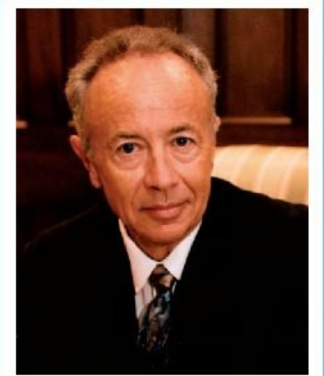
"Success breeds complacency. Complacency breeds failure. Only the paranoid survive." Andy Grove

January 2017

Taken from the Finsbury Growth & Income Trust PLC Annual Report year ended 30 September 2016 - Portfolio Manager's Review.



Andy Grove

1936 – 2016

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The entertainment world has lost a number of its well-beloveds in 2016, but business has taken some knocks too notably Andy Grove, who died in March. This Hungarian, who fled Communism, became one of the founders of Intel and was CEO as that company grew into the world's largest manufacturer of semiconductors. In 1997 Time magazine voted Grove "Man of the Year" for being "the person most responsible for the amazing growth in power and the innovative potential of microchips."

I head this investment report with one of Andy Grove's most famous quotes, which neatly captures our current state of mind and subsequently I'm going to offer several more pieces of his wisdom – which seem to me to be of relevance for all investors today.

Success breeds complacency and only the paranoid survive. If you'll forgive the note of self-congratulation, you'll understand why that quote might resonate with us at Lindsell Train. We know we've enjoyed a surprisingly sustained period of outperformance for your Company. The fact is all three investment themes (broadly defined as: consumer brands, software and media, and stock market proxies) and a good number of the holdings that offer participation to those themes have delivered strong multi-year returns and pushed prices of the best performers to levels where we know some of our shareholders – although not us – have begun to worry. In particular all the big consumer staple stocks we own have hit new all-time highs in 2016 – Diageo, Heineken, and Unilever. And I ask myself – are we paranoid enough about our winners? Have we become complacent?

Well, on this issue – mark us down as complacent. We are not sellers of our consumer shares at current valuations. Of course we can see circumstances when they underperform for a period, but we do not believe Diageo, Heineken and Unilever have become strategically overvalued. Or put another way – we are sure that patient investors in these companies will earn very attractive returns from current share price levels over time.

In the end what it boils down to is other investors' judgement about what constitutes "expensive" as regards these consumer branded companies is just too cautious. The way I think about it is this. Say your family was lucky enough to own 90% of the shares of Heineken (or Diageo, or Unilever), with the other 10% traded on the public markets. As a long term shareholder you know that Heineken's dividend has increased c5-fold since 1995, or at 7.5% per annum compound and since 1995 the shares have risen from €8.5 to €72 today and you think there's a decent chance that sort of wealth creation can continue. But then someone points out to you that at €72 Heineken's shares have more than trebled since the 2008/9 crisis lows and now sell on a P/E of 23x. And that same someone then makes you an offer. You can switch out of your entire family holding in Heineken into an Index Fund that tracks the MSCI World Equity Index. The MSCI is today valued on a look-through P/E of 19x. That's nearly 20% less than Heineken! For all that extra diversification and improved liquidity! Does your family want to take this once in a generation opportunity to sell its stake – all or nothing, here and now and at the market price? But you wouldn't dream of selling, would you? The obvious excellence and reliability of Heineken's brand and global assets – its proven durability and rarity (there's only one truly global beer brand and it is Heineken) makes the idea of swapping all that for the mediocrity of the average, even if the average is 20% cheaper, seem nonsensical. Or it does to me. And if that's true if you own 90% of the equity it also ought to be the case if you only own 100 shares. Though sadly, just for the sake of clarity, my family doesn't own 90% of Heineken.

But now reverting to Andy Grove; we assure shareholders that we find plenty to be paranoid about in equity markets today

and for your portfolio. Here's another Grove quote which summarises what keeps us awake at night:

"You have no choice but to operate in a world shaped by globalisation and the information revolution. There are two options: adapt or die."

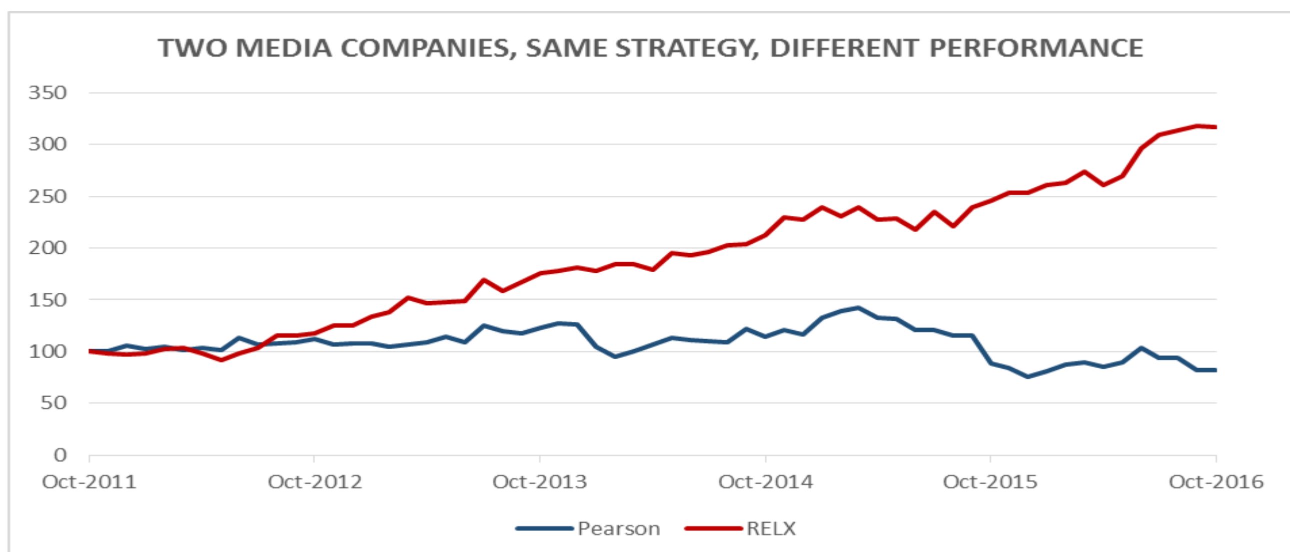
The nature of our paranoia is perhaps best illustrated by the table below.

Stuff We Think is Important

Top Five Global Companies by Market Capitalisation to the end of July:		
2016	**2006**	**2000**
Apple	Exxon	Microsoft
Alphabet	General Electric	Cisco
Microsoft	Microsoft	General Electric
Amazon	Gazprom	Intel
Facebook		Vodafone

What it shows is that at the end of July 2016 the top five biggest companies in the world as measured by their market capitalisation were all US Technology or Digital businesses. This is the first time this has ever been the case. As you can see even back in 2000 at the peak of the TMT mania General Electric hung on to a top five position. And in the interim several big banks and oil companies have made appearances too. But this clean sweep of the top five in mid 2016 feels significant. To us it emphasises just how important Technology has become in driving economies and stock markets. In fact we don't think much else really matters. And it's a reasonable prognosis to expect world stock markets to be meaningfully higher in 10 years time – the good news – but those gains to be delivered by companies and even industries that one is today barely aware of – the less good news.

The table also reminds us how quickly tech stock market wealth can be created. Of course Alphabet (Google) and Facebook barely existed as companies a decade ago and are now valued in the hundreds of billions of dollars. Meanwhile Amazon was trading at a share price of under $6 as recently as 2001 ($825 today) and Apple at $1 a share in 2001 too ($115 today). But if Technology makes fortunes quickly they can be taken away quickly too. Even Andy Groves' Intel, a top five company back in 2000, is still over 50% below its share price peak of that year. More parochially, but confirming this sense of how quickly wealth can be built and lost we think about Daily Mail & General Trust. About 10 years ago that company invested a total of £80m into a property website: PrimeLocation.com. Today the total value DMGT has derived from that investment stands at getting on for £600m (largely its stake in Zoopla) – more than a 7-bagger. Good stuff; but that online property advertising used



Source: Bloomberg. Comparison of RELX PLC and Pearson over five years to end October 2016. Cumulative total return with dividends reinvested.

to fill the pages of DMGT newspapers and for them value has been lost forever.

Our paranoia engendered by these swings and roundabouts of Tech is really brought home when you consider some of the main contributors and detractors to your Company's performance over the last 12 months. We enjoyed wonderful gains in software company Sage and digital service and data provider RELX (the old Reed Elsevier). But look at the laggards and there squats Pearson, as it attempts to negotiate a tricky path from text-books to software publishing.

Here are two more Andy Grove quotes that help frame the opportunities and threats faced by all these companies:

"We are now living in Internet time. It's a new territory and the cyber equivalent of the Oklahoma land rush is on."

"When a change in how some element of one's business is conducted becomes an order of magnitude larger than what that business is accustomed to, then all bets are off."

So – mulling over that pair of comments and to pick on Pearson – that company still has a real opportunity to stake its claim as a global leader in the land rush to dominate digital education services. According to the company it already has more paid for subscribers to its digital learning products than all its competitors put together. On the other hand, the technology-driven challenge to Pearson's traditional business is evidently intense. Meanwhile, Sage claims it now has a wholly new opportunity to bring its services to the 80% of all the small companies in the geographies where it is active that, amazingly, still have absolutely no accounting software at all. Yet that opportunity hangs on Sage's success in transitioning its business to a "Cloud" model – a transition that brings risk and competition.

I have limited this part of the discussion to just the technology-related holdings in your portfolio and some shareholders may wonder if it wouldn't be less stressful to just ditch these and concentrate on a more "reliable" bedrock. But here I must reveal the full depths of my paranoia. The more I think about it the more I believe this next piece of Andy Grove wisdom is the defining challenge for all investors today:

"I have been quoted as saying that in the future all companies will be Internet companies. I still believe that. More than ever really."

That is an exciting but scary proposition. But it's one that fits in with our understanding of what is driving business performance at the moment. The companies doing interesting things with digital – whether they are Tech companies or far removed – are the ones making progress. While the cost of ignoring Tech, despite the risks associated, looks to be irrelevance. When companies report results or come and see us I find more and more this is what they want to talk about. And to them, and us as investors, it really matters that, say, visits to Hargreaves Lansdown's website last year approached 105m, up 19% year-on-year. Or that Burberry's digital customer contacts rose over 30% in the last financial year to 40 million. Meantime, we regard it as very significant that Unilever has just invested $1bn in the acquisition of an e-commerce business – Dollar Shave. Even Unilever, that stalwart of widow and orphan investors and maker of unglamorous soap and deodorants, is making a big bet that the Internet is shifting the balance between brand owners, retailers and consumers. Or, back to my earlier example of Heineken. Talk to Jean-Francois van Boxmeer, the CEO and you're left in no doubt how crucial the company regards its digital marketing strategy – as a means to keep the Heineken brand in the minds of the millennials who will be the next generation of drinkers.

To us the point is that there is nowhere to hide. It is so important to ensure to the best of your ability that you're invested in companies where technology can be their friend.

To conclude – two more Andy Grove quotes:

"You have to keep your spirits up even though you understand you don't know what you're doing."

"Give me a turbulent world as opposed to a quiet world and I'll take the turbulent one."

Yes. I am more excited about the outlook for global and UK equities – and hence for the shares of your Company – than I have ever been. Almost every company we meet can see an opportunity for unprecedented growth or efficiency gains or both. Investors by and large are far too pessimistic about the outlook. And yet the pace of technology change – even as this creates

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the opportunities – means more and more potentially ruinous surprises for individual companies. No wonder we're paranoid.

Nick Train, Portfolio Manager

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