Ravenscroft

Q1 2024 Global Blue Chip

INSIGHTS

Welcome to our first quarter Global Blue Chip Insights commentary, the third edition.

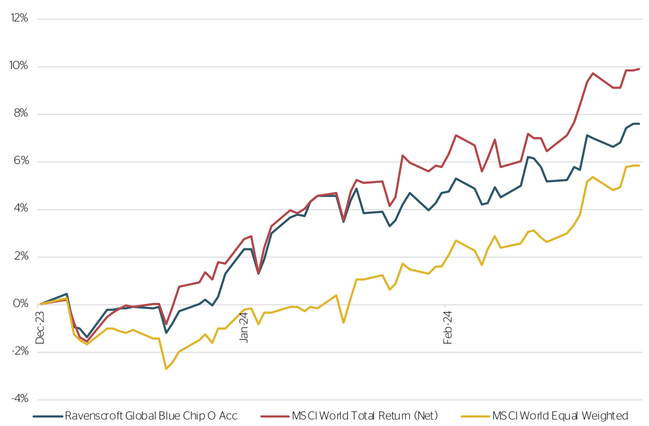
In this update we will cover the following:

PERFORMANCE COMMENTARY

GLOBAL BLUE CHIP
Q1 2024
by BEN BYROM

The Q4 stock market rally carried its momentum through the first quarter of the year with the MSCI World Total Return (Net) registering a 9.9% return in GBP. In contrast, the Global Blue Chip strategy returned 7.5%[1].

Chart 1. Ravenscroft Global Blue Chip Performance Against MSCI World (Net) and the MSCI World Equal Weighted for Q1 2024, in GBP



Source: FactSet and Ravenscroft, compiled 03/04/2024

The cohort of stocks awarded the 'Magnificent 7' moniker once again delivered a good proportion ~44% (~4.3%)* of the market's return for the quarter. Not owning NVIDIA 'cost' the strategy 2.9%* in relative performance alone, whilst being underweight Microsoft, selling Alphabet mid-way through the period and being unexposed to Meta, Apple, and Tesla 'cost' a further 1%*.

Interestingly, cracks have started to appear within this clique as shares in Tesla capitulated ~28%* and Apple's stock declined almost 10%*. 42% of Tesla's move lower, and more than half of Apple's decline came in the month of March where we witnessed a rotation from 'disinflationary boom' businesses such as technology and consumer businesses that typically do well in a falling inflation, falling interest rate environment to sectors that will benefit from a cyclical uptick in global growth and a stickier inflationary environment such as commodity mining companies and related businesses and financials. Investors will understand that we have little in this area of the market due to their cyclicality, leverage, and lack of pricing power. Charts 2 and 3 below show how each sector contributed to the performance of our strategy and the market over the first quarter and, to demonstrate the rotation, the month of March.

Chart 2. Contribution by Sector for Q1 2024 (returns in GBP)

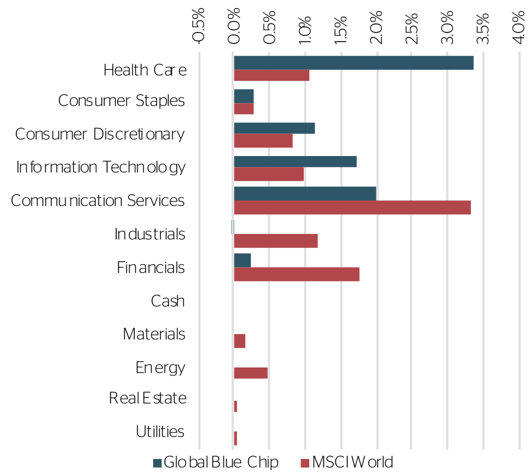
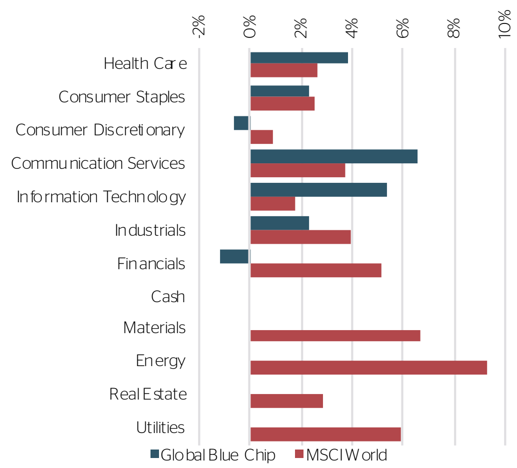


Chart 3. March sector contributions (returns in GBP)



Source: FactSet and Ravenscroft, compiled 04/04/2024

[1]* Returns for the quarter in GBP unless stated otherwise

Financial promotion – the value of your investments may go down as well as up – you may get back less than you invested

PERFORMANCE COMMENTARY

Focusing on the quarter's performance, healthcare was the biggest contributor to the strategy's overall return with all but two healthcare holdings delivering a positive return over the period. GSK, Edwards Lifesciences, and Bruker were the standouts with all three making the top five contributors list, adding roughly 0.96%, 0.96%, and 0.90% respectively to performance. Edward Lifesciences provided a number of encouraging announcements including the earlier-than-expected US FDA approval of their Evoque valve and the spin-off of their critical care business in late 2024 to focus solely on structural heart disease. Both these developments should be value accretive. With the Evoque approval, Edwards has once again broken new ground in heart valve replacement therapies changing the treatment paradigm for patients with unmet need.

Sanofi and Alnylam contributed negatively with the latter falling quite hard over the quarter after management announced a short delay to the readout of an important clinical trial due to some adjustments to the trial's data analysis plan. The stated intention is to demonstrate differentiated clinical efficiency in the clearest possible way. While the market took a cynical view on the delay, we are of the mind that management are credible, and their actions justified. Results are due in late June or early July.

Our communication services positions were the second biggest contributor to returns with Walt Disney leading the charge, contributing a whopping 1.5%, which was the biggest contribution across all holdings, and Netflix which generated a respectable 0.6%. We sold Alphabet at the end of February for a flat return on valuation and management concerns.

The main driver behind Walt Disney's performance was the encouraging progress management has been making towards profitability within its streaming service Disney+. CEO Bob Iger also announced a new sports streaming initiative in conjunction with Fox Sports and Warner Bros. Details are light at this stage, but it did offer investors a glimmer of hope that Iger had found a way to better monetise its sporting content, helping ease the growing concern over escalating costs to acquire sports rights. Details are light at this stage and we caution that alliances such of these have been fraught with issues in the past. We are therefore not banking much on this venture at this stage. Fortunately, our investment thesis does not require it to be successful either.

Table 1: Top and bottom performers

	Top 5 Contributors (GBP)	**GBP Contribution**
1	Walt Disney Company	1.47%
2	GSK plc	0.96%
3	Edwards Lifesciences	0.96%
4	Oracle Corporation	0.94%
5	Bruker Corporation	0.90%
	Top 5 Detractors (GBP)	
1	Alnylam Pharmaceuticals	-0.49%
2	Etsy Inc	-0.39%
3	Nike	-0.33%
4	Adobe	-0.32%
5	Dropbox	-0.28%

Source: FactSet and Ravenscroft, compiled 04/04/2024

It was a mixed bag of performances within our technology holdings, but the whole did better than their sector peers. Adobe and Dropbox made the detractors list whilst Oracle redeemed itself after a poor showing last quarter.

Adobe continues to show good growth aided by its AI-powered suite of new tools. However, it would appear the market was looking for more and reacted negatively to the softer Q2 guidance set by management. These types of reactions always make us sit up and think about the longer-term arbitrage opportunities (see our piece on Explaining Time (Horizon) Arbitrage in our Q4 insights here) and we added to our position shortly after.

In its earnings announcement, Dropbox admitted that its core business in file save and share had effectively reach maturity and will see little growth in the near future. This contravened our expectation of mid-single digit growth and ultimately led us to question our original investment thesis. Whilst management is working on a new product that could have the potential to reinvigorate Dropbox's outlook it is not commercially ready, and the timing and magnitude of revenues is an unknown quantity. As a result, we sold Dropbox, but may revisit this one at a later date if and when there is more clarity.

Oracle was our best technology performer and fourth biggest contributor to performance after the company announced bookings for its Oracle Cloud Infrastructure segment, far in excess of analyst expectations. Comments from management suggested that there was more to come and that expectations were on the conservative side.

The strategy's consumer holdings did well relative to the market. Whilst the staple positions were mainly low single-digit gainers, there were some good performances from our discretionary holdings. Airbnb, eBay, Stellantis and BMW provided the bulk of the returns with above market performances during the quarter. However, this was offset by Nike and Etsy who both made the top five detractors list after they announced earnings and guidance that did not meet expectations.

Last quarter (Q4 2023), Etsy returned to Gross Merchandise Sales (GMS) growth which sparked a fierce rally in the shares. During its Q4 earnings announcement it showed a decline in GMS which disappointed the market. The company has announced a number of initiatives to drive retail activity across the platform, so we will see what impact this has on GMS in the next quarter. However, we are mindful that we cannot wait forever – especially if the market wants to offer us other investment opportunities.

Nike, on the other hand, showed continued growth with the Nike brand across its D2C and wholesale channels, although this growth was offset by declines in Converse. Management also guided a soft first half, with growth geared more towards the second half of the year. The market reaction was predictably negative and shares sold off sharply. It's been a long time since Nike's shares have offered investors compelling future returns (derived from our discounted cash flow analysis) and we are not far off one of those rarefied moments. Any broader market sell-off could see us pick up additional stock.

Our single exposure within financials is Visa, which is currently consolidating after a strong run in performance. We are unlikely to expand our interest in this sector beyond payment companies for the lack of balance sheet transparency and level of regulatory involvement that favours financial stability across the banking sector.

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Within industrials our underweight is for lack of attractively priced opportunities. We have looked under most thematic 'rocks' from automation, grid resilience, manufacturing of critical equipment etc and we find a number of high-quality businesses that are, unfortunately, fully priced. However, we did manage a relative value switch between incumbent holding Honeywell and our new position Rockwell Automation. Rockwell has been on our monitoring list for a while as a well-positioned play on the move towards automation and operating efficiency.

Through the quarter we sold Dropbox, Honeywell, and Alphabet. Some of the proceeds were recycled into new positions, WPP and Rockwell Automation, with the remainder placed into cash. Cash is slightly higher than we would normally like, and we will look to take this down as and when opportunities present themselves. This quarter's Stock in Focus outlines our investment case in WPP.

PERFORMANCE TABLE

	31/03/2023 - 31/03/2024	31/03/2022 - 31/03/2023	31/03/2021 - 31/03/2022	31/03/2020 - 31/03/2021	31/03/2019 - 31/03/2020	Annualised Since Inception 31/12/11
Global Blue Chip Portfolio	14.65%	5.06%	9.18%	21.71%	2.39%	11.5%

Source: Ravenscroft, compiled 26/04/2024
It is important to note that past performance is not a reliable indicator of future results.

PROCESS INSIGHTS – VALUATIONS: THE FALLACY OF PRECISION
by SAM CORBET

There is a common misconception when it comes to valuing businesses that precision leads to accuracy. As a result, analysts are often tempted into building increasingly complex models (with an almost infinite number of variables) to justify why a company is worth exactly the price they have ascribed to it. To understand why this is a flawed approach, let's take a look at how such a method might look in the real-world.

Let's assume you are planning to attend a gig which starts, promptly, at 19:00. Prior to the concert, your significant other has tasked you with buying groceries. It's currently midday and to prevent being late, you perform the following actions:

1. You calculate the quickest route from your driveway to the car parking space nearest the supermarket entrance, taking into account the various speed limits, acceleration/deceleration times and anticipated traffic patterns. You do the same for the return leg.
2. You call the supermarket and go through the list of items you have been asked to purchase and make note of their location in each isle and position on the shelf. You also ask for anticipated checkout times.
3. Armed with this information (and a copy of the store layout) you calculate the distance you will have to walk from the car, around the supermarket and back to the car. Using your average stride length, you convert this into the number of steps and, after determining your average steps per minute, you calculate the time required to complete your carefully choregraphed journey around the aisles.
4. When you get home, you will have to put the groceries away. You opt to perform a dry run with "mock groceries" making sure to perform exactly the same number of trips to the fridge/freezer/pantry as will be required once you have the actual groceries to hand (ensuring you open and close the cupboards along the way).
5. Finally, you calculate the time required to get from your home to your concert seat – taking account of all the aforementioned factors.

Having completed that very precise analysis, you calculate that that you need to leave home exactly 4 hours 15 minutes prior to 19:00. You leave home at 14:45. So long as your assumptions prove to be correct, you arrive dead on time and will be rewarded with a performance from your favourite band. However, unfortunately, enroute to the venue, there is road traffic collision resulting in significant delays. The whole process ends up taking five hours and you only manage to catch the last 15 minutes of the (hour long) show – paying four times more per minute of experience compared to concert goers who arrived on time.

Our approach to valuations is somewhat different. For us, the purpose of performing valuation work is not to determine a specific fair price but rather to ascertain the purchase price at which we have a high degree of confidence in making an outsized return.

This is a small but important distinction. We are cognisant that our input variables are estimates. By their nature, these will often vary from the results actually achieved. The difference between the predictor and the result is known as the error-term. In isolation, small errors have limited impact. However, when you compound numerous errors together, the size of the aggregate error (and thus the distance between our prediction of a company's worth and its fundamental value) will be amplified.

To combat this, we prefer to use models with relatively few inputs and ascribe to the mantra that it is better to be roughly right than precisely wrong. Additionally, given our stated objective, we are less concerned with errors that arise when actual results exceed our estimated values. In other words, when determining the appropriate values for variables in our models we have a natural tendency to err on the side of caution. This approach builds in a buffer which can (to a point) be used to absorb the impact of any adverse results. We commonly refer to this as our "margin of safety" and its existence is something we not only find reassuring, but that simultaneously leaves scope for upside surprises – returns in excess of the rate originally anticipated.

We also recognise that no matter how well you prepare, or how good the quality of your research is, there will always be outside factors that can adversely impact how much a company is worth. To protect against this, we add an addition layer of safety by using an investment hurdle rate that is higher than the return that has conventionally been required (over a prolonged period of time) to beat the market. For instance, if we believe the return required to outperform over our investment time horizon amounts to the equivalent of 7% per annum, we will only accept opportunities where we anticipate a return greater than 10%.

Returning now to our real-world illustration, below is how the same scenario might look using our approach:

1. History and experience gathered from purchasing the weekly groceries (from the same store) for the last 20 years tells you that the average round trip takes two and a half hours. On occasions where the traffic is bad, this increases to a maximum of 3 hours – you use this as your base case. Your significant other is pretty consistent, nevertheless, you factor in an extra 15 minutes in case any unexpected items crop up and you have to enquire about these or their location.
2. In the past, grocery shops without any frozen goods have never taken you more than 20 minutes to put away. If a trip to the outside freezer is required, this adds an extra five minutes. You estimate 30 minutes total to be on the safe side.
3. On a normal day, the journey to the concert venue typically takes one hour. You add an extra 30 minutes to account for the expected increase in congestion arising from the concert attendees.

Your anticipated journey time (based on conservative estimates) is five hours and 25 minutes. Knowing that things don't aways go as planned, you assume six hours is a reasonable time frame and decide to set off for the supermarket at 13:00. As with the initial illustration, the whole process ends up taking five hours and you encounter the same 45-minute delay due to the road accident – thank goodness for that margin of safety! Despite this, you arrive at the venue for 18:00. The support act is on stage and, to your pleasure and joy, they are fantastic! Compared to anyone arriving on time, you enjoy double the amount of entertainment for the same cost. This was an unexpected bonus (please see our previous article on optionality contained within our Q3 Quarterly Insights).

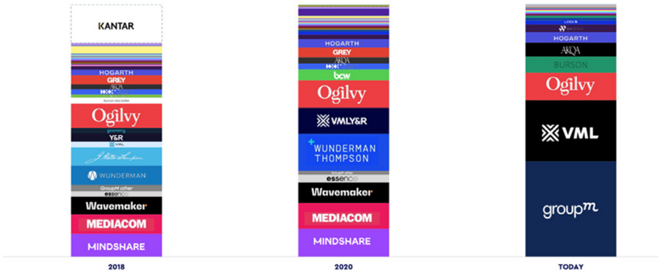
As we hope this example demonstrates, investors seeking sustainable returns would be well served avoiding investment managers who seek to bamboozle investors with overly complex models and fanciful estimates – these could be a red herring. Within the Global Blue Chip team, we are very upfront regarding the limitations of our simple valuation models and the fact that whatever price they assign a businesses is almost certainly incorrect (although no more so than the very precise models we've seen elsewhere). Luckily for us (and you), being precisely right is not a prerequisite to delivering respectable investment returns.

STOCK IN FOCUS: WPP

by OLIVER TOSTEVIN

"The most powerful force in the universe isn't technology, it's imagination".

Ajaz Ahmed, AKQA founder & CEO



Source: WPP Capital Markets Day 2024

During the first quarter the Global Blue Chip fund acquired shares in WPP plc. Many clients will be familiar with WPP, a UK-based blue chip and FTSE 100 constituent for over 25 years.

Founded in 1969, WPP's business was, believe it or not, the manufacture of shopping baskets ("Wire & Plastic Products"). Starting in the mid-1980s, WPP underwent one of the all-time great pivots under the direction of Martin Sorrell who used the company's stock market listing to roll-up WPP into a giant advertising and marketing business. Until his ouster in 2018, Sorrell spent the intervening years growing WPP into the largest advertising agency holding company in the world.

By 2018, Sorrell had assembled a behemoth. On the one hand WPP possessed some of the most iconic agencies in the world, including Ogilvy, J Walter Thompson, Young & Rubicam, Wunderman, Grey and others (in fact more than 500 distinct brands). But on the other hand, revenue growth had stalled, margins were coming under pressure and debt was high. WPP was bloated. It brings to mind an old adage of Silicon Valley legend Dave Packard: more businesses die from indigestion than starvation.

In 2018, Mark Read took over as CEO and set about diagnosing and resolving the underlying issues. In brief, Sorrell had run WPP for margin at the expense of creative talent, back office investment and organic growth. He had also left WPP's agencies entirely standalone with little synergy to speak of. An early move was to sell a large controlling stake in market research business Kantar, with the proceeds being used to reduce debt. Next Read sought to make WPP more effective and efficient, in particular by simplifying the customer proposition with a smaller number of client-facing brands through consolidations and disposals – in total he has retired around 300 brands. Efficiency drives included moving to fewer software systems and closing 840 offices. Lastly, he overhauled WPP's compensation policies to ensure that creatives (WPP's most important asset) were better incentivised and retained.

By and large, we believe that Read has done what he said he would: WPP is back to modest growth, margins are increasing and debt is down. Today, the business is split roughly equally between WPP's global integrated agencies (GIAs) and groupM, with a small remainder attributable to specialist agencies (e.g. PR). There's a lot more to the GIAs than what can simply be thought of as traditional advertising. A couple of examples: AKQA is somewhat more like a technology business than an advertiser, while Ogilvy has been increasingly encroaching into the domain of consultants but with the notion of using creativity rather than spreadsheets to solve problems. Whilst groupM is WPP's media buying business and the largest of its kind – in basic terms, groupM uses its scale to buy advertising space in bulk across different media, and then resells this to clients along with advice on placement and strategy.

Having taken years, the transformation is now largely complete. In our view WPP today is unquestionably a better business than under Sorrell, yet the shares trade at a far lower valuation – the patient has been cured, but investors haven't noticed. It's worth noting that investors have a couple of other industry-wide hang-ups beyond this, however.

The first concerns the fact that, for years, WPP and its closest peers have been underperforming the growth of global advertising spend as a whole. But it's not to say they're losing work or doing less – in fact, they're doing more work but just getting paid less for it. In the good old days, advertisers used to be paid on commission, but starting in the 1980s the industry switched to an hours-billed system. It's pretty clear that the industry (and likely its clients too) would benefit from switching back to a performance-based fee system – creatives are better incentivised to add value for clients, while clients only pay high fees when their campaigns are successful. While an increasing share of WPP's revenue is shifting back to performance-based, we don't have any strong views on how this dynamic will unfold. Nevertheless, we are sufficiently persuaded that Read has, at the very least, stabilised the business and we don't feel the need to make any guesses.

The second hang up concerns artificial intelligence and the fear that in a world with easy access to generative AI, there will be less need to pay for advertising. WPP has been investing heavily in proprietary AI technologies in order to help its creatives be more effective in their work – but critically, the process will continue to begin and end with something AI cannot do: imagination. Therefore, in conjunction with these increased investments, WPP has been doubling down on its creative culture. Indeed, creativity has never been more important for those who wish to stand out from a sea of uniformity. If WPP gets it right, its services are likely to be highly valued for many more years and they could continue to generate attractive profit margins - we see AI more as opportunity than threat. We recently wrote more about this topic here.

But let's assume WPP's business remains merely stable – at a price/earnings ratio of only eight times, it can still be a very attractive investment. At a recent capital markets event, management set out medium-term commitments for revenue and margin growth, and if we parse these into a range it comes out at annual EPS growth of around 5-7% in the coming years. In our experience, companies growing at 5-7% should trade on a P/E at least twice as high. To reiterate, we don't need this level of growth for our investment to work out, but at this stage, we do believe management are credible and there's room for significant further upside – we have previously called this dynamic, optionality.

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