PetersMacGregor
GLOBAL FUND

Quarterly Report March 2018

Closing the discount to discounts

Peters MacGregor Capital Management Limited
ABN 77 087 181 600
AFSL 225984
APIR WPC0002AU
mFund PMW01

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GLOBAL INVESTING

Global Fund Snapshot

Fund Facts

Portfolio Managers	Wayne Peters Michael Haddad
Structure[1]	Global Equity Fund A$ unhedged
Inception Date	10 September 2004
Fund Size	A$110 million
Distributions	Annual, 30 June
Management Fee[2]	1.35% p.a.
Performance Fee	Nil
Buy / Sell Spread	0.10% / 0.10%

Fund Features

Investment Style	Value
Portfolio Composition	20-30 stocks
Cash Holding	0 - 20% cash
Benchmark	Unaware
Minimum Investment	$10,000 ($5,000 with a regular investment plan)
Recommended Investment Timeframe	5 years plus

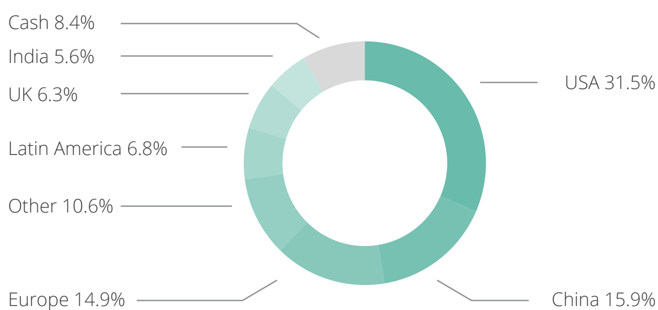
Portfolio Characteristics

Number of Holdings	21
Active Share[4]	99%
Up Market Capture Ratio	80% since inception
Down Market Capture Ratio	64% since inception

Top Holdings in Alphabetical Order

Stock	Sectors
Discovery	Broadcasting
Fairfax India	Investments
GCI Liberty	Cable
JD.com	Internet Retail
Liberty Broadband	Cable
Liberty Global	Cable
Liberty LiLAC	Cable
Naspers	Internet Services
NVR	Homebuilding
Telecom Italia	Cable

Geographical Exposure by Revenue[3]



[1] 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.
[2] All fees are inclusive of the net effect of GST.
[3] Geographical exposure by revenue breakdowns are approximations.
[4] Active Share is the percentage of portfolio holdings that is different from the benchmark holdings.

Growth of $10,000 Since Inception

Fund Performance[1]

	Fund %	Index %[2]	Excess %
1 month	-2.43	-0.58	-1.85
3 months	-1.55	0.99	-2.54
1 year	5.79	14.22	-8.43
3 years (p.a.)	4.20	7.97	-3.77
5 years (p.a.)	11.99	16.12	-4.13
7 years (p.a.)	10.93	12.62	-1.69
10 years (p.a.)	8.62	7.43	1.19
Since inception (p.a.)	7.56	6.86	0.70
Total return since inception	168.63	146.29	22.34

Monthly Performance - Net %

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	-0.74	0.10	0.57	3.87	1.52	-2.46	**14.85**
2017-18	2.18	0.09	0.55	1.92	1.55	-1.83	2.78	-1.83	-2.43				**2.85**

[1]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.
[2] MSCI ACWI NR AUD

Quarterly Commentary

Introduction

The Peters MacGregor Global Fund fell 1.6% during the quarter ending 31 March 2018, trailing the MSCI's 1.0% gain. Over the past year, the fund produced a 5.8% return, trailing the MSCI's return of 14.2%.

General commentary

With the bull market entering its tenth year and interest rates increasing, what's worked so well since the GFC, including buying high growth stocks, defensive businesses and high yielding stocks, is unlikely to work well through the cycle's next phase.

US growth stocks have officially registered their longest ever winning streak over value stocks. It seems only a matter of time before the unusually low level of volatility that's characterised markets in recent years is replaced by more normal levels of volatility and returns.

Most of the questions on investors' minds currently surround the risks of a large fall in the sharemarket due to higher interest rates. But before we address that fear, let's see what you would've earned had you bought the following four well-known companies at the absolute peak of the bull market that triggered the GFC (refer to Figure 1).

Legendary US investor Peter Lynch warned that, 'Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves'.

In all four cases, despite the markets hitting historical peaks, their stock prices were undervalued due to gross misjudgements. **ARB Corporation** is one of Australia's best businesses, but the market thought high oil prices would kill demand for four-wheel drive accessories.

CSL is a difficult business to handicap, but its share price languished due to a plasma supply glut. The same thing had happened years earlier and decimated profits, but the market was far more consolidated second time around and the glut didn't last long.

Home Depot (the US version of Bunnings) was poorly run in 2006 but eventually the CEO left, and it's been a phenomenal investment since, despite its exposure to the US housing market during the GFC. **Google** was thought to be a mature, one-trick pony, but has made some excellent investments since, including YouTube for an unbelievable US$1.7bn. Some estimates currently value it at 100x that.

These are just four examples out of hundreds, but the key point is that the fundamentals of a business and its valuation are far more reliable predictors of future returns than economic and market fluctuations. In fact, it's been shown that US rainfall has a higher correlation to stock returns than GDP.

Lynch also said that 'If you spend more than 13 minutes analysing economic and market forecasts, you've wasted 10 minutes'. His point is that forecasting changes in macro-economic variables is so difficult that few, if any, can predict them consistently to make money. That's not to say that the macro environment isn't important.

Our portfolio is mostly made up of businesses whose products and services are recession resistant, but we won't receive full value for our European bank holdings unless interest rates increase. Keep in mind that nine years since markets bottomed in 2009, the official interest rate in Europe is still negative 0.4% i.e. banks are paying to hold money with the European Central Bank.

With European economic growth beating US growth at one point last year, higher interest rates should be less than a year away. If the US experience is repeated, that's when valuations for European financials will start closing the ~40% gap to their long-term valuations.

Analysing the impact of the economic environment on the businesses you own is just one of hundreds of questions we consider in our analysis. As research continues to show year after year, the reason most individuals don't earn anywhere near the same returns as the funds they invest in is because they try to time markets. They typically buy high and sell low, without much, if any, opinion on the value of the stocks in the portfolios they're selling.

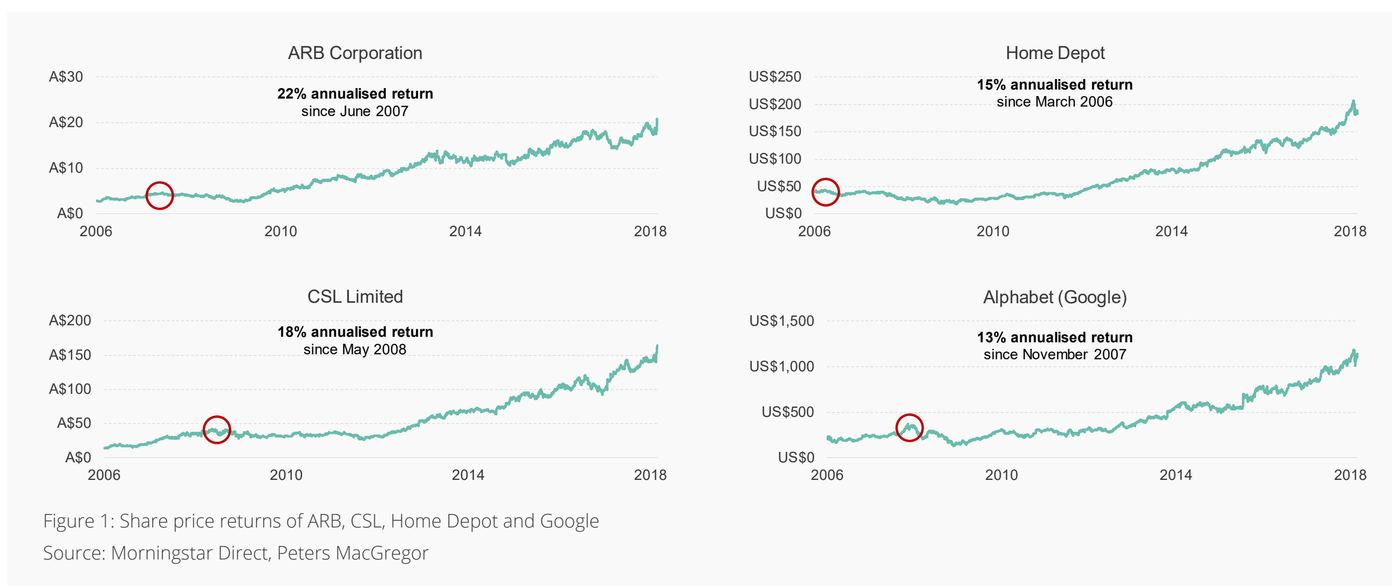


Figure 1: Share price returns of ARB, CSL, Home Depot and Google
Source: Morningstar Direct, Peters MacGregor

So, what are the key lessons here? First, preferring preparation over prediction, we build your portfolio to survive the worst economic conditions by focusing on the number one or two players in their respective industries. We also demand a margin of safety in the price we pay for each stock, regardless of how great we consider the business.

But as the world is beset by uncertainty and technological change, as a final layer of protection we have a diversified portfolio so that no single mistake or stroke of bad luck can have a lasting impact on your investment.

Thinking back to the four stocks discussed above, our process means little without the patience and wherewithal to stay invested during times of duress.

Many investors right now are fearing that the market reaper is going to carry their portfolios out in a casket in a redux of the GFC. If we owned many over-priced businesses (via an ETF or index fund, for example), or had a large, debt-fuelled one way bet on an asset increasing forever that only pays off if interest rates stay low, then we'd be worried too.

Falling asset prices under this scenario tend to be permanent, not temporary like the GFC was for many high quality and safe businesses including the four businesses discussed above. It's our job to buy those businesses and steer clear of the over-valued ones.

In a recent podcast, legendary technology investor Roger McNamee said, 'It doesn't matter what you own going into a bear market. It only matters what you own coming out.'

Bear markets produce incredible, but rare opportunities to increase returns and reduce risk, and shouldn't be feared if you're prepared. Instead of fearing market downturns, we must be prepared to embrace them. Or, as a mentor once said, if you're going to panic, panic early.

Portfolio commentary

During the quarter, **Tencent** was sold as it reached our estimate of fair value, though we retain an indirect exposure to this Chinese tech titan through **Naspers**, discussed below. South Korean internet provider **KT Corporation** was the only new addition to the portfolio. The investment case is explained at the end of this report.

Markets have been impeded by fears surrounding a US-China trade war, higher interest rates, higher inflation and the potential regulation of the tech giants following Facebook's botched response to the Cambridge Analytica data breach (which we covered in our podcast).

But the chief culprit for our recent underperformance has been the lack of heavy lifting from our largest investments. This includes two of our cable TV and internet providers; **Charter Communications**, which is owned indirectly via holding companies **Liberty Broadband** and **GCI Liberty** (formerly Liberty Ventures), and **Liberty Latin America**.

Bad news equals opportunity

It's said that you can't have bad news and high share prices. Which is just as well, as it's the market's overreaction to short term news that sustains a value investing process.

The US cable TV industry remains in flux, as people swap high-priced cable TV bills for cheaper online alternatives like Netflix. Contrary to popular opinion, we believe the growth of Charter's internet division will outweigh the loss of cable TV subscribers over time.

As the upgrade of subscribers from the Time Warner Cable acquisition to Charter's higher-priced Spectrum service is completed the company will also increase its share buybacks. The company bought back a remarkable 12% of its own shares last year, yet the share price has languished.

As the company's operating performance improves in the years ahead, so will shareholder returns and our performance. But we may not have to wait that long.

The telecommunications and cable industries are merging, as companies are under pressure to cut costs and protect margins from declining prices for a variety of services.

Telecommunications companies are also under pressure to invest heavily in 5G networks that can offer faster internet speeds and new services. 5G is considered an important step in the evolution of driverless cars, for example, which rely on the rapid transmission back and forth of huge amounts of data.

This makes Charter's large cable network highly sought after, with numerous companies opening takeover discussions last year. With major shareholder John Malone being a seller at the right price, a deal may not be far away.

Liberty Latin America (LILA) is a spin off that's been left for dead. Having admitted to overpaying for an acquisition 18 months ago, revenue growth dried up as the company reset growth expectations before hurricanes temporarily decimated its small Puerto Rico division.

While this confluence of events has helped cut the share price in half over the past two years, it should only delay the high returns we expected when we initially purchased the stock.

LILA was only a small part of **Liberty Global** before it was recently spun off, which meant Liberty Global CEO, and LILA chairman, Mike Fries, had little incentive to focus on LILA. With new CEO Balan Nair properly incentivised and in full control of the company's acquisition-led strategy and finances, all things equal, we expect double-digit returns for many years as internet usage rates in its South American markets catch up to those of developed nations.

Along with our recent purchase of **Discovery Inc** (see more below), these companies currently offer high returns as the market questions their value in industries undergoing rapid change. Boasting exceptional assets and management, and most importantly, attractive valuations, we expect time will reveal the current uncertainty as great buying opportunities regardless of market and economic fluctuations.

In early March, activist US investor Elliott Advisors announced a position in **Telecom Italia** sending the shares up as much as 7% on the day.

Elliott is proposing a new board of directors and listing the Italian wired network. Later we also expect it will recommend selling the Brazilian operations, which will help reduce the company's large amount of debt. These are all sensible moves that will help release the large amount of value that we see in the stock.

How the new board members and controlling shareholder **Vivendi** might get along is uncertain, but the fight for control of the company will culminate in early May. Although we hold the non-voting shares due to the valuable dividend, we favour Elliott Advisors' more decisive and concrete plans but are still comfortable with Vivendi's control should it win.

Watch our video on Telecom Italia to discover the company's efforts to upgrade the old copper network to Fibre To The Cabinet.

Discovery Inc is the world's largest unscripted entertainment content producer, including the Discovery Channel, Animal Planet, Oprah Winfrey Network, Eurosport and numerous others.

In March it merged with **Scripps Networks Interactive**, owner of the Food Network, HGTV and others. The deal offers huge cost savings and greater negotiating power in distribution and advertising deals.

We're generally sceptical of mergers, particularly when a lot of debt is used. But Discovery CFO Gunnar Wiedenfels believes the initial US$350m of cost savings will easily be met, which CEO David Zaslav has recently reiterated on several occasions.

The merged company clearly won't need Discovery's 600 existing sales people and Scripps's 500. Huge savings should accrue here and in content production. The two companies currently spend US$3bn annually on content, which has produced a valuable library of over 300,000 hours. There's clearly plenty of low hanging fruit.

It's not just about cost savings, though. Scripps' direct advertising sales have been more successful than Discovery's, while Discovery will distribute Scripps internationally for the first time.

The shares have been under pressure with cable subscriber losses in the US, but overall revenue has been increasing mostly due to increasing international subscribers which the company has invested heavily to attract. The 2018 Winter Olympics was a huge success (it was the first of an eight-year deal), adding half a million new subscribers to its existing Eurosport subscriber base of 1m.

We added the position at around US$17 after the share price had fallen from the low US$40's, as investors fretted about the debt used to purchase Scripps. If the cash flows can at least be maintained, then at the current price of around US$20 the shares offer a highly attractive starting free cash yield of 15%. We expect Zaslav and his team to do much better.

Read our investment case on Discovery Inc for more insight.

Naspers recently sold a 2% stake in Tencent, the owner of the WeChat messaging service, for US$9.8bn, to fund existing investments and new ventures. With Naspers' initial US$34m investment compounding at 70% annually since 2001, it's sensible to raise some cash rather than take on debt. Naspers still owns 31% of Tencent worth US$149b, which it has agreed to hold until at least 2021.

We sold Tencent during the quarter as it reached our estimate of fair value, but we still own Naspers. The company trades at a 38% discount to its Tencent holding alone, implying a negative value for investments in leading online businesses such as **Flipkart**, the equivalent of Amazon in India, and OLX, which is the largest online classifieds player in developing economies such as Brazil.

This is irrational in our view, and we believe the discount should close when some of these businesses are sold, go public or the company actively targets the discount with shareholder friendly moves such as a share buyback.

The Chinese government swiftly approved plans recently for Chinese companies that are listed offshore to be listed on the mainland Chinese exchange in the form of Chinese Depository Receipts (CDRs). While allowing locals to own shares in the country's most successful businesses is a positive, it has no impact on our investment in Naspers.

Liberty Ventures recently changed its name to **GCI Liberty**, following the acquisition of Alaskan internet provider **GCI Communications**. The stock currently trades at a 16% discount to its net asset value, which we believe significantly undervalues the underlying assets i.e. a discount on a discount.

GCI's share price is being pressured by the stigma of cord cutting in the US. In contrast to most current share buybacks that we expect are a waste of money, GCI announced a new $700m share buyback plan in March that brings the total authorisation to $1.3b, or 23% of the company's current market value.

Combining the value of the large share buyback at prices well below our estimate of intrinsic value with the growth in its operating businesses, which includes Charter Communications, the stock could be trading at nearly twice the current price in a few years.

To get an overview of the portfolio, we also recommend watching the March 2018 investment update webcast.

Conclusion

Our recent performance has lagged because the share prices of our largest holdings have recently stood still in a rising market. We expect these businesses to prosper in the decade ahead in a way the broader market won't, given such high current valuations for so many businesses that don't deserve them.

We remain disciplined and look forward to more opportunities to put our cash to work in great opportunities as higher interest rates reflect the maturity of the business cycle.

Stock in focus: KT Corporation

In 1999 telecommunications companies were falling over themselves to bid for high priced spectrum in government auctions. It promised a digital revolution and massive profits to those with the deepest pockets.

History shows that it was yet another boom that went bust. Companies that overpaid for spectrum were left burdened with debt and ever since the industry has faced fierce competition, falling prices and heavy spending to grow and expand networks. Returns on capital have collapsed alongside valuations.

In contrast to 1999, telecommunication sector valuations are now one of the market's lowest. We recently purchased **Telecom Italia**, as the low valuation belied a much brighter outlook due to new management and the prospect of faster revenue growth as more Italians pay up for fast internet speeds.

Our recent purchase of **KT Corporation** is similar. KT is commonly considered a poorly run, former national monopoly that is plagued with terminally declining revenue as people discard their home phone lines.

Both companies have had weak historical results, and the market appears to be ignoring their transition to being primarily internet providers.

Due to its home telephone network, KT has a direct line into every home in South Korea. These digital highways are incredibly hard to replicate. Streets and sidewalks must be torn apart and walls destroyed to run new lines into a building. We still believe that wired connections running directly to users' routers are the most efficient form of internet delivery.

Many expect that new 5G cellular technology will replace existing cable or wired connections. However, just as 4G LTE didn't replace your home internet provider, 5G won't either. The higher frequencies required for faster 5G speeds mean that the propagation is very poor in real world conditions. In layman's terms, that means the signal doesn't travel well through walls, for example (see this short video for the explanation).

For an example of the inverse relationship between higher wireless frequencies and a reduced range, consider when you leave the city on a road trip. The first radio stations that go static are the higher frequency FM ones, while the lower frequency AM ones remain.

This is the issue with 5G; the higher frequencies that foster faster speeds plague 5G with an extremely limited and weak range. As Charter's CFO said somewhat facetiously at a recent investor presentation, '5G works great; as long as there is no wind, rain or leaves.' 5G is a step change due to its low latency, but it won't be your home internet provider any time soon.

Despite slow but steady growth prospects for KT's internet division, it's one of the cheapest telecom companies in the world at just 2.6x this year's cash flow measured by EBITDA (Earnings before interest, tax and depreciation and amortisation). That's almost one third the multiple that similar Western telecom's trade at, such as AT&T and Verizon.

The cherry on top is a massive portfolio of surplus real estate that's potentially worth up to half of the company's current market value, which management is either selling or redeveloping.

Koreans turning Japanese

Like in Japan, Korean companies have regularly remained statistically cheap for many years, plagued by bureaucracy, complicated ownership structures, wasteful spending, cultural issues that lead to over-staffing and poor returns on investment, often due to large cash holdings.

That makes it even more remarkable that Chang-Gyu Hwang cut KT's bloated workforce by 25% in his first year as CEO in 2014, including 30% of the executives. Such high-level staff cuts aren't common in Korea where there are many levels of upper management that slow innovation and decision making.

Hwang's reputation built at world leader Samsung preceded him. In 2002 he published what became known locally as 'Hwang's Law', predicting that memory chip density would double each year. In 2004, he also met with Steve Jobs who was trying to make the iPod thinner with better battery life. When Hwang demonstrated Samsung's newly developed flash memory, a project that Hwang had led, Samsung becoming a key long-term Apple supplier.

The telecommunications sector has come full circle since 1999, when investors saw nothing but blue sky. Despite home phone revenues falling to less than 10% of KT's total revenue, the stock trades at an all-time low. At this price, not much has to go right to achieve satisfactory returns.

Further reading

- A look at Telecom Italia
  https://petersmacgregor.com/news-insights/stock-stories/look-telecom-italia/
- Everything You Need to Know About 5G
  https://spectrum.ieee.org/video/telecom/wireless/everything-you-need-to-know-about-5g
- Investment Update Webcast – March 2018
  https://petersmacgregor.com/news-insights/videos/investment-update-webcast-march-2018/
- Peters MacGregor Global Investing Podcast – The Facebook episode
  https://petersmacgregor.com/news-insights/podcasts/the-facebook-episode/
- The investment case for Discovery Communications
  https://petersmacgregor.com/news-insights/investment-case-discovery-communications/

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