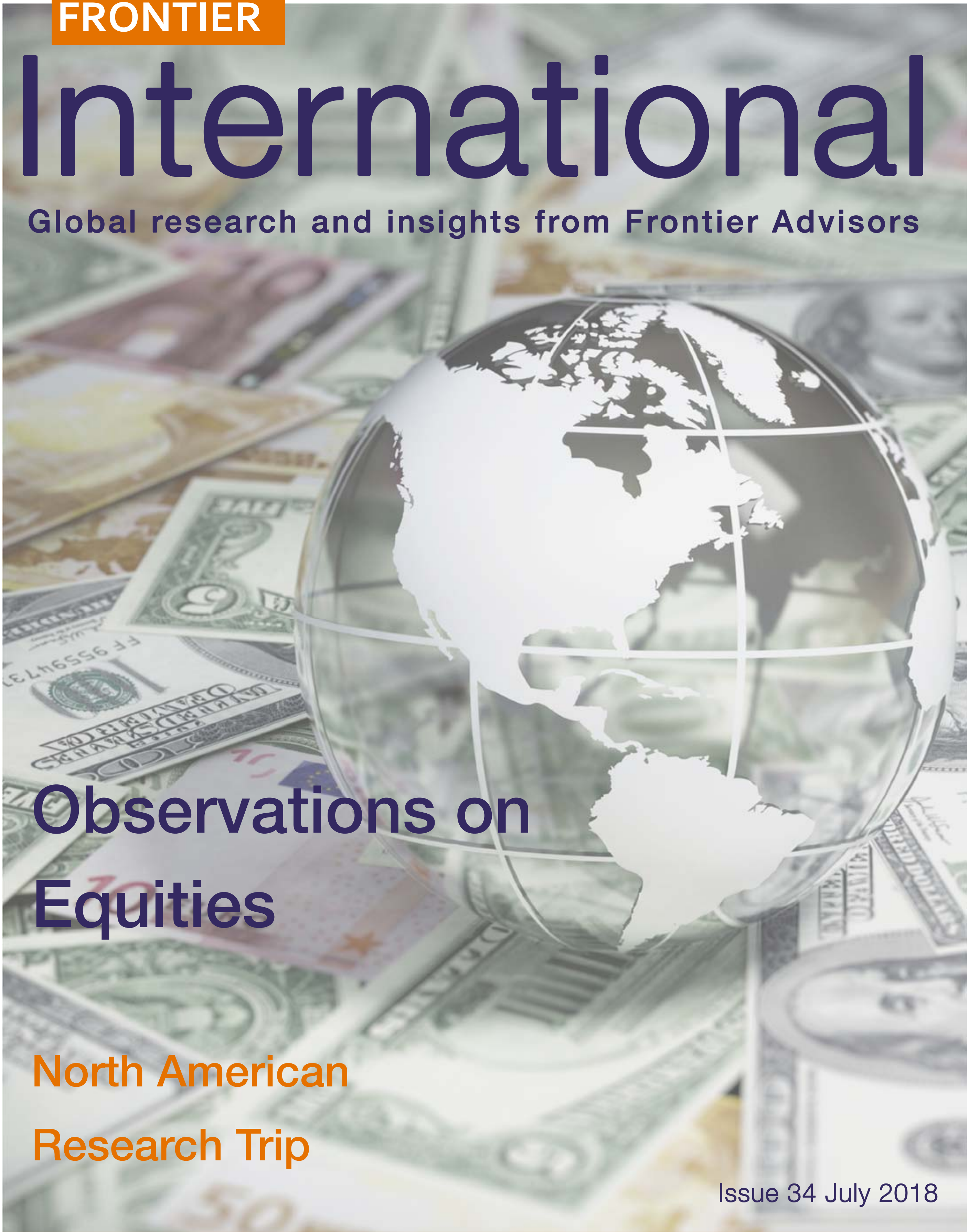

FRONTIER

International

Global research and insights from Frontier Advisors

Observations on Equities

North American Research Trip

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FRONTIER ADVISORS

Frontier regularly conducts international research trips to observe and understand more about international trends and to meet and evaluate, first hand, a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high-level assessment on the key areas and observations unearthed during this recent trip. We would be pleased to meet with you in person to provide further detail on these observations.

AUTHOR

Sarkis Tepeli

Principal Consultant

Sarkis Tepeli is a Principal Consultant at Frontier, having joined the firm as an Associate in 2007. His current responsibilities include leading several client service teams across the superannuation and higher education sectors and membership of Frontier's Responsible Investments Group (RIG). On the research side, Sarkis is the Deputy Head of Equities and also a member of Frontier's Member Solutions Group. Before joining Frontier, Sarkis was employed by WorleyParsons as an Engineer/ Consultant working in the Oil & Gas Customer Sector Group before moving to Electrical Power Group. Sarkis holds a Masters of Applied Finance from Macquarie University. He also holds a Bachelor of Commerce and bachelor of Engineering (Electrical) (Honours) from the University of Melbourne.

AUTHOR

Fraser Murray

Director of Research

Fraser joined Frontier in 2012 and leads our Equities Research Team. He was previously at Ibbotson Associates/Intech Investments for nearly 15 years where he held a variety of roles including five years as Head of Manager Research and five years as Head of Equities and Property. Fraser started his asset consulting career at Towers Perrin in 1994 as a Research Analyst in its Melbourne and London offices. Fraser holds a Bachelor of Commerce with Honours from the University of Melbourne and a Graduate Diploma of Applied Finance and Investments from Finsia, and is a Fellow of Finsia.

Introduction

Disruption is a theme that has been creating winners and losers since the start of the industrial revolution. It comes in many forms and has the potential to eradicate or revolutionise entire industries, while spawning entirely new ones. It takes from those unwilling or unable to recognise structural changes and gives to those with the depth of research and sophistication to develop an awareness of these risks and opportunities. Although this disruption theme impacts various sectors including debt and private equity, this paper is written from an equity investor's perspective based on Frontier's Equities Team's July 2018 international research trip.

On this trip, Frontier met with 30 Investment Managers in Chicago, Boston, New York, Montreal, Toronto, San Francisco, San Diego and Los Angeles and specifically discussed how managers are dealing with the ongoing threat of disruption across the entire investment universe. Most discussions centred on looking for investment opportunities in disruptors as well as the potential to make money from investing in the disrupted. Discussions varied in their nature given the meetings were with developed markets, emerging markets and global small caps managers employing value, growth and quality-oriented investment approaches. Most managers were only too keen to discuss this theme and relished the opportunity to put forward their views, indicating that this was clearly very important to them.

During our discussions, it became apparent that disruption is not confined to a select group of sectors like IT and HealthCare, but pervasive across the entire investment universe, where it continues to transcend conventional GICS (Global Industry Classification Standard) classifications. In fact, the sources of disruption on a given industry are increasingly emanating from outside the industry, making it increasingly difficult to identify and assess its eventual impact, particularly for managers with staff operating as sector specialists.

For Australians accustomed to a market dominated by Financials and Resources companies, the contrast to the US Equities market has become stark. The US is seeing disruption on many dimensions and at a speed far quicker than most Australians would realise. Accordingly, their investment opportunity set and the US market index looks increasingly different to Australian Equities.

One area we didn't anticipate prior to the trip was around the disruption of the investment management industry itself. There were a selection of managers we spoke to that had given considerable thought to the evolution of their team structure and processes to keep up with the ongoing rapid change in the investment landscape and underlying sectors.

This issue of Frontier International briefly summarises the key talking points.

Causes of disruption

There were several explanations offered on the causes for the rapid disruption that is impacting stocks. These effectively boiled down to:

1. The amount of available computing power continues to grow exponentially, while prices continue to fall.
2. The availability of cheap funding that is enabling many start-ups and smaller businesses to raise sufficient capital to develop and launch disruptive technologies/products/services.
3. The ability to leverage off other established disruptive technologies like the rise of social media platforms to target-market new products and services in a more cost effective way.
4. The desire by certain well established technology oriented businesses to use their surplus cash and entrepreneurial risk taking culture to reinvest profits into new and potentially disruptive ventures across other industries and regions.

Although there is wide agreement that the availability of cheap funding is cyclical in nature, there was a common held belief the other forces outlined above are likely to continue and intensify further, particularly as the “culture” of disruption broadens across corporates universally.

Small caps versus large caps - mixed views on the leaders of innovation

There were mixed views around the disruption potential of small caps versus large caps. Some managers believed that small caps were in a tough place and had to innovate to survive against much larger and better placed rivals. There was, however, also a view that, in certain industries, small caps had established more entrepreneurial corporate cultures intent on using the most recent advances in technology to maintain or gain market share from large mature companies that were slow to innovate. A common example was around small caps using new advertising platforms like YouTube, Facebook and Instagram to promote their products more efficiently and compete with rivals with much larger advertising budgets.

Adopting innovative approaches wasn’t exclusively confined to small caps however, with a number of examples of much larger organisations either 1) embracing a level of start-up entrepreneurship to launch new businesses (like Tencent launching business payments business and education platform business), or 2) responding powerfully to a technology led threat to an existing business (like Kroger responding to the threat of Amazon entering into the US supermarket industry).

Value in the disrupted?

Several of the value oriented managers we met with had a view that, in certain instances, the market can overestimate the disruption potential of an emerging threat.

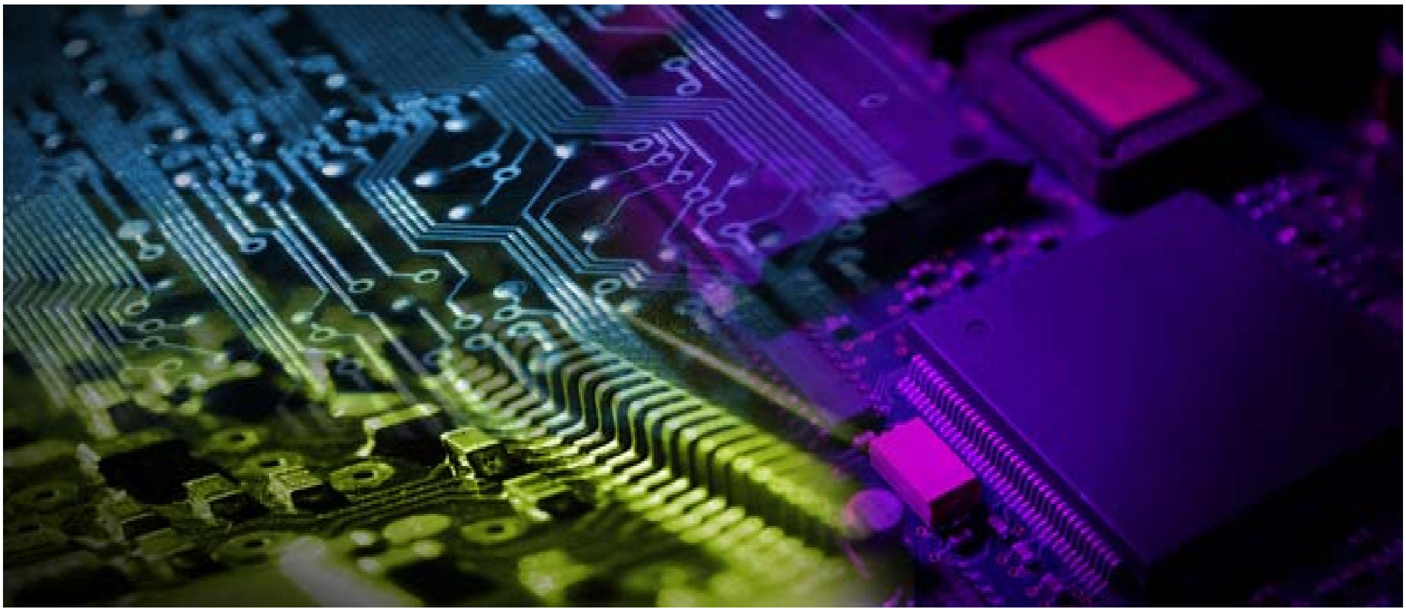
Betting against the market is part and parcel of value investing, but we found that the better managers had developed a very-thorough appreciation of disruptive threats and undertaken deep research to back their views, particularly when it came to disruption. Some value managers still invested materially in those being disrupted, while for other value managers, this is quite limited given disruption threatened permanent loss of market share.

Frontier's observation was that value investing based on mean reversion in a world of disruption is more fraught with danger than ever. In general, we find more comfort in those value managers limiting their exposure to the disrupted, rather than backing their judgment that a cheap price is sufficient compensation in the face of disruption.

Supply the disruptors – "sell picks and shovels"

Some managers we spoke to sought to access the theme by investing in suppliers or enablers of disruption. This varied from investing in specialised electronics manufacturers that produced diagnostics and controller chips for server boards used in data centres to investing in DRAM (Dynamic Random Access memory) manufacturers, which are a key supplier of many electronics supply chains.

This wasn't entirely confined to electronics however, with one manager investing in the Toronto Stock Exchange, for its crypto-currency exchange. This approach often led to more lowly priced stocks, rather than owning the more highly priced leaders of disruption. This was one of the aforementioned forms of value investing that did not involve owning the cheap disrupted stocks.



Regulation lagging

Regulation is a question mark for various new and emerging technologies and themes. In most cases, regulation has tended to lag behind technology.

The universal view is that corporates have powered ahead of regulation and built their businesses for the often prevailing regulation-light environment with little regard for the impact it will eventually have. There is, however, a clear risk that regulation will follow and determine the winners and losers to a greater extent than we have seen to date.

In some cases, managers commented that they had identified a disruptive change in a certain sub-industry or region, where there are numerous players competing to become the market leader, but chose to stay on the sidelines due to an expected regulatory response. Managers were unsure about the form future regulation would take and didn't want to take on this risk.

Disruption for the investment management industry

Based on our meetings, we felt the investment management industry is also evolving in a world increasingly dominated by disruption. We are seeing certain managers employ disruption specialists whose task is to operate as a generalist trying to identify insights that either leave portfolio held companies vulnerable to disruption, or identify disruption trends and investment opportunities.

We are also seeing some managers employ generalists in teams formerly entirely comprised of sector specialists. This is in recognition that the disruption theme is pervasive across the entire market, whereas sector specialists (or region specialists), may miss disruptive opportunities and threats from other sectors.

Some managers we met with were increasingly hiring industry experts, particularly in specialised sectors like biotech (gene editing), finance (crypto-assets) and industrials (automation and robotics) etc. These Managers are increasingly of the view that conventional analysts are not sufficiently equipped to fully understand, grasp, follow and make the required investment connections in fast moving areas that require the assessment of highly technical areas of expertise.

Some Managers are also looking at ways to increasingly incorporate technology into their own research and investment work streams to attain ever higher levels of productivity from individuals and teams alike. The level of technology adoption is varied across the industry, ranging from the use of cloud-based databases to house research reports, to using more internally or externally developed systems to assist with quantitative screening, to more specialised task management software to better understand and get the most out of various work-streams across investment teams.

Quantitative managers are presented with the option to purchase ever-increasing data sets covering numerous industries ranging from consumer (e.g. online shopping habits, transactional data, construction (e.g. permit details, satellite imagery on construction sites), logistics (e.g. shipping manifests), industrials (e.g. business to business data points), agriculture (e.g. satellite imagery on agricultural regions, rainfall, waterway flow data) etc.

In one case, one of the Boston-based quantitative managers we met with said there simply weren't enough available data scientists to back test the efficacy of the multitudes of available data sets available. Similarly, the California-based investment managers were struggling to attract the talent they were seeking, given those with technology skills were choosing to work directly for Silicon Valley's technology companies.

The final word...

If there are any takeaways from our exploration of the disruption theme and how managers are responding to it, it is that disruption is here to stay, is on a large scale, and is happening faster than most Australians would appreciate.

Disruption seems unlikely to abate, and if anything will continue to accelerate across all industries. We believe Australian investors need to seriously think about disruption and how it is represented in their equity portfolios.

As it has for almost every industry, this theme is likely to create winners and losers in the investment management industry. Those managers that have evolved their team structures, hired the right skills and continue to evolve their research program will likely come out winners, while those that underappreciate the potential for disruptive change, will likely lag behind.

Although all managers are likely to be impacted, we consider value-oriented managers to be most at risk as they will naturally be drawn to cheap companies and could be at risk of underestimating (or entirely missing) a major structural change.

Quality oriented managers, paying high multiples for limited growth with "competitive moats", are also likely to be at some risk, particularly when disruptive change allows competitors to overcome these moats.

Growth managers are perhaps best positioned to benefit from the opportunities created by disruption, given they are most likely to be drawn to the disruptors promising high levels of future growth, and may have more internal capability to assess disruptive dynamics. However, growth approaches are not without risk as there exists a different challenge.

Given the high valuations associated with potential disruptors, there could be some painful lessons if the manager overestimates their disruptive/growth potential or overpays to acquire disruptors.

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