Lindsell Train

Reflections on Liquidity and Capacity

May 2019

Since the beginning of the year our UK Equity representative account ("UK fund") and Global Equity representative account ("Global fund") have continued to grow in size, thanks largely to continued net subscriptions. At end March the UK fund's NAV was £6.2bn and the Global fund's £6.8bn. As the funds grow it is important that we ensure that size itself does not provide any impediment to the integrity of our approach and in particular affect our ability to invest in the companies that are most suited to each strategy. We need to be sure that we have as much capability to generate excess returns as we did when the funds were smaller.

As longer-term investors in the funds will know, since launch there have been relatively few changes in the underlying portfolios. In the case of the UK fund there have been 6 purchases, 6 sales and 4 takeovers over the 10+ year period since the fund fully established itself; whereas in the Global fund there have been 3 purchases and 3 sales over the 8 years since inception. This has resulted in more than 80% of each fund by NAV being the same as it was when the fund began.

Looking at performance, the annualised excess three year returns from each fund are detailed below. As you can see there has been no systematic diminution in performance as time has passed and the funds have grown. Instead the excess returns fluctuate, driven by the underlying performance of the constituents of the funds and independent of size of the companies generating the returns.

	Annualised Excess Returns	
3 year periods to March:	UK Fund	Global Fund
2010	+2.9	
2011	+8.9	
2012	+7.8	
2013	+10.4	
2014	+9.6	+6.1
2015	+11.1	+6.5
2016	+8.7	+4.6
2017	+4.5	+3.8
2018	+3.4	+7.1
2019	+2.8	+8.1

Source: Morningstar Direct. Excess returns are calculated from comparing the UK Equity representative account with the FTSE All-Share and comparing the Global Equity representative account with the MSCI World. Total return (with dividends reinvested) is provided net of fees. Past performance is not a guide to future performance.

Any strategy like ours that invests in only a limited number of companies is destined, if successful over time, to build substantial positions in those investee companies. Indeed at the end of March, Lindsell Train (LTL) owned stakes of over 5% in 16 of the 54 companies that are owned across all the funds and portfolios that we manage. Collectively these 16 holdings account for £6.5bn or 28% of AUM. 4 are companies with a market capitalisation under £1bn whilst some, such as the 7.3% stake in the LSE or the 11.1% stake in Hargreaves Lansdown, are companies with market capitalisations exceeding £10bn. The average market cap of the group is £4.5bn.

For us it makes no difference whether we own 0.1% or 10% of a company, either way we think of ourselves as part owners of a business rather than owners of shares to be traded. You might think that by owning a larger stake in a company we have more

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engagement with its management. That can be the case but it is not the rule and we may well interact with companies where we own a small percentage of the equity as much as we do if we own a more substantial holding. What we have certainly learnt from our interaction with companies over the years is that they tend to appreciate our ownership as thoughtful long-term investors, which, if the management is not kowtowing to the shorter-term agendas of others (some do unfortunately), can make for a constructive alignment of interest between management and owner.

One internal guideline which we have always followed is not to own more than 15% of the votes of any company we own, looking across our three strategies. It's an arbitrary limit admittedly but one that sends a signal to our investors and investee companies that we do not want to be activist investors. We are not interested in owning companies for the purpose of exercising or influencing any control. We don't have the expertise to manage businesses - that after all is the role of the executive team of the company. As passive shareholders we expect to hold the management to account over time but don't want to be involved in the granular decisions of running a business from day to day. Using this 15% rule and setting a minimum target weighting for each of the companies in our portfolio, we can calculate the theoretical maximum size for each strategy we run, allowing also for the overlap between the strategies. Of course that maximum is a moving target because it depends on the market capitalisation of the smaller positions. If these companies' market capitalisations continue to rise in value, as we hope they will over time, the maximum size per strategy will also increase. Indeed since we started monitoring this data in 2016 the potential size of the Global strategy has risen from £10bn to 15bn.

The other concern relating to size is the underlying liquidity of each individual holding in our portfolios. Five years ago, when we managed less than £4bn in total assets under management ('AUM') versus the £17bn we managed at end February this year, 56% of our entire assets could have been sold in one month assuming that the sales equated to no more than 20% of the average turnover in each company over the previous six months. Today that figure is now 47%. So to state the obvious, increasing size may reduce our flexibility to trade in large volume. Should this matter? For us liquidity is a less important consideration than for many other investors who rely on trading as a key part of their strategies. After all the cornerstone feature of our approach is to own positions in companies for multi-year periods and not to trade. Indeed the lack of liquidity for some companies we own ensures that they perennially trade at lower valuations than they would otherwise. Although not all investors would see this as an advantage, for us this is an opportunity which we can exploit. For instance we own in the UK and Global portfolios Heineken Holdings, the family holding company rather than the main quote, Heineken NV. As shareholders we have exactly the same economic interest as if we held Heineken NV but, due to many other investors' concerns about liquidity, we are able to buy the shares at a discount. That discount varies - it has ranged between 3% and an extraordinary 39% over the last 20 years (averaging 15%) and is currently 5%. Similarly we own the preference shares of Ito En in Japan which trade at a 54% discount to the ordinary shares despite paying a dividend 25% higher (the discount has ranged between 14% and 54%, averaging 33% since the preference shares were issued in September 2007). Here we sacrifice votes but retrieve them in the instance of a change of control - which arguably, in a family controlled company, is one of the only times you would need them.

Looking again at the sixteen 5% or larger positions, it is true that most of them could take a significant time to liquidate. On the assumption that we only traded 20% of the previous six months average volume, ten of those positions would take more than six months to sell out of completely. Whether that is a good guide in practice is anyone's guess as it of course depends on the circumstances at the time. In difficult markets it may well take even longer. In normal circumstances, however, it is possible we would seek to sell in a block trade which might liquidate the position far sooner than historic figures would suggest.

Liquidity does matter to us when it comes to treating you, our clients, equally. Most of LTL's AUM are in open ended pooled funds where subscriptions and redemptions average less than 0.3% a day, with frictional cash averaging 2% of NAV. Normally we sell or buy the underlying holdings that offer the best valuation opportunity at the time. In this way we are able to accommodate these flows whilst at the same time striving to enhance the integrity of the portfolio for those investors choosing to remain invested in the funds. Occasionally we receive larger subscriptions, at which time we institute a low cost programme trade pro rata across most if not all positions in the portfolio. Again the disturbance to the portfolio is minimal. More importantly, subscriptions leading to a bigger fund should be beneficial as the fund's costs are amortized over a larger pool of assets. This is both because some costs are fixed and because greater scale gives greater ability to seek reductions in

both management and administration fees. To illustrate, the ongoing charges (OCF) for the standard institutional share classes of the UK fund have declined from 80bp to 70bp from 2013 to 2018 and the Global fund from 84bp to 72bp over the same period. We have been in the fortunate position of having had few sizeable fund redemptions to date but last year we had to liquidate a £700m segregated Global Equity mandate (on the back of a UK pension fund selling down its public equity exposure for de-risking purposes). It took five days to sell 94% and three weeks to sell the rest without any undue disturbance to market prices. Thus, we would expect in the normal course of events to cope relatively easily with sizeable redemptions. It's important though that fund holders should know that in exceptional circumstances we would need to balance the long-term interests of ongoing shareholders over those seeking an exit. It would mean that in the event of an outsized withdrawal in any of our funds we would not just depend on raising cash from the more liquid holdings, we would also aim to sell down the less liquid ones in addition. This would mean that, if we judge it necessary, we would need to accept lower prices than quoted in the market at the time for these companies in order to facilitate that liquidity. Of course this could be injurious to the short-term interests of both remaining fund holders and those redeeming; but in time, once prices had settled, the distortion brought about by the demand for instant liquidity should reverse, leaving long-term fund holders little affected.

Although not impossible, we think that the probability of fund redemptions of a size large enough to cause this liquidity problem is low and continue to believe that growing the funds bring benefits to scale that outweigh these concerns. But there is no doubt that as our funds become larger so the outcome of such a liquidity event could become more significant and potentially damaging to short-term performance. It means that large scale fund holders who might for whatever reason decide to sell their holdings in one go should be aware of this existential risk. It could also affect smaller holders if enough fund holders chose to sell concurrently. In my experience prolonged periods of fund redemptions tend to follow times of market stress - and note that we do not try to "time" markets - or a phase of poor fund performance, both of which are bound to happen at some point in the future. Overall, our message to all investors in our funds is to recognise that their investment is best thought of as a multi-year commitment, mirroring the commitment that we make as fund managers to the underlying companies in which we invest.

Michael Lindsell, Portfolio Manager

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Sources: Lindsell Train & Bloomberg

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