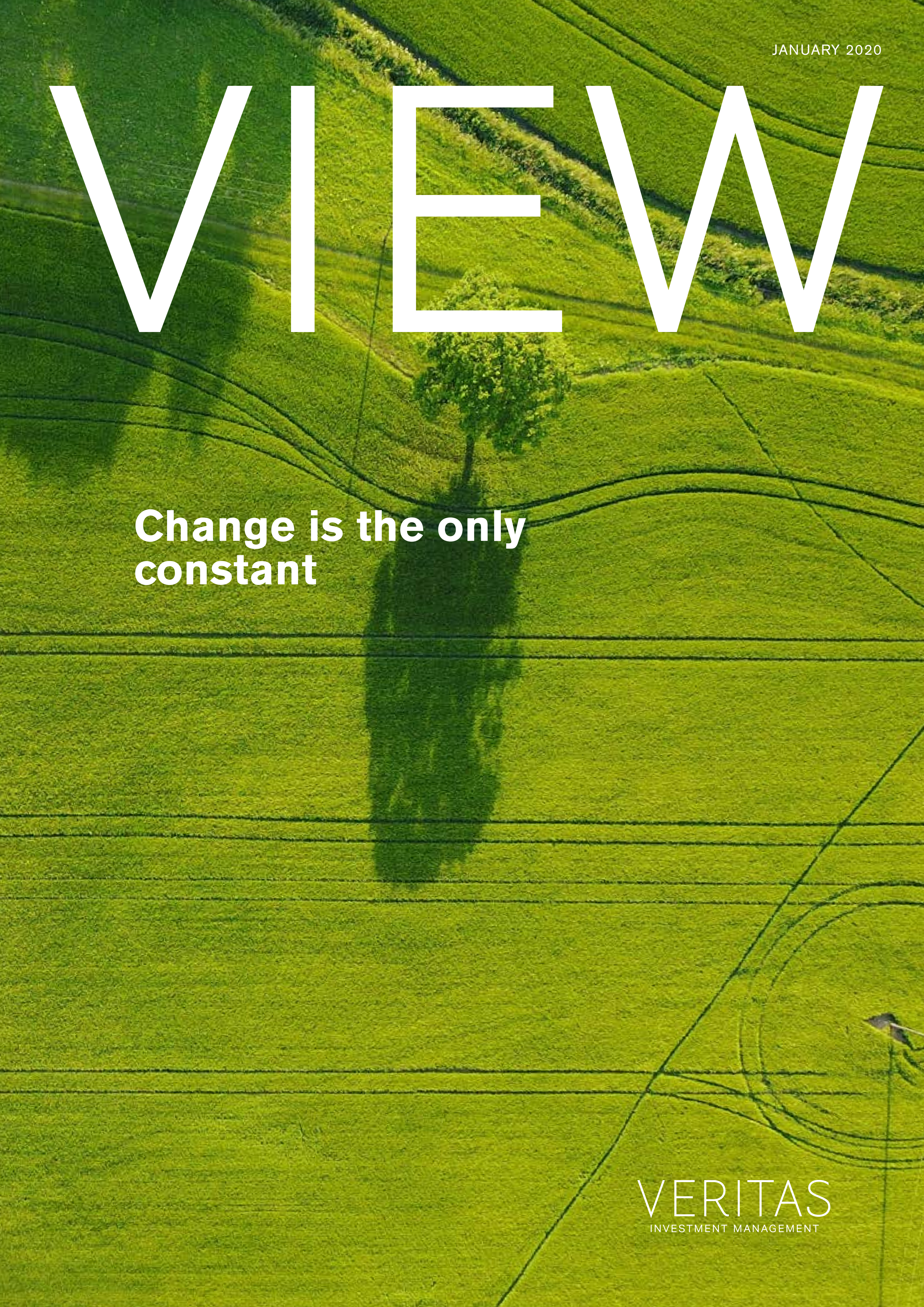
JANUARY 2020

VIEW

Change is the only constant



VERITAS
INVESTMENT MANAGEMENT

HAPPY NEW YEAR

Civilisations have been setting New Years' resolutions in one form or another for around 4,000 years. Whilst ancient Babylonians were likely galvanised by the prospect of a good crop, rather than a call for 'New Year, new you!', resetting expectations at the beginning of a new year is ingrained in our society. The end of a decade heightens the sense of renewal.

While the past 10 years have been positively pedestrian compared to their equivalent 100 years ago, the 2010s brought change; on the political stage (the Arab Spring, Trump, Brexit), the rise of social media, and a series of natural disasters that focused attention on climate related issues. The decade also brought changes to the way we live and work that, when totted up, amount to a fairly seismic shift. This newsletter was largely written on an iPad, which celebrates just its 10-year anniversary this month. We remember fondly, and not that long ago, a colleague who still had their emails printed and left on their desk each day to read.

"Change is the only constant", as Heraclitus[1] (sort of) said. This presents a challenge to our investment approach, which is to identify predictable and durable companies, and hold them for the long term. We constantly adapt our research process as we learn and improve, and several years ago we tweaked our 'quality of business' checklist to explicitly consider the potential disruption to business models from technology. The scale and speed of change taking place today is perhaps the best reason why a truly active approach to investment management is the right one: it has never been more important to avoid the disrupted and identify the disruptors.

This last point matters. Thinking about the risks to our businesses is key to preserving and growing our clients' wealth, but we also ask ourselves whether the opportunities from technology are integral to a management's strategy – in all sectors.

1. Greek philosopher c.500BC. Quoted by Plato in Cratylus as saying "Everything changes and nothing stands still".

INNOVATION

One of the reasons new technologies are developing so rapidly is the exponential growth[2] in the amount of data being generated, alongside the computing power available to analyse and make sense of it. More people + more devices + more apps on those devices = a lot of data. This explains how IBM was able to claim in 2017 that 90% of the world's data (then!) had been created in the past two years. These two factors, data and computing power, combined are the key ingredients of machine learning, which is the most common form of artificial intelligence (AI) we are starting to see applied in our day to day lives.

At an internal meeting focused on this subject, we were reminded that really successful AI won't be noticeable. Already, e-mail filters anything it detects as junk or a promotion, sending them to separate folders. It drafts responses and reminds us to reply. Even functions previously thought of as too difficult to crack are rapidly evolving: the time taken to teach a computer to recognise an image has fallen from 3 hours to 88 seconds in the last two years[3]. The cost of doing this has fallen from $2,300 to $12. Much of this improvement has come from advances in AI processors, many developed by Alphabet (Google's parent company), manufactured by Taiwan Semiconductor Manufacturing Co (TSMC) and available to rent on the cloud for as little as $1.35 an hour.

This rapid fall in the cost of AI democratises the technology, and throws up new and better ways of doing things. At their investor day in September, Swiss pharmaceutical company Roche described the investments they are making in digitalising and standardising all their past and present drug research and clinical trial data. This is helping bring better diagnostics and personalised medicines closer to reality. The scope for improvement is clear: it takes, on average, 12 years, >7 million hours of work, >6,000 experiments and 400 researchers to bring a new medicine to market. The CEO makes a convincing case that "it is easier for Roche to learn tech skills and hire tech talent than it is for the FAANG[4] companies to learn healthcare and regulatory skills".

Conversations with management teams this year increased our conviction, echoing Roche, that deep industry knowledge and unique data sets are the vital ingredients for digital success. One of the most data rich companies we invest in is Experian. In the US market they hold 18 years' worth of credit history for 247 million adults. This is two petabytes of data – four times the amount of data needed for a NASA mission to space that orbited the earth 40 times, conducted 200 experiments and brought the ship back to earth safely.

The march of 'digital' into our lives is throwing up some surprises. In the stodgy world of consumer goods, for example, we had feared that the ease with which new businesses can now be created and scaled up online could prove challenging to the dominant positions of Unilever and Nestlé. In fact, these companies tell us that their online market shares are in fact higher, with greater profitability to boot. Newspapers stoke fear with predictions that automation will destroy swathes of jobs, yet the evidence shows that companies that have adopted robots over the past 20 years have created more jobs[5], and improved productivity.

Despite political events and trade war concerns we have found opportunities. Dental specialist Align Technologies, purchased in the autumn, is growing sales c.20% per annum as its digital mouth scanners replace putty moulds, and its Invisalign clear plastic aligners replace wires and brackets. Innovation for the selfie generation. Kerry, the Irish listed food and flavourings business (also purchased in the autumn) points out that 75% of food consumed today comes from just 12 plants and 5 animal species. With the global population predicted to increase by >30% by 2050, the question is how can the planet feed all these people. Kerry's innovations in taste and nutrition will be a critical part of the answer. Another company we are looking at has developed an animal feed that reduces the amount of methane produced by cattle!

The common thread that unites our investments is something structural in the demand for their goods or services, that should allow them to grow through a more difficult backdrop. We use our themes to identify companies benefitting from this growth, and then try to buy them when the market gives us the opportunity to do so at a price below our estimate of intrinsic value. We spend as little time as possible worrying about whether this makes us 'growth' or 'value' investors.

2. Exponential growth: if you take 30 steps along the sequence 1,2,3,4 you get to the number 30. Thirty steps along the sequence 1,2,4,8 you get to a billion. Source Baillie Gifford.
3. https://dawn.cs.stanford.edu/benchmark/
4. FAANG stands for Facebook, Apple, Amazon, Netflix and Goog (Alphabet)
5. Source: Koch et al, Centre for Economic Policy Research, 'Robots and Firms' 01.07.19

LOOKING *FORWARD*

Janus, the Roman god of doors, beginnings and endings (after whom January is named) has two faces. One looking back, and surely marvelling over the remarkable innovations of the past decade, and one wondering what comes next.

In late 2009 we were still reeling from the global financial crisis. Central banks had removed the threat of total financial meltdown, but the world still felt fragile. Commentators predicted rampant inflation as a result of low interest rates and monetary stimulus. As we now know, this has yet to materialise in most countries (cases like Venezuela the sad exception, where worthless bolivar notes are now turned into origami and sold for fractions of the sum of their former parts). The Bank of England chose 2019 to rename its Inflation Report the 'Monetary Policy Report', the timing of which caused us to raise an eyebrow.

There is, of course, a great elephant in the room when discussing the 'absence' of inflation: that of asset prices over the past decade. If it felt in late 2018 that this trend was stuttering, 2019 soon put paid to that idea, and we can now look back on 10 years of strong returns from equities, bonds and gold. Private equity firms are sitting on a record $1.45 trillion[6] of cash at year end, and insider selling at US corporates reached a two-decade high[7]. Nothing screams great value in a world where interest rates have been this low for this long.

Much rests on whether you believe rates are being held artificially low by central banks, or whether this is their natural level given powerful deflationary forces such as debt, demographics, e-commerce (which brings vastly improved price transparency), falling energy prices and technology. If it is the former, then the severe market reaction in Q4 of 2018 to the Federal Reserve Bank's attempt to normalise policy rates and its balance sheet does not bode well. Our view is that it is a combination of the policy response and the more structural deflationary drivers. From a valuation perspective, we have kept our discount rates high (8-10%, depending on the degree of cyclicality) and resisted the urge to wizard up value by lowering our investment hurdles.

While it feels as though the deflationary power of technology in particular has never been stronger, we would be foolish to forget that at some point, change is inevitable. A political consensus is developing around the need for governments to add fiscal stimulus to the monetary artillery, funded by more government debt. Trade barriers could alter supply chains (indeed this is already happening) and reverse the process of globalisation that has contributed to lower prices. We won't repeat previous conversations on debt, save to remind ourselves of the Hemingway quote: "How did you go bankrupt? Two ways. Gradually, then suddenly."

So with this in mind, we will set the same resolutions as every year both at home (read more, look at our phones less) and here with our clients' investments in mind. Amidst much that is changing, the core tenet of our philosophy remains constant: to own 25-40 well-managed companies, that can grow their sales and cash flows through economic cycles, maintain strong balance sheets, and allocate capital sensibly, as this will ultimately flow through to shareholders in the form of a rising share price. We will continue to devote all of our time to ferreting these out.

Written by **Catriona Hoare**
on behalf of the Investment Team

6. Source: CNBC 03.01.20
7. Source: The FT 24.09.19

STEWARDSHIP REPORT 2019

This report aims to bring our stewardship activities to life by offering a window into our company engagement and voting activities over the past year.

Our stewardship activities are constantly evolving. While some aspects, such as this report, may be recent developments others, such as the continuous monitoring of investee companies, have long been a crucial part of our investment process. Just as we acknowledge that the companies in which we invest are continuously improving, so too are we and we look forward to sharing more details of our stewardship work as it develops over the months and years ahead.

For more information on our stewardship processes, please read our Engagement and Voting policies which are available on our website, alongside our statement of compliance to the UK Stewardship Code.

COMPANY ENGAGEMENT

During 2019, we had over 125 meetings with companies. The majority of these were with companies in which we invest but some were part of our broader investment research.

We communicate with companies whenever opportunities arise, in good times and in bad. We view our engagement with companies as a chance to build and sustain long-term relationships. With any interaction, our goal is always to work with companies for the long-term benefit of the companies themselves and shareholders, including our clients.

Of course, building relationships is all well and good, but our fundamental aim remains to deliver real returns for our clients. Should any of these meetings lead us to believe that the investment case for a company has changed so that our clients' capital is at risk, then we would vote with our feet and sell the shares. During this year, none of our engagements led us to take such action.

As is always the case, the reasons for our meetings with companies this year have been varied. Sometimes they occur before we buy a single share. Prior to our investment in **Align Technology** this year, we spoke to the company about disclosure around environmental, social and governance risks, such as plastic waste and conditions for its global workforce. Despite a strong investment case, we were concerned that during our initial research process we had been unable to find evidence that management fully understood and were addressing these risks. However, our conversation was reassuring: management is tackling ESG issues but the different regulatory requirements and investor interest in the US mean that disclosure has been less of a priority. It turns out that the plastic content of their core aligner products has already been reduced by 50%, while Align offers employees packages above local standards and norms. And although progress on improving disclosure is slow, there are signs that this is changing.

Other engagements have been in response to one-off issues. In January, we had a call with US diagnostics provider **LabCorp** following a cyber-attack on the company's systems. We spoke to a number of executives, including the Chief Information Officer and Chief Information Security Officer, proof that while we will never be the biggest shareholders, we can still gain access to senior management. Attended by our resident healthcare and technology experts, the call covered multiple issues, such as board oversight, internal resources and regulatory responsibilities. It was clear to our team that the company has a very robust security system: it detected and closed down the breach rapidly and has taken further steps to enhance its protection against further attacks. With millions of patient records under its control, cyber-crime is a huge risk for the company, so we were surprised to hear that few investors had investigated this area in the same level of detail.

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VOTING ACTIVITIES

Most of our meetings have been part of our ongoing monitoring work. Quarterly results may move share prices, but we believe it's the long-term picture that matters and have used meetings over the last year to discuss issues such as long-term strategy, governance and board structures, capital allocation, the competitive environment and culture. In October, members of the investment team met with **Unilever** to discuss sustainability and the company's approach to tackling environmental and social risks, such as plastic pollution and deforestation. While the scale of the challenge is enormous, so is the company's response. We were impressed by the extent to which addressing these issues is embedded in the long-term business plans and forms part of management compensation. There are no easy solutions but the many initiatives the company has introduced across its supply chain and production processes are all steps in the right direction.

Occasionally, roles can be reversed and meetings take place at the request of the companies themselves. The Investor Relations team at **Avery Dennison** contacted us towards the end of the year to ask our opinion on director commitments and proposed changes to executive pay. As well as giving us the chance to help the Board with their enquiries, we used the meeting to engage on four further issues: the independence of the Lead Independent Director (who was also on the call), sustainability governance, the living wage and auditor tenure. We were reassured on each of the issues we raised and were delighted to have the opportunity to share our views and examples of industry best practice with the company.

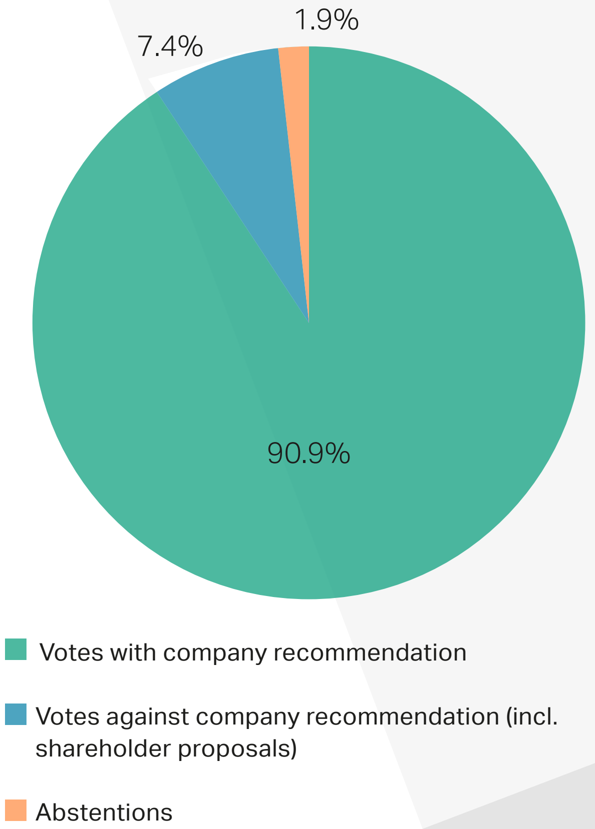
We believe shareholder voting is an important way of communicating with companies and we therefore exercise our right to vote on behalf of our clients wherever possible. Each voting decision is taken on a case-by-case basis by our investment managers, based on independent judgement, analysis and the outcome of engagements with companies. While we have voting guidelines, we believe taking a one-size-fits-all approach is not always in the best interest of companies and shareholders. As Tim Martin (the founder of Wetherspoon) noted, if all banks adhered to the 9-year tenure rule for directors, there would currently be no-one on bank boards who saw the same bank through the global financial crisis in 2008![8] As we aim to only invest in well-run companies which have strong management teams and governance structures, we typically expect to vote with the board recommendations. Further, we consider ourselves active, rather than activist, shareholders and hope there will never be a time when we need to report multiple examples of voting against companies. That said, there have been cases this year when we felt it necessary to vote against certain proposals. When we do vote against proposals, we always write to the company to explain our decision.

Company case study – Fresenius Medical Care
We voted not to approve the General Partner and the Supervisory Board at the AGM this year because of the company's violations of the US Foreign Corrupt Practices Act. This was certainly not an easy decision, especially given that the company self-reported the violations, worked closely with the US authorities to resolve them, and that those directly involved in the bribery practices are no longer with the company. However, given the long time period over which questionable business practice occurred and the fact that it was unclear whether relevant senior executives had been held accountable, we wanted to highlight our concerns over Board and management oversight by voting against these resolutions.

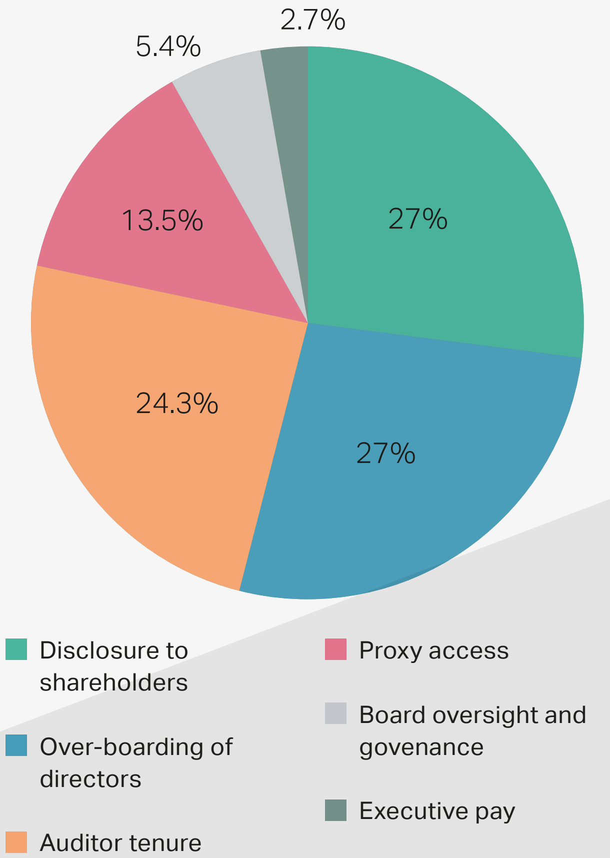
Writing to the company to explain our decision paid dividends in this instance as it led to two meetings

8. Source: thetimes.co.uk 14.11.19

Overall voting record[9]



Votes against companies & abstentions by theme[10]



to discuss the issues, the first with the Head of Investor Relations and the second with the Chair of the Supervisory Board. Both occasions gave us the opportunity to share our concerns and our experience of best practice across other companies and industries, whilst improving our own understanding of German governance structures (complicated at the best of times). Through this dialogue, we were reassured that the specific issues which led to the fine had been addressed and the risk of a repeat occurrence had been reduced. Our investment case therefore remains intact.

Issue case study – Over-boarding of directors

We encourage board diversity in all forms and believe it is particularly important for directors to have a wide range of skills and experience. However, directors sitting on too many boards are unlikely to be able to dedicate sufficient time to perform the role effectively, limiting their ability to hold executive teams to account and provide the necessary perspectives, creativity and insights. We therefore voted against the re-election of certain board directors who we believe to be "over-boarded".

But as we often say, investment management is an art, not a science. At the Avery Dennison AGM, we voted for the appointment of a new director, Mark Barrenechea, even though he is the CEO of a technology company and already holds another non-executive position. On paper, this list of responsibilities might warrant a vote against his appointment. However, we accepted Avery's argument that his skills and current experience with new technology will be extremely valuable to the company and that he has proved he has the time to commit fully to the role. This demonstrates the importance of not having red lines, of taking each decision on a case-by-case basis and, wherever possible, of talking through these issues with companies.

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9. Source: Veritas Investment Management
10. Source: Veritas Investment Management

Issue case study – auditor tenure
Several of our abstentions and votes against company proposals from US companies have centred on the issue of auditor tenure. We take our responsibility as shareholders for auditor appointment seriously, especially given several recent high-profile failures.
Best practice in Europe is to re-tender after 10 years and change auditor firm every 20 years, with the UK Government considering more stringent regulations to ensure auditor independence. However, in the US indefinite tenure is common (in fact, changing auditors can be seen as a sign that something is wrong) and we found that some of our investee companies have had the same audit firm since the 1950s or even earlier. Of course, the quality of a company's financial statements is ultimately the responsibility of the Directors but having truly independent auditors, who can thoroughly review statements with fresh eyes and open minds, is a crucial safeguard. Auditor rotation also reduces the cost of the audit and shortens the time taken to uncover financial misreporting.

On each occasion, we wrote to the company concerned to explain our rationale. We received several responses but it will take time for practices in the US to catch up with Europe, so we will continue to pursue this with companies.

Shareholder proposals
When it comes to shareholder proposals, we take the same approach as we do to company proposals: decisions are taken on a case-by-case basis. Proposals we have supported this year include those requesting reports on gender pay gaps and supply chain practices at US technology firms, and greater disclosure around spending on political lobbying.

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