. We watch with interest.

Against a backdrop of tightening monetary conditions, major declines to oil prices and the recent easing of long-term interest rates can both be seen as stimulatory for the economy. But more concerning is their predictive quality for the periods ahead. The strong US economy of late has been to a large degree supported by job creation in the energy sector – jobs that are increasingly marginal and at risk with lower oil prices. Declines to the 10-year rate in the face of rising short rates, too, signify the risk of yield curve inversion, which generally precedes economic recessions.

Having been teased into 'optimising capital structures' with cheap and readily available debt, including to repurchase richly valued equity, many companies are carrying excessive leverage and pose real risk to both debt and equity holders.

A tighter and more expensive credit environment, together with slowing economic activity could become the death knell for many firms in the periods ahead.

We believe a Keynesian approach to economic management makes sense. During the good times, governments should run surpluses and build the firepower to then pivot and be able to run deficits to help mitigate the effects of private sector downturns. It's just sensible. But the situation we find ourselves in today is of governments – and the US government in particular – having lowered taxes, increased spending, and effectively pushed budget deficits to unprecedented levels not during recessionary conditions but rather right at the *peak* of economic activity. Where does that leave them during the downturns?

Against the precarious backdrop of a hawkish Fed, worsening macroeconomic conditions, spent corporate balance sheets, and a government debt and deficit profile which leaves little room for fiscal stimulation, investors are increasingly forced to contend with disruption to business models and greater dispersion of outcomes among individual stocks.

Portfolio Commentary

Given our concerns around the broad economic and market environment, we took the decision this past quarter to materially increase cash across client portfolios. For risk management reasons driven by a combination of the concerns outlined above, as well as internal changes to our investment team resulting in reduced coverage of certain names in the portfolio, various positions have been exited or trimmed back across the portfolio. As a consequence, we're presently carrying an unusually high level of cash at approximately 70%. We expect this to be a relatively temporary status as we continue to do work on a number of companies that we'd like to own at appropriate prices. Given the precarious market environment we believe we've now entered, together with valuation levels that remain relatively high and discount relatively low broad market returns for the decade ahead, time is on our side and patience will – in our view – reward our long-term investors as we seek to deploy portfolio cash into great opportunities.

It is also important to note that while cash has been raised, this is substantially held in US dollars and thus in its own right delivers much of the 'global' diversification desired.

While we've substantially increased cash in the portfolio, we do continue to own a number of quality businesses at attractive prices. Two of which – newly purchased Apple and longer-held Discovery – are profiled in *Stocks in Focus*, below.

Conclusion

We've been in this business for nearly 20 years and have always taken a long-term view with the management of clients' hard-won capital. Even though we have clearly trailed the broader index in recent times, longer-term returns have been robust and these have been achieved in a way that is different from the underlying indices. We have returned a compound 11.9% p.a. after fees for the past 10 years, comfortably ahead of the index's 9.3% p.a. return.

We appreciate your ongoing support and as usual, please feel free to contact us at any time.

Stocks in Focus:

Apple

The fund recently initiated a position in Apple. Although this is one of the most widely covered stocks in the world, we feel the market is overestimating the risk of the smartphone segment declining and under appreciating the strength of Apple's ecosystem.

Through years of exceptional design and execution, Apple has accrued a tremendous amount of mindshare and goodwill with its consumers. Although Apple has many competitors, it has a total monopoly on iOS *(its operating system)*.

With every service that an Apple member begins using, the company's moat grows a little wider. To name a few: iCloud, iMessage, the App Store, FaceTime, KeyChain, Apple Music, iTunes, AirPods and the unrivaled Apple Watch. Apple consumers are increasingly locked into the Apple ecosystem, ensuring a high probability of recurring revenue.

The easiest way to demonstrate this 'lock-in' thesis is to ask a current iPhone user what they would do if they lost their phone. Nearly everyone we have talked to has said they would "just buy another iPhone." Any other major household purchase would see the consumer compare models and shop around for the best deal, but a repeat iPhone purchase is a no brainer.

We are mindful that Apple is not perfect and acknowledge the company is significantly behind in the smart speaker market. By mistakenly focusing only on a high end smart speaker like the HomePod, they priced themselves out of contention for the vast majority of consumers and further entrenched Amazon as the connected home leader.

However, we think it's premature to call Apple as having completely missed this opportunity. A significantly lower priced HomePod mini is expected to be released in the first half of this year which should lift their market share and encourage developer support.

Also, at last week's CES expo in Las Vegas, Apple stunned the audience by announcing its proprietary streaming protocol, AirPlay, *(which lets users stream media from their iphone to their TV)*, will be coming to multiple third-party manufacturers like Samsung, LG and Sony. This follows a late December announcement where Apple said the Amazon Echo would now support Apple Music. Although not widely focused on by analysts, these small moves to accept the reality of consumer demands is an extremely important indication that management is flexible and adapting to the marketplace.

At just 11x earnings, Apple trades near one of the lowest points in its history and is at more than a 25% discount to the S&P. In our view, the market has unduly punished the shares to a level that provides ample margin of safety for investors to buy a great business, at a great price.

Discovery

While the market continues its praise of Netflix, we feel the more exciting media investment is Discovery Communications. Discovery owns a number of unique brands with Discovery, TLC, HGTV, Animal Planet and The Food Network being the most well known. Investors are concerned about cord-cutting as Netflix, Amazon and YouTube continue to take share. However, we feel the market is not digging deep enough into the underlying economics and is offering a compelling investment opportunity for investors.

In line with our expectations, cord-cutting continued to increase in 2018. In the third quarter, more than 1 million customers in the US cancelled their cable TV or Satellite subscription. This brings the amount of US cord-cutter households *(and cord-nevers)* to 10.8m, up from 8.9m in Q3 2017 and 7.5m in Q3 2016.

It is understandable why consumers are cancelling their traditional TV service. As of 2018, the average monthly cable bill in the US was $107; up more than 50% since 2010. The higher cost has been primarily driven by increasingly expensive sports channels which distributors force into the bundle to retain customers.

However, many cord-cutters are unwilling to skip their favorite programs, consequently lower cost "skinny bundles", which have just 50 channels instead of the traditional 200, are demonstrating strong growth. US leader, Hulu is on track for a 35% increase in subscribers to 23 million in 2018. It's this transition from the traditional TV bundle to the skinny bundle that we expect will push Discovery's results beyond its peers.

There are hundreds of scripted series online with Netflix and Amazon Prime but only one company that carries unique programs like Shark Week, House Hunters or even 90 Day Fiancé. Unlike traditional broadcast networks, Discovery is not available to cord-cutters via free to air antenna. This 'must see' content means Discovery is in high demand from skinny bundles and should finally close the gap for its ad rates relative to its peers. Discovery CEO David Zaslav touched on this point at a December media conference disclosing their existing ad rates on traditional bundles monetized at just 40% of the broadcast networks *(with the same total audience levels)* but the improved data analytics of skinny bundles would help eliminate this divergence.

Not only are we comfortable that Discovery will be able to successfully manage the cord cutting transition, but we think it is an increasingly attractive acquisition target. As legacy media companies like Disney desperately try and catch up in their transition to online streaming, the ability to instantly ad hundreds of globally watched shows to their library and drive subscriber growth makes a lot of strategic sense.

Discovery shares currently trade near the low end of its historic range at just 7.1x 2019 EBITDA and 8x 2019 earnings. To put the 7.1x EBITDA figure into perspective, both Sky and Fox's entertainment assets were recently purchased at ~16x EBITDA.