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ASSET MANAGEMENT

# C WorldWide Stock Picking
## Using Global Trends and Themes

WHITE PAPER

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### Key takeaways

- We are first of all stock pickers at C WorldWide. The stock specific dimension is the dominant factor, but it is our view that C WorldWide's Trends and Themes support good Stock picking.
- For us this is not a new fad or discipline as we have been Trend based, thematic stock pickers since our inception in 1990.
- We are often asked how we use Trends and Themes in our work. This White Paper has the purpose of explaining just that.

*For more specific insights into our thematic work please consult the different White Papers we have published over the years at cworldwide.com.*

### Why trends and themes?

Trends and themes are the prisms through which we look at the world in order to understand and anticipate change in society.

Our trend-based, thematic investment approach helps us to differentiate between the day-to-day noise in markets and what is truly lasting knowledge that one can accumulate and hopefully provide superior investment insights over time. Stock markets are often myopic and short-term in nature reflecting biases in human behavior. This has become both more evident and pronounced over time. We believe that taking a long-term view is the best way to achieving alpha for active investment managers.

We think of trends as being behavioral in nature and very long term, typically generational. Trends capture glacier-like shifts in society and are therefore not particularly investable. They are, however, very valuable in organizing thought processes.

Themes are organized around the major trends, and as such, are more operational when it comes to thinking about how to deploy capital. The longevity of a theme can also be decades, but typically they tend to develop and mature over 3-10 years. We have identified more than 50 themes linked to 5 major trends.

Trend-based, thematic investing is a framework that stimulates forward-looking long-term thinking. It focuses our resources on the most promising areas of investment and, as a result, leads us away from benchmark thinking – with the benchmark reflecting the past and not the future. It is an approach that ensures a more efficient use of the scarce resource of time.

## Stock valuation in a thematic framework

The classic way of looking at the value of a stock can be useful when considering how trends and themes directly influence stock prices. The value of a stock being the risk adjusted NPV of future dividends/ free cash flows highlights the importance of the key components of time, growth and risk.

## Time – longevity

The importance of time is underestimated in financial markets. The power of compounding is essential and linked to longevity of structural change. Obviously the NPV calculation benefits from longevity – the longer you have thematic tailwinds the better – hence thematic tailwinds can justify higher short-term valuation multiples.

In the 1970's Stanford University computer scientist and longtime Head of the Institute for the Future Roy Amara observed that "We tend to overestimate the effect of a technology in the short run and underestimate the effect in the long run". This observation later become known as Amara's law.

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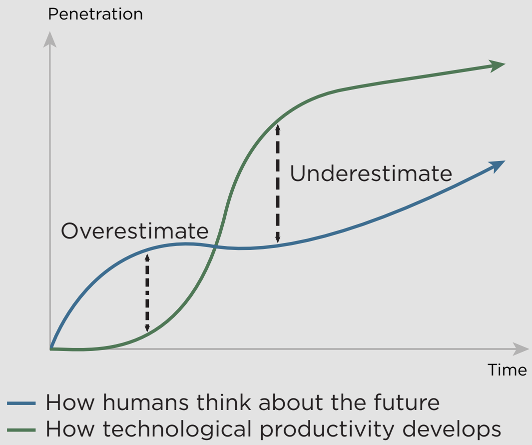
We think this observation is an excellent way to frame thematic thinking as well as a way to explore behavioral biases in equity markets. It also neatly explains why the idea of "mean reversion" in equity markets is so often a myth, and something that the longterm focused investor can take advantage of.

**Figure 1:**
Amara's Law




Source: C WorldWide as of Dec. 2019

When a new theme emerges markets often become over-excited about the imminent possibilities that it gives. Then, time goes by and nothing much happens. Soon the cynics are starting to say the whole thing was hype. This turns out to be just the inflexion point when the theme turns ubiquitous and disruptive.

We have a growth bias but focus on the sustainability over magnitude of growth. Typically, we view the early hype phase as being too early for us to deploy capital, while we tend to get more involved once we have gone past the initial hype and gotten confirmation it's not a fad and market leaders are evolving. It is this phase of the theme development we deem most lucrative as there will be a tendency in markets to discount too early the maturation of growth – or the eventual reversion to the mean, which so often tends to be premature.

At this point in the cycle you typically will pay a high price for the company, but if the company has strong thematic support you are rewarded by the compounding of earnings for much longer than the market is pricing. We spend most of our time working out “what to own”. Valuation is a critical input in our decision-making process, but it is rarely if ever our starting point. Our margin of safety has more to do with our confidence that a company’s competitive advantages will stay strong and or get stronger, than some estimate of a discount to intrinsic value. In our opinion, it is easier to be correct on the strength and longevity of the business model than the estimate of intrinsic value.

If a theme is coming to the end of its life you run the risk of not just losing the thematic earnings (cash flow) support but also the thematic valuation support as perceptions change. It is our experience that perceptions change slowly and need dramatic events like profit warnings to eventually influence the stock price. You have time to react.

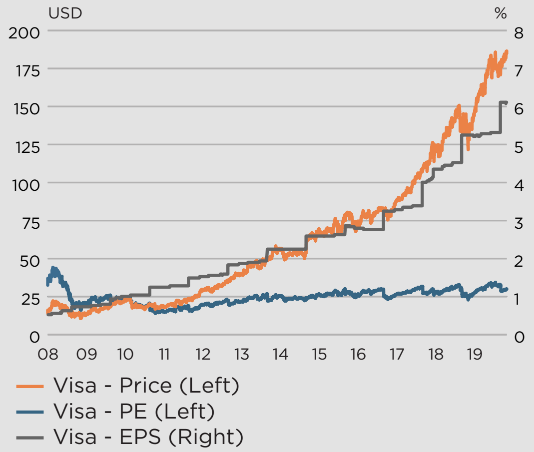
It can be difficult to figure out how long a theme is going to last. Therefore, it is important to understand if a theme is weakening or strengthening – essentially answering the question: are thematic developments moving in the right or the wrong direction in the shorter term – as one of several ways of understanding stocks and longevity.

> **"The importance of time is underestimated in financial markets. The power of compounding is essential and linked to longevity of structural change.**

We believe that investment risk can be minimized by looking for companies with strong moats and high returns that can be reinvested at the same or a higher rate of return. An example of this could be VISA, that has the support from several themes like Cash2Card, Financial Inclusion, e-commerce and Emerging Markets Middle Class growth. Visas share price has done well rising along with its underlying earnings power which has been supported by favourable thematic exposures as the chart below shows.

**Figure 2:**

Earnings Growth Drives Share Prices




Source: Factset as of Dec. 2019

Past performance is not a reliable indicator of future performance

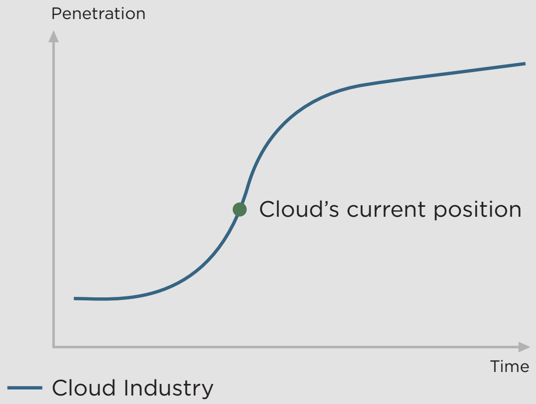
## Growth

The growth rate is another key in compounding – building a bigger company faster. The stronger the theme, the better the opportunity for the company to become bigger – helping the stock price development over the compounding period. Hence, you ideally need to understand how fast and for how long the company can expand. Total addressable market (TAM) considerations are useful in this evaluation. The acceleration phase for a theme can be very powerful but it is also important to understand how long that phase is and what happens after that phase. Our priority is sustainability above magnitude of growth.

Themes have different S-curves depending on the longevity as well as the growth rate of the theme. Some are longer and some shorter, and some are very steep while others may be shallower. Taking the ‘cloud transition’ theme as an example, we believe we are potentially investing into one of the strongest themes in living memory since the cloud companies are amongst the fastest growing large companies ever. We also believe the TAM opportunity of the cloud companies is hugely

underestimated and therefore the growth phase will be much longer than is currently being priced in by markets.

**Figure 3:**
The Cloud Transition




Source: C WorldWide as of Dec. 2019

## The discount rate – perceived risk

There are themes we have higher confidence in than others – a dimension you also want to take into consideration. We would argue that you should use a higher implicit discount rate for early stage technologies such as 'augmented reality' since both market leaders as well as the business models are unknown. By contrast, we believe the theme of 'cloud transition' is so well established and we know the dominant players of the future, so we can discount future cash flows at a lower discount rate compared to what the market is applying today.

Furthermore, some types of companies probably deserve significantly lower discount rates than others in similar phases of their life cycle. These are the "winner-take-all" platform companies who, because they control large and scalable networks of clients/consumers, have very defensible business models which are extremely difficult to disrupt.

In addition, we believe one of the most important trends of our time – namely demographics and the aging population – is having a significant influence on discount rates via the real interest rate, that will stay secularly low for an extended period. This is described in our White Paper entitled Demographics, Real Interest Rates And Equity Markets (July 2018). This is of utmost importance since demographics for at least the next couple of decades will act as an anchor for discount rates to the benefit of owners of long duration assets like growth stocks.

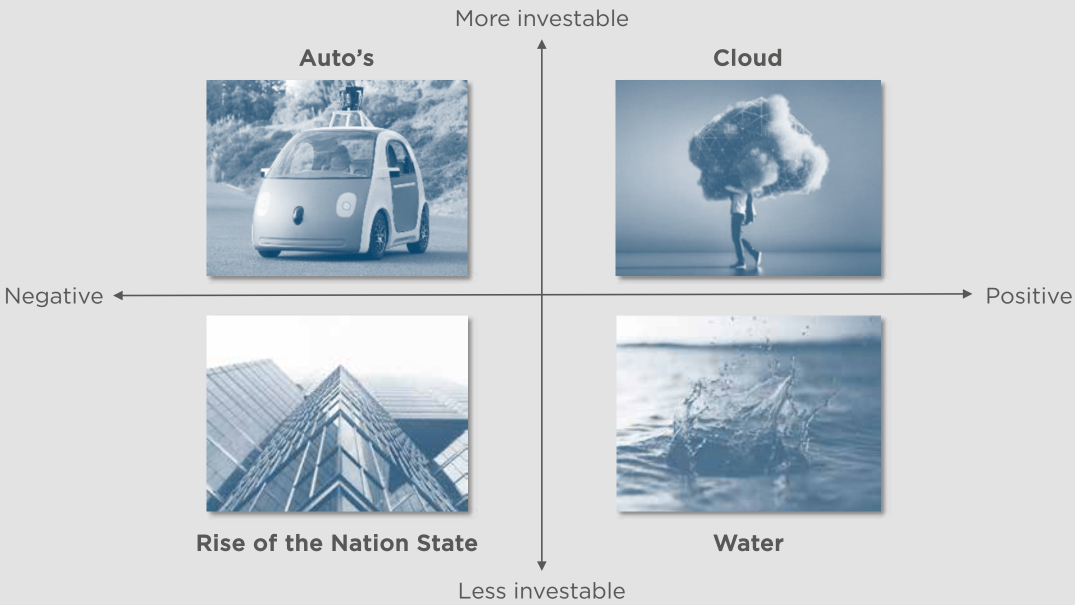
## The relevance of themes varies

As a long-only equity manager the themes we focus on tend to be positive drivers of change for exposed companies. However, increasingly themes can also be negative and reasons for exclusion. Furthermore, some themes are very important to understand because they have a broad impact on society but, at the same time, are less investable for us. Therefore, one can also think of themes along the two axes of 1) investability and 2) degree of positive change.

We recently repurchased Microsoft as we have become even more convinced that the transition to the cloud is still in the early phase of enterprises shifting IT budgets to public and hybrid clouds. Cloud computing is an example of a highly positive as well as investable theme. The market has a very high degree of concentration as only a handful of players (primarily Amazon, Microsoft, Google in western markets) dominate the market. We have written about The Age Of The Cloud in an earlier White Paper (Sept 2016) and more recently in Cloud Computing at an Infliction Point (Oct 2019).

As an example of a negative and investable theme one can look at what is happening to the global auto sector. The sector is going through unprecedented change due to the simultaneous shift to electrification, autonomous driving as well as transportation as an (app) service. The investment needs for the incumbents are enormous, while there is almost zero visibility when it comes to the longer-term profitability of the sector, except to say that it will most likely be much lower than we have witnessed historically. Therefore, we view the themes affecting the auto sector as being both investable

**Figure 4:**




Source: C WorldWide as of Dec. 2019

also but highly negative. Our conviction is that most of the companies exposed to legacy internal combustion engine (ICE) technology are value-traps which we don't need to spend resources on analyzing. We have written about the auto industry in the White Paper The Coming Cambrian Explosion in technology.

Water is an example of a potentially highly positive theme because one should expect that the growing scarcity of water would lead to some interesting investment opportunities. However, for us water is also an example of a less investable theme, since water related companies are either highly regulated low return utilities or extremely fragmented tech/equipment manufacturers typically owned by conglomerates where the water exposure gets diluted.

**We we will never invest in a high conviction theme through a low conviction stock. At the end of the day, the stock is what generates the return.**

Lastly, we view the rise of the 'nation state' as an example of both a less investable as well as a negative theme. It is very important to consider the implications of the rise of the nation state, since at its core, it is an attack on globalization and therefore indirectly impacts the economic superstructure that has been built up since around the early 1980's. The ramifications for trade, security and supply chains could potentially be significant. We have recently published two White Papers touching on these issues, namely Made In China 2025 and The New Tech War And The Geopolitics of 5G.

Finally, it's important to highlight that while themes support portfolio construction by identifying interesting pockets of growth, and help us prioritizing our use of time, we will never invest in a high conviction theme through a low conviction stock. At the end of the day, the stock is what generates the return. The holy grail of compounding of earnings is more likely to happen when we can combine a high conviction theme with a high conviction stock pick.

**Figure 5:**
Interaction Between Themes And Stocks

| | High conviction theme | Low conviction theme |
|---|---|---|
| High conviction stock | "Where magic happens" | Occasionally |
| Low conviction stock | Never | Never |

Source: C WorldWide as of Dec. 2019

## Contribution

It is difficult to accurately separate out the level of alpha generation that has been generated by pure stock picking and the contribution of return from our themes selection. Because at the end of the day our documented alpha generation is not generated by themes but by the stocks we are invested in. However, we remain convinced that our thematic focus steers us in the right direction when selecting stocks. The strongest contribution to our long-term outperformance has been in the themes of Emerging Markets, Connected Lives, US Housing, Energy and Demographics. Certain themes that have worked less well for us have been Energy Efficiency, Financial Recovery and Abenomics/ Japanese restructuring. In general, the most important lesson we have probably learned over the last 30 years of thematic stock picking is that stocks and themes that are dependent on political decisions and/or government regulation in order to play out, carry more risk than investment themes that can develop independently of politics.

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**We focus on sustainability over magnitude of growth, and believe a thematic analysis helps us identify companies that can compound earnings over many years.**

## Integration of thematic thinking and stock picking is essential

For us, theme-based stock picking is not a fad but something we have been doing for the past 30 years and which is ingrained in our stock picking process. We believe our trend-based thematic investment approach is an important part of our alpha generating capability, in that we think it both focuses our attention on the most likely areas of value creation as well as enabling us to explore behavioral biases in markets that have become excessively short-term focused. We focus on sustainability over magnitude of growth, and believe a thematic analysis helps us identify companies that can compound earnings over many years. As the world evolves over the coming years, we will continue to analyze change through the prism of themes and hopefully continue to generate outperformance as we have done for the last 30 plus years – with our unique style of trend-based, thematic stock picking.

# Active Investments

C WorldWide Asset Management Fondsmaeglerselskab A/S is a focused and independent asset manager. Our objective is to deliver consistent, long term capital growth for clients through active investments in listed equities on global stock exchanges.

Our clients are primarily institutional investors and external distribution channels. Our product range includes discretionary asset management services and commingled fund products.

The combination of a unique investment philosophy based on careful stock picking and long-term global trends coupled with a stable team of experienced portfolio managers, has since 1986 resulted in world-class investment performance.

Please find more of our White Papers on cworldwide.com

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