Mondrian
INVESTMENT PARTNERS

Mondrian's Valuation Discipline

End of Year Commentary

Quarter 4 2020

It doesn't matter how long one has worked in this industry, no two years are the same. Working in the stock market is fascinating as one is always learning, one is always being exposed to new themes and one is often caught off guard by events, however hard we try to prepare our portfolios for most eventualities. 2020 was no different as we were faced with the most devastating event to hit the global economy and society in decades. On the one hand, Covid-19 has shaken the global order in unimaginable and unforecastable ways; but on the other it has merely served to accelerate certain themes that were already in train, and have now become more entrenched. This is of course most evident as it relates to the adoption of technology.

There are a myriad of lessons to learn from 2020, but from an investor's perspective, the pandemic highlighted the need for us to be adaptable, open minded and flexible. What looked like a good business or good investment in early 2020 may now look a broken one, while many other business prospects have been enhanced. We did our best to identify these trends as early as possible and adapt the portfolio accordingly.

Alongside these trends has been the continued underperformance of the MSCI EM Value index versus the Growth index; but maybe it is the definitions themselves that are part of the problem? While as investors we need to show a degree of adaptability in our thinking as business trends change, if there is one area of the investment industry that has remained intransigent over the last decades, it is the way in which it typically considers and defines value and growth stocks. For the most part, the definitions are backward looking, taking into account historic metrics such as price to earnings, dividend yields or price to book metrics. Yet carrying low valuation parameters is far from synonymous with underpriced. It is easy to be seduced by the former, but a stock with a low P/E for example is likely a bargain only if the future prospects are sound.

At Mondrian, we employ a tried and tested valuation discipline, a Dividend Discount Model (DDM) focusing on attractive long-term fundamentals, real growth in future earnings, cash flow and ultimately dividends. We emphasise companies with strong balance sheets, sustainable free cash flow generation, and value accretive capital allocation. It is worth dissecting this methodology to understand what really drives our valuations

1. **The model is long-term** – we are not forecasting the next few quarters but numerous years out. This enables us to capture and differentiate between long-term structural growth trends and guard against areas that may be in structural decline. It is therefore evidently **a forward looking valuation approach** whereas traditional value metrics are backward looking.
2. **The model requires growing or sustainable free cash flow generation over the long term and a strong balance sheet –** without this, we cannot have confidence in the future growth of dividends, and hence an attractive investment case.
3. **A DDM methodology requires management to be aligned with shareholders –** the above may be rendered worthless if management don't retain or invest cash flows effectively.
4. As a result of the above, if we buy attractively valued companies within the DDM framework**, we should create above average returns with lower than average volatility**.

The DDM is the bedrock of Mondrian's valuation discipline, with its success rate primarily down to the accuracy of our future earnings, cash flow and dividend forecasts. The majority of the industry and MSCI's traditional way of defining value is backward looking, while there is also a focus on tangible assets and accounting earnings, but not cash flows. Many features of the traditional definition of value are arguably ill-suited to today's economy. As the industrial age gives way to the digital age, the intrinsic worth of businesses is not well captured by old style valuation methods. This has

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been complicated by a shift from tangible to intangible capital – from an economy where factories, office buildings and machinery were key to one where software, ideas, brands and digital investments matter most. The way intangible capital is accounted for (or rather, not accounted for) distorts measures of earnings and book value, which makes them less reliable metrics on which to base a company's worth.

In a technology driven global economy, the value of a business is increasingly in intangibles - assets you cannot touch, see or count easily. For example, think of the intellectual property of various game franchises, such as that owned by Netease; or the skills from thousands of software engineers at the Indian outsourcing company Infosys; or the billions spent by Baidu into its autonomous driving platform Apollo through in-house development; or Tencent and Alibaba's data pools and algorithms that help it generate significant cash flow streams. Companies therefore which invest through R&D, develop software, grow their brand, and build strong internal cultures, are investing in intangible assets that could generate cash flows in the future. This evolution that more accurately captures businesses today is not adequately captured by either a focus on historical tangible assets or on past accounting earnings. Similarly, it could be argued that assets which in the future generate increasingly lower cash flow (such as non-renewable fossil fuel sectors, or physical retail), should be worth less than book value today, thereby confirming that an optically low P/BV may well be justified.

The global economy has changed. The way investors need to think about valuation arguably needs to change too. At Mondrian however, we have the perfect model to capture and value these trends given the long term focus and emphasis on cash flows, hence Mondrian's valuation tool and discipline remains unchanged.

Within the Mondrian EM portfolio, we have shifted our portfolio exposures over the last few years to try and avoid some of the most troubled areas of the asset class, from a top down and bottom up perspective - many of which are classified as 'value', in favour of more resilient and attractively valued structural growth areas. Covid-19 merely furthered this evolution in favour of Asia, which has dealt with Covid-19 better than most other parts of the world; and towards technology linked companies as the business evolution the world is going through has become even more tech centric, a trend which will surely not be reversed.

We continued our recent development of buying into a range of industrial and consumer related technology companies in 2020. We focused on more value oriented technology companies that had sold off such as Hikvision; or had been overlooked by the market given their transition to new growth areas such as Baidu, Hon Hai and Delta Electronics; or were at the cusp of structural growth in areas like solar renewables such as Longi Green Energy. We chose these names over sectors such as energy, industrials or utilities where we have far lower long term conviction. We have stuck rigorously to our DDM valuation discipline, identifying resiliency in these new names which are highly cash generative companies exposed to attractive sector dynamics but are also attractively valued. We are not buying mere themes however. Of the Top 100 stocks in the MSCI EM Growth Universe, we own less than 10% of the names. Of the other 90% in the growth index, there are many companies also exposed to these areas, but we don't own them given valuations we struggle to justify. It should be evident therefore that our valuation framework is helping us to avoid buying both value traps, and overvalued securities based on excessive optimism.

When the industry considers value and growth however it has mostly not adapted to the profound changes in society and the business world that have taken place and will continue to prevail. Due to backward looking measures, value is perceived to be within old economy sectors despite the fact that many of these companies will struggle to sustain current profit levels over the long term and therefore may in fact be far less "value" than simplistically assumed. At Mondrian, we have been open minded in our approach and adapted to the changing world we live in today. We are fortunate that we have a valuation discipline and methodology that is forward looking and doesn't define value based on simplistic short-hand indicators such as historic based PE or PB measures. Of course there will be brief periods when traditional value stocks will outperform, but we question the sustainability of such a rally absent long term structural growth.

We believe we have a portfolio today that is well placed for whatever the next twelve months and beyond should bring. However, as much as we try to protect for all eventualities, 2020 once again taught us that shock events regularly occur. As we sit today, despite the highly encouraging vaccine roll out; the fall out for economies globally from Covid-19 will undoubtedly be severe. Furthermore, we are witnessing events in the US political systems that are unfathomable. Challenges and uncertainties therefore still persist.

Nevertheless, if we maintain our valuation discipline, and focus on highly cash generating businesses, with strong balance sheets and management teams that are aligned with shareholder's best interests, we believe we should achieve our long-term goal – delivering attractive returns in this asset class, in a sustainable and stable manner.