

DM Monthly Report

November 2015

PORTFOLIO ACTIVITY

In October, we sold our long time holding in McDonald's, as the company continues to face stiff competition in the quick serve restaurant space.

FEATURE STOCK

Apple Computer (AAPL)

Apple's latest quarterly results helped to bolster the iPhone's status as the greatest consumer product ever. In its fiscal Q4, AAPL sold 48 million iPhones, up 22% over the same period last year, and doubled its sales to China. The product's extraordinary pricing power was also on display, with the average per unit price steadily increasing during the time frame from \$603 to \$670. During his review of the quarter, CEO Tim Cook offered three reasons that growth will continue. First, the majority of iPhone users have yet to upgrade to the "6" model; second, iPhone is winning market share from Android, with roughly 30% of new buyers switching from that platform (AAPL is confident that this momentum will continue); and third, Cook sees huge potential for additional growth in China, where the iPhone's high price tag—once considered a liability—is now a draw, allowing it to stand out against the pack of low cost smartphones, and enhancing its image as a premium brand.

SHOULD WE CARE ABOUT WHAT'S HAPPENING IN CHINA?

Though DM's investment process is rooted in individual company analysis rather than macro economic forecasting, we do still keep an eye on major global developments, especially as they might impact the relative outlook for different industry groups. Prominent among current macro issues is the state of China's economy, and in particular the sharp slowdown it is now experiencing. Interestingly, much recent commentary on the subject seems to be divided against itself, on one hand lamenting that the world's growth engine is decelerating and on the other imploring China's leaders to speed up the country's conversion from an emerging economy, dependent on manufacturing and capital investment for growth, to a more mature one, in which consumer spending and services would account for a greater share of output. What seems to be lost in much of the analysis, however, is a recognition that these goals are innately conflicted—in other words, *mature economies almost by definition generate less growth than emerging ones*. For us, then, the appropriate question is whether the current slowdown is part of a healthy transition, or the beginning of the end of China's economic renaissance.

Though we are not economists, several anecdotal pieces of evidence encourage us to believe that the country is undergoing a rebalancing, rather than a collapse. Sales of branded consumer products are surging (see panel to left); food imports and movie ticket purchases are up 20% and 50%, respectively, so far in 2015; internet traffic through mobile devices has nearly doubled over the same period; air travel is increasing steadily and, while industrial rail freight traffic fell by 11% in the first nine months of this year, passenger train trips increased by nearly 10%. As well, though China just reported its lowest rate of growth since the financial crisis at 6.9%, its services sector expanded by a much stronger 8.4%, providing additional support to the transition thesis. Even within the commodity space signs of a shift can be found, as Chinese consumption of coffee, sugar, and gasoline has grown in 2015, while demand for heavy industrial materials such as coal, cement, and iron has plunged.

So, if the Chinese economy is in fact maturing, what might be the investment implications? First, it would probably mean that growth coming from that corner of the world would be lower than in the past, but built on a more stable and enduring base. Second, if China's infrastructure and investment boom is fading, it's difficult to foresee a rebound in the country's demand for raw materials. And, finally, makers of recognized consumer brands, providers of business services, and pharma companies should find fertile opportunity in the Middle Kingdom. Given our investment approach and portfolio composition, that backdrop would suit us just fine!