Phillip Capital Management

OUTLOOK 2021

CIO's Letter

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Salient Points:

- *Bright Outlook Ahead*
- *Opportunities Amidst Crisis*
- *Identifying superior growth*

Dear investors,

We are cautiously optimistic on the outlook for markets in 2021, after a year like no other. The pandemic in 2020 has pushed the global economy into its deepest recession since World War II. Equity markets plunged in March, then rallied strongly following unprecedented support from central banks and governments. We see stronger growth and lower real yields ahead led by the roll-out of vaccines, lending support to elevated stock valuations. The politics of inequality will keep deficit spending high even as debt ratios hit historical levels globally. New central bank policy stances are likely to keep interest rates low even in the face of rising inflation. Stocks will trump government bonds in this environment. The pandemic has also accelerated structural trends underway such as the increased focus on sustainability, rising inequality, and the dominance of e-commerce at the expense of traditional retail.

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Our funds and ETFs are well-positioned amidst a potentially volatile environment going forward even as economic recovery gains momentum. Our S-REITs, APAC REITs, and Singapore Income ETFs offer investors capital appreciation opportunities, while our Money Market funds (USD and SGD) provide great shelter when the markets are choppy. We also plan to stay ahead by investing in future world-changing ideas, sustainability, and high-quality growth companies. The last several decades may have been all about computers and internet, but the next decade will be about artificial intelligence, robotics, sustainability and the science of life.

Bright Outlook Ahead

Looking back to 2020, investors in our income-focused funds have done relatively well as they have been resilient amidst the sharp correction during the pandemic. The Lion-Phillip S-REIT ETF and our dividend-focussed Phillip SGX APAC REIT ETF provide well-diversified exposure to high-quality REIT leaders in Singapore and the Asia Pacific (ex-Japan) regions respectively. Investors have wisely chosen to add significantly during the downturn and had been rewarded by the strong upturn since then. Lion-Phillip S-REIT ETF for example, was the fifth most-traded ETF in the SGX and ranked third in terms of dividend yield (~4.5%) with net inflows of around $56 million for 2020 alone. Its AUM has grown close to $200 million and we expect strong inflows to continue in a yield-hungry world.

The S-REITs sector has been buttressed by the strong top-down support from the Singapore Government to address the negative impact of the pandemic. Swift regulatory measures were implemented to provide greater flexibility for S-REITs in managing their cash flows and raise funds. For example, the increase in leverage limit to 50% (from 40%), deferment of the new interest coverage ratio, and the extension of their distribution period of their taxable income was well-received by their stakeholders. Although the dividend yield of many S-REITs had fallen in 2020, the gradual reopening of the economy and its borders will provide the much-needed boost to the hospitality and travel sector. Retail sales have been gaining momentum, benefiting retail S-REITs which have outperformed their peers in US and UK as the disruptive effects of "Amazonization" has been less pronounced in a small city-state such as Singapore.

Outside of REITs, the Phillip SING Income ETF has generally outperformed other Singapore stock-market focussed ETFs. It ranked fourth in dividend yield (~4%) while offering growth potential and exposure to quality essential services in Singapore. The Phillip Money Market Fund had strong inflows in 2020 and its AUM increased 75% to S$1.4 billion and it has also a track record of zero credit default throughout the fund's history. Even during the Global Financial Crisis in 2008, many investors sought the fund for liquidity and safety while some of the peer funds "broke the buck".

Opportunity Amidst Crisis

COVID-19 has accelerated the adoption of disruptive technologies caused by decreased mobility, social distancing, remote working and learning. When it ends, the pandemic would have permanently shaped consumers behaviour moving forward. We expect trends such as e-commerce, online education, video-conferencing, cloud computing, telemedicine or digital health, to continue their momentum going forward. Some of the global demands for office spaces, retail stores, etc., will be replaced with the value-chain contributors of these trends. Think data centres, wireless networks, and warehouses.

Also, sustainability has become increasingly important as companies with better Environmental, Social, and Governance (ESG) scores offer lower investment risk. In the third quarter of 2020 alone, a very significant amount (US$80 billion) had flowed into ESG funds and stood at US$ 1.2 trillion by the end of September 2020. In the near future, sustainability and climate change will be well-supported by the world's two largest economies. The new Biden administration is expected to introduce climate-policy reforms while China has set goals to commit to net-zero emission in the future. The regulatory support from US and China will spark the adoption of sustainability worldwide.

Identifying Superior Growth Leaders

We believe that now is a great time to centre our strategy around those companies that are aligned with these major trends. These are the superior growth companies that will potentially rival today's mega-caps or remain at the top in the next five to ten years. For example, the pandemic spurred many industries towards digitising and

automating their infrastructures or platforms. Cloud computing, IoT, robotics, and telemedicine/digital health had experienced massive growth and will maintain their momentum even when the pandemic subsides in the future. World-changing ideas that will take time to develop such as renewables, electric vehicle, gene-editing, or the ones that have been around for a long time such as e-commerce, are not to be counted out as they are still not widely adopted worldwide. E-commerce currently only represents a fraction of retail sales in the US (4.2% in 2010 and 11.8% in 2020), while gene-editing (CRISPR - Genetic Scissors) and innovative life-saving technologies such as the messenger RNA (mRNA) will usher new ways to treat diseases and create new vaccines that traditionally take many years to develop. Moderna and Pfizer BioNTech vaccines for example, had successfully used mRNA to program human cells and stimulating our immune system to combat the COVID-19 virus with an over 90 percent efficacy rate. There will be more exciting developments to come as gene-editing technologies such as mRNA and CRISPR are still at their early stages of development and there is a long runway of growth.

To help investors to seek out the winners in each high-growth industry, we have developed five criteria to identify those that exhibit the superior growth profile. They are innovation performance, resiliency, valuations, internal drivers, and growth strategy. Growth is undoubtedly inseparable from innovation. To measure a firm's innate ability to innovate, a more novel approach can be considered by comparing how much it spent on R&D, how the spending is converted into yearly revenue growth, and also its gross margin standing within the industry. The ones that top their peers in this regard can be classified as the innovation leaders. The rationale behind this criterion is to find companies with a continual innovative mindset, but also to avoid associating big spenders to the ones who can really innovate. From our initial findings, the innovation leaders also range from larger-cap companies such as, Tesla, Salesforce, Zoom, Facebook, and Autodesk, to smaller emerging ones such as Mitek Systems and Niu Technologies. These are the firms that are pumping more than 10-30% of their revenue to R&D while successfully yielding above-average revenue growth and margin yearly.

However, it is easy to be infatuated with a company's potential without considering the risk involved to achieve that level of growth. In other words, investors should look for the high-quality growth companies that are enduring and resilient during tough times, especially at times as uncertain as now. The resiliency of the companies may be exhibited by their free cash flow growth and other risk metrics such as liquidity and gearing. Positive FCF and FCF growth rate directly translate to the capability of the firm in settling liabilities and reinvesting for future growth while high and below industry-average liquidity and gearing respectively signify durability when the unexpected happens. While elevated stock valuations often accompany growth, we should always weigh this against the firm's product competitiveness and total addressable market. We want to stress that we are not looking for growth at all cost, but growth that can justify the current lofty price tags.

Furthermore, we believe that it is important to evaluate a company beyond these measurable fundamentals. In this case, the firm's internal drivers such as founder-led leadership, CEO qualities, and employee satisfaction that are favourable in cultivating the innovation culture of a firm are viable considerations. There is substantial evidence that founders do lead long-term growth. The S&P 500 founder-led companies are more innovative, generate 31% more valuable patents, and are more likely to make bold investments to renew and adapt the business model while demonstrating a willingness to take risk to invent the future. The CEO's it factor is usually determined by the combination of their technical knowledge, leadership experience, visionary strategy, and their undeterred passion to move forward in forging the future. This is true across all time periods. Looking at today's largest and longest-lasting companies, visionary founders and star CEOs are always their most signifying feature. From the late 1800s General Electric's Thomas Edison, J.P. Morgan, Standard Oil's David Rockefeller, and Ford Motors' Henry Ford, to today Tesla's Elon Musk, Facebook's Mark Zuckerberg, Amazon's Jeff Bezos, Google's Sergei Brin, and Larry Page. However, it is important to evaluate these CEOs objectively - not to be blinded by their star power and miss the potential red flags. For example, the unmistakable ones prior to the ousting of WeWork's ex-CEO Adam Neumann.

Historically, there is a strong positive correlation between the best performing firms and the best workplaces for employees. For example, a hypothetical equally weighted index that was rebalanced every year with the "Fortune 100 best companies to work" list returned 11.7% annually for the past two decades, outperforming nearly 5% more than the equivalent returns for the benchmark US all-cap Russell 3000 Index (6.7%) and US large cap Russell 1000 Index (6.7%) within the same period. Although the concept can seem to be counter-intuitive at the first glance, we can look at the three major players in the US retail industry – Walmart, Kroger, and Costco, as a case study. Between 2014 to 2019, Costco has seen higher average revenue growth of around 7% or 3.5 times of Walmart's 2%, and 1.75 times of Kroger's 4%. This couldn't be attributed to a single factor, but the 3 companies mainly differed when it comes to generous compensations and other employee benefits. For example, Costco is closed on the holidays to give employees more time with their families. This is despite the fact that the holidays are arguably the most profitable periods for those in the retail market – holiday seasons can make 20 to 33% of the annual total sales of various retailers in the US. Other Costco employee benefits also include health insurance to both full and part-time employees, 401(k) plans, and abundant professional opportunities for growth. All of the above has resulted in Costco's employee turnover rate of 6%, much lower than the average 16% across the retail industry, and this has definitely translated into the outperformance of the company. The 10–year total return of Costco today is as high as three times the return of Walmart or twice of Kroger, when both are the leading competitors by market share above Costco. A dollar invested 10 years ago in Costco would have yielded $6 as compared to Kroger's $3 and Wal-Mart's $2.3.

And lastly, since our goal is to identify the next world-beating winners, it is essential to evaluate if the firm has the same qualities and characteristics that today's mega-caps exhibited in their early days. These are firms with excellent business model, great product offerings, and most importantly have displayed an expansive growth strategy-expanding reach of product portfolio in order to target other segments of the market, build synergies across products, and stick users in an ecosystem. Salesforce in the software space for example, has been building its product portfolio for the past few years that are targeting different segments of the market and have good potential to synergize with each other (eg. Salesforce CRM, Tableau, Slack, etc.). This strategy has been proven by Amazon, Google, Apple, and Microsoft in the past as it resulted in easier cross-selling of products, strengthened overall platform, and stickier customer base tied to the ecosystem. As long as Salesforce products remain competitive and continue to develop, there would be little incentive in the future for customers to shift to a single-focused competitor product and fragment their user experience overall.

In conclusion, with your support and trust we are well-positioned to capitalize on the numerous recovery opportunities ahead. Our dividend-focused ETFs offer very attractive yields relative to real negative bond yields. Our MMF has withstood the test of time and tide both during the pandemic and GFC. It is a great alternative for investors in times of market volatility. Wishing you every success in the year ahead!

Sincerely yours,

Jeffrey Lee
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