FLAGSHIP
ASSET MANAGEMENT

Quarterly Telescope Q3 2022

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01

We are a global specialist investment boutique

Flagship is a specialist global asset manager founded in 2001.

We are 100% independent and fully owned by staff and directors.

Our mission is to be the navigators and global authority of your complete investment future, wherever it may lead.

02

We manage global portfolios in three distinct strategies

Global Equity | Global Flexible | Global Fund of Funds

We believe in a focused approach to fund management

Our longest running Funds have track records spanning over two decades

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03

We are long term investors who manage concentrated portfolios

Our investment approach is process-driven and rigorous, and our definition of quality is demanding and exclusive.

Our equity portfolios are focused. We own a maximum of 25 shares, diversified across geography and sector.

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The Flagship Global Investment Team

Pieter Hundersmarck

Pieter is the co-manager of the global funds at Flagship and has been investing internationally for over 15 years. Prior to Flagship he worked at Coronation Fund Managers for 10 years and also co-managed a global equities boutique at Old Mutual Investment Group. Pieter is a dual Dutch and South African citizen, and he holds a BComm (Economics) from Stellenbosch University and an MSc Finance from Nyenrode Universiteit.

Kyle Wales CA (SA), CFA

Kyle is the co-manager of the global funds at Flagship and has been investing internationally for over 14 years. Prior to Flagship, he worked at Coronation Fund Managers for 9 years in the Global and Global Emerging Markets teams and also co-managed a global equities boutique at Old Mutual Investment Group. Kyle is a South African citizen, a qualified chartered accountant and CFA charter holder.

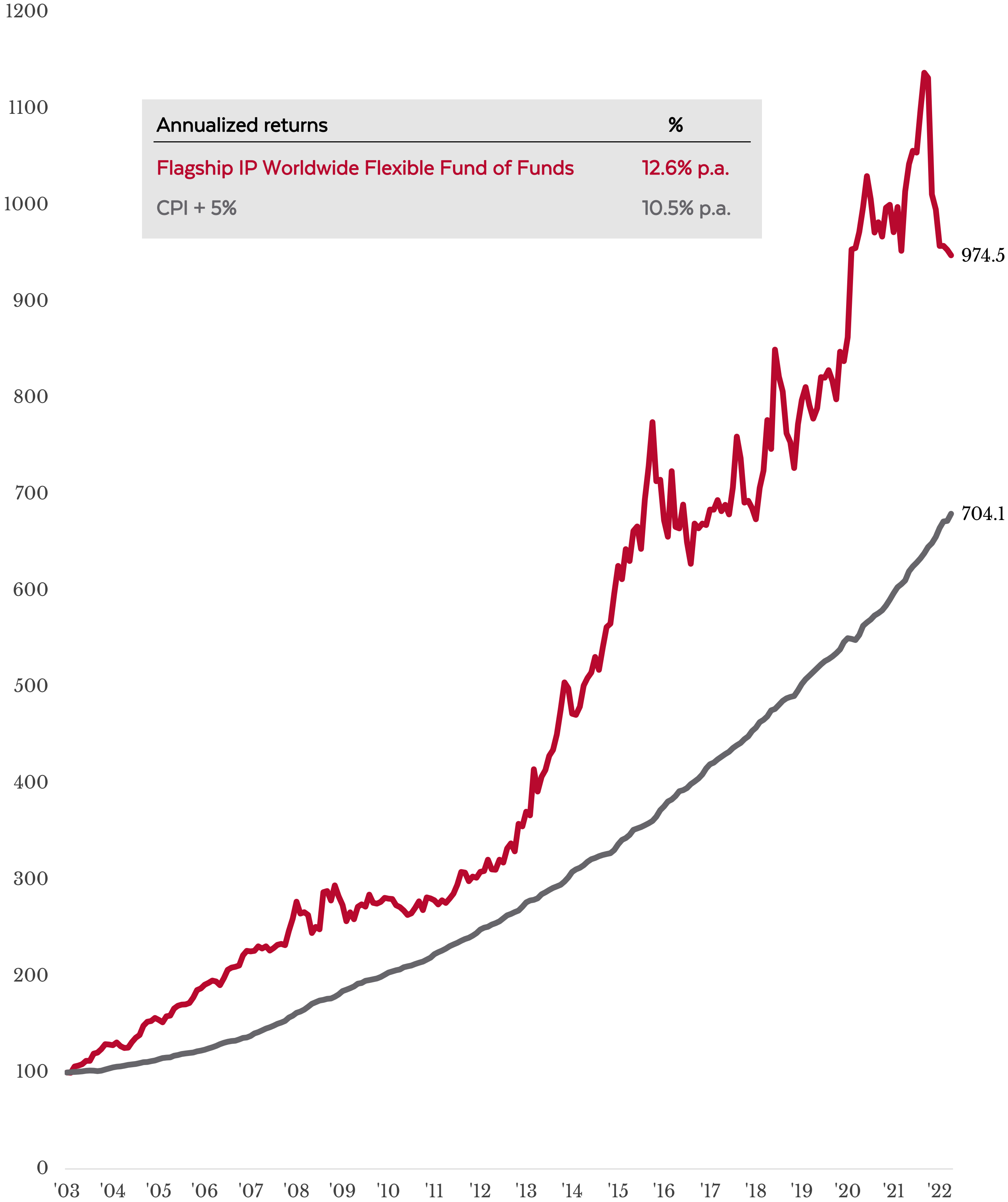
JD Hayward (B.Eng.)

JD is an equity analyst on the global team at Flagship for two years. Prior to Flagship he worked as an engineer and also spent 2 years at an Edu-tech startup in Cape Town. JD graduated from Stellenbosch University with a B.Eng. (Civil) in 2016 and has passed all three levels of the CFA exam.

The Power of Long-term Compounding

The **Flagship IP Worldwide Flexible Fund of Funds** (net of all fees) vs. SA CPI +5%

from 3 April 2003 to 30 September 2022 (19 years, 6 months)



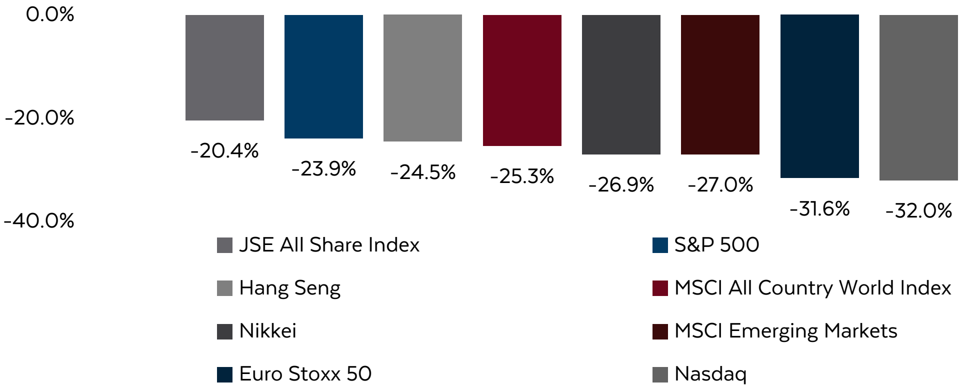
Annualized returns	%
Flagship IP Worldwide Flexible Fund of Funds	12.6% p.a.
CPI + 5%	10.5% p.a.

Ouch.

"As a money manager, I have frequently looked at an investment decision that I felt had a high probability of success on a three-year horizon, but about which I had many doubts on a one-year horizon."

– Robert Kirby

Chart 1: Global Index returns in USD (Dec 31, 2021 to Sep 30, 2022)



We are now three quarters of the way through 2022. So far, the year has been dominated by the Fed's response to high levels of inflation, the possibility of a recession and a resulting bear market. Macroeconomic weakness, which seemed sporadic in the first two quarters of the year, is now showing up in all consumer and industry related data.

We argued in our Q2 Telescope (found here) that if you invest with a long-time horizon, you should expect – and be prepared – to face rough markets. Seemingly on cue, we come off the back of one of the worst Septembers, worst Q3s and worst YTD of our careers in terms of the breadth of assets classes declining.

Since Jerome Powell's remarks at Jackson Hole in August, capital markets have begun a more urgent selloff. Why is this? Because Powell's remarks reaffirmed the Fed's hawkish stance toward inflation, which some – clearly more optimistic – market participants had doubted.

Powell's remarks reaffirmed the Fed's hawkish stance toward inflation, which some – clearly more optimistic – market participants had doubted.

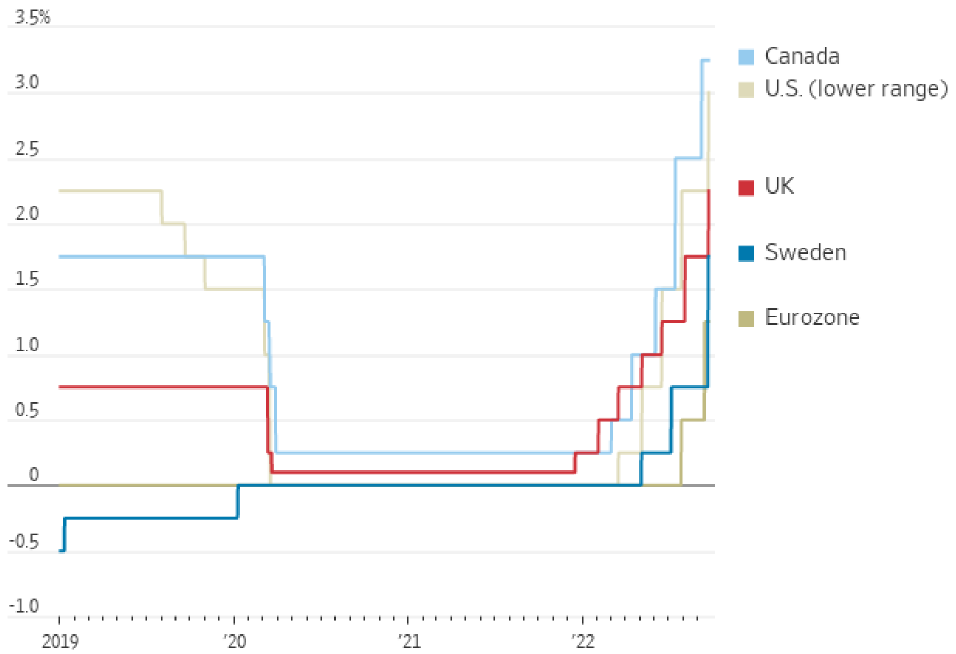
There is a growing realisation that it will be hard to avoid a recession if the Fed is actively trying to slow the economy. This doesn't seem to bother the Fed, with Powell's more recent remarks on the 29th of August confirming this:

"I want to start here today by saying that my main message has not changed at all since Jackson Hole. The FOMC is strongly resolved to bring inflation down to 2%, and we will keep at it until the job is done. So, the way we're thinking about this is the overarching focus of the committee is getting inflation back down to 2%."

This hawkishness was identified in our Q2 Telescope where we stated *"Investors seem to be toying with the idea that the Fed can both tame inflation and avoid a recession, but this seems highly unlikely to us in light of historical precedent. History teaches us that, most of the time, rising interest rates lead to recessions."*

So how far along are we? The chart on page 2 shows the sharp tightening that has taken place this year. US rates (now at 3.25% at the upper bound) have some ways to go in order for positive 'real rates' to become a reality, and the likelihood is that something may break on the path to lower inflation.

Chart 2: Central bank policy rates have risen sharply



Source: FactSet

Where is inflation coming from? The usual suspects:

1. Businesses are passing costs on. Energy prices are the common denominator to everything - and corporations have passed through a lot of costs to consumers. While some costs may subside, the new prices that consumers are paying for most items and services will not.
2. Pressure from the job market. The labour market is still tight as evidenced by jobless claims. Companies are still looking for workers, which puts upward pressure on wages, impacting profits as well as consumer spend.
3. The rental market is rising, with crucial lags. Zillow's index of the rate of inflation in leases taken out each month is inflating much more slowly than in the past. The bad news is that monthly rental inflation continues to be significantly greater than it was in the years before the pandemic. So, this effect is still filtering through to CPI, and will continue to do so for another 6-8 months.

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Chart 3: Inflation is everywhere you look (12-month change)

Note: EU harmonized index of consumer prices
Source: Eurostat

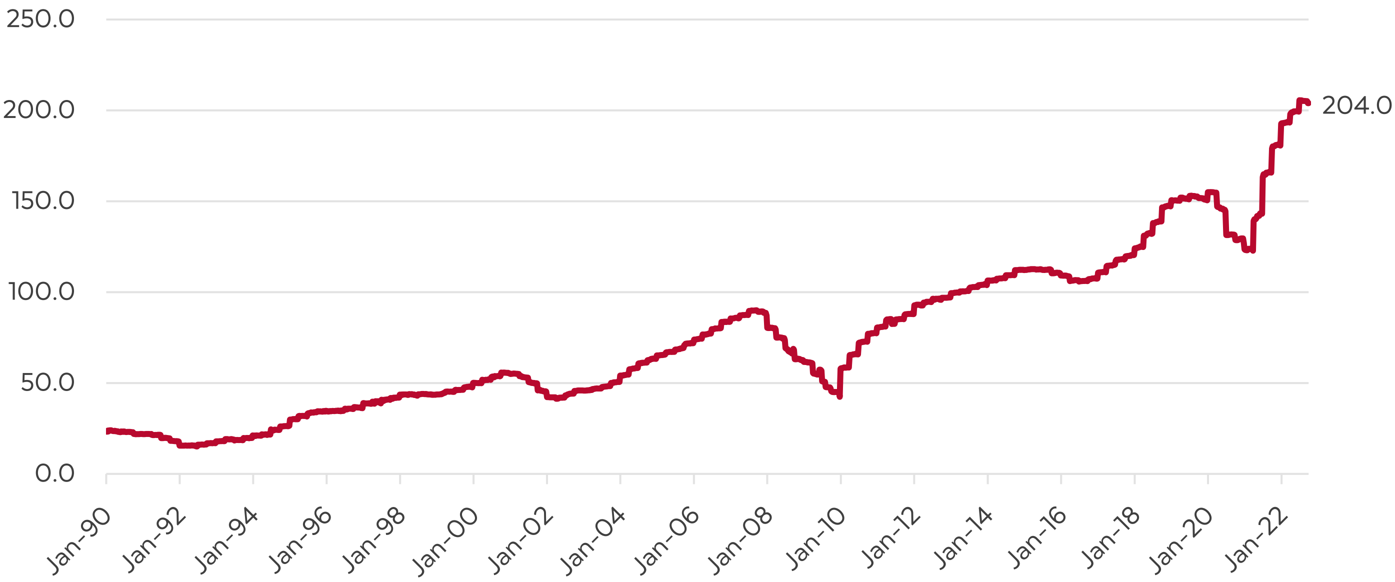
While valuations continue to contract, earnings expectations are still adjusting.

The pain in stock markets so far has come largely from a contraction in the valuation placed on stocks (the P/E ratio). Soon, we believe earnings expectations for the broader market will begin to decline.

Chart 4: S&P 500 P/E Ratio History, Current & Average to September 30, 2022

Why do we say this? As evidenced by the chart below showing trailing 12-month earnings for the SPX index. The EPS of 204c of the past 12 months is expected to grow over the next 12 months by +15.7% (at the time of writing). We believe the likelihood of earnings growth in a recession – which is the likely outcome of Fed tightening – is low. This leaves the PE ratio of 17.6x looking especially optimistic, not to mention forward estimates.

Chart 5: S&P 500 Trailing 12M earnings per share to September 30, 2022



Asset Allocation

So, given the current environment, what are we doing in our flexible funds?

Exposure to risk assets is low in our flexible funds, and will only rise as earnings revisions make market valuations more attractive.

1. **Despite the 20%+ falls in equity markets year-to-date, equity valuations are at risk to increased earnings revisions.**

Our funds have a growth bias, with the benchmarks of our flexible funds assuming a 50% or greater exposure to equities. On a mid-cycle basis, one would therefore expect equities to be the asset class we have the greatest exposure to and this, together with the decline in equity valuations from the beginning of 2021, should have made us far more constructive on the asset class. However, the risks to equities remains high.

The reason for this is that while forward P/E multiples are currently below their long run averages, we are concerned that market estimates for future earnings are still too high. Thus, a market that appears to trade on a 17.6x P/E multiple may actually be trading on a 19X multiple or even higher if true earnings express themselves. Currently our exposure to equities in the flexible funds is 53%. We intend to add methodically as market levels recalibrate to the likely future of lower earnings in 2023 and beyond.

2. **Fixed Income is not a desirable asset class in light of the current risks to inflation and interest rates.**

Fixed income is best viewed as two separate asset classes. The first is short duration fixed income (or "cash") and the second is long duration fixed income (or government bonds). We like the former but not the latter. Cash is attractive because increases in cash or inflation expectations has a limited impact on its market value while holding it allows one to buy other undervalued asset classes should their market values fall. The prices of government bonds, however, can see massive drawdowns should long term inflation and interest rate expectations move higher. The only long duration government bonds we hold are SA government bonds where we believe real interest rates have become too attractive to ignore.

3. **Inflation hedges are attractive.**

In past periods of high inflation, the asset classes that have performed the best are: (1) oil, (2) gold and other commodities and (3) real estate. We have an exposure to each of these asset classes in our funds. With respect to the first asset class, we have taken our exposure to oil through two equity positions which we have counted under our "equity" exposure. With respect to the second asset class, our primary exposure has been through two equity ETFs. Finally, with respect to the third asset class, we hold a short-term Real Estate Investment Trust (REIT) ETF, an instrument which contains a range of REITS whose nominal rentals reprice more frequently than average (yearly instead of 3 yearly), allowing them to pass through increases in inflation more easily. We believe this instrument will perform well through periods of high inflation,

4. **The USD is cyclically strong.**

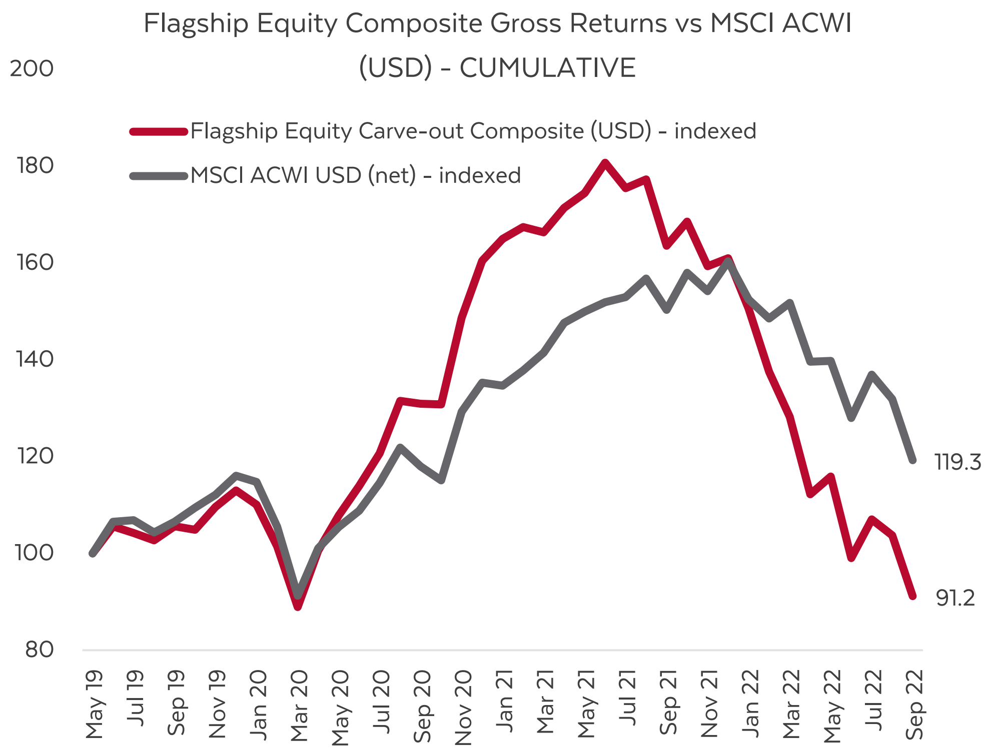
There is no question in our mind that the USD is trading at very high levels relative to most currencies. This is a cyclical phenomenon relating to interest rates, the Eurodollar market and the status of the USD as reserve currency. Our portfolio is positioned to be robust during this time of USD strength and to benefit from it (via strengthening EM as well as Euro/Yen denominated earnings) as the USD eventually weakens.

Performance

It's been a brutal year in the capital markets. As of Q3 2022, our global funds are down between -9% (for our Flexible Fund of Funds) and -35% (for our Global Icon Fund), from the same time last year. Indeed, Q3 2022 now marks one year of the Flagship Global Strategies' underperformance.

The chart below depicts this, showing the cumulative gross returns of our equity portfolio since May 2019. The underperformance since Q3 2021 has been severe.

By almost any measure, the companies that we own are in as strong or a stronger position than one year ago.



Nevertheless, by almost any measure, we believe the companies that we own as the core of our funds are in as strong or a stronger position than one year ago. Let's go through a few of them now.

Dick's Sporting Goods, one of the largest positions in our equity portfolios, is more profitable and valuable today than it has been at any point in its history. It's omnichannel business model has proven resilient through COVID and the recent re-opening. Gross margins have expanded from 29% pre-COVID to 35% today, and dividends and share buybacks have accelerated. Free cash flow will be in the region of $800m over the next 12 months. Shares outstanding have declined by 9.9% (from 84.2m to 75.8m) over the past year. Dick's trades on 9.6x 12-month forward earnings and generates returns on invested capital (ROIC) of over 15%.

Capri, the owner of the Michael Kors, Versace and Jimmy Choo brands, grew its revenues 22% y-o-y in constant currency excluding China (which found itself in the midst of crippling lockdowns) to deliver record 1Q23 revenue. Operating margins remained robust at just shy of 20%. Versace is Capri's primary growth-driver, and since Capri acquired Versace in its 2019 financial year, it has more than doubled Versace's revenues and turned it from loss making to earning operating margins of 18.5%, despite the headwinds from Covid. Management believe they can double Versace's revenues once again and further increase its operating margins. Capri trades on 5.6x 12-month forward earnings and generates ROIC of over 24%.

PagSeguro, a leading challenger bank and payments processor in Brazil, is much stronger and more entrenched than it was one year ago. It has increased the number of customers it services as well as its consolidated total payments volume (TPV) by an impressive 58%. While rising interest rates in Brazil have been a headwind for the investment case, we believe interest rates in Brazil have peaked already, and declining interest rates should be a tailwind for earnings going forward. PagSeguro trades on 14.0x 12-month forward earnings and generates a ROIC of over 27%.

AMAT and **UCTT**, our holdings in the semiconductor capital equipment space, are set to benefit from enormous tailwinds for semiconductor capex over the next three years. The proliferation of semiconductors via the Internet of Things, the growth in onshoring of semiconductor facilities and government stimulus (the CHIPS Act) are all positive for their prospective returns. Both have strong balance sheets and proactive capital management policies, with AMAT in particular reducing its share count by 5% in the past year. AMAT and UCTT are trading on 11.1x and 7.2x times earnings respectively. Even if semis exhibit their traditional cyclicality, these stocks will *remain on low earnings multiples*. AMAT's average 5-year ROIC is 28%, while UCTT is just over 10%.

AMAT and UCTT are trading on 11.1x and 7.2x times earnings respectively. Even if semis exhibit their traditional cyclicality, these stocks will remain on low earnings multiples.

Square Enix, Take Two and **Ubisoft,** our investments in video gaming, are on the cusp of new launches for their valuable IP across their platforms. Video gaming is the new frontier of media entertainment, and will also feed into the virtualisation of life, recreation and commerce (the metaverse). They trade on 15.6x, 23.3x and 20.5x their next 12 month's earnings respectively, while ROIC averages between 12-15% for each of these businesses, which includes substantial investments that have yet to generate meaningful returns in our view.

Informa, the largest trade-show organizer in the world, took a large knock as a result of Covid but it is well on its way to recovery. In its latest 1H results Informa grew its underlying revenues by 43.9% and its adjusted operating profits by 226.6%. It has reaffirmed its 2022 expectations at the top end of its guidance. It has also sold two of its non-core business at EV/EBITDA multiples north of 25x (roughly equivalent to P/E multiples of 35x+) and plans to use part of the proceeds to buy back shares which will be value accretive.

Zalando, the largest online retail platform in Europe, will surpass 50m active accounts in 2022 from 14.7m in 2014. It will process 256m orders, versus 41.4m in 2014. Its gross merchandise volume will surpass EUR 15bn this year, with gross margins of over 40%. The Company is trading on the same share price it listed at over eight years ago, despite being 5x larger and more profitable. Margins are expanding due to its more profitable services division, and the Company is net cash. Zalando trades at 23.9x historical earnings and generates a normalised ROIC of over 18%.

IFF, one of the largest flavours and fragrances companies in the world and a supplier to some of the world's favourite branded tastes and smells, is displaying its pricing power in this environment as it passes on rising raw material costs to its customers. As a result, it expects to grow its FY22 revenues by 9-12%, with EBITDA following (with a lag). These growth rates are in line with its competitors Givaudan and Symrise, which trade at substantial (and in our view unwarranted) premiums to IFF. IFF trades on 24.4x 12-month forward earnings and generates a normalised ROIC of c. 15%.

Our latest addition to the fund (and the only change since Q2) is Universal Music Group, the owner of the world's largest music rights library. We will discuss UMG in the next Telescope.

While capital markets distribute capital, they also distribute humility. So, which companies are not performing so well?

Adobe, the leader of digital and creative experience tools, negatively surprised the market in September by overpaying for an acquisition. The resulting share price decline has wiped off nearly twice the amount of capital spent on the acquisition. While this is a misuse of shareholder capital, the share price adjustment is overdone in our view. Adobe trades on 24.2x prospective earnings and remains a very high ROIC company with a large addressable market.

Meta is facing increased challenges to its social media dominance from TikTok, at the same time that the online advertising market is slowing, and Apple has made the delivery of online ads more difficult on the iPhone platform. On top of this, the Company has decided to spend nearly $9bn per annum (20% of its Net Income) on an unproven bet on the Metaverse. These setbacks are the reason the share price now trades at 13.2x 12-month forward earnings while generating ROICs of over 23.8%.

Rakuten is a Japanese company that is best viewed through the lens of being an ecommerce company at its "core", coupled with a nascent mobile business which is consuming large amounts of capital as it rolls out a physical mobile network. In its latest set of quarterly results, the Rakuten "core" revenues grew robustly at 9% y-o-y and operating income at 8.5%. However, market concerns around how it will fund the roll-out of its mobile business remain and capex demands are substantial.

Duck Creek is the fastest growing provider of cloud business solutions to insurance companies. While its annual recurring revenues (ARR) growth slowed in its last set of quarterly results, it continues to grow at over 20%. The company has also broken even on an EBIT basis in its latest set of results and is sitting with net cash on its balance sheet. Duck Creek trades on an EV to sales multiple of 3.8x, which, while expensive, is attractive given the business prospects in our view.

Looking past the current environment, let's move to the future.

If our stocks remain well positioned, why is the market ascribing such a low value to them? Inflation and interest rates, and their impact on valuation, are certainly culprits. However, there is also investor psyche at play. As the famed investor Benjamin Graham said, "In the short term, the stock market is a voting machine; in the long term, it's a weighing machine." Once the voting is over, our companies will be weighed over the next few years, and we believe the market will conclude they are very heavy indeed.

Once the voting is over, our companies will be weighed over the next few years, and we believe the market will conclude they are very heavy indeed.

We believe the tailwinds behind semiconductors, video gaming, social media, payments, e-commerce and luxury are enduring, and our companies will benefit from these tailwinds. The businesses we have invested in provide a consumer surplus: things that consumers need now and will continue to need in future. Moreover, the majority of our companies do not need external capital to grow, and will continue to generate mid to high teen returns on their invested capital.

Investing is challenging because events don't unfold in an even, or predictable, manner. There are some great periods, there are nasty drawdowns and there are extended periods where you seem to go nowhere. With the vast bulk of Flagship's directors' and employees invested in the Funds, we feel every movement as keenly as you do. We firmly believe that if your horizon stretches five or ten years or more, then owning a good business is one of the safest places to be. Even better: own a portfolio of such businesses.

Investors will need to relearn old lessons

By Pieter Hundersmarck

Markets are in complete disarray. There is a war in Ukraine, contradictory fiscal and monetary policy in the UK, a coming recession in Europe, high inflation and commodity prices and a strong dollar wreaking havoc on central bank tightening plans. Investors, who for over a decade have been taught to 'buy the dip', have been crucified for executing on their training this year.

Behind these losses lie a more serious conditioning that has taken place, and which needs to be interrogated.

At the time of writing, we have come off the of one of the worst Septembers, worst Q3s and worst YTD of many investors' careers in terms of asset value declines. No asset class or sector has been spared, with some market observers heralding the death of traditional 60/40 equity/bond portfolio construction favoured for so long.

Behind these losses lie a more serious conditioning that has taken place, and which needs to be interrogated.

For years, investors have been trained to repeat, "it always comes back." In saying this, it's easy to forget that starting points matter: the decade of easy monetary conditions which led to equities outperforming since the GFC can be followed by S&P 500 returns below T-bills, and even below zero, for more than a decade (when looking at the 1970s for example).

I still recall in 2010 when markets were recovering from the GFC how the S&P500 only reached it's 2000 level (10 years prior) in that year. This was an entire decade of zero returns from global markets. Yes, it came back. But not in a rush.

The S&P 500 from October 6 2000 to October 6 2010

What makes investing difficult is that things don't unfold in an even, or predictable, manner. There are some great sequences of events, there are unanticipated drawdowns and there can be prolonged periods where you seem to go nowhere.

If you can't rely on monetary policy to reflate your assets for you, then you need to rely on the asset to do the work for you.

Whether inflation will be with us for one year or 5 years, shares undoubtedly remain the asset class with the best prospects for real growth longer term. However, investors need to get back to pricing them correctly. Going forward, investors will have to unlearn the bad techniques used in bull markets, and relearn their fundamentals.

Let's look at the PE multiple for example. The price-earnings multiple is the principal method investors use to value shares. Yet, most investors don't have a clear idea of what a certain multiple implies about a company's prospective financial performance. They also don't understand how and why multiples change over time.

The untidy use of multiples is everywhere you look. Some investors (and I'm sorry to say even this investor has been guilty of this) use multiples in an apples-to-oranges comparison between businesses with different economics. They use growth rates as the only differentiator between businesses trading at different multiples. Most alarmingly, they also claim that a company's multiple should revert to levels that it has traded in the past without a solid economic justification to do so.

The untidy use of multiples is everywhere you look.

Price-earnings multiples are widespread in use yet remarkably poorly understood. Let's use an example to dig into this.

Imagine we have 2 companies, A and B.

Let's say both companies will earn $1 per share next year, and will also grow their earnings 10% per year going forward. Suppose A trades at a (forward) P/E Ratio of 10x. So, each share of A costs $10. By contrast, B trades at a P/E Ratio of 20x. So, each share of B costs $20.

Which company is the better investment? You'd assume A right? After all, both companies earn the same ($1/share) and they are growing at the same rate (10% per year). But A is cheaper than B (10x vs 20x P/E).

Choosing A would be wrong. Because it's not just about earnings, or how fast earnings will grow. Rather it depends entirely on how efficiently these two companies grow. How much does 10% growth cost for A versus B?

Let's say A is able to generate a return on investment of 8%. This means it deserves to trade at a low multiple, as this is barely above its cost of capital.

If B can generate higher returns, then it deserves to trade at a higher multiple.

Capital efficiency matters: in order to grow, A needs all the money it makes and has less surplus available to pay dividends (or buy back shares) while B can do both. The table below (from Credit Suisse) provides a potential framework for investors to use when assessing P/E multiples and returns on invested capital.

Exhibit 5: P/Es Given Different Scenarios for ROIC and Growth

		Return on Invested Capital			
		4%	8%	16%	24%
Earnings Growth	4%	7.1x	12.5x	15.2x	16.1x
	6%	3.3	12.5	17.1	18.6
	8%	NM	12.5	19.4	21.8
	10%	NM	12.5	22.4	25.7

Source: Credit Suisse.
Note: Assumes all equity financed; 8% cost of capital; 15-year forecast period.

When falling share prices increase the universe of potentially attractive opportunities, investors can afford to be fussier and look at firmer measures of earnings power.

Beyond the sloppy use of multiples, there is also a lot of adjustments that have been allowed to creep into earnings over the past 10 years. Most of you will be familiar with the (as far as we are concerned, settled) debate around whether share-based compensation is an expense or not. 'Adjusted' earnings tend to add back this line item, for example. When falling share prices increase the universe of potentially attractive opportunities, investors can afford to be fussier and look at firmer measures of earnings power.

Time to buy US Consumer Discretionary and Tech Stocks?

By Kyle Wales

Investors have favoured defensive sectors in a US stock market that has experienced its worst year-to-date performance in many years.

Contrary to general market consensus, however, we believe the least-loved sectors of the market are starting to offer compelling value for investors with a long-term horizon, even though they face near-term macro-economic challenges.

Contrary to general market consensus, however, we believe these least-loved sectors are starting to offer compelling value for investors with a long-term horizon.

Consumer discretionary and tech bear the brunt of the deteriorating sentiment

The divergence in sectoral performance on the stock market has been the widest it has been for some time. While the energy sector rose more than 30% in absolute terms year-to-date, outperforming the S&P index by more than 50% on a relative basis, the Consumer Discretionary sector fell almost -40% in absolute terms and underperformed the index by -17%.

In comparison, Communications Services (which includes many tech names) and Information Technology declined -23% and -32% respectively.

The stark underperformance of consumer discretionary stocks can be explained by the pressure that rising commodity prices and interest rates are placing on consumer incomes, while tech names have fallen from lofty valuations due to the increase in higher risk-free rates, known as the discount rate.

The market uses the rate, elevated by the Fed's rate hikes, to value distant future payoffs that rely on a period of strong growth, which, currently, is far from certain.

In contrast, more defensive sectors like Utilities, Consumer Staples and Healthcare received a boost from increased risk aversion among investors against the backdrop of Russia's invasion of Ukraine and a rapidly deteriorating inflation outlook.

With investing, it comes down to what is priced in.

Table 1: S&P sectoral sell-off in recessions (peak to trough): Almost three-fourths of an average recessionary sell-off may be behind us.

S&P sectors	Early 1990s recession	Early 2000s recession	GFC crisis	COVID-19 recession	Average	Current sell-off from peak	Ratio of current sell-off to history
Energy	-16.1	-18.9	-49.8	-54.4	-34.8	-35.8	1.0
Cons. Discretionary	-29.1	-29.3	-56.2	-20.1	-33.7	-33.9	1.0
Real Estate	0.0	-4.4	-75.2	-20.9	-25.1	-25.1	1.0
Comm. Services	-22.6	-48.8	-46.7	-17.8	-34.0	-31.4	0.9
S&P	**-19.0**	**-31.4**	**-52.6**	**-20.0**	**-30.7**	**-22.9**	**0.7**
Information Tech.	-27.0	-71.4	-51.3	-25.9	-43.9	-28.8	0.7
Industrials	-23.7	-22.7	-60.2	-27.5	-33.5	-19.4	0.6
Healthcare	-32.8	-26.3	-37.3	-15.2	-27.9	-15.3	0.5
Materials	-24.5	-23.9	-57.9	-26.6	-33.2	-17.7	0.5
Utilities	-15.8	-34.0	-40.9	-19.5	-27.5	-13.5	0.5
Financials	-43.5	-20.3	-80.0	-32.3	-44.0	-21.2	0.5
Consumer Staples	-32.5	-28.0	-30.3	-13.7	-26.1	-12.2	0.5

With investing, however, what has historically mattered most, is what is being priced into asset valuations. Typically, the market bottoms just before the historical data prints are at their worst.

As the table on the previous page shows, percentage peak-to-trough declines in both the consumer discretionary and tech sectors have matched those experienced in the last four recessions, while milder sell-offs in most other sectors would imply there is further to go.

Capri trades on a P/E multiple which is 50% below its long-run average

Capri Holdings is an example of a Consumer Discretionary stock that we hold in the Flagship portfolios. Capri is an apparel company that owns the Michael Kors, Versace and Jimmy Choo Brands. Today the company trades on a blended forward P/E multiple of 5.6x, well below its average since listing of 15x.

At its current gross margin, we believe its revenues would have to fall by 27% for its P/E multiple to equal this long run-average. Incidentally, sales declined by 27% during the Covid epidemic when many of its stores were closed.

The business has improved over time, and today is a superior and more diversified business than it was on listing when it owned a single brand, Michael Kors (MK). Today it has two additional luxury brands in its stable and there's potential for these brands to grow to 40% of sales in the medium term.

Adobe, trading on a P/E multiple of 24x, compares favourably with Colgate Palmolive

Adobe is a good example of a technology company that we believe is mispriced.

Adobe is an excellent business. Its "Creative Suite" product is to creative professionals what "Microsoft Office" is to those in the finance world. It is also one of the pioneers of the "Software as a Service" based revenue model, as opposed to a licence-based revenue model, which has made its revenues more resilient in a downturn.

Adobe currently trades on a 24x multiple. While optically high, this has to be evaluated in the context of Adobe's growth and returns relative to other companies trading on a similar multiple. Colgate Palmolive is a good example.

Adobe has grown its reported earnings at a CAGR of 34% over the last five years while Colgate Palmolive has seen its reported earnings decline 1% (refer to the table below).

While the differential in Colgate's and Adobe's growth in earnings per share (EPS) is expected to contract substantially, Adobe is still expected to outgrow Colgate by a wide margin.

Reported EPS (growth y-o-y)	Fiscal year "FY" 17	FY18	FY19	FY20	FY21	CAGR	FY22 (estimate "est")	FY23 (est)
Colgate	-16%	20%	0%	14%	-19%	-1%	16%	8%
Adobe	46.0%	53.9%	15.0%	80.2%	-7.7%	34%	22%	20%

Source: BBG, 20 July 22

While optically high, this multiple has to be evaluated in the context of Adobe's growth relative to other companies that trade on this multiple.

While the recent acquisition of Figma has impaired – temporarily – the capital of Adobe, the market correction has been overdone and the growth rates will continue to be higher than similarly rated peers, in our view.

Conclusion

In the words of Howard Marks, "the market is a pendulum that swings between euphoria and depression" and, while recent moves may have brought the overall S&P 500 multiple to within sight of its long-run average, as you scratch below the surface a very different picture emerges.

Investment Case: Universal Music Group

UNIVERSAL

UNIVERSAL MUSIC GROUP

⇒ Universal Music Group is the world's largest owner of music rights. As more people pay for music streaming on apps such as Spotify, and music use evolves into the digital world across all social and advertising platforms, the value of music rights will grow.

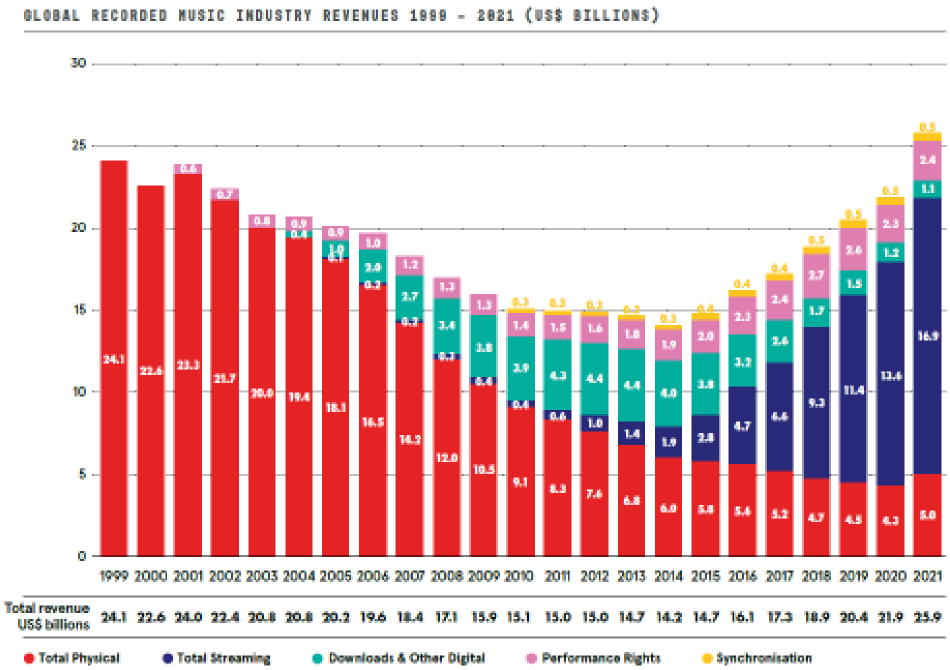
⇒ We see UMG as a way to capitalize on one of the biggest themes over the next 10 years - the proliferation of streaming music across the digital platforms that are increasingly forming part of our daily lives.

⇒ UMG's business model is uniquely positioned to capture this trend. We see the publisher and owner of the actual music (UMG, Warner, and Sony) to be superior to the distributors (such as Spotify) due to their ownership of content and strong bargaining position versus the distribution.

"The internet has allowed music to become measurable, traceable, and enforceable from the owner's perspective. As the world moves online (look at your parents' lives, your lives and children's lives, each generation is becoming successively linked to the digital world) then it seems logical that every aspect of that world will have musical content."

Global Recorded Music Industry Revenues

The music industry has staged a dramatic comeback since piracy decimated the industry from 1999 – 2014. Recorded music sales, which bottomed out at $14bn in 2014, have accelerated to hit $26bn in 2021, according to the International Federation of the Phonographic Industry (IFPI) data. Notice how streaming (the purple bar below) has become the lifeblood of the industry.

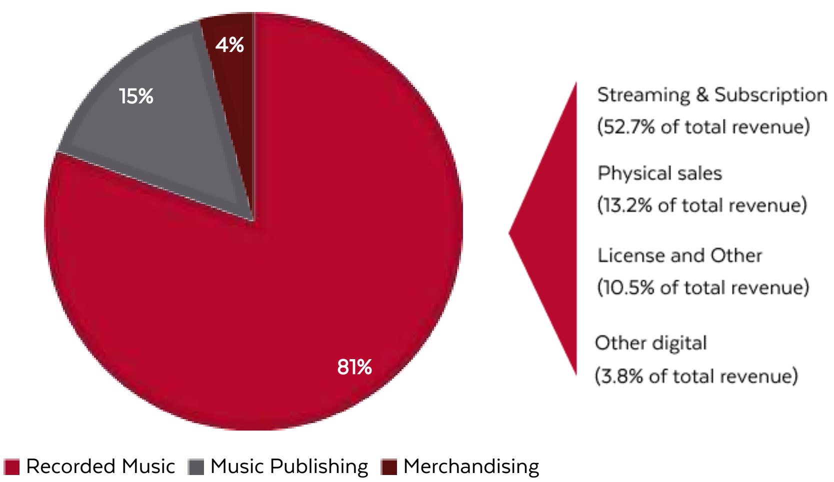


Universal Music Group

Universal Music Group is easily the largest record label in the world, followed by Warner Music Group, Sony Music Group, and then a group of independent record labels.

The three largest record labels - Universal Music Group (32% market share), Sony Music Entertainment (20%), and Warner Music Group (16%) - hold a 68% share of the music recording market. This share is the result of many years of consolidation, driven in turn by the scale and expertise required to be a modern-day music label and publisher.

There is a clear distinction in the marketplace on how rights are exploited between recorded music and the music publishing business. For UMG the split is 80% of revenue coming from recorded music sales and 15.2%% from publishing, with the remaining 4.1% from merchandising. The total split is shown below:



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This is the core of Universal: the notion of artistic sensibilities and discovering talent. There is a very traditional method for achieving this, and it doesn't change and, like art, it cannot be mechanised.

The music industry is complicated. We will begin by differentiating between the recording industry (the production of music) and the publishing industry (the exploitation of the copyrights associated with the production of music).

Recorded Music

The recorded music business works the way it has worked for a while, where record labels (or specifically the A&R or "artist and repertoire" team within record labels) discover artists that they think may have potential.

This is the core of Universal: the notion of artistic sensibilities and discovering talent. There is a very traditional formula for achieving this and, like art, it cannot be mechanised. It involves being on the gig circuit within particular genres, finding artists and developing them on a very personal level.

Once discovered, UMG invests in these artists by financing their music production, their recordings, their videos, and their marketing efforts. In return, the label enjoys the rights to exploit the recorded music across all the platforms. There are 2 major parts to the recorded revenue stream:

1. **Frontline -** 42% of UMGs recorded music revenue comes from "frontline" music, or music that is less than three years old.
2. **Catalog -** 58% of UMG's recorded music revenue in 2021 came from Catalog sales (defined as content older than three years).

There are high reinvestment needs to the frontline business. In addition, the artist fail rate is high (for every Taylor Swift there are hundreds of artists who fail to crack it) and that means writing off the cost of the record, advertising, promotion and advances that were forwarded to the artist.

Publishing

Publishing focuses on the intellectual property of the music business, which is the song or the work. If a songwriter writes a song, in whatever form that may be, from that point on they own the copyright. However, they're not necessarily exploiting that copyright.

That's where the publishing industry comes in. Publishers actually sign songwriters. In some cases, songwriters are also artists, but they really wear different hats at that point. Once signed, publishing companies then exploit their songs in a number of ways. Most notably in the digital space, there are three main publishing rights that are being exploited:

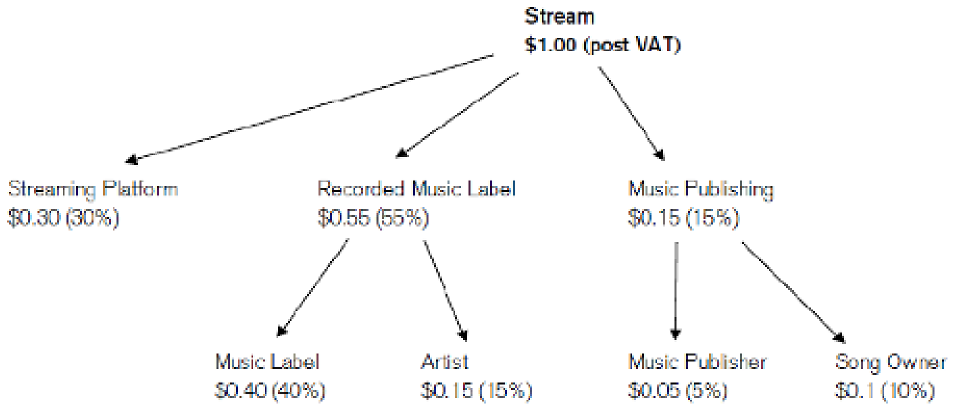
1) **The mechanical right**, which is essentially the right to make copies and distribute a song once recorded.
2) **The public performance right**, which is the right to publicly perform a song in a sound recording. For example, a stream on Spotify would be a public performance. A radio play would be a public performance.
3) **The sync right,** which gives the publisher the right to synchronize audio and video, which is needed for videos that have any music in them.

It's important to note that the first rights, the mechanical and performance rights, are very highly regulated. Mechanical rights in the US are set by the Copyright Royalty Board (CRB), and typically on the performance right there is an antitrust framework in place that limits what the players can do.

Revenue generation

Music distributors, like Spotify with its business model of all you-can-eat, premium subscription, need to license all of the rights mentioned above. As streaming services' revenues grow, so does the label's share of that revenue.

Under the subscription-based streaming model, revenue from all subscribers on the platform (e.g., Spotify) is pooled, called "the label pool", and royalty payments are issued to artists' record label proportionally based on the share of total music streams each artist generated. The split of the revenue looks like the diagram below:



Summary

The increased penetration of music is a trend we believe will be more robust in a downturn than other forms of consumer consumption.

The business fundamentals support a multi-year revenue growth algorithm, with the mix effect of higher streaming leading to higher sustainable EBIT margins. The increased penetration of music is a trend we believe will be more robust in a downturn than other forms of consumer consumption. There are also a number of catalysts occurring for the investment case:

- **New licensing opportunities** - While the streamers (Spotify, Amazon and Apple) remain the dominant source of revenue, Universal will benefit from recent deals it struck to license its catalogue to new types of customers such as social networks Tiktok and Meta, and companies such as Peloton and Fortnite.
- **Regulatory changes** - In October 2021, the UK competition regulator (CMA) announced its intention to launch a market study into music streaming. In their update on July 26th, 2022, the CMA concluded that competition is working well for consumers and decided not to make a reference for a more in-depth market investigation. This is positive for UMG profitability.
- **Emerging market growth** - Emerging markets, such as China and India, are only just starting to pay for music IP. According to IFPI's 2019 Global Music Report, China was the seventh-largest music recording market, and India was not even in the top 10, despite accounting for more than a third of the world's population.

Taking all the above into account, we believe the valuation for UMG is compelling. UMG generates a high (+18%) ROIC on its recording and publishing business, which supports an above average PE multiple of 19x in our view. We believe earnings growth will be in the region of mid-teens over the next five years, and we have an internal fair value which is over 60% above the current share price.

In conclusion

We write these Telescopes so that our investors know what it is we are doing, and why we are doing it. For many of you, we are the caretakers of your global investments, and we would like to use this opportunity to thank you for the trust you place in us, and emphasize how deeply committed we are to the responsibility you have placed in our hands.

We believe it is of the utmost importance that all clients feel a true sense of the word “Partnership” in how we are aligned. Our portfolio management team reflects this with significant personal investments in the Flagship strategies.

Flagship funds own a selection of businesses that we believe to be of unusually high quality, and will prove to be financially resilient whatever the prospects of the global economy.

We expect the value of these businesses to rise at an attractive rate over the coming years, and that owning these businesses at a discount to what they are worth will make an additional contribution to your returns.

While we believe that Flagship funds will continue to outperform over longer-term periods, there will inevitably be shorter-term periods over which our funds will not outperform. This is the nature of markets – one’s alpha (or excess performance relative to one’s benchmark) is lumpy and doesn’t accrue in a straight line.

Warm Regards,

Pieter, Kyle and the Flagship Global Team

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Specialist Global Asset Management. Your Future is Safe with those who Know.

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