NORTHSTAR
ASSET MANAGEMENT
Market Report

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Markets and what strategy should be adopted?

Bill Gross coined the 'New Normal' in 2009:

The previous PIMCO Head, Bill Gross, coined the term "New Normal" in 2009 to describe a world where the horrific bear market of 2009 would give way to an economic environment characterized by a long and hard journey of sovereign and corporate deleveraging leading to an extended period of slower growth.

The link between economic stagnation and stock market returns:

As the 'real' economy slows, Gross argued that investable assets would, in time, mirror this state and investors would need to come to the realization that obscenely elevated historical returns would give way to significantly lower future returns. He argued further that smart investors would consider reducing risk and diversifying asset exposures towards a more sedate asset allocation mix.

Have Gross' predictions unfolded accurately?

Although Gross' prediction has at times looked pretty inaccurate, particularly in that central banks fuelled stock markets gains after the 2008 crisis, it is hard to argue that the economic backdrop is not resembling his thesis and central bank interventions are 'pushing on a string'. Validating this view are the following observations:

Economic growth in the developed world is erratic and slow. US GDP rose 0.5% in the first quarter of 2016, this was the weakest pace in the last two years. The German economy grew by a tepid 0.7% in the first quarter of 2016, and this called for a celebration as 0.7% was more than double the measly 0.3% growth in the final quarter of 2015.

Economic growth in the developing world is inconsistent and as a whole, weak: Brazil's economy is expected to shrink -3.4% in 2016, it shrank -3.8% in 2015. The World Bank predicts that the Russian economy will contract by -2% in 2016 after it contracted -3.7% in 2015. India is a bright light, with a growth rate of 7.6% expected in 2016, this can be ascribed to sound performances from their manufacturing and farming sectors. Chinese growth remains an enigma, but is forecast to be 6.7% this year, except for the crisis in 2009, this is the lowest level since peaking at 23% in 2007.

Global inflation is presently benign. Because emerging market inflation is often distorted in the short-term by currency fluctuations, a clearer picture on inflation trends emerges by assessing developed markets or OECD (Organisation for Economic Co-operation and Development) data and the following applies. Inflation expectations for the year ahead remain stubbornly subdued as follows: UK 1.5%, the US 1%, Japan 0.7% and China 2.5%. Low inflation is in itself not the problem, it is instead what it tells us about the state of the world's economy and that is concerning. Benign inflation represents, in our opinion, a complete lack of demand for goods and services globally as well as proof that excess manufacturing capacity exists within the global economic system.

In most economies Interest rates are at historically low levels. Negative real, and in certain instances, negative nominal interest rates are a sure sign of a world economic system that remains unhealthy. Rates in the UK are 0.5%, in the US 0.5% and the official European Union rate is 0%. Concerning is that projected interest rate hikes in the US are being pared back suggesting the long-term equilibrium rate or natural rate of interest is falling. For our readers with a technical bent, the equilibrium or natural rate of interest is the interest rate consistent with real GDP equalling to potential GDP, which requires an absence of transitory shocks to demand.

Markets are range bound:

It is important to acknowledge that the long-term growth rates of listed companies is influenced by nominal GDP growth, so perpetually low economic growth makes it harder for companies to generate earnings.

So although Gross' projections on markets initially did not reach fruition, his economic prognosis has been dead accurate and stock markets have been stagnating since the middle of 2014. These are signs that Gross' market views are starting to unfold. Below we show the performance from the World Index since the middle of 2014 – markets have not delivered any returns.

Figure 1. MSCI World Index remains range bound Source: Bloomberg

So how do investors counter this problem?

We believe that a number of important strategies need to be implemented as follows:

- Understand that investing is a multi-decade plan, the markets might provide limited returns for a period of time, but great businesses with pricing power will generate earnings and these will be reflected in rising share prices over the longer-term.
- Understand the concept of fruit versus the tree. The tree is the capital return which an investment provides and the fruit is the yield that emerges from that investment. Wise investors look towards the fruit over the course of the investment timeframe and capitalize on the tree closer to the end of its useful life. Most trees go through growth spurts and then lulls, but fruit is more persistent. The fruit, in the case of equities, is the dividend yield and in a world characterized by low growth rates, the dividend becomes a larger component of the total return available to investors. It is important to own companies with meaningful cash flow generation during depressed periods of economic growth.
- Diversify asset exposure – Expose capital to varying asset classes as we move through investment cycles. Long-term exposure to equities remains our preferred positioning, but we must acknowledge that investment cycles call for varying asset exposures at varying times. For exactly this reason at Northstar, we have introduced a simple and compact range of products to ensure that we remain completely focused but offer our clients an opportunity to migrate to less volatile assets when times demand such an approach.
- It is our contention that the bulk of client capital is well suited to be housed within a well-diversified and long-term focused share portfolio; however, we do feel that a portion of capital should capitalize on bouts of extreme market pessimism and optimism (along the lines of Gross' predictions) that requires a more active approach. This is an environment highly suitable to a small and nimble manager with a deep research focus. An active approach is easier to implement within a unit trust, versus a private client share portfolio due to tax consequences and hence Northstar is launching an equity fund – this was always Alexander Otten's wish.

Roche:

The qualitative criteria which we assess before investing in a business include assessing the firm's management team and their expertise; establishing whether the business operates within an industry with sound economics and, whether the firm in question enjoys a competitive advantage within its industry.

This entire process is designed to prevent us from buying into firms with unpredictable and unexpected outcomes. Buffett validates this with his quote: 'When a management team with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact.' With this analytical framework in mind, what follows is a summary of our assessment of Roche, the world's largest biotech company with its deep-seated expertise in immune-oncology.

Roche the business:

A thoroughbred pharma business:

98% of Roche's profit is derived from pharmaceuticals, which involves the production and sales of drugs and medicines. Only 2% of the Group's profits come from diagnostics, so this is a highly focused pharma business. Roche's area of specialization is oncology and in particular, immune-oncology which is a form of treatment that enables the patient's own immune system to stop the growth of cancer cells.

Not only is oncology the largest part of Roche's business, but it is the fastest growing component within the business, accounting for 66% of its revenue in 2014 from 42% in 2005.

The macro picture – tailwinds or headwinds?

Staying in business is often the greatest challenge for any business, but it is certainly made easier when natural tailwinds exist that drive growth without a management team needing to create demand for a product or service. Roche and the other large global pharma companies which we have analysed exist within an industry with almost unparalleled tailwinds. These come in four forms:

- An ageing population in the developed world.
- Rising healthcare costs – increased disease complexity creates opportunities for higher revenue and increasing profit margins.
- Emerging market growth and an ever increasing need for medical access.
- New discoveries and technologies – specialty medicine is becoming a more important opportunity for pharmaceutical manufacturers.

With respect to the aging population in the developed world seeking increasing levels of medical support, in 2012, 61% of the global spend on medicine came from three areas – the USA, Japan and Europe.

With respect to disease complexity, the extent to which increasing numbers of people worldwide are facing cancer plays into Roche's hands. As per the National Cancer Institute (NIH), the cancer statistics speak for themselves:

- In 2016, an estimated 1.7 million new cases will be diagnosed in the USA and 596 000 people will die of cancer.
- Approximately 39.6% of American men and women will be diagnosed with cancer at some point during their lives.
- National expenditure for cancer care in the United States totalled nearly $125bn in 2010 and is expected to reach almost $160bn in 2020.
- In 2012, there were 14 million new cancer cases and 8.2m cancer-related deaths worldwide.
- The number of new cancer cases worldwide will rise to 22 million within the next two decades.
- More than 60% of the world's new cancer cases occur in Africa, Asia, Central and South America. Seventy percent of the world's cancer deaths also occur in these regions.
- For certain countries, such as the United States, the overall cancer death rate has declined since the early 1990's. With death rates declining, the number of cancer survivors has increased.

To fully appreciate the extent of growth that is available to the pharma industry, one simply needs to take note of the total global spending on medicines and expected projections for the years ahead. From the attached graph, it is clear that spending grew 30% between 2007 and 2012 and growth is forecast to rise 22% between 2012 and 2017, turning the total industry value into $1.2tn annually.

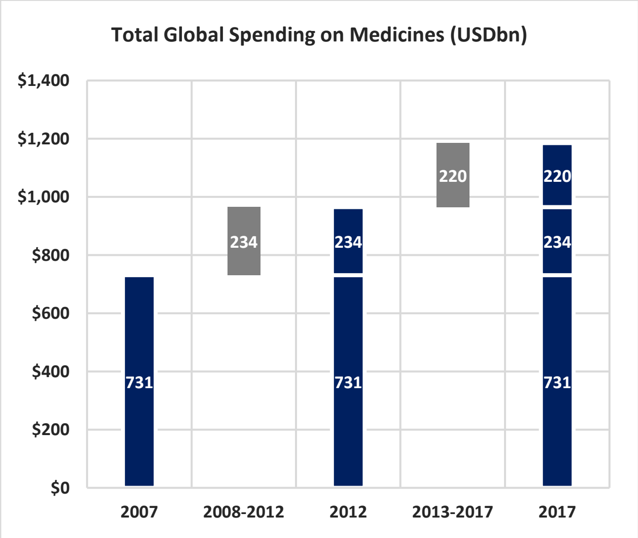

Figure 2. Annual global spending on medicines is expected to rise to $1.2tn by 2017
Source: IMS Institute for Healthcare Informatics

In addition to general medicine growth in medicine sales, it is worth noting that oncology spend in 2017 is forecast to be about $80bn in the developed world and $20bn in the developing world. This is more than double the spend levels on diabetes, which happens to be the therapy with the second highest spend rate.

The structure of the industry:

Natural tailwinds aside, the structure of the pharmaceutical industry is also suited to producing returns in excess of the cost of doing business.

It is an industry that is highly concentrated with approximately 25% of global medicine spending dominated by only four firms. The top thirteen companies account for between 50% and 60% of the industry's revenue. Most drug categories have only two or three dominant players, thus reducing competition and ensuring positive pricing dynamics.

Barriers to entry are also elevated. The cost of research and development is a key differentiator in this industry and unlike the incumbents that enjoy significant cash generation from their existing approved products that can fund R&D, new entrants experience cash burn as they undertake lengthy research projects, this even before the often insurmountable regulatory approval process.

From a buying power perspective, healthcare providers (the clients of the pharma companies) are price takers as against price makers. With such a powerful industry dynamic, it is tough to see normal competitive forces reducing the powerbase of the pharma giants and hence the constant desire for regulators to impose legislation in this space.

Whilst legislation is a risk, we rate the pharma industry fundamentals as outstanding.

The Management team:

Roche has the strongest drug development pipeline in the industry with over 25 phase III projects and multiple projects in registration. The company is at the forefront of R&D, with approximately 19% of its annual sales going into research and development.

From 2000 to 2008, the company restructured to focus on biotechnology and divested from two businesses, fragrances, flavours & vitamins, and fine chemicals. The big focus became advances in diagnostic techniques and medicines aimed at molecular targets – the goal being to detect diseases earlier and treat them more specifically. It further acquired strategic stakes in powerful biotech businesses to consolidate its positon – Genentech in 2009 being transformational for Roche.

These strategies have resulted in phenomenal returns to shareholders. Normalized Returns on Equity have been above 70% over 5 years and returns on invested capital have exceeded 35% over this period.

It was an inspired decision by the Management team to focus on biologics, as this part of the pharmaceutical market is growing significantly quicker than the rest of the market, yet represents a mere 18% of the industry currently. The headroom for significant further growth thus exists.

Validating Roche's position as the world's largest biotechnology company, it has 14 biopharmaceutical medicines on the market and 39 biopharmaceuticals in the pipeline.

The valuation:

We initiated this assessment on Roche by indicating that it is a company satisfying all our requirements for a position in our portfolios subject to being priced correctly. Sadly, this is the one area that deters us from holding significant stakes in the business. Although well off the share price highs which exceeded 275 Swiss francs, reached in December 2015, Roche remains slightly overvalued relative to our calculated intrinsic value.

We believe that a margin of safety is required before committing to an investment, this margin is a discount at which the stock must trade to our calculated intrinsic value to provide enough upside to warrant the investment. Roche is subject to bouts of share price weakness as stock markets ebb and flow; we wait patiently to seize a moment to acquire sizeable positions across all our portfolios.

Adrian Clayton and the Northstar Team