Latitude Horizon Fund

LATITUDE
INVESTMENT MANAGEMENT

FREDDIE LAIT
LATITUDE INVESTMENT MANAGEMENT

Annual Report 2017

Dear All,

Over the last eighteen months Latitude has found its feet in the choppy waters of the investment management industry. Like many of our portfolio companies discussed in this annual report, our own industry is undergoing incredible disruptive change. Understanding these forces, and the revolution of improved customer experience, is key to long term sustainable value creation for shareholders.

What will investment management businesses of the future offer in order to thrive?

Strong returns are key, generated in a risk controlled way with sharp focus on sustainability both at a corporate and social level. So too are improved transparency, accessibility, and pricing, and many things beyond. We have invested hundreds of hours into formulating our investment process and business strategy, ensuring they are truly consistent with our core philosophies and are set to meet the highest standards in the future.

We are keen to do everything we can to better serve you, our customers, so please let us know what a business focussed on the future should be doing today.

Thank you, as ever, for your support.

Freddie Lait

Performance

Since inception on 1st November 2016 to 31st December 2017 the fund rose 9%, a first quartile performance against our peers and substantially ahead of inflation at c.2.5%. Critically, risk taken to achieve these returns was, in our opinion, very low. Our volatility was low at 5% although we note strenuously that volatility is only one measure of portfolio risk, and a relatively poor one at that. Our lack of macro exposures, our diversification, and our lack of style bias were the key contributors to our low risk profile since launch.

Taking the equity portfolio on a standalone basis the intrinsic value rose c.12% as represented by the average growth in earnings, dividends and book value per share. This measure seems to us a reasonable near-term guide to value creation within the portfolio, and we are pleased with the steady progress. The equity portfolio itself was up 18%, representing a re-rating of 6%. The portfolio now trades on an aggregate 15x price / earnings, has a 15% ROE, 6.3% free cash flow yield and should generate near 10% earnings growth over the coming years according to our estimates.

As expected our equity positions generated a large portion of our returns since inception, contributing c.7.5%. Our non-equity positions performed well over the year, adding 1.5% while decreasing risk within the fund.

Activity

During the year we sold three stocks, namely **Micron, Colopl, Orix**, and one **(DH Corp)** was successfully bid for and taken private by a private equity firm. We bought no new stocks as the market rose steadily throughout the year. We have a long list of potential candidates to add to the portfolio but for now our patience has triumphed over boredom.

We added a position in Emerging Market currencies which has benefitted from the USD depreciation. We also added a small (4%) position in Emerging Market bonds, to benefit from currency appreciation and an attractive yield.

Portfolio Breakdown

As a result of our trading activity and market movements, our overall equity allocation fell from 52% to 44%. This movement is an effect of bottom up decisions based on valuation of individual companies, and not on any overarching "asset allocation" decision which seeks to time the market. We continue to target around half of the portfolio being invested in stocks, but will be patient to find the right stocks at the right prices throughout economic cycles. Any stocks we buy at this stage in the cycle we are likely to hold through the next recession – so they have to be both attractive enough to dominate their market in that scenario, and also cheap enough to offer us a margin of safety. That combination is exceptionally rare these days.

The current portfolio allocation is shown below:

Equities	44%
Inflation Linked Bonds	4%
EM Currencies	20%
EM Bonds	4%
Gold	6%
Cash & Equivalents	22%

As of December 31st 2017

Outlook

Entering 2018 our outlook is, as ever these days, uncertain. Our confidence in our process and our philosophy remains high, and we believe the fund's long term diversified approach is very well suited to the current environment. It is clear that expected returns are low at this point in the cycle for traditional asset classes, and there are signs of irrational exuberance in less traditional asset classes such as cryptocurrencies and venture capital. A variety of risks will increase over the coming years, and our belief is that focussing on fundamental single stock analysis is the greatest way to avoid overarching market risks. We discuss all of our investments in some detail below, equity and non-equity alike.

Analysis of underlying Holdings

Equities:

Shiseido. We first looked at this 100-year-old company in 2015 when the new CEO, Masahiko Uotani, had been in office for a year. The first outsider ever appointed to the role, this Americanised marketing executive began by saying he would "stake his life on this job, and create one of the greatest global companies for the next 100 years". A can-do attitude like this, combined with a deep understanding of both the Japanese and global markets, as well as a sense of just how dire the situation was at Shiseido, were all essential initial ingredients for their successful turnaround. Sales growth in the preceding 8 years had been roughly zero, while competitors had grown at 4% per annum. Hard decisions needed to be made, and the results are impressive. Since 2014 sales have grown by 30%.

R&D had always been seen as the focus for the business, but at 2% of sales it is far less important than marketing costs which sit at 36% of sales. A shift in focus to brand positioning and marketing has generated huge incremental returns on investment, and looks likely to continue to do so for many years ahead. Despite the recent success, the stock still trades at half the multiple of sales of their main peers L'Oréal and Estee Lauder, despite growing more quickly.

The market remains sceptical of their margin expansion plans but the wind is in their sails and momentum in sales growth across their regions should drive operational leverage for the next 5+ years. While Europe and the US have been slow to recover, their China and Travel segments are posting record profits.

When investing in businesses which are undergoing restructuring we prefer to buy businesses with strong management, strong balance sheets, who sell long lived products in a consolidated market, and Shiseido fits all of those criteria. They have very little debt, and cosmetics are not only long-lived product ranges, they are also a very defensive sales category (the market grew during the 2008/2009 recession).

Since I first invested in 2011 into the auto parts retailers (of which our holdings in **Autozone** and **Advance Auto** are two out of three large players) the sector has been an incredibly attractive investment. Our largest holding, Autozone, has delivered a 100% growth in net income, using cash flow to buy back 50% of its shares outstanding, resulting in nearly a 400% increase in EPS. Last year the stock price fell dramatically as we saw the businesses enter two bear traps: namely disruption from Amazon and from increasing penetration of electric and autonomous cars. Given how worried the market has become, inverting the bearish analysis in both cases reveals a strong risk reward in favour of the long-term shareholder. It's true that growth rates in mature industries fade, however, the market consistently overestimates the speed of that decline, in particular in industries with strong fundamental dynamics. Buying Autozone today an investor pays 15x earnings, a multiple implying little future growth in earnings. For context over the past ten years, including the recession, earnings have consistently grown at 15% per year, and we believe they will continue to grow at c.5-10% per year in the near future. The short-term threat from autonomous driving is misguided. There are 253m cars in the US, with an average age of 11.4 years, and an average new cars sales rate of 16.8m. If we assume conservatively that autonomous cars arrive on main street in 2020 (we think it will be closer to 2030), and 1/3 of all cars are autonomous, then 5 years from now, the stock of cars in the US will be c.270m of which 11m will be autonomous. Critically in that period the sector will have still been able to grow earnings and cash flow per share, through consolidation, increased cost leverage, buybacks and a higher average vehicle age.

Regarding the threat from Amazon, 65% of industry sales are to small garages, often fulfilled on a 30-minute delivery time, from a locally managed assortment of inventory. Mechanics care little about cost, and far more about job turnover in their bays, and are thus happy to pay for this availability and quick delivery. Amazon can only compete on a next day basis in the US, so we see little current threat to this side of the business. The remaining 35% of sales is DIY, 86% of which is non-discretionary repair or maintenance spend. Of Amazon's 20 top selling "automotive" products, only one is non-discretionary, due to the fact that items are bulky, fragile, and often require a level of service at the point of sale. As a result, only 10% of the 35% DIY segment is currently online (of which around half is Amazon) so even if Amazon were to double their sales in automotive, and all of those sales were to take share from the listed companies (unlikely given most share is being taken from non-discretionary purchases at garages, mass merchants etc) then this would imply just a 1.7% sales drag to the industry. Despite the clear bear cases, and perhaps some continued short-term volatility, we believe the best is yet to come for this industry from a cash flow focussed shareholder's perspective.

From 2000 to 2014 returns across the European Telecom sector fell from around twice their cost of capital to a level roughly equal to their cost of capital, assumed for this analysis to be roughly 8%. The value of the sector, when including both equity and debt, is roughly equal to the total investment capital, which tells you that investors have decided there is to be no future growth or increased profitability for the sector ever again. There are four reasons why a boring sector such as this piqued our interest in 2014 and continues to do so today. First, over the last few years we have finally seen an easing of regulatory pressures. Second, the three businesses which we own (**Orange, KPN** and **TDC**) generate an average 4% dividend yield and an 8% free cash flow yield. Even without growth this is an ample return for little risk and a wonderful ballast to a well-diversified portfolio. Third, we believe that the recent inflection in revenue and earnings growth which we have seen (the first in fifteen years) is an early sign of a potential decade of improving fundamentals. Finally, there is a very specific way that the sector can improve both top line and bottom line performance: digitalisation. Incremental sources of revenue are arriving which, prior to recent technological advancements where not available. These include geo-location advertising, payment and banking services, and software solutions for consumers. Digitalisation also works behind the scenes, replacing costly labour forces and reducing friction within the processing and maintenance areas of the industry. All this while improving customer service and retention rates. With so many possible upside scenarios, and nothing "in the price" for this uninteresting sector, we believe these stocks add great value to our portfolio as a whole.

Digitalisation also presents great opportunity for our US banking stocks (**Bank of America (BoA) / Goldman Sachs**). To date, most fintech companies have focussed on payments. Greater digitalisation in this area presents substantial benefits at BoA, where they spend on average $5bn moving coins, currency and cheques through their business; around 10% of total annual operating costs. Moreover, the cost to service a customer making a digital payment versus a physical one is around 80% cheaper. It's no wonder that BoA has recently spent c.$3bn on their digital transformation, driving rapid adoption of their mobile and digital platforms, as this could generate cumulative earnings growth of 25% through cost savings alone. Peer to peer businesses offered the first glimpse of how difficult it is to compete with established banking franchises on their core business: lending. Lending Club, the bellwether of the sector, has fallen from $27 per share two years ago to $4 today as costs of regulation and bad credits have risen.

The banks have high and growing barriers to entry through scale and experience. Some commentators suggest that perhaps a big tech challenger, such as Amazon, will attempt to disrupt banking itself. If so, it would require two things: capital and expertise. BoA's tangible book value is c.$170bn compared to Amazon's $14bn. Above this required capital, the challenger would need to raise deposits to offer out as loans. Some would come naturally from their existing customer base, but most would require a higher rate to tempt them to switch. If on average, the deposits cost 50bps more, this would imply net income margins of around 200bps for the challenger v 250bps for BoA. Given the lack of credit history and underwriting experience, plus the fact that early adopters of challenger banks tend to be lower quality borrowers, it's fair to assume a required provisioning of 100bps compared to BoA's 50bps. Therefore, even giving a challenger the benefit of the doubt on capital efficiency, cost efficiency, average loan yields and more, we see that returns would be less than half the level of the incumbent while requiring huge capital investments. BAC currently generates a return of 12%. This is not a sufficiently juicy carrot for fintech unicorns to feast on at this stage, and we see little disruption to the underlying banking industry in the years ahead.

The current disruptive technology revolution is the primary driver of the demagogic and populist momentum sweeping through global politics. Big tech's image is starting to crack. 'Don't be Evil' - **Google's** founding principle, has started to sound like an industry which doth protest too much. Investors are worried about increased regulation which is probably overdue. That said, I continue to believe Alphabet (Google's parent company) is one of the best value long term investments in the market. Since their 2004 IPO their income statement has been a testament to their zero operating leverage business model - margins don't rise as revenues do, because investment in the business rises commensurately. As a result, returns on equity and future growth continue to surprise positively. Over the past 13 years sales have grown 40x - a compound growth of 27% per year, and earnings per share have increased exactly in line with sales. Last year they grew 20% and it seems likely they will continue at this pace for many years as search revenues are ploughed back into monetising mobile, maps, YouTube, cars, medtech and many other things beyond. Unlike many of its large cap tech peers this is not a "concept" stock, and trades on 13x next year's operating profit, which we still believe significantly undervalues both the defensive nature of the business and the growth potential for the next decade and beyond. I have invested in Google for more than five years and, while the share price often ebbs and flows with the global advertising cycle, a regulatory cycle of its own, as well as intense competition in all of its businesses, its staying power will surprise all bears for years to come.

Sony is a name which needs no introduction but a stock which is often misunderstood. The business has been around for 70 years and over the past ten years has suffered as growth in net asset value has been negligible as cumulative earnings were zero. However, following a visit to meet them in Tokyo in 2014 I became very interested in the outlook for the next few years, and hopefully beyond. The shares were at JPY 1,500 then, and are at 5,000 now, but still have the potential to reach 10,000+ in the coming years if the business continues to perform and re-rate as it has now started to. Sony is a collection of fabulous businesses including #1 position in console gaming (Play Station), music, movies, and CMOS sensors used for electric vehicles. They have a large financial arm in Japan which generates cash used to invest across these businesses. Their legacy hardware businesses (TVs, MP3 players, handsets etc) are all under review from the aggressive CFO who has taken great strides to reduce investment in unprofitable divisions. Considering the strength of these individual businesses a simple "sum of the parts" model of Sony shows a continued discount to intrinsic value, despite the recent successes.

For 25 years **Tesco** was a textbook example of growth and reinvestment, and putting the customer first. Think about it as the Amazon of its day, taking each year's increase in margin and spending it on improved facilities, service and better pricing for customers. This virtuous circle which attracted shareholders including Warren Buffet, began to unwind in 2010 as management began to break their everyday low-price promise with consumers, increasing confusing promotional activity and giving rise to the discounters (Aldi and Lidl whose simple offerings have catapulted them to an impressive 10% of the UK market). In 2014 Dave Lewis arrived from Unilever and has set about a rejuvenation plan which we think merits attention. He has reset the balance sheet, weeded out bad practices, cut prices by 6%, ahead of the whole market since 2014, and yet grew margins by around 1%. At the same time customer and supplier KPIs have improved dramatically, and the business is making use of its dominant market position to secure its financial future. Tesco, the first bastion of "customer big data" through its club card program, has many new digitalisation initiatives up its sleeve over the coming years, and online retail (where it is still the largest player globally with 15% market share) will be a major pillar of that strategy. Given that historically the business enjoyed 5% margins when it was supporting a growth-biased cost base, I see no reason why in the future the business couldn't achieve similar levels to this again or even exceed it. This would imply a share price of between 400-500p, which compares favourably to its 210p price tag today.

Nokia is a contentious and contrarian investment. As one of three main providers of network equipment they operate in a wonderfully concentrated market, with low threats from new entrants and, to some degree, certain future demand patterns as consumers and corporates require ever-increasing levels of data traffic, which all runs through Nokia supplied pipes. We are, however, between product cycles as 4G penetration is stabilising and no one yet knows what 5G will look like. In a market which continues to mis-price uncertainty, Nokia is therefore very cheap, but without a clear near-term catalyst. Why is this not a value trap? We believe that the synergies from the Alcatel Lucent integration will come through this year and next, driving costs lower and reducing capital employed in the business. Nokia's patent portfolio is still the envy of the mobile industry – indeed Apple have been in litigation with Nokia for years but have performed a recent volte face and are now partnering with them on future designs. Beyond this, growth optionality from hyperscale technology players, secure government networks and private networks for industry gives Nokia great optionality over the coming years. At 12x our estimate of earnings next year, we believe the market's temporal shackle to one-year forecasts is missing the bigger picture.

We have a strong belief that businesses which generate sustainable excess returns above their costs of capital are fantastic ballast for portfolios, and **Unilever** is the best example of this at the most attractive price. For the last ten years their market share has been growing, in particular in the Emerging Markets where they sell 60% of their products. While winning share, they have grown margins by 200bps to nearly 17%, with a target of 20% by 2020 well in reach. Their CEO Paul Polman is renowned for his belief in sustainable business practices, which has resulted in fantastic value creation since he took over a decade ago, and leaves the business with far firmer foundations. The business was making great progress prior to the bid from Warren Buffet and 3G, but these programs have been accelerated. A slightly more leveraged balance sheet optimises returns to shareholders, and selective disposals and acquisitions continues to drive the business towards higher margin categories. Cutting costs in advertising will lead to positive margin leverage. As a result, the marginal return on capital that Unilever generates is the highest in its peer group at 24% (versus an underlying return on capital of 19%). To paraphrase Warren Buffet – Unilever has historically chosen to invest incremental dollars in expanding its moat (competitive advantage / brand positioning) as opposed to building its castle (margins), but now it is able to simultaneously do both. The business is capitalised at £130bn, and generates £10bn of operating profit and £6bn of free cash flow. Over the next few years we believe operating profits can rise to £13bn, and free cash flow could reach £8bn. A business with this level of consistent earnings power could be valued closer to £200bn, 50% higher than it is today.

I first met **Dollar Tree** during the recession of 2008/2009 and began investing in 2011. The dollar store sector had a fantastic time through the recession as consumers traded down, and managed to build on their new-found custom through enhancing in-store experience and focussing on fresh assortments and seasonal products. Dollar stores don't replace your weekly shop, they compliment it. In 2011 at a conference an analyst from New York said to me that "these days my wife, my friends, and everyone I know shops at Dollar Tree". Entry into middle class acceptance in the US is a ticket to riches, and this was an early breakthrough with many years to run.

Eight years later and revenues, EPS, and free cash flow have all risen c.500% and, as a result, the stock price has as well. Dollar tree has 15k stores selling 7k items split roughly 50/50 between food and non-food products. They grow comparable store sales each year by improving the local assortment, and by selling more private label items, at incrementally higher margins to the business. They are a few years into the integration of a large competitor which should drive margin expansion for the next two to three years. At 19x earnings the stock is only 15% more expensive than the market as a whole, and yet should grow earnings at 15% per year for the next few years and seems set to grow at c.10% for many years beyond. Free cash flow should increase even more rapidly as working capital is reduced through the integration, and from further benefits of scale leading to better terms with suppliers. The business will benefit from the tax breaks in the US in two ways. First, their corporate tax rate will fall, improving earnings by 20% and the propensity to spend of lower income families, who also see tax breaks, is expected to rise rapidly this year. All together the slight premium one pays for the business still undervalues the many sources of growth over the next five to ten years.

Visa has one of the deepest moats in the world. Between them and Mastercard they dominate the global (ex China) payments industry and extract a very small amount of economic rent from more than $10tn of payments each year. Visa partners with banks and merchants alike, ensuring control of both ends of the payment value chain. Banks issue their cards, and assume credit risk, while paying a small toll for using their networks. The merchant agrees to accept their cards (almost ubiquitously) and pay fees for the pleasure of being able to accept secure card transaction. Visa earns its place in the world by investing 50c of every $1 it earns back into the business, to enhance security, functionality, analytics and drive technological advances such as contactless payments and spend analytics. Although ubiquitous, Visa is twice as large as Mastercard and six times as large as American Express. Profit margins of 30% are the result of this dominant market position. Revenues grow at about 10% per year which is the result of winning share and winning new customers in new countries where the addressable market itself grows faster than underlying GDP as digital transactions continue to displace cash. The stock is reasonably priced on 22x EPS given the highly defensive nature of these earnings and their growth.

The oldest company in our portfolio, which recently celebrated its 500th birthday, began a total transformation five years ago which is very much still in train. In 2013 **Royal Mail** was sold to investors at 320p per share – a cheap valuation reflecting the size of the challenges ahead. The most critical three issues were: unions demanding better terms; a DB pension which was close to crippling the business; and a terminal decline in letter volumes. At the end of the year the first two points remained unresolved, however, at the time of writing we have just received confirmation that an attractive deal has been reached on both. So, the story surrounding the stock should move from one of extreme uncertainty (present day investors bête noire) to one of manageable transition. At 500p today the stock is still priced for past uncertainties, not future possibilities. While the letter business is in decline, parcels are growing rapidly and will benefit from continued investment in technology and digitalisation. Their international business GLS is growing well ahead of the market peers, and yet trades at an implied valuation of half of the market. Business simplification, lower capex, property sales (they still own large swathes of London real estate) and improved technology should all drive higher cash flow in the coming years. Starting from a 10% free cash flow position as they do today, such growth may be a surprise to those who believe this business is still stuck in the Tudor period.

Tobacco stocks have been one of the best performing sectors for the past twenty years, proving that stocks without “bull cases” can generate substantial and sustainable profits for their shareholders. **Imperial Brands** has increased dividends paid from c.£100m in 1997 to £1.5bn today, offering investors a 7% yield with expected 10% growth in dividends per year. The stock trades on 10x earnings.

This is the case for two sets of reasons – first, there is still no bull case for tobacco twenty years on so short term focussed investors have nothing to believe in. Second, there are stock specific reasons why Imperial's earnings have suffered. These are principally due to brand migration (consolidating local brands into international packaging) which causes some loss in revenues, and a reduction in brands available for sale. They are also behind on their "next generation products" to compete in the e-cig and "heat not burn" markets. These issues aside, earnings have now bottomed and are returning to growth, and we believe it won't be long before the share price does the same. In the meantime, we wait to see if there is further consolidation in the sector which would be a big positive, and we are content to earn our 7% dividend and watch the book value slowly tick up.

Over the year we sold three stocks, which we detail briefly below**. Micron** makes memory chips for PCs and mobile phones and operates in an industry where 93% of sales are split between only three companies. Despite this concentration, returns are incredibly cyclical and ongoing cycles require vast investments in upgraded technology, keeping cash flow tight. Returns on capital in the three cycles since 2000 averaged -5%, 0% and 5%, and we believe 10%+ is possible this cycle. We bought the shares at $12 and following a rapid share price rally due to short term supply/demand imbalances, the company's enterprise value reached 1.5x the value of its total invested capital. This valuation led us to believe investors are either overpaying for the short-term pricing impacts of supply outages, or have a far rosier view of future *through cycle* earnings than we do. **Orix** is a diversified financial business in Japan with interests across the globe. The business has been on a recent acquisition spree which complicated the earnings of the business. With only a small remaining discount to long term value we exited the position at a small gain. **Colopl** is a top ten mobile video games producer, which had fantastic success in the Japanese market for the past fives years. Last year, however, they made a strategic change of direction to enter the virtual reality market. While we see the merits of this shift, and would support the management team to succeed in this venture, the risk reward changed in too great a way for us to remain investors, and we sold the position at a small loss.

Non-Equity Investments

All of our non-equity positions are selectively chosen to reduce risks using fundamental assessments of the macroeconomic risks facing our portfolio of stocks. If we can get exposure to an equal but opposite risk, using non-equity instruments, and can do so profitably, then our performance improves at the same time as the overall risk falls.

This year we added non-equity positions post the election of Donald Trump, designed to reduce our implied exposure to the USD. We explain our thinking below.

Post the financial crisis currency markets lost, and have only just regained, their compass. The ramifications of this development continue to be felt in every asset class, and dominate macroeconomic analysis. Like it or not, every portfolio manager has to form a view on the US Dollar.

The most effective tool for forecasting a currency's value is 'Interest Rate Parity'; comparing two countries interest rates and the effect that this differential has on forward rates. With most countries exhibiting zero interest rates, this process was replaced with an approximation, at best, that comparing economic performance was a reasonable proxy for future changes in exchange rates. The result was many years of exchange rate volatility.

This partially normalised in 2014 when the Federal Reserve began discussions of tapering and, now, tightening monetary policy. The US Dollar promptly rose 20% (trade weighted) and hovered around that level until Donald Trump's election, when it rose another 5% on "reflation" expectations. At this point, in January this year, the interest rate differential had rarely been as high between the US and the rest of the developed world, resulting in a large risk for any portfolio exposed to the US Dollar, US rates, or "reflation". Central banks globally faced a choice of two policy options and we saw an opportunity to hedge the portfolio profitability for either eventuality.

For US interest rates to rise as expected, a coordinated global recovery would need to be in place, implying a strong likelihood of monetary tightening in the rest of the world, which would lower the interest rate differential in a bullish way. If instead that coordinated economic recovery was threatened, it was likely that rate rises in the US would come through more slowly, if at all, thus lowering the interest rate differential in a bearish way. In either scenario it felt likely that the US Dollar had peaked and it was at this point that we initiated our 'Emerging Market' position.

The position consists of 20% EM Currencies and 4% EM Bonds. In aggregate the position has a yield of 5.5% and has returned 6% since we initiated it in January. All of our non-equity positions must diversify or hedge a risk in the equity portfolio, and must have a positive, asymmetric return profile. The key question is does this position still exhibit these characteristics? As markets continue to adjust to the rediscovery of their valuation compass we expect more volatility. Reducing our exposure to this volatility is attractive, especially if, as we continue to believe, we will be paid a reasonable return (5.5% yield and c.3-5% expected appreciation) to do so.

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