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Confronting disruption in investing

The age of disruption

Innovation and disruption is a theme that the JANA Global Equities Research Team has been tracking for some time through its investment manager interaction and observation of market developments.

Disruption isn't a new theme, but it seems to us to be becoming more and more important in investment outcomes. In this article I explain what disruption means in the investment world, how it isn't just about technological change, and why it is a consideration for all styles of investment management.

What is 'disruption', in the investment context?

Disruption isn't a term that is particularly associated with investment, so it is important to establish some context. The investment task involves a lot of uncertainty and the challenge for investors, in broad terms, is to limit the extent to which they rely on uncertain outcomes and, where possible, to increase reliance on certainty.

One of the few certainties in the world is history and we can think of few credible investment approaches that do not, as a starting point, rely on the assumption that tomorrow is reasonably likely to be like today. What we are talking about when we refer to disruption is anything that potentially upsets the established order and challenges existing assumptions about the future based on past outcomes.

When the topic of disruption is raised, there is a tendency to think first of technology and that is understandable given the rapidly growing impact of the internet, mobile telephony and social media on our daily lives.

Sceptics argue that 'it is never different this time'; that there has always been change and the current environment is no different. It is true that there has always been change, but it is hard not to argue that change is coming at an ever faster rate - that the rate of change has accelerated.

One of the key reasons why it may be 'different' today is that the power of the internet has facilitated a new, capital-light business model. The growth of railway and telephone companies was limited by the massive capital expenditure necessitated by the vast physical infrastructure needed to create their networks. Contrast those business models to those of the current technology giants that were literally created by 'a couple of guys in a garage', with very little capital and physical infrastructure requirements, enabling them to grow to cash-generative behemoths in a handful of years.

Why is understanding the impact of disruption important?

Perhaps this is best illustrated with an example. One of the most fascinating case studies in investment is that of the Finnish company Nokia Oyj (Nokia). How did a company with its roots in 19th century Finnish timber and rubber companies survive two world wars and a Russian invasion to evolve into a 21st century mobile telephony giant, before being ignominiously 'sold for scrap' to Microsoft Corporation a few years later? The investment ramifications are well illustrated in the stock chart below (Figure 1).

Clearly, if you have the investment insight to identify a successful innovative or disruptive idea at an early stage, the economics are staggering. As a mobile telephony innovator and pioneer, Nokia was able to dominate a huge new market. However, as new entrants were attracted to the market, Nokia was either unwilling to or unable to match the greater innovation brought by Apple and Samsung and the Android operating system. While the prize may appear to have been catching the two big share price upswings in the 1990s and 2000s, an equally great challenge was identifying that Nokia's powerful incumbent position was not a sufficient barrier against new competitors and that the company was headed for oblivion, or close to it.

Disruption goes beyond technology

We believe that the all-pervasiveness of technology may at times narrow the focus

of the disruption debate within an investment context.

While the most obvious and easily explained examples tend to centre on technology, we see many disruptive factors at play in the world at the present time and many are not technology related, though it is possible to find some technological link to most. Disruption can have many outcomes and it can be difficult to differentiate cause from consequence. However, in this discussion, we are focussing on the impact of disruption on industry and business models, and its consequent financial impacts.

Important disruptive forces that we can identify, other than technology, include:

The global financial crisis (GFC)

We believe that the GFC is an event which will weigh on the world for many years to come and the impacts are many: suppressed global growth, governments under financial strain, unsustainable debt burdens and deflationary pressures. In many ways, the stress and austerity in the wake of the GFC have created fertile ground for the growth of efficiency-creating, cost-saving innovation. The globally synchronised nature of this crisis is also manifesting itself in increasing geopolitical tensions.

Global demographics

The challenges of an ageing world are fairly well recognised, but are quite far reaching, and include greater health care requirements, reduced tax revenues and the impact of the 'Baby Boomer' generation realising assets and paying down the debt they accumulated over recent decades.

Climate change

The increasing awareness of the dangers of climate change is impacting both industry and investment manager behaviour. We see the investment community, like the broader community, somewhat divided as to the reality of the threat and the implications for investment outcomes. However, there is a growing awareness of the investment potential of clean energy technologies and the risks of 'stranded assets', for example, coal reserves held by a company that may never be burned due to changing environmental attitudes and regulations.

Chinese competition

While this phenomenon receives less publicity in recent times due to the slowing pace of Chinese growth, China has a large number of companies that constitute major competitive threats to the leading developed world brands. This rapid development grew from a booming economy, easy access to capital and a drive to succeed on the global stage and, it has been suggested in some cases, aided by poor policing of intellectual property rights. However, regardless of the means, the competitive threat to major incumbents is real.

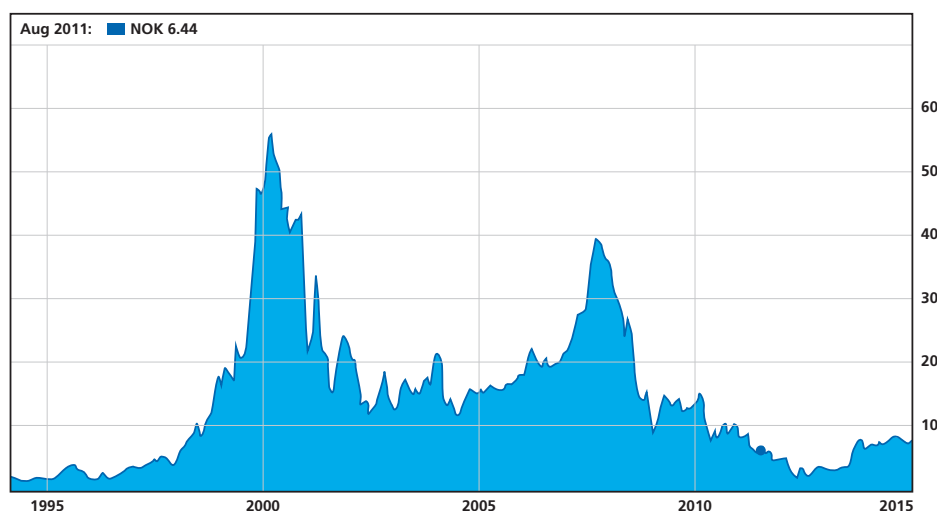
US shale energy

The rapid resurgence of the US as an energy producer within the last 10 years has been one of the most surprising developments of recent times. Aided by technical innovation, the cost of extracting oil and gas from tight shale has dramatically declined, boosting production. The disruptive potential of this development is widespread and potentially world-changing, as the economic and geopolitical ramifications work through the global economy. The recent collapse in the oil price, in part due to the supply impact of US shale, represents the latest iteration of this theme.

The investment challenge

Our earlier example of Nokia is just one case study of the issues that disruption raises for investors. As shown, the reward for timely investment in the winners from change can be significant. Conversely, being on the wrong side of disruption, whether at a company level or macroeconomic level, can be very costly. Given our focus on managing risk, our own consideration of the investment implications of change has led us to focus as much on the likely losers as the likely winners.

Figure 1 Nokia Oyj (NOK) NYSE share price



Source: Yahoo Finance, NYSE, 18 February 2015.

Part of the difficulty in incorporating evaluation of disruption into an investment process is that some themes will be very long term, and may or may not eventuate as envisioned. A theme such as the impact of ageing on leverage and asset prices will take many years to unfold, with unpredictable shorter term consequences. In this situation there is little more that can be done other than to factor the potential risks into an overall secular themes/risk backdrop, since to make specific stock decisions based on uncertain long-term outcomes may not be prudent.

However, in the case of technological innovation, it may be possible to develop more reliable short to medium term views on the impact on industry dynamics and the competitive environment, particularly the risks, and feed those expectations into stock specific insights.

We believe that few, if any, equity investment approaches are immune from these challenges. Our observations of the impact of disruption on a range of investment styles are summarised below.

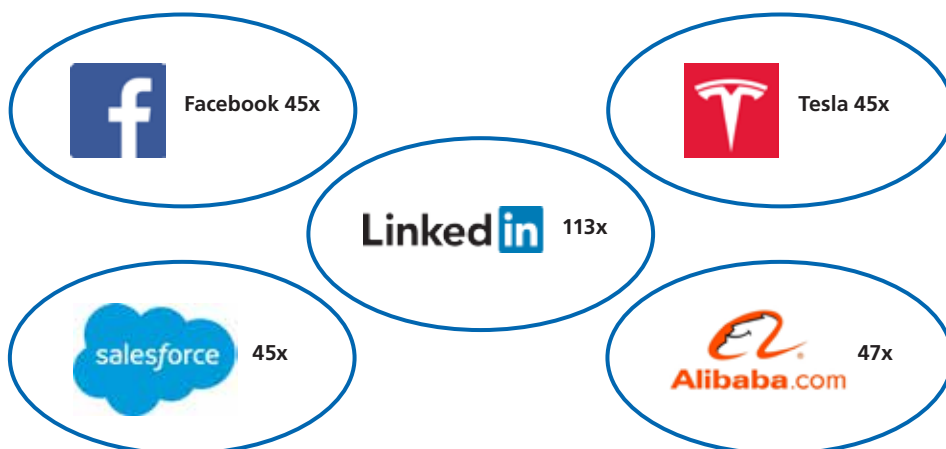
Thematic managers

Thematic managers are investors that, in general terms, approach the investment challenge by seeking to identify a range of themes that they believe will influence investment outcomes. It may be expected that such a mindset would lead to well informed views on disruptive influences and in fact, it is from such managers that come some of the most well-rounded discussion pieces that we have seen. The challenge for thematic managers is not to overcomplicate the exercise by seeking to exploit too many long term themes, while underestimating the potential for poor medium term outcomes. Put more simply, things do not always progress in a linear fashion within a given time frame. We have seen cases where well-argued long-term growth themes have not played out neatly in investment theses due to unforeseen or disruptive factors. Examples include solar energy (increased competition and oversupply) or ageing demographics and health care (uncertainty over US health care policy).

'Growth' managers

Broadly speaking, growth managers seek to invest in companies which they believe have growth prospects in excess of market expectations. They may be prepared to pay a high valuation for such a company where their research suggests that future earnings will justify the valuation.

Figure 2 Innovative growth companies, but earnings expectations are high



Source: Factset

Technological innovation creates fertile ground for growth managers, but brings challenges at times, such as very high valuations and complex competitive environments, compounded by shortening product cycles. A sample of high profile growth companies with high trailing Price to Equity (P/E) ratios is shown above (Figure 2).

In the current low growth environment, companies with strong and 'visible' growth are being rewarded by high P/E multiples, which means investors expect these companies to deliver earnings to justify current valuations. Here, the focus of investment managers is on company managements and the execution of business plans, as well as being watchful for emerging companies or trends that may undermine the key business drivers. Experience shows that companies that disappoint on earnings growth are punished by the market, and JANA's discussions with managers centre around company fundamentals and valuation methodologies.

'Value' managers

Value managers as the name suggests, look to buy assets at discounts to their estimate of true worth. However, the way in which managers define 'value' differs. In broad terms we would distinguish between 'deep value' managers, who refer to value metrics such as P/E and Price to Book ratios, and 'intrinsic value' managers, who seek to make their own assessment of the present value of the future income streams from an asset. Intrinsic value managers take a not dissimilar approach to that of growth managers, and the challenges posed by disruption are likewise similar.

For managers at the deep value end of the spectrum, history is an important reference point: is this asset cheap or expensive versus its history? Here, we see two particular issues raised by disruption. In the first instance, how does a metric such as Price to Book deal with a company with no 'book'? That is, the new asset-light business models permitted by the internet do not create a great deal of value in terms of plant and equipment and other tangible assets, nor do they have very long track records against which to judge their earnings patterns. Further, if a company's valuation is depressed against its history, is it cheap, or losing out to new industry dynamics?

Returning to the Nokia case study, many value managers rode the share price down, believing the market to have underestimated the value of the franchise. It is not easy to make investment decisions about companies that are at risk of obsolescence (Figure 3). Often they have substantial assets such as cash or patents, as well as meaningful if declining market shares, that are difficult to dismiss. But JANA's focus in looking at value managers is the extent to which their processes may be vulnerable to these 'value traps'.

Passive managers

Passive investment approaches are those that target a specific market exposure on an aggregate basis without seeking to add value from active management. Market exposures may be broad, such as the MSCI World Index, or may target some other factor or smart beta exposure. By eliminating active management, each of these approaches, by necessity, relies

Figure 3 Cheap or obsolete?



on historic data or relationships of some form upon which to construct portfolios, whether market cap, fundamentals, low volatility, equal weighting or some other factor characteristic. To our mind, processes that rely on historic metrics are most at risk of being caught unawares by sudden dislocations caused by disruption. They are the strategies that have owned and ridden down companies such as Kodak, Nokia and Lehman Brothers.

Conclusion

This aim of this discussion is to expand the checklist of disruptive complexity beyond the dominant subject of technology. From our observations and discussions with investment managers, we feel confident in stating that there is something different this time; that the number, interrelationship and speed of change and disruption is creating pressure on investment processes. Investment managers are well aware of the situation, though responses vary and of course, there are no black and white answers in such a dynamic world.

No investment approach is immune from these challenges and there is no easy means of identifying disruptive factors, whether positive or negative, but it takes willingness to be flexible and open to challenge to be successful. The key attributes we look for in investment managers are:

- Experience to enable them to recognise the things that are different this time and the things that aren't, and
- Humility and a respect for the unknown, and an ability to size investment positions appropriately for the risk, valuation and potential upside.

These two factors are pivotal for investment managers to succeed in a period of investment disruption.

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