Strategy Notes March 2017– Have Notepad, Will Travel

As our long-time investment partners will be aware, a continual and rigorous company visitation schedule remains at the core of our investment process. Being fundamental, bottom-up investment managers, we are required to continually visit companies, management teams and the various components of each businesses ecosystem (their suppliers, competitors, customers, disrupters) to be able to fundamentally piece together each business's future earnings potential. A good part of this analysis also requires us to travel to the offshore markets that Australian companies operate within, to gauge the underlying mood of the region, the macro drivers of the market, and the views of the people operating on the ground. Below are some observations from our travels this month across China, Perth and the UK:

China – From Cranes to Skincare

When Australian analysts returned from visitations to mainland China 10-15 years ago, the common observations tended to include an analysis of the number of cranes on the city skyline. Stories of mass construction efforts and 10-lane highways led to volumes of research on resource intensity across the steel and construction material industries, with photos of multi-story apartments springing up across Chinese cities of 5m+ inhabitants, the majority of which Australian investors had never even heard of.

Fast forward to today and the 'observation de jour' has moved from the hard industries to the growing Chinese consumer. As the long-expected move from manufacturing and exporting to a demand-driven economy takes shape, the photos of construction cranes have been replaced with stories of baby infant milk formula disappearing from supermarket shelves and listings of cosmetic products on Chinese retail websites (the majority of which, until 3-4 years ago, Australian investors had never heard of – sound familiar?). After shrugging off a difficult start to the calendar year 2016, the China equity market has staged an incredible recovery, led by the efforts of domestic legislation designed to further promote mass growth and maintain their (newly revised) +6.5% GDP growth target.

2017 has already has been a stellar year for Chinese equities, with the MSCI China Index now +14% since January 1st – its strongest start to the year since 2006, and ranking it as one of the best performances for any world equity index since the GFC. While mainland Chinese equity market movements and valuations need to be taken with a grain of salt, the leadership of the market paints an interesting story – the recovery was led by...