

# A Q&A WITH DANTON GOEI

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Danton Goei of Davis Advisors, portfolio manager of the Pan-Tribal Global Equity Fund, recently visited Australia and shared his insights with financial advisers.

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## Q: What attracted you to Davis Advisors?

**A:** Davis Advisors (Davis) has a very entrepreneurial, collaborative research-driven culture. I was attracted by the company's long term investment focus, an anomaly at a time (1998) when investment firms were becoming increasingly focused on the short term.

I also liked that it was a private, family owned business, focused on the long term as a business, not just as an investment philosophy. Davis has a real culture of stewardship. The average account is US\$36k – people saving for their children's education or for retirement, we're not just looking after the wealthy.

Importantly to me, Davis takes a world view and had a focus on global investing at a time when it was rare in the US. As analysts, we look at each industry on a global basis, and consider the global competitive set, even if investing in US shares – after all, all companies are competing on a global stage.

The Davis family and employees 'eat their own cooking'. Collectively, we have more than US\$2 billion co-invested in the funds, and compensation is based partly on how well those funds perform over rolling five year periods; again, a commitment to the long term.

## Q: How does the Davis Investment Discipline drive every day investment decisions?

**A:** The Davis Investment Discipline underpins the way we look at companies over the long term; in fact, we can spend months or years watching a business before we decide to invest. There are a range of important considerations.

The first of these is that the business has a durable competitive advantage – for example:

- Scale (e.g. Amazon)
- Strong brands (e.g. Naspers)
- Technology (e.g. Google)
- Culture (e.g. Berkshire Hathaway)

It's not just competitive advantage that's important, it needs to be durable – will it be there in five years' time and how strong will it be? We consider the industry trends and the risks to that competitive advantage.

If you own a company for five years or more, as Davis generally will, the quality of the management is incredibly

important; we look for honest, ethical, and capable management, with relevant experience.

Secondly, as a long-term investor, capital allocation is critical – Davis believes that over the long term, capital allocation is the management team's number one job.

- When undertaking research, Davis screens for capital allocation policies and looks to ensure they are implemented
- Davis votes all its own proxies and has discussions with board members about business strategy and compensation structures; board members speak to Davis because it is a long term, focused investor, one which can be a large holder of that company's stock.

Finally, valuation is key – there is no such thing as a 'must own' stock. Davis considers a proprietary metric, 'owner earnings'. It measures the excess cash a business generates after reinvesting enough to maintain its capacity and competitive advantages, and adjusts cash flow for items such as depreciation. This is how private businesses analyse their own financials. Davis looks at every business as though it owns 100% of the company and determines how much we would be willing to pay for it.

When considering valuations, there are many adjustments we make to company financials to get a true picture of the business.

For example, when looking at price and earnings, the two components of the P/E ratio so important to many investors, there are important factors that aren't incorporated into these numbers. These include debt, underfunded pension and healthcare liabilities.

In 2008, General Motors had US\$58.4 billion in underfunded pension and healthcare liabilities. It wasn't the shareholders who owned GM in 2008, it was the employees and retirees!

In terms of adjusting the earnings, an important consideration is the type of accounting practices used. The standard practice generally expenses items as costs are incurred, and books profits as they are made. The alternative is program accounting, where expected sales over a specific time are estimated, together with expected costs and, from there, the average profit the company will book each year is calculated – even for year one.

Program accounting represents a long-term view – but how can an organisation really know how many sales they will make and at what cost? As a result, there can be quite a difference in reported profitability, depending on the accounting methodology adopted.

**Q: You invest in three types of companies – can you describe each type of business using a current portfolio holding as an example?**

**A: Market leaders** – leading companies with a strong balance sheet and competitive advantage; these represent the largest portion of the portfolio.

#### **Example – New Oriental Education (China)**

New Oriental is a leader in Chinese education. There are 230 million students in China and, of the K-12 population, 80% attend after school tutoring programs. These programs are popular as parents want to send their one child to the best schools; there is a test in middle school to get into the top high schools, then a test in high school to get into the top universities.

In the US, the acceptance rate at top universities is 28%; in China, the top 40 universities have an acceptance rate of 2%...hence the focus on after school and holiday tutoring.

Until recently, after school education was not corporatised; it was a cottage industry with teachers tutoring students in school at the end of the day. This started to change in 2008 when the government decided this was a conflict of interest – would better marks be given to those students whose parents paid for tutoring services?

Today, New Oriental has 4.2 million students enrolled at circa 70 centres across the country – and that's only 2-3% of the market! It has a huge competitive advantage compared to smaller single school businesses, or even regional players with 20-30 schools. New Oriental has invested in online education, it pays teachers 20% more on average, and can better leverage its marketing dollars. It is a high margin, high growth business, with enrolments growing 40% year on year.

Although New Oriental trades at 25 times multiple, with 40% enrolment growth and 30% earnings growth, that multiple falls very rapidly.

**Out of the spotlight businesses** – otherwise known as 'boring but beautiful compounding machines', these are businesses that are underfollowed or overlooked, which have strong business fundamentals.

#### **Example – Safran (France)**

Safran is a market leader in the jet manufacturing business. There are three major players in the commercial jet engines market; Safran (JV partner General Electric), United Technologies (which is also in the Fund's portfolio) and Rolls Royce. It's a very tight oligopoly.

Safran focuses on narrow bodied jets, the Boeing 737 and Airbus A320. Overall, Safran has 75% market share; 100% market share of Boeing 737 and 50% of Airbus A320. A jet lasts 25 years and typically, so does the engine, providing a long multi-decade stream of parts and service revenues for Safran.

Safran recently launched a new engine, the Leap-1A, replacing an engine that has a 75% market share; the new engine is 15% more fuel efficient and is rapidly gaining market share. It will be a couple of decades before Safran needs to replace it.

We particularly like the long-term approach taken by Safran's management – CEO Philippe Petitcolin readily discusses the company's 2050 plans and the business is already undertaking research and development for their next generation of engine.

Safran is a long tail, long term business. It has 8-9 years' worth of orders booked and is expected to grow average earnings 10-12% per year.

**Headline risk or contrarian investments** – made on a selective basis where the risk/reward trade off appears favourable; it often involves controversial situations where Davis believes the market has overly discounted a company's shares.

#### **Example – Adient (Ireland)**

Adient has 35% market share globally of the car seat business, and works with 40 car manufacturers. Importantly, it has 40% market share in China, which is the fastest growing market in the world. The global car parts business is growing 2-3% per year.

Adient was divested by Johnson Controls; because it was a small portion of Johnson's business, investors got very small positions in the new company and, as a result, most sold those positions cheaply. As Adient was no longer an S&P500 stock – or even an S&P MidCap 400 stock – passive managers also sold their allocation.

Adient employed a management team focused solely on car part manufacture and created a very good business...one that Davis could buy cheaply; it was trading at only 4.5 times earnings, and for a growing business. This is a good example of an active manager being able to take advantage of dislocations in the market.

## Q: Where do you see the investment opportunities in 2017 and beyond?

A: There are four key areas of interest at the moment:

1. US Financials – there are still opportunities for US financials to grow over time; valuations are up a little, but still attractive, especially for businesses with strong balance sheets and strong franchises.
2. Industrials – companies such as Safran have significant growth opportunities.
3. China – currently, about 20% of the portfolio is in China, focusing on the Chinese consumer. We shifted the portfolio away from infrastructure/commodity businesses 3-4 years ago, to focus on the growing consumer-facing segment of the Chinese market. There remains a lot of room for growth. The consumer comprises approximately 37% of Chinese GDP; it is 68% in the US and 55% in Europe. We expect 1% growth per year; this means if the economy grows 6-7% per annum, retail sales should grow 10-11% per year.
4. Energy – in this sector, our focus is on low cost North American shale oil producers; they are typically less capital intensive than traditional oil producers, have low-cost production, ample reserves and will benefit from an increase in energy prices as global demand grows.

## Q: What is the Davis view on the two big As – Amazon and Apple?

A: **Amazon** is a company we've been following for a long time and have owned three times. Most recently, we bought Amazon 18 months ago, and made it a much larger position; although it has grown significantly, we believe it is attractive enough to maintain as a major position. It has a strong global online business with the advantage of scale, is growing 20-30% per year, and keeps increasing its categories. In the US, customers can get Amazon orders delivered in 1-2 hours, a real competitive advantage.

Amazon Web Services (AWS) may be larger than the retail business over the longer-term; its focus is to replace companies' in-house servers. It is much more efficient and cost effective to plug into the computing power, storage and IT security provided by Amazon.

Davis believes both aspects of the business have strong growth prospects.

Our analysts review **Apple** on a quarterly basis, each time it releases a financial report. Although it's a great business, at its most basic, it's a hardware company largely reliant on the iPhone. Today however, phones are a commodity – functionality across the board is similar in terms of speed, screens, access to systems, and memory.

The iPhone is priced at US\$700 compared to similar phones in China that retail for US\$100 – can Apple maintain its pricing? The history of consumer electronics companies suggests not. Apple will need to move a lot of units to maintain its current financial position.

In the developed world and some developing world countries, cell phone penetration is very high – in China, mobile technology leapfrogged fixed line and computer sales. The replacement cycle is slowing as the technology improves; if that replacement cycle is driving sales, that makes for a tough business environment.

There has been a lot in the press about Warren Buffet talking up Apple in his letter to Berkshire Hathaway investors; we view Apple as a very long term, low growth investment that returns cash to shareholders, the latter point explains the appeal to Berkshire Hathaway.

## Q: Finally, what's a little-known business that Davis is excited about?

A: Naspers is one of the largest businesses you've never heard of. It's a South African multinational investment conglomerate, with a market cap of US\$70 billion.

Naspers owns a range of media and internet holdings in emerging markets, including:

- a leading satellite TV business in Africa
- a high margin online classified ad business that operates in 31 countries and is the number one classified ad business in Brazil, Russia and India
- 15% of Flipkart, one of the three biggest e-commerce companies in India
- one third of Chinese internet portal Tencent Holdings, which owns messaging app WeChat (with 700 million plus users) and video gaming business SoftCell.

For information about the Pan-Tribal Global Equity Fund, please contact your Key Account Manager or go to [www.pantribal.com.au](http://www.pantribal.com.au)

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Applications to invest in the Fund must be made on the application form which can be downloaded from [www.pantribal.com.au](http://www.pantribal.com.au) or obtained by contacting Pan-Tribal on (03) 9654 3015.

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