For Professional Investors and Advisers Only

RWC

RWC Global Horizon

Global Musings Vol. 5 | May 2017

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Global Horizon

Louise joined RWC in April 2013 to establish the RWC Global Horizon Strategy. Louise and her team seek out equity investment opportunities from around the world with little regard for the benchmark and a focus on the supply side of industries. The team's multi-year time horizon allows them to identify businesses whose share prices are trading at a fraction of their intrinsic value. Alignment of interest runs throughout the strategy: the team not only aims to align itself with its end clients but also emphasises the importance of alignment between shareholders and investee company management.

Louise was previously Global Portfolio Manager at Marathon Asset Management, and was at Clerical Medical (later known as Insight Investment) before that.

> … If you won't or can't embrace powerful trends quickly. If you fight them, you're probably fighting the future. Embrace them and you have a tailwind.
>
> JEFF BEZOS' SHAREHOLDER LETTER, AMAZON 2017

I am fearful of adding to the noise of the active versus passive investing debate but active management has only itself to blame! No business can overcharge and underdeliver forever. High fixed fees for sub market returns over many years have created a soft underbelly of excess profits which the passive market is eating into. With investment outcomes, by definition, being uncertain it is alluring to focus on achieving the lowest possible fees. However, low-cost passive could be an expensive solution if the investment outcomes are poor.

Nevertheless, while there remain so many 'active' managers who are excessively benchmark sensitive, the odds are in the favour of passive investing gaining share. The RWC Global Horizon approach has always sought to provide superior alignment by encouraging clients to take a very low management fee and a multi-year performance fee, thereby only rewarding us if we generate enduring alpha, and linking our fees to the value we create.

Yale University Endowment added its perspective to the debate recently, stating, according to Bloomberg, that a low-cost passive strategy would have 'short-changed' the Endowment. Yale appears to have understood that it is not about price but rather value. It's asset allocation has also evolved from over 80% of the Endowment's assets being invested in US stocks, bonds and cash in 1985, to just 10% being committed to domestic marketable securities now. This philosophy sits comfortably with our unconstrained approach which includes being geographically agnostic to whether a company is located in Birmingham, UK or Alabama. In the same way it is ridiculous to suggest that acquiring a stake in a US company such as Amazon is anything other than a global investment. Looking at the RWC Global Horizon Fund ("the Fund"), the geographic split of revenues of our investments is strikingly different from the geographic breakdown of the companies from a domicile perspective (see figures 1 and 2).

FIGURE 1:
Geographic exposure by revenue

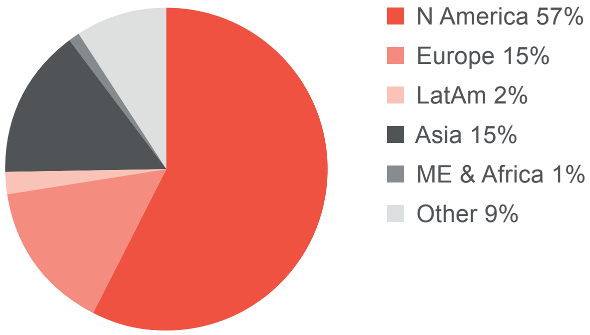
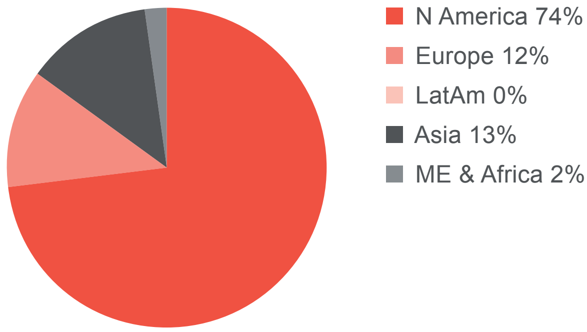


FIGURE 2:
Geographic exposure by listing



Source: RWC, Factset, as at 28 February 2017

Debt is often seen as the safe haven asset but the quest for yield in a low interest rate environment has dramatically increased the likelihood of capital loss in bond portfolios. After all, how much will investors be prepared to pay for five year paper yielding 1.5% in two years' time? Will pension funds be forced to take a capital loss on their bond portfolios or commit to holding to maturity? The beneficiaries of this period of cheap financing are companies and their equity holders as the lower cost of funding increases the return on investment of projects. Nevertheless, there will be management teams who have gorged on cheap money and used it to make bad investment decisions feasible. In these circumstances the equity and debt holders will bear the brunt. In this way, we see the importance of wise capital allocation being of even greater significance in these times.

From a duration perspective, most investors would think of infrastructure and real estate as long duration asset classes, but holding a stake in a business is rarely seen as such. If a business is managed prudently and effectively there is no reason why it cannot endure well beyond us all, as many have. Yale believes that their long time horizon is well suited to exploiting illiquid, less efficient markets. The most obvious inefficiency that exists in public markets, in our opinion, is the time arbitrage. In other words, the excessive focus on the daily share price gyrations of a business which should survive decades. Our approach seeks to monetise that time arbitrage which is created by impatient money causing untimely assets to be bid down to below their intrinsic value.

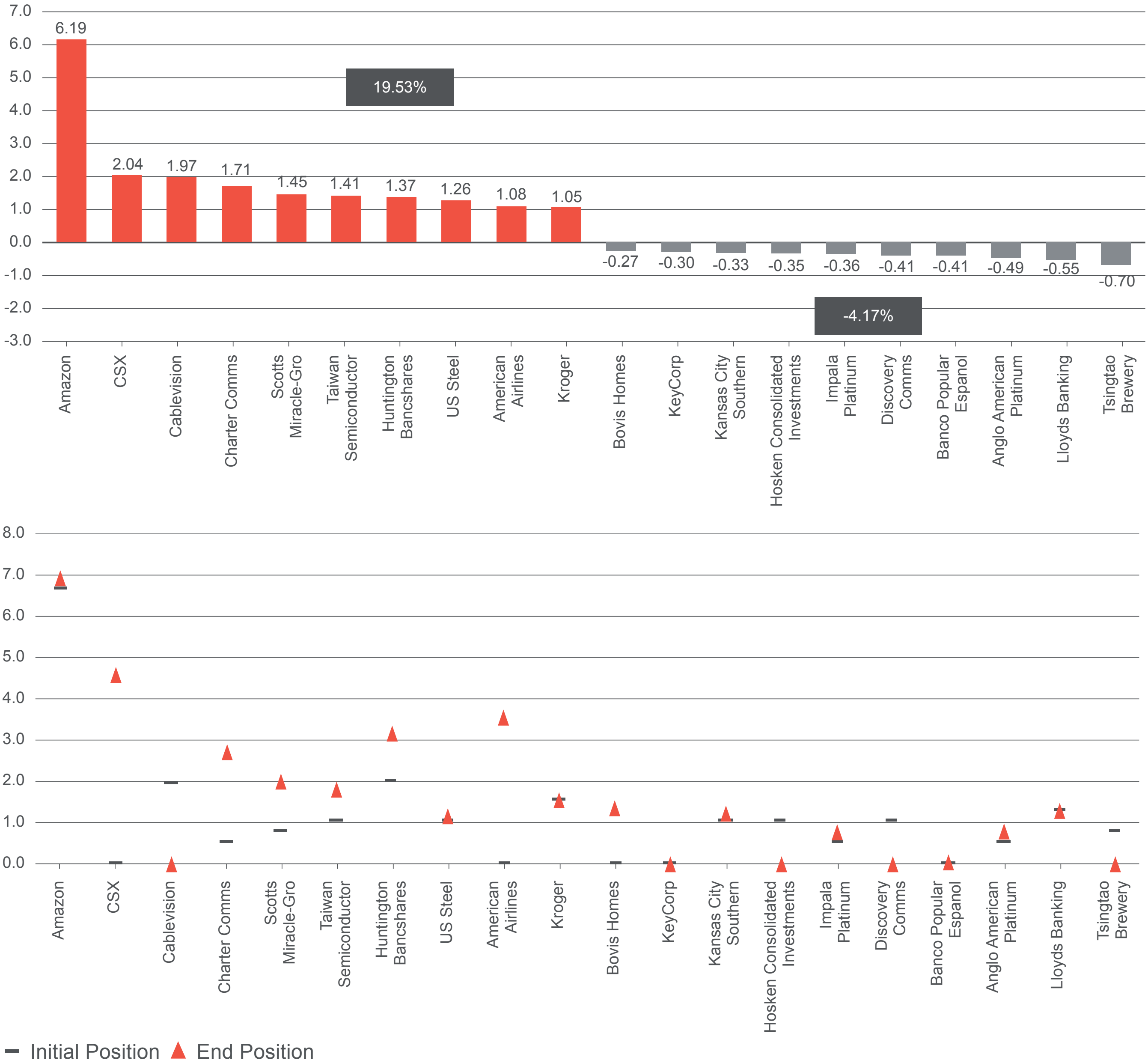
The desire to provide multi-year client alpha is our overriding focus which governs our day-to-day work, from choosing what to read to which companies to see. Our favoured fee structure of a very low management fee coupled with a multi-year performance fee aligns client and investment manager outcomes (thereby ensuring value for the client). This fee structure discourages us from growing assets beyond the point where we are able to deliver enduring alpha. Not only do we think that morally this is the right structure, but Jeff Bezos' quote should be a warning to asset managers who have failed to focus on client outcomes and the value proposition.

Is it all about Amazon? Sources of alpha and the role of the incubator

Looking at sources of the Fund's out and underperformance since inception (in November 2013), we can see that our top ten outperformers have added a lot more to performance than the bottom ten have detracted. This is clearly a good start but some have questioned whether the performance of the Fund is 'just Amazon'? So we have looked at the hit rate in the top ten names within the portfolio to understand whether our confidence has been well placed. We also wanted to investigate whether the incubator was additive to the portfolio's returns.

FIGURE 3:

Top ten contributors/detractors to Fund relative performance and their weights since inception



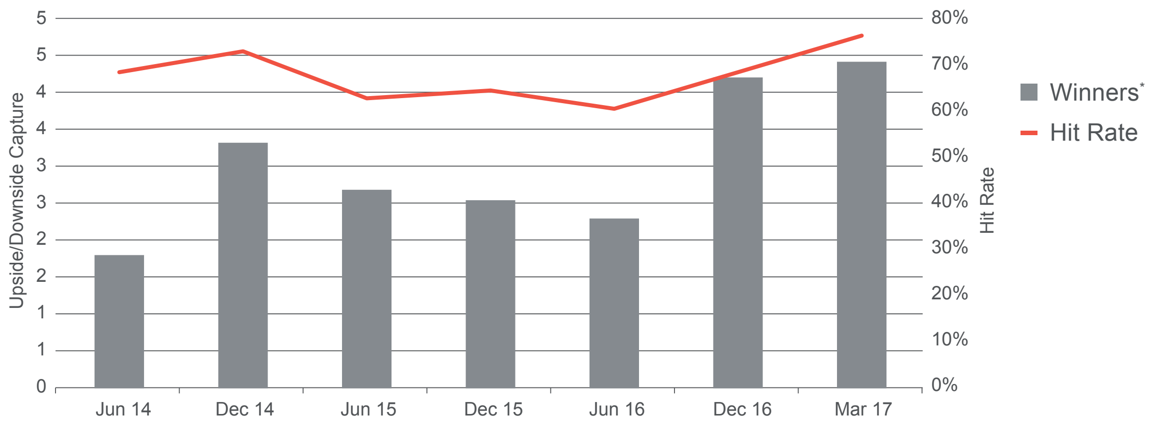
Source: RWC calculations, Factset, as at 30 March 2017

Since inception the top ten contributors have added +19.53% to relative performance and the ten worst performing investments have detracted -4.17%. This positive skew is a good starting point, however, to consider the breadth of the Fund's outperformance since inception we need to look at hit rate. A hit rate using standard methodology is calculated by summing the number of days that a single name outperforms (marked as 1) or underperforms (marked as 0) the benchmark. As such, it measures the linearity of returns and makes no assessment of the magnitude of the out or underperformance in each day. We manage money to generate enduring alpha rather than consistent, linear performance so we do not think the 52% official hit rate for the whole portfolio (according to Factset) is particularly insightful. Instead, we looked at the top ten names of the portfolio in six month intervals (over the life of the Fund) and measured how many of those investments outperformed the benchmark to the end of the first quarter 2017 (or until we sold out of the investment). Taking this methodology, the 'hit rate' of the top ten names has remained above 60% (as seen in figure 4) and is currently in the high 70s. Anything above 50.1% suggests that we have picked more winners than losers.

This high hit rate among the biggest positions in the portfolio suggests that the source of alpha has been broadbased. In each six month interval, the 'winners', i.e. those investments which have outperformed the benchmark have contributed more to the performance of the portfolio than the bottom performers have detracted. We can infer from this analysis that our confidence in the biggest investments has been well placed in general.

FIGURE 4:

Upside/downside capture versus hit rate for top ten investments in the Fund



*'Winner' defined as a day in which a sin le name outperforms.

Source: RWC, as at 30 March 2017

The upside/downside capture ratio is the statistical measure of the Fund's net relative performance calculated by dividing the sum of the relative outperformance by the sum of the relative underperformance. If this upside/downside ratio is above 1, then it implies that the positive relative contribution from the Fund's winners has been greater than the drag from the underperformers. The Fund's ratio (for its top 10 investments) has been consistently above 2 and more recently above 5. The fact that it has trended upwards over time could be explained by our long-term approach. In other words, our investments often have a gestation period as it takes time for the improvements in the supply side of an industry to unfold and for the share price to react.

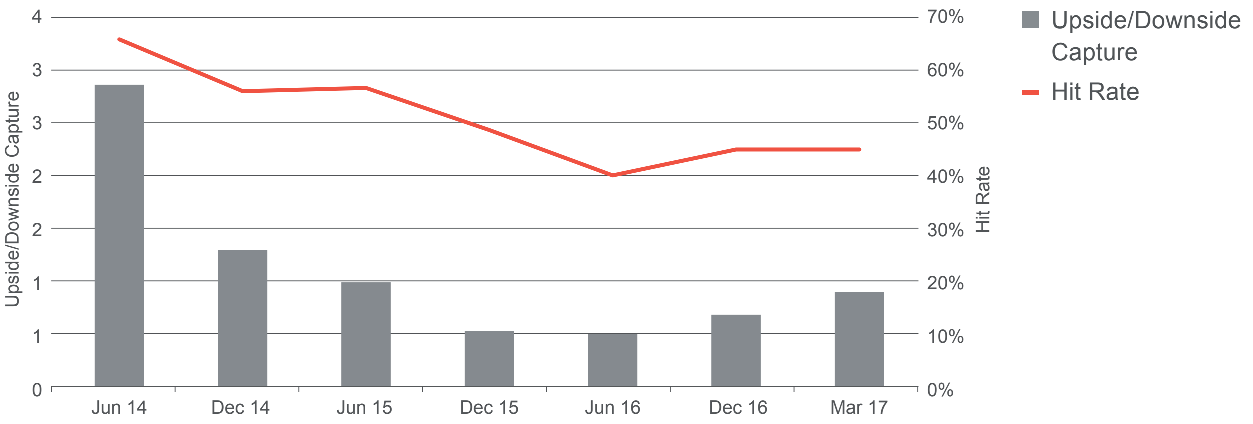
The incubator part of the portfolio holds investments with significant upside to intrinsic value, but we retain some concerns. Nevertheless, the price at which the shares are trading is sufficiently attractive that we believe the risk reward is skewed to the positive. This is merely an extension of our approach to position sizing across the portfolio which is driven by the interplay of three factors: the upside to intrinsic value, the downside if we are wrong and our confidence factor around the investment case. It is our hope that as time passes more of the unknown of the investment case are clarified and we can have a larger investment in the company. If not, we exit the investment. Consequently, we have seen higher turnover in the incubator part of the portfolio than the total Fund.

By having a dedicated incubator, we believe that it allows us to have exposure to companies where there are sufficient identified unknowns and risks that it would not be appropriate for a more concentrated portfolio. Our concern with the idea of a concentrated portfolio approach is that it can lead to a quality bias and less upside potential within the Fund, hence why we prefer the 60+ names we hold within the Global Horizon portfolio.

The hit rate[1] of the incubator is lower than the overall portfolio at 37.5%. As this measure divides the number of investments (in the incubator) which have outperformed the benchmark versus the number which have underperformed, we are not surprised that the hit rate is lower than the main portfolio. A hit rate above 50% in the incubator would imply that we should have had higher conviction and put more of the investments straight into the main portfolio rather than the incubator.

FIGURE 5:

Upside/downside ratio versus hit rate of incubator (6 month interval data) to end Q117[2]



Source: RWC, as at 30 March 2017

Again the upside/downside ratio[3] is above 1 across all time periods so we can say that the 'winners' have added more than the 'losers' have detracted from the relative performance of the incubator part of the Fund. It is hard to infer much from the downward trend as it may be that new ideas have been high conviction and therefore gone straight into the main portfolio, thereby bypassing the incubator, or that there are fewer good ideas in the incubator.

1 Calculated by dividing the number of investments in the incubator which outperformed the benchmark (from entry in to the incubator to end Q117 or sale from the portfolio) in to the number of investments which underperformed in the incubator over that same time period.

2 Will include investments which started in incubator and graduated to the main portfolio. Shares which have been demoted from the main portfolio will also be included once their weight is below 50bp.

3 The sum of the relative outperformance divided by the sum of the relative underperformance

We don’t expect many of the investments in the incubator to hatch but when they do we want them to go up a lot. Consequently, the dispersion of returns in the incubator is very wide with the best performing investment Charter Communications having seen a nearly 200% increase in its share price since our initial investment. This is also an example of the incubator breeding a top ten position for the portfolio as Charter transitioned from being a 50bp position at the inception of the Fund, to being 2.72% at the end of March 2017 (see following report for full analysis of the investment case). So, the incubator should have a sub 50% hit rate, but when a name performs it should have outsized upside.

As a long only equity investor, our downside is capped at zero but our upside is uncapped. This means that we can allocate a small portion of our capital to investments where we believe there is an asymmetric risk/reward profile due to the depressed share price. Interestingly, only three of the incubator names are also top ten detractors from relative performance since inception: Impala Platinum, Anglo American Platinum and Banco Popular. The average aggregate weight of these three investments, over their respective holding periods, was 1.77% and they detracted 1.26% from the Fund’s relative performance. This compares to Charter Communications which had an average weight of 0.99% and contributed 171bp to relative performance.

These results highlight that the incubator is a way of investing in opportunities which have a wide dispersion of outcomes (one of which may be zero), but given the limited capital we allocate, it is a capital efficient part of the portfolio. We are aware that our focus on the supply side can result in us identifying an improvement in the structure of the industry way before it is reflected in the financial results, leading to us being early in our enthusiasm. We believe that the incubator allows us to express that enthusiasm in an appropriate scale.

Cable consolidation in a smart pipe world

Charter Communications is the second largest cable company in the United States. It provides video, internet and voice services under the Spectrum brand, catering to 26 million customers across 41 states. Charter has enjoyed a tumultuous history. The company was built up in the 1990s through a series of acquisitions, which accelerated when Paul Allen, the co-founder of Microsoft, took a controlling interest in 1998. The company went public in 1999, but struggled in the following years under the burden of an excessive debt pile and disparate systems, resulting in poor customer service and high levels of customer churn. Charter then filed for Chapter 11 in March 2009, yet emerged from bankruptcy at the end of the year after agreeing a debt for equity swap with its bondholders. In 2011, the board recruited Tom Rutledge, the highly regarded CEO of Cablevision, to take the helm, before John Malone, the so-called 'Cable Cowboy', took a 27% stake in the company in 2013. We have owned a stake in Charter since the inception of the strategy in 2013.

Charter is a good example of our investment approach in practice. From a capital cycle perspective, it demonstrates the benefits of consolidation within an industry and how the process can lead to improved returns on invested capital at both the company and industry level. The presence of a long-term shareholder in the form of John Malone should encourage disciplined capital allocation due to management also being owners.

The cable industry displays a number of attractive characteristics. First, the subscription nature of the business provides a recurring revenue stream. 90% of Charter's 2016 revenues came from monthly subscription fees. Second, the high fixed costs of building the cable infrastructure and network create a significant barrier to entry for new competition. Any new entrant would have to absorb significant upfront capital expenditure which would only be rational with a very long term perspective and if the incumbent providers were achieving supernormal profits.

Investor sentiment towards the cable companies has evolved in recent years, from the view that they are merely 'dumb pipes' (providing little more than basic connectivity services and competing solely on the basis of price), to being at the core of a household's media and content consumption. Moreover, our view is that the broadband pipe into the house has increased in value within the service bundle (as it allows access to a broad array of over-the-top (OTT) content such as Netflix and Amazon Prime as well as internet-based content) and that the value of the TV component has diminished. This plays to the cable companies' strength, in that they own the broadband connection and, in general, only resell the content.

Over the last decade, the US cable industry has experienced a wave of consolidation, which has accelerated in recent years. By 2015, consolidation had left six major players – Comcast, TimeWarner Cable (TWC), Cox Communications, Charter, Cablevision and Bright House Networks – who controlled 85% of the market. This has since decreased to just four companies, following Charter's merger with TWC and its acquisition of Bright House Networks, and Altice purchasing Cablevision for $17.7bn to create Altice USA. As a result of this consolidation process, four players now make up 95% of the US cable market, with Comcast and Charter accounting for the lion's share.

Why has such large consolidation occurred and what benefits does it bring to the industry? Video revenues have been declining and programming expenses rising. Within the cable TV industry, the largest cost item (typically 35-40% of operating expenses) is the fee paid to programmers such as Viacom and Discovery. Programming costs have been rising ahead of inflation for many years. These costs have pressured margins and reduced the affordability of the end product as cable providers have passed through escalating programming costs. A more consolidated cable industry is better placed to negotiate with content providers who require cable companies as their primary route to market. At the same time, the absolute number of video subscribers is in decline, driven by the rise of OTT services. Consolidation should also increase the likelihood that the cable operators cooperate on R&D-heavy initiatives like 'TV Everywhere', which would allow subscribers to stream video content online and on mobile devices as part of their existing television subscription.

At the time of the Charter's merger with TWC, Malone stated, "Charter will now be of a size where they can have a meaningful Video On Demand offering, perhaps in cooperation with other operators, delivered on a broad scale and cost effectively". Malone has repeatedly argued that the failure to come up with a viable TV Everywhere – also known as 'random access' service was a huge misstep from the cable industry, creating an opportunity that streaming services such as Netflix have quickly exploited.

The economies of scale present in the industry also drive consolidation. To quote Malone, "we are very aggressive in consolidating the cable industry because we saw from the beginning that scale economics was going to determine who was going to survive and who wasn't". The cable industry is characterised by high fixed and low variable costs. As the company adds more customers, it is able to spread fixed costs across a larger user base. Scale also allows for increased investment in improving the user experience. For instance, Comcast and Charter spent $9bn and $5bn respectively on capital expenditures in 2016, levels far in excess of smaller competitors. These forces create a virtuous circle that is difficult for competitors to disrupt. A combination of these economies of scale and the benefit of being the incumbent data railroad should provide Charter and Comcast a sustainable competitive advantage.

Malone targeted Time Warner Cable and Bright House Networks for these very reasons. Firstly, the combined company has nearly doubled Charter's owned or managed video subscriber base, and positions the company as the clear number two cable video provider in the US. Charter is, as suggested, also betting more heavily on broadband than video, hoping to improve currently low broadband penetration of just 40% among its customers, compared to 57% for Cablevision. In terms of scale benefits, Charter thinks it will achieve $500m in expense synergies in the year following the closing of the Time Warner Cable deal, and has already upgraded annual expense synergies from $800m to $1bn for the next three years. These synergies will arise mainly from reduced programming costs and increased revenue per household as a result of greater product penetration.

John Malone's significant stake, held through his Liberty Broadband vehicle, and truly long-term mind-set gives us confidence that capital allocation will be thoughtful. He has a well-established playbook that has delivered significant value to the industry over a number of decades. It was as CEO of Tele-Communications Inc. that Malone led the first wave of consolidation of the fragmented cable industry, driving free cash flow through economies of scale and leveraged growth. Malone pioneered the active use of debt in the cable industry. In his mind financial leverage not only magnifies returns on equity, but also shelters cash flow from taxes due to the deductibility of interest payments. As such he targeted a 5x debt/EBITDA ratio across his investments, and Charter is no different, currently running at 5.8x leverage. The firm's low cost of borrowing and predictable revenue streams should ensure this debt is serviceable. Malone has also demonstrated a continued preference for free cash flow versus accounting earnings. He is laser-focused on the cash a business can generate, rather than the near-term accounting earnings it spits out each year. This should allow for a long-term approach to capital allocation at Charter, and a willingness to take actions in the long-term best interests of the company.

Under its original management, Charter was an underinvested asset, yet one with plenty of potential. Under Rutledge's stewardship, capital expenditure has focused on upgrading cable systems which should help improve historically poor customer service. Indeed, capex as a percentage of sales has increased from 18% to 24% during his tenure. As a result, since 2013 Charter has delivered product penetration and subscriber gains, increasing internet and voice penetration rates by 700bps and 300bps respectively. Over the same period, Charter has increased revenue and EBITDA per customer at a faster rate than its competitors. A shift of emphasis away from single play to bundled triple play subscriptions has helped greatly in this regard.

From an incentives perspective, it is encouraging to see that remuneration is geared towards variable compensation, as opposed to executives picking up a large pay packet for merely turning up to work each day. Short term incentives, based mainly on revenue and EBITDA growth, could be better, as they could be seen to encourage excessive leverage in the quest for growth. Tom Rutledge has been gradually building up his ownership in the company, holding 280,000 shares worth $97.8m. We take comfort from Malone's large stake.

We continue to believe that Charter is undervalued by Mr Market. Management should be able to successfully integrate the Time Warner Cable and Bright House Networks transactions, and pursue a strategy that drives meaningful growth in free cash flow (FCF). Residential customer revenues, which account for 80% of total revenues, should continue to grow at 3-4% per year, while commercial customer revenues, from a lower base, should grow at 9-10% per year. Alongside higher revenue per customer, driven by new packaging and pricing initiatives, namely increased triple-play penetration (currently at 35% yet growing strongly), this would result in blended revenue growth of 7% per year. Therefore on a five year time horizon, the company could generate around $58bn in revenues, versus $42bn at present. Operating expenses should fall due to the merger synergies, meaning operating margins could reach 19%, resulting in operating profit of $11.1bn by 2021. Capex has been elevated in recent years, due to investments in converting subscribers to all-digital packages and improving broadband speeds. However, capital spending should begin to taper from 2018 onwards as these investments roll off, from $7.5bn to $6bn, leading to higher FCF conversion. As a result, Charter would be generating $8bn of FCF at this point. While M&A remains a possibility, management has expressed a preference for buying back shares. Rutledge has committed to an $8bn annual buyback programme, afforded by net debt/EBITDA of over 4x, which would reduce the share count by 30% over the next five years (assuming the shares are bought back at a 10% premium to the market price), resulting in free cash flow per share of $44. Management displays a reassuring attitude to share buybacks, only entering the market if they believe the company's shares are undervalued. If we were to apply a 12x price to FCF multiple to this figure, we would arrive at an intrinsic value of $529, suggesting compelling upside of 52%.

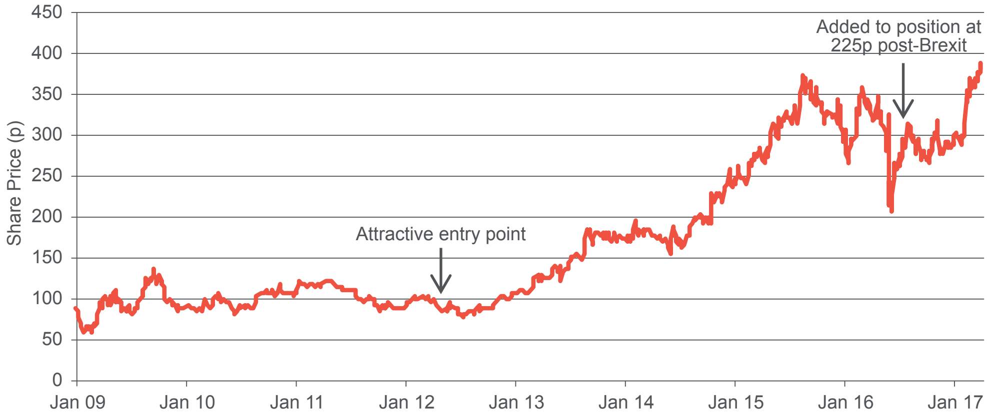
Charter is set to reap the benefits of consolidation, leveraging ever greater scale and improved bargaining power over content providers. Simultaneously, the underappreciated value of the cable operators' 'dumb pipe' should become clearer with time. The presence of John Malone is highly encouraging from an alignment perspective, and should lead to superior capital allocation over the long term. We anticipate these characteristics being reflected in Charter's share price over time.

UK: The land of uncertainties and opportunities

The UK has been the largest positive contributing region to relative performance so far this year. In the wake of the Brexit vote in summer 2016 we saw the share prices of many UK companies collapse along with the value of Sterling. We took this opportunity to increase the size of our investment in Marshalls, the stone company as we felt that its conservative balance sheet and strong competitive positioning would allow it to weather even a 'hard' economic landing in the UK economy.

FIGURE 6:

Marshalls' share price since initial investment in 2012



Source: Bloomberg, 02 January 2009 - 03 May 2017

We also initiated a position in Savills, the real estate service company. With cash on its balance sheet and a capital light business model we felt comfortable that the company could weather a sharp decline in the commercial real estate market. The company does not own real estate itself but provides services to owners and tenants of property, predominantly commercial real estate. With people accounting for the vast majority of its cost base, we were reassured that a large part of compensation is variable and is driven by the profitability of a team. Consequently, a collapse in the commercial real estate market would automatically trigger a significant step down in compensation. This is what has occurred in the past. In fact, it was during previous downturns that Savills gained market share as less financially secure companies faltered.

FIGURE 7:

Savills' share price

Source: Bloomberg, 03 April 2012 - 03 May 2017

We also made a 0.50% investment into the incubator part of the portfolio in Mitie. This company provides a broad range of services such as facilities management. Previous management used the attractive cashflow from the core operations and acquired faster growing businesses at high valuations resulting in goodwill write offs. The Executive team have now been replaced and new management are committed to a more organic growth focus which will enable the cashflow to be reinvested in the business or to be returned to shareholders. Our assessment of the intrinsic value of the business is £4.30 per share, the current share price is £2.38. The new CEO also appears to believe that the current market price undervalues the business as he acquired £3.6M shares in the open market in November 2016 at £1.94 per share. This business is in turnaround mode so we remain cautious as the management team get to understand the challenges they face. We hope to be able to commit more capital to the investment over time as the challenges become clearer.

And Finally[5]...

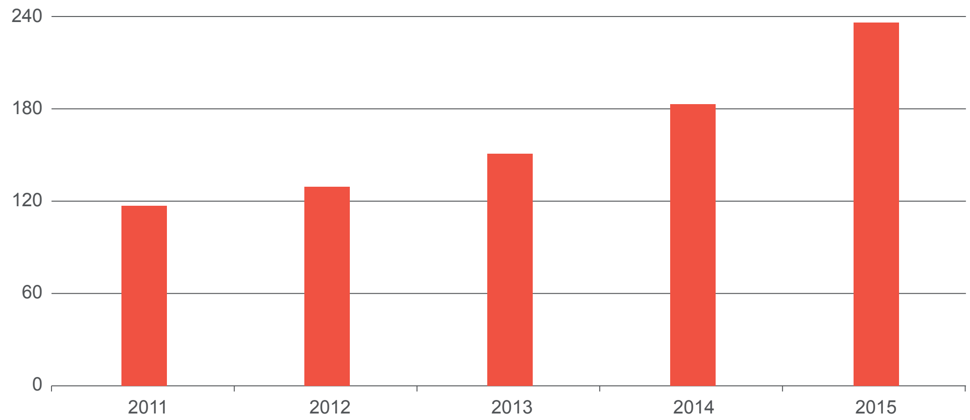
Gin and its unintended consequences

Since the end of 17th century, cheap gin began to be consumed in large quantities in Britain and laws introduced by William III actively encouraged distillation. Sometimes gin was even distributed as part of workers' wages. As gin was taxed at 2d per gallon, while strong beer was taxed at 4 shillings 9d, gin consumption soon outstripped demand for beer. However, the widespread consumption of gin was causing serious health and social problems, and it is cited as one of the reasons why the death rate in London overtook the birth rate in this period.

In 1729, gin sellers were required to hold a license (at a cost of £20) and the duty was raised to 2 shillings per gallon. The Gin Act of 1736 tried to make gin prohibitively expensive through increasing the cost of the license and duties. Rioting ensued and in the following seven years, only three licences were bought as the gin market went underground. The Act was repealed in 1742 and the gin problem reached its peak during that decade, before a new system of regulation was introduced in 1751. So the tax man neither brought the gin market under control nor gathered revenue, unintended consequences indeed.

FIGURE 8:

Total number of gin distilleries in the UK



Source: WSTA, The number of new distilleries opening in the UK

Fast forward to 2009 when three individuals wanted to launch Sipsmith gin, again it was the British taxman who proved to be the biggest hurdle for the budding entrepreneurs. With plans to start up the first copper pot base distillery in London in over 180 years, the tax authorities said that their plans to produce less than 300 litres at a time was so small that it was technically 'moonshine'. It took two years of lobbying by the trio before the law was changed and Sipsmith was granted a licence. This heralded a dawn of craft gin producers and enabled whisky producers to improve their working capital by producing short cycle gin to generate cash while their whisky matures in cask.

Figure 8 shows the steep rise in the number of distilleries in the UK in recent years.

I doubt that HMRC understand the full ramifications of their actions or that the incumbent big brands took much notice at the time but from little juniper berries has big business grown.

5 Taking a leaf out of evening news programmers, we aim to end with a lighter-hearted piece

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Information Required for Distribution of Foreign Collective Investment Schemes to Qualified Investors in Switzerlan

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