

DM Monthly Report

SEPTEMBER 2018

PORTFOLIO ACTIVITY

In August, we opened a new position in Middleby Corp. in DM Foreign Equity. Middleby is the #1 manufacturer of commercial food service equipment in the US.

FEATURE STOCK

Microsoft (MSFT)

MSFT shares reached another all-time high in August and, since Satya Nadella took over as CEO about 4 years ago, the stock has roughly tripled. While it's been a good run for many names in the tech space, much of the credit for MSFT's performance has to be given to Nadella's radical transformation of the company. Crucially, he saw that the company's future was not in its core offering at the time—the *Windows operating system*—but in cloud computing and mobile platforms. Whereas MSFT was once a vendor of proprietary software products, it now embraces open architecture, collaboration, and subscription services which generate sticky, recurring revenue. The company has also made well-received strategic acquisitions, buying business networker LinkedIn and code-sharing service GitHub. While past acquisitions were seen as catch-up attempts in areas where the company was weak, recent ones seem to be more about positioning for the future and getting ahead of curve. With its solid outlook and focused management team MSFT remains a core DM equity holding.

EMERGING MARKETS: worth the bother?

Occasionally, we're asked why the equity portfolios we build for clients don't include allocations to emerging markets (EM). To put it plainly, we've never felt that the potential reward of investing in these regions compensates for accompanying drawbacks. Some of our reservations with respect to EM investing include:

Legal framework - from property rights to securities law, most EM countries don't offer the type of investor protection that we take for granted in senior markets;

Accounting practices - loose financial disclosure and audit practices in many of these jurisdictions can make sound investment analysis very difficult;

Forex - taking currency risk in other developed markets is one thing, but owning assets denominated in Malaysian ringgits or South African rands is quite another;

Cost - to mitigate these shortcomings, a manager should install a dedicated EM team on the ground to verify financial statements, properly gauge management strength and integrity, and assess the prevailing political climate in each country.

Speaking of politics, this is another reason that we've had a hard time committing client capital to these regions. Fact is, EM indices are meaningfully populated by nations with less than desirable systems of government, including one party states (China), disorderly democracies (Brazil), de facto autocracies (Russia), and strong-man regimes (Turkey). When things go badly, such systems are often lacking the strong institutions, such as nonpartisan courts and independent monetary authorities, needed to steer the nation back on course. We're now seeing this play out in real time in Turkey, where a dangerous accumulation of foreign-denominated debt is colliding with a rising US dollar and the purported intervention of President Erdogan in the policy direction of the country's central bank. So far this year the Turkish lira has plunged by 40% against major currencies, with concern building that similar troubles could spread to other emerging markets.

The chart below compares the performance of DM's major equity mandates with that of the iShares Emerging Markets ETF dating back to March 2011, or the date that we launched the DM Small Cap Fund. As you can see, not deploying capital to the EM space over the past 7+ years hasn't diminished our results in the least.

