Oldfield Partners

Global Equities Investor Day

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Oldfield Partners (OP): *Richard Oldfield = RO, Andrew Goodwin = AG, Richard Garstang = RG, Robert White = RW, Juliet Marber = JM, Harry Fraser = HF,*

RO: Good afternoon everyone.

As usual we will spend 40-45 minutes on the presentation and then 15-20 minutes on questions. We will stop at 5pm for a 10 minute tea break and then continue in the German AGM model image, where we're not allowed to leave until you have decided you have finished asking your questions.

This is an afternoon devoted to the Global Funds we manage. We'll begin with performance (pg. 2).

When we last met we were pretty optimistic and we remain optimistic, about the potential in the portfolio for returns over the next five or ten years. The upside in the portfolio was higher than at any time since March 09. The upside remains at a very high level, having in fact been even higher at the depths of the market on 11th February which I think we're going to look back on as the turning point. We will see. We're below for the year to date in sterling terms, just below breakeven and that is a little bit behind the World Index. That follows a few years in which we've had a pretty rough time. I will explain first of all in overview terms why we remain optimistic and then we'll get into the specifics of the portfolio.

We've shown you this chart before, which shows the performance of the MSCI World Value Index relative to the MSCI World Growth Index (pg. 3). It's the bottom half of the MSCI World Index in value terms (price to book value, earnings and cash flow) against the top half of the Index. We've had this extraordinary period in which growth has out-performed value for longer than any time in my experience. It's also been about as severe as at the end of the 90s which was obviously a quite exceptional period in terms of the polarisation of markets. The elastic gets ever more stretched. At some point it has to snap back. Of course the credibility of those who are pointing to the stretched nature of the elastic diminishes the further it stretches but it doesn't make it any less true that the snap back when it comes will be very powerful. We've had eight or nine years of relative famine, we're due for an eight year feast in relative terms.

This next chart (pg. 4) presents basically the same thing in a slightly different way. It shows the ten year rolling performance of value versus growth is now almost as bad as it was in 2000. Value has under-performed growth by roughly 2% per annum over the last ten years and that has not been matched since 2000. Of course this time it came from an even higher peak and so this has been a more severe period than that one.

Why might it change? We came across a chart from Franklin Templeton (pg. 5) which shows that the average return in the three years following a Fed Funds increase. There have been six occasions since 1974 in which the Fed Funds has begun to rise. So in those six three year periods this is the pattern of the average return. It shows in green the MSCI World Growth Index, which has done pretty well on average after a Fed Funds rise, up 30% over the ensuing three years which is equivalent to about 8% a year, a little bit below long term nominal equity returns The Value Index is plus 50%. Why might that be so? I think one reason is that if interest rates go up then you have to apply a higher discount rate to earnings and cash flow that are long into the future in order to justify the valuation of a growth stock. So a higher discount rate is bad prima facie for growth stocks.

The second reason is that you tend to see higher interest rates associated with more normal economies and that favours cyclical stocks and it's very often the more cyclical stocks which are in value territory. That is certainly so for us now. I would say that for us the major risk is one of recession. We do not believe and have not believed that we're going to see a recession in the US in the short term. We don't see the ingredients for it. We've got low interest rates, a very low energy price, the consumer is pretty strong, car sales are strong, housing is strong. Those are not the usual precursors to a recession. If there is a recession, if we're wrong, then we've got a problem, but if there isn't, it seems to us that recession is embedded in the valuations of many companies, certainly many of those we hold. Therefore if there is no recession the upside is huge.

The second major dislocation in markets has been the outperformance of the US market over the last several years (pg. 6). We've seen the US outperform to an unparalleled extent, going through these previous peaks of outperformance. Now there is no sacred law to say that this line can't go up and up. The US has been a wonderful place with a very resilient economy, a very low price of energy and a quicker policy reaction after the financial crisis, but it does seem to us that strength has been reflected in the valuations of the stock market. So again this is a piece of elastic which has got too stretched and it needs to reverse.

This next chart (pg. 7) shows that when the Fed Funds rate begins to rise then non US markets tend to outperform the US. This is again the average pattern of performance in the nine major periods of Fed Funds increases since 1970.

The chart on page 8 shows returns on equity in different markets. The point about this is that the US return on equity which is in the top, the grey line, has been much higher in recent years than in Europe or Japan but this is not a permanent state of affairs, Europe has quite often had a higher return on equity than the US, there is no reason why it shouldn't have it again in spite of the headwinds which Europe faces compared with the US. There is no permanent guarantee that the US will always have a higher return on equity.

Japan is the dark blue line and its return on equity has been on an increasing trend. You will hear more from my colleagues as to why we think we're quite likely to see that trend continuing.

Turning to the portfolio at the aggregate level these are valuation figures for the portfolio (pg. 9). We tend to have lower valuation measures on average than the market, that may not be so for every measure at every point but generally across the board the valuations of stocks in the portfolio will be lower than the average for the market. That is so now with a price to earnings ratio of 12 versus 19 for the market, the price to book is very much lower, not far off half. In return for that there is some sacrifice of return on equity but not very much in exchange for the lower valuation. Then finally the net debt to equity in the portfolio is a good deal lower than that of the market. We don't like to combine very high operating leverage with very high financial leverage in the same company, we do make exceptions to that from time to time, Fiat for example was a notable exception, but generally we avoid that combination of financial and operating leverage and at the portfolio level the financial leverage will always be a good deal lower from that of the market.

Those measures over time have been lower for the portfolio than the market. Price earnings ratio is much lower than the market now, price to book much lower than the market now, price to cash flow much lower than the market and dividend yield much higher. The point I want to make in looking at the history of these things is that the gap is wider now than it's been at almost all times in the past (pg. 10).

So that is the introduction. My colleagues will talk about some specifics. First of all, Andrew.

AG: Firstly let me talk about the contributors and detractors. You can see here for 2015 one of the key things to note is that all the contributors are Japanese. That hasn't continued into 2016 and you can see the worst performer year to date is Mitsubishi UFJ and I'll touch on that in a moment. It's also pleasing to see in 2016 two of our worst performers of recent years, Barrick Gold and Tesco, both up strongly in the year to date with Tesco up 30% and Barrick Gold up a whopping 80%. Richard will touch on Barrick Gold and commodities later.

First let me deal with Japan. We continue to be excited by the valuations we find there and the growing sense of corporate change that we can see. As you can see in this chart (pg. 12) here Japan still trades on a very low price to book, it's low relative to its historic range and it's also a significant discount to the US today. Now in Japan you can get very low returns from the corporates - in Japan today there are still around a third of corporates that have a return on equity lower than 5%. One of the key reasons for this is (on the bottom graph) the amount of net cash and large equity portfolios that are held on the balance sheets of Japanese corporates. Some 55% of Japanese corporates sit with net cash on the balance sheet and as a proportion of their market value it's the highest globally. Then we have the large portfolios of equity holdings. They serve to depress the actual return on equity, but we are seeing signs of change in Japan.

In June last year a new corporate governance code meant that corporates must justify why they hold each holding to their shareholders and we've had the introduction of the new index, the Nikkei 400, which we've talked about previously. Inclusion in this index is importantly based on a return on equity criteria of 5%. Also the Bank of Japan is basing its purchases on the Nikkei 400. All of this is changing corporate behaviour. It means that these corporates focus on the efficiency of their balance sheet and the returns and this can significantly drive shareholder value.

We are seeing these sleeping giants in Japan waking up across all sectors.

One such sleeping giant is Kyocera, which we hold in the portfolio. There are three key things I want you to take away about Kyocera. First of all this is a good quality business. It's the market leader in packaged ceramics, it has about 80% market share globally. It is also developing battery storage solutions for its solar panel business, fuel cell technology. It has exciting long term growth prospects for this business, yet its return on equity is less than 5%. Why is this? This is the second key point, it's the sum of the parts valuation (pg. 13).

Kyocera sits with about a third of its market value in net cash on its balance sheet. There's another half of its market value in equity holdings, the largest of which is KDDI. All this serves to depress its ROE at the group level. If we strip the net cash and equity holdings out, not only does the core business itself trade on a p/e of less than 2 times and comparables in the market are on 13 to 14 times, but the return on equity is actually mid-teens levels.

The third point is there are signs of change here. KDDI is the largest proportion of the equity holdings and there's a good reason why it holds KDDI, it founded that business and still supplies mobile phones and base stations to KDDI, which make up around 10% of its sales, so it's a key customer. It hasn't sold a share of this business since it IPO'd it in 1993, that is until this year.

It's a small sale - they held 12.7% of KDDI and it has fallen to 12.4%. What we are seeing is an evolution, not a revolution...but speaking to the management at a recent company visit they say that this is the start of a process. They themselves cited the changing corporate governance environment in Japan and actually, the first time they mentioned this as a way to drive their own return on equity. This is the start of a process, we're seeing this in Kyocera and across a raft of corporates in Japan. Importantly, this can drive shareholder returns irrespective of the underlying economic environment because these are assets that they hold on their balance sheet.

Now we turn to the banks. MUFJ, Mitsubishi UFJ, was one of the best performing shares last year in the portfolio, but it's actually our worst this year to date. To some extent we have Mr Kuroda at the Bank of Japan to thank for that with his move into negative interest rates. This shocked the market in that only a week before he denied that such a move would take place. It is a negative for the banks, as it squeezes their interest income and, not surprisingly, the banks' share prices reacted significantly. MUFJ was down around 40% on the back of this move.

We can understand why Kuroda has made such a move in Japan. He's trying to shake Japan out of this 20 year deflationary mind-set that's built up among the corporates and among households. If cash is going to be worth more in a year from now, or three years from now, it's no surprise that corporates and the households hoard it. It's perfectly rational behaviour, but as the flow of capital calcifies in Japan, the economic growth slows to a trickle. Kuroda with this move is attempting to open the floodgates.

Today, we can buy MUFJ on a price to book ratio of 0.4 times (pg. 14), that's a significant 40% discount to its global peers, even in Europe where we also have negative interest rates. Importantly, MUFJ has a very strong balance sheet. One of the key attributes we like is the strength of this balance sheet. In terms of liquidity it has a 70% loan to deposit ratio, so has ample liquidity. It also has a large portfolio of equity holdings which it is now reducing and committed to reduce over time. Again, having met the CFO for the bank he stated that this move by Kuroda will cause them to be more aggressive in the sale of these equity holdings and that will realise significant profits from capital gains. We think that the bank will continue to do very well and the banks will be great beneficiaries of Kuroda's policy.

Now I'd like to hand over to Richard Garstang to talk about another bank that we own.

RG: Thank you Andrew. I'm going to talk about Citigroup which has also had a tough start to the year. However we do remain excited about this investment and see upside of more than 50%. I'd like to start with a bit of background.

We're approaching 8 years since the great financial crisis and banks around the world are still working through the consequences of the crisis. Citigroup was badly hit and required significant support from the US Government. New regulations impacted both its capital positon and its underlying business. New management and a recovery plan were put in place. They worked on paying back the Government's support, they reduced their leverage, they improved their capital ratios, they closed down certain businesses and they created a bad bank called Citi Holdings. However the share price was not reflected in this improved outlook and we were able to buy Citigroup in May 2012 at just half its book value.

So what does the bank look like now? As part of the restructuring Citigroup split itself into a good bank called Citicorp and a bad bank called Citi Holdings. The good part Citicorp is comprised of two divisions, Global Consumer Banking and Institutional Client Group. Global Consumer Banking focuses on personal loans and credit cards. It's a global franchise and current operating trends are very favourable. It's got loan growth, good net interest margins, excellent cost control, stable credit and returns in this business are generally excellent.

The Institutional Client Group comprises banking services for large corporates and involves activities like treasury solutions, corporate lending, M&A advisory services and fixed income and equity trading. It's been widely publicised that all these businesses have been struggling recently.

Finally there is Citi Holdings, the bad bank. In recent years this has been loss making and a drag on the overall group's profitability. However as this chart (pg. 15) shows on the right, when Citi Holdings was first established in early 2008 total assets in this bad bank were 900 billion dollars, there were a lot of bad assets to work through. However over the last 7 years you can see assets have just fallen to 70 billion dollars which comprises 4% of total assets and this "bad" bank is now performing and generating a profit for Citigroup.

So what is the current outlook? We're now starting to see underlying loan growth, which includes the recent purchase of the Costco credit card loan portfolio. The net interest margin is stable and, whilst a dangerous prediction, the US does appear less likely to adopt a negative interest rate policy. There are some non-interest income pressures from the trading activities I just talked about. Cost control remains excellent, while still investing in new parts of the business. C credit also remains excellent, although we do allow for some increases in provisioning given where we are in the credit cycle and with exposures to the energy sector.

Finally, I'd like to talk about capital and valuation. Citigroup remains one of the most well capitalised banks in the world with a core equity tier 1 ratio of 12% and capital continues to grow at a good pace. While reassuring in one sense, this high level of capital actually has a negative impact on return on equity. Citi can't leverage its return on assets to the same extent as other banks around the world. So a key next step in the investment thesis is being able to return capital to shareholders and it does this via a stress test each year with the Fed. Last year it passed the stress test and subsequently returned almost 7 billion dollars to shareholders through share buy-backs.

We expect Citigroup to continue to pass the stress test. It's now a much better bank with a strong capital position and as a result we think capital will continue to be returned and buy-backs will increase. This will drive growth in earnings per share growth and book value per share.

In terms of valuation we believe Citigroup can achieve earnings per share of over $5, which means the implied price to earnings multiple is less than 8 times. Tangible book value is currently $65 per share and that compares to a share price today of $42. So you can buy this company at just 0.6 times its book value. As you can see in the chart on the left (pg. 15) this is towards its historic lows.

We believe that the fair value of Citigroup is 1 times book value, so $65, and that gives an implied upside of more than 50% from today's level.

RO: Okay now we go to another area of the portfolio where there has been a lot of movement in share prices and that is in commodities. This chart (pg. 16) shows the gold price in light blue, then in grey iron ore and in dark blue crude oil. The chart shows the extraordinary turbulence we've seen in the last few months which makes this an unavoidable topic. Some value managers avoid all together commodities and energy where you have resource prices which are very difficult to predict and I think that's an understandable attitude. We take the attitude that with commodities and energy you know that the commodities are going to be needed, you don't know the quantum so you don't know the price, but you know that unlike a Nokia smart phone iron ore is not going to go out of fashion. So we do invest in commodity stocks and energy stocks and try to make sure that we're investing when they're deeply unfashionable. Of course they may get more deeply unfashionable, and that has happened with Rio Tinto and with the energy stocks in the last couple of years, but when they are deeply unfashionable we feel that in particular the undeveloped assets tend to get overlooked in the valuation. Gold of course has had a recovery. As you see in the bottom left (pg. 17), Barrick Gold has a cost of production down at the bottom end of the cost curve. This is the cash cost of production, not the all in sustainable cost of production which includes development cost, which is about $830 an ounce. So they are by far the most efficient of the major companies. We've also put a ring around Newmont to the right here, which is its other largest competitor and has a significantly higher cost of production. So Barrick will be making money down to $830. The chief executive of Barrick has told us that they would be able to pay a dividend if gold were $800 an ounce. That is pretty implausible but I think it's a sign of the profitability of the company that they could do that. 60% of their mines have a much lower average cost than this even. So if gold were to fall significantly they could cut back and still remain profitable. It's not a very desirable scenario because they'd be shrinking the company but it's a token of the cost efficiency.

The valuation is pretty much at rock bottom (bottom right graph on pg. 17), it lifted a great deal with this big rise in the share price this year but there are not many times in which the price to book has been lower than now.

The gold mining stocks are still extremely depressed relative to the gold price. The chart in the top right corner is simply the Philadelphia Stock Exchange Index level divided by the price of gold bullion, so we were right up here at 35% and now come down as low as 5%. In those terms given the relative performance of bullion and gold shares the upside is enormous - one could easily see a double or even a triple in gold mining shares from here. We've seen already close to a double.

Valuation of the companies remains very low. The enterprise value per ounce of reserves compared with the price of bullion is still way below its long term average. We think Barrick itself intrinsically very attractive, they're doing what we regard as the right things, they have focused on return to shareholders, they've cut back on a lot of their most expensive projects, they've reduced their level of debt by $3 billion last year. Some of the deals they've done in the private market imply a much higher value for Barrick than the current valuation. So we believe that they're on the right track, and also they believe that they can reduce the all in sustainable cost of production much further because in the halcyon years a lot of fat built up. Then we have the fact that it is a gold company, and that in the end it all depends on gold. We have talked about gold often. We do believe that the chances of a dislocation of some sort over the next couple of years are sufficiently high that to have some gold mining exposure makes sense. We've now seen the central banks running out of room in monetary terms, we see more and more talk - Martin Wolf, Paul Krugman, Larry Summers - about fiscal stimulation, and in many cases in fact adopting Corbynista policies. What has been talked about recently in terms of helicopter money is not very different from Corbyn's people's quantitative easing as he called it. There's a lot more pressure for fiscal action if we really have run out of monetary ammunition and therefore the chances of a dislocation are significant. We hope it won't happen. It would be better if it doesn't happen but if it does then gold shares will be proving their worth so we want to retain a reasonable exposure to Barrick.

I turn back to Richard to talk about our purchases and sales in the last couple of quarters.

RG: Thank you. We've only had one purchase in the last six months, that of Volkswagen in November, and one sale that of Microsoft which we started in late October and finished in January. As an aside, portfolio turnover was 33% last year, in line with our long term holding period of between 3 and 4 years. First I will talk about Volkswagen.

The opportunity in Volkswagen arose as a result of the emission scandal which broke last September. There was fear, there was panic, and a significant fall in the share price and we started looking at the company and the issues it faced in great deal straight away. This chart (pg. 19) summarises our thinking.

We value the underlying business and then subtract an estimate of the liabilities we think the company faces. The majority of the value lies in the passenger cars, the trucks and the financial services and there's also equity value in the Chinese joint ventures. I'll talk through those bits now.

Volkswagen is one of the largest automotive makers in the world and it has an impressive collection of brands including Volkswagen, Audi, Porsche, SEAT, Skoda, Bentley, Lamborghini and Ducati. We value this business at just under 70 billion Euros. We've assumed some loss of market share and margin pressure here as a result of the scandal. This equates to a price to earnings multiple of just 9 times despite its high margin prestige brands.

The truck business we value at €16 billion. This includes Scania and MAN. Again, we value this business quite conservatively. The value of the MAN business is implied in here at 6 billion Euros and yet the minority listing implies closer to 10 billion Euros. Furthermore, this business actually hasn't been impacted by the scandal at all.

Next we value the financial services at just under €15 billion. We value this business at 0.75 times the book value. We've taken quite a big haircut on the book value here to allow for potential funding pressures and concerns over residual values of the cars. Finally, we value the Chinese joint ventures at €15 billion. This equates to a price to earnings multiple of just 6 times.

We then adjust for some debt and other balance sheet items, the €2 billion there. All combined that gives us a value of €111 billion for the underlying business. That compares today to the market cap of just €63 billion.

However, we do have to consider the liabilities the company faces. First of all we look at the recall costs and we estimate these to be around 9 billion Euros. We've taken the amount of cars that have been affected and applied a cost to fix them. Next we look at the potential fines. This is obviously an area of much uncertainty. We've looked back over the last 20 years of EPA-related fines and cases and their eventual outcomes. We've also looked at the fines that were incurred by General Motors and Toyota most recently for their recalls. We've also spoken to several legal experts including an ex-lawyer from the Environmental Protection Agency.

The outlook on the legal front is clearly uncertain but we think that the company faces approximately €16 billion for fines. This compares to the largest ever EPA fine given to date of just $1 billion. We've also got a small fine for the C02 emissions which is now really dealt with but initially was a potential problem. We also have a contingency of €5 billion to allow for the uncertainty.

Combined with the value of the underlying business, this gives us a fair value of nearly €81 billion compared to the current market cap of €61billion. I think it's fair to say we've been fairly conservative in our valuation of the underlying businesses in terms of the multiples and some of the assumptions used around margins etc. and fairly punitive on the legal side. However we still get to this fair value of €81 billion which gives us more than 40% upside from today's value.

Finally I'd like to talk about Microsoft, our sale during the quarter. I think the key message here is patience. We held Microsoft for nearly 11 years and it proved to be a fantastic investment providing a return of 173% compared to the MSCI World of 83%, outperforming the Index by more than 90% (pg. 20). We've always believed that there was a wide gap between the share price and the intrinsic value of this business and that eventually this value would be realised. During this period there were plenty of sceptics telling us that it was past its best, and at worst it was downright finished. But the valuation always remained extremely attractive.

Over the last couple of years sentiment changed and excitement grew about the prospects of its cloud-based business and the share price rose quickly.

Having reached our estimate of fair value we decided to sell. It took nearly 11 years but with a bit of patience we did make an excellent return.

RO: This (pg. 21) is the country and sector breakdown of the portfolio. As usual we won't dwell a lot on this because we're trying to choose companies which are essentially sound at excellent valuations and the country breakdown is entirely an outcome of the stock selection with some controls. The sector breakdown similarly but as you see we've got a lot in Japan - 33%, and we have relatively little in the United States. Then to finish I will leave this slide on the portfolio (pg. 22) which may stimulate some questions.

Question: Could you say something about Lukoil, is it regarded as very risky in the portfolio?

RO: The risk in Lukoil is obviously Russia and there's no escaping that Russia is a very difficult place to invest. Lukoil is not an organ of the state, it's not like Gazprom which if told to buy a TV station or some newspapers in order to suppress the free press then it does it. Lukoil is independent but with a management which has always got on well with the Kremlin. Of course that could change. In corporate governance terms it has the best corporate governance that there is in Russia, which may not be a beauty contest that is very hard to win but it's better to win it than not. They have GAAP accounting, they've got shares which are quoted in London, they've got a very independent Board with a majority of independents and most of them are international. It's about as good as it gets in Russian terms. Let's assume there is a 25% chance that Lukoil is worth nothing and then assign a 75% probability to our base case to reach an overall valuation. The Russian oil stocks and Lukoil in particular, are so cheap that you could still see a doubling in the share price even with that 25% probability of zero. If it were to double it would still be at something like a 50% discount to the other international majors, so it is principally a Russian risk rather than an oil risk. They've benefited from the weakness of the ruble because their costs are in rubles and their revenues are in dollars. Their profits and cash flow have not suffered nearly as much as the non-Russian oil companies and it is quite remarkably cheap, you buy a barrel of reserves at Lukoil for now $2.

Question: One inevitably has to say you've got a lot of car companies, you've got a lot energy companies, you've a supermarket chain and there are certainly some people I work with who would say those are yesterday's businesses. I just wonder if you thought when you bought Volkswagen should we really buy another car company?

RO: Well we are conscious of the exposure to car companies and we don't want more than about 15% of the portfolio in car companies, even if we think they are extremely cheap.

I think that these instances of disruption have to be taken individually. We have written research papers ourselves on disruption, it's the big vogue word and is going on in every industry. Every industry is being "ubered" and to some it's puzzling. I'll deal with retail first.

On the retail front we own Tesco. I think Tesco was one of our avoidable errors where we listened too much to the management, Phil Clarke, the Chief Executive. We accepted his view that they would be able to maintain trading margins of 5.2% even though our own work was calling that into question. I hope we've learnt our lesson about that. For now and the last year or so we've seen Tesco at quite an extraordinary valuation where the overseas assets alone accounted for nearly all the market cap of the company, with nothing attributed to the UK company. What is the UK company worth, is it really worth nothing? We don't think so and I'll just run through this in general terms.

Online grocery is still only about 7 or 8% of the market, and it's advanced pretty slowly - why is that? It's because people do still want to touch and smell and choose their groceries before they buy them. They may order their bottled water, tissue paper and other items in, but they do on the whole want to visit, see and pick their fresh food. I worked, when I was 19 or 20, in Harrods Food Hall and I saw a fledgling version of online then. It was called the telephone. In those days, Lady Snodgrass used to ring up from Whitehall Mansions and say "could you bring me...." and you delivered a box of whatever was requested to Whitehall Mansions. That was the precursor of online. But still the Food Hall was absolutely packed with people because they wanted to go and visit the shop and see and buy the food for themselves.

We don't know where the ceiling is in terms of online and we haven't got there yet, I think we can be pretty sure of that. I find it very interesting that last year sales of hard copy books rose very strongly and sales of Kindles fell. It appears that we've got to saturation point in that particular piece of disruption. It's possible that we've reached saturation in groceries, but supposing we haven't then who is better equipped to deal with it than Tesco? They've got the distribution network. Of course they have the new competition of Amazon with Morrisons but Ocado is now producing a very small amount of profit and still valued extremely highly. Ocado has the great battle that it does not have the distribution network that Tesco has, so it's no surprise that Tesco has 50% of the online grocery market.

As for retail more generally, in the 80s and 90s we learned that, to the surprise of some of us, retail was in fact a leisure activity. That's precisely what shopping is about for many people, it does include having a cup of coffee at Starbucks because it is a leisure activity. Bluewater, Westfield and these other places are still packed with people because people spend their leisure hours doing it. Howard Marks of Oaktree is very good about this, he says it's not that these fundamental things are not happening, of course they are happening and they are very significant, but markets get over-excited about them and I think we're seeing a similar kind of over-excitement about disruption that we saw about tech in 1999 and 2000. That is then reflected in valuations on the upside for all the disrupting companies which have sky high valuations with no profits. It is also reflected on the downside with very low valuations attributed to the boring old world companies. Andrew, do you want to say something about cars?

AG: Sure. On the auto industry, let's call it the "Tesla World" disruption that's articulated by Elon Musk, but first of all let's look at the investments in the portfolio.

Today you have GM, which we are invested in as value investors, it's on a p/e of six times, it generates lots of free cash flow that's being returned to you as shareholders - you're going to get a 5% dividend yield and $9 billion share buy-back and it's generating good profits and margins, having gone through a really strong period of restructuring. So in GM you have a $50 billion market cap business making 9 million cars a year.

That compares to Tesla which has a $37 billion market cap today. It's hoping to make 50,000 cars at the end of this year and it's losing around $500 million a quarter. In the world of Elon Musk, he says that we'll have fleets of Uber-provided cars which are electric vehicles. We won't need to own a vehicle because the autonomously driven car can drop you off at work then go back to your home to pick up and drop off your children at school etc. There are some compelling arguments for this. We use the car for only around 4% of its useful life so there's a huge waste of capacity. It's a great, bright future with higher productivity in the Tesla world. This is nothing new. GM, in the post war period, proposed something very similar, autonomous vehicles, using the technology that was available at the time. It held a big exhibition on railway technology, we were going to drive our vehicles onto the motorways or the freeways and there would be rails you would fit onto and could let go. There would be automatic breaking that was employed in the railway systems. That was around 1949 they were talking about that.

If you look at the market today the top three bestselling cars by far in the US are large SUVs. Sales of electric vehicles have actually started to decline in recent years and part of that could be down to the cheaper oil price. The reality is somewhat different given what we're seeing on the ground. The Google car still has two drivers ready to intervene and to do mapping etc. There is a huge amount of potential infrastructure that's required to enable these cars to operate on the streets. There was a crash last week with the Google car. The ramifications of what standard we hold these new vehicles to is huge. As an example, the cars will have to decide between the option of hitting one person in a car or a young lady or a child pedestrian on the street - the computer has to make these choices.

We're still a long way away from that sort of technology being able to operate on its own and make those choices. Mass adoption is probably decades away, because these cars have to be able to operate everywhere, they can't just operate in an urban environment. If it is going to replace your car you need it to also replace the long distance trips that you make when you're not operating in an urban centre.

What we do think you will see is greater driver assistance. BMW is already perfecting an almost semi-autonomous system which can take corners on motorways without you touching the steering wheel. However, we think it's almost like auto pilot on a plane, we've had auto pilot for 30 years but you still require an alert, sober, pilot who's ready to take charge and intervene when necessary, which means that the cars still need a steering wheel. The Google vision is that there isn't even a steering wheel, so you can't intervene, it's all computerised, so it's a 100% autonomous and computer controlled. Speaking to companies like Toyota, they talk about driver assistance that will augment the human and on that basis it's the traditional OEMs that have the expertise in terms of production, design and development and also the huge capital budgets required.

It is worth noting that GM bought a stake in Lyft, which is a competitor of Uber, so they've got their foot in there as well. Our view is that these autos are not only delivering great value and great returns to you as a shareholder but they also can be the winners in this new paradigm.

RO: Thank you Andrew. I promise you we are not "head in the sand" about this, we have vigorous debates about this topic and some of us have a more optimistic view of the future for electric cars. What we are united on is that there is some way to go before there's a significant impact.

In a way the most threatening piece of disruption is in energy. In the 1980s, as I came in to London on the train from Kent I'd see Sky satellite TV dishes appearing week by week on more and more houses. Now as I come in I see solar panels appearing on more and more houses and that is a big worry, there could be uberisation (replacement) in energy, that is very credible. We do worry about that, about what we call the squeezed medium term. In the short term oil may spike lower, who knows, but in the medium term it looks highly probable that demand is going to catch up with and overtake supply and therefore a price of oil of $30 is unsustainable, the price needs to be $60-65, which is what we use in our modelling work.

Question: What about interest rates, particularly in relation to wages because there has been some sign of wage pressure in the US? Japan is fairly close to full employment, and you'd expect more wage pressure there, everywhere else wages seem to be coming down but how much of a concern is rising wages both in terms of margin pressure and in terms of pushing the interest rates up eventually?

RO: It is a concern in the US where the economy appears strongest. The mood on this shifts from month to month. Two months ago there was a pretty widespread view that as far as interest rates were concerned it was just one and no more soon. I think that has now dissipated and probably the general view is that we will see a couple of interest rate rises this year. We do think we will see interest rate rises but probably not to a very high level given the fragility of the economy. We also are concerned about profit margins in the

States and that is one of the reasons that we have little exposure there, along with the high valuations.

We think the picture for Japan and Europe, the outlook for interest rates, is less bad or good, depending on which way you look at it. It's less likely that we will see interest rate rises in either place for quite some time. On wage pressures in Japan, Robert or Juliet do you want to say anything?

RW: I think we're looking at maybe 2-2 ½ % increase this year.

JM: And Mr Kuroda has said in terms of the introduction of the negative interest rate which you've talked about, that he can't change the deflationary mind-set alone, he needs the co-operation of the Japanese corporate sector - he needs wages to go up.

Question: Can you comment on Staples, is the merger with Office Depot dead? Is it going to be an independent company? If so what do you think the future is and is the dividend sustainable?

RO: Well it is not quite dead, but it looks as if it's in the last chance saloon. The FTC ruled against the merger with Office Depot. Staples have appealed and there's a decision in mid-May. The chances are it will be negative because FTC recommendations are usually upheld. So there is maybe a 10% chance that they manage to wriggle their way through to allowing the merger to go ahead.

Staples is under review. It's recovered from its bottom in the last few weeks or so, but it is not a great business. If you go to a Staples store it is a dispiriting experience, little is being sold, and it suffers from a double disruption. It sells products which are becoming less useful, for example ink, printers, paper, stationary, and for all of those sorts of products the mode of delivery is being replaced by the internet. Consumers might want to go and buy fresh food in store but they do not want or need to go to a store to buy ink and paper. In the most recent figures, traffic through their stores is down and ticket sizes are down so that is double pressure causing sales to decline. They're cutting stores because they recognise these are the problems. We've got a valuation which gives it some upside from here but it's very much under review.

Question: Could I ask about the timing of your Volkswagen acquisition? When you get these corporate scandals, the litigation tends to go on for years and years, how can you assess it? You get numerous lawsuits that tend to overhang the stock price. The discount to implied value you've calculated is not enormous, so I wondered why you were so attracted by it?

RO: Let me answer in the generality and then Richard (Garstang) you can answer in the specific.

We are always attracted to things going very badly wrong. To give two examples from the past, when Merck's big anti-arthritis drug Vioxx was withdrawn in 2004, we were already invested in Merck and doubled the position the day after Vioxx was withdrawn. When the Macondo oil spill happened we were all over BP for the next three months or so, we didn't own it, but bought it three months after the spill. On the whole these huge class action suits result in enormous figures being bandied around which do not come through. For example with BP, figures being talked about were of $100 - 120 billion. We used $120 billion in our worst downside case, then we had a probability for a base case. In fact the probability weighted cost of Macondo, we had back in 2010, was around $62 billion, which is almost spot on the cost as we stand, although that is coincidence. On the whole the figures being estimated get exaggerated and so we're always attracted to these cases. We don't want too much of the portfolio in similar situations, we wouldn't have 20 Volkswagens in the portfolio, but if the upside is large enough then we will be interested. We class these types of investment as being in toxic corner where there is a significant downside risk but if the downside doesn't materialise the upside is huge. If the probability weighted upside is large enough we will be interested but we limit the number and size of these positions as the variability of outcome is so large.

RG: Obviously the 40-50% upside, if you take three or four years, that's still an annualised return of double digits. The other aspect is how conservatively we valued it. In every one of those blocks (on pg. 19) we'd say we've been conservative on both assets and liability. If we split the passenger cars by brand, then Porsche, Audi and Bentley would come to a much bigger value because we could start putting on luxury car company multiples. May be not Ferrari but with BMW say, you'd come to a much bigger valuation. 0.75 times book value for the financial services is low, other car companies would be closer to 1 times, which adds significant value to our estimate.

Then €16 billion for legal costs and fines. It's difficult to estimate, there's a wide range of potential costs but the EPA's maximum historic fine has been a billion dollars and Toyota and GM paid much less with their recall issues, because you come to negotiate a settlement. For each one of those blocks we would say the upside could be significantly higher - we're trying to be conservative and yet we still get 40-50% which is a reasonable return.

Question: I'm going to ask, how are you all? I ask because of the psychology of managing money in the institutional investment world…

RO: We're very determined that in the long run we will out-perform. It is the nature of what we do that you have these lumpy periods of relative performance. We've seen some ghastly periods: 98-99 was minus 10% versus the MSCI World in each year, then in the first quarter of 2000 it was minus 8%.

When people ask if we are enjoying ourselves I say, sometimes I don't enjoy it at all, but I'm addicted to it. In what I call performance-adjusted terms we are well, we all recognise that this comes with the territory of deep value investing. You go through long periods when you're out of tune with the market but I think we may be at a turning point having had two false alarms last year in the first four or five months when we were a long way ahead of the World Index, and then in October when we were 7% ahead of the Index in a two week period.

Question: I have another question about Tesco. Your point about retail as being social places - the Tesco near me has such unbelievable dreariness, that any idea of going for a cappuccino there is beyond me. Do you think about those sorts of things when you decide whether or not it's got a future?

RO: We do. One of the fundamentals of Tesco was that Terry Leahy rode the company too hard. He reduced staff, service deteriorated, it was very noticeable that it was not a very pleasurable experience. Customer satisfaction went through the floor and we all have our own anecdotal experiences. Dave Lewis came in saying we've got to do two things, we've got to cut our prices and we have to increase our stock because service has been too poor. They know that's what has to be done and I think we're seeing the early signs.

Question: On that theme, Morrisons is perhaps too small for you guys to look at but obviously it's been a star this year and you touched on the fact that Morrisons is the first to get in bed with a larger online retailer. Is that a tide shifting move? Should Tesco go along those lines? With Sainsbury's M&A news as well, will we see something of a consolidation in this sector? Given Tesco's is your first or second top weight in the portfolio, what lessons will be taken from those other competitors and how they're positioning themselves?

RO: A year or two ago one would have through there might well be consolidation and Morrisons would be the victim but that threat has receded with the business stabilisation in the sector as real incomes have increased. The other thing that's happening is that Aldi/Lidl encroachment has slowed down. Of course they're still going to take market share because they're opening an awful lot of stores but their same store sales are hardly above zero, whereas they were running very strongly +5, +6, +7% a year ago so the discounter move has slowed down and the industry leaders are in a stronger position.

As for a potential further step similar to Sainsbury's, well we don't think so. They've got 49% of the online grocery market and they've got all the networks, distribution centres, ports and so forth. They are in the strongest position possible to give Ocado and Amazon a run for their money. There is no reason why they shouldn't make a success of their online.

AG: Morrisons had to do that because they were so far behind. Tesco was still the only one that had its online delivery system profitable, Ocado has been losing money hand over fist and I'm sure these will as well. It's the scale of Tesco. It's the same with convenience stores where they're by far the market leader.

Question: You've got 32% of the portfolio in Japan. Do you stick to your position of not hedging the currency?

RO: We do. It's not a permanent position, but it is true that we have never hedged currency in the global portfolio. We have in the ex US strategy where we had a larger amount in Japan and also no natural US dollar exposure. In global we have never hedged since 1996. In 2012 we did very actively consider hedging the yen but didn't. We monitor it constantly and it's not out of the question that we hedge in the future but we're not inclined to right now. On a purchasing power parity basis the yen is very cheap in exporting terms - parity is around 58 yen to the dollar so Japanese exports are overwhelmingly attractive relative to European exports. That is an argument against hedging at this level.

Question: I'd like to ask a question about UK house builders. How do you think about the macro risk when it comes to house building, it seems to be one of those sectors, a bit like banking, that's just very, very exposed to the macro, house prices and interest rates? How do you think about that?

HF: It's a major concern if you get a recession in the UK. Obviously the big risk currently is Brexit and if that was to eventually lead to tighter immigration controls then clearly we're going to need less houses. There is a risk we have to consider. We say over the long run, even with these dips, house builders make sense but we still know that at any point they could be one of our worst performers. The reason we specifically like Bovis, which we hold in the Smaller Companies strategy is because it is the very cheapest of all the UK house builders and should grow the best if we don't have a recession. That is of course a big if, but it is the best positioned to grow. The wonderful thing about housebuilders and where they differ from banks is that when you do have those recessions the cash flow actually comes in because they liquidate inventory and don't buy as much land. Bovis doesn't have any debt so certainly won't go bankrupt, so you get a fantastic opportunity to buy it at the much lower valuation.

Question: I checked and quite a lot of the UK house builders, perhaps not so true of Bovis, but they're currently showing margins and returns on capital which are back to the pre-crisis peaks. It feels like it's late in the cycle to be buying them?

HF: That's certainly fair and with companies such as Bellway at almost 2 times book value, but Bovis is much cheaper. By owning Bovis we are saying we think that the UK is actually getting better and we're seeing for the first time in a long, long time real incomes growing, and the banks are in better shape.

Question: It's kind of fascinating because it does look as though there's a structural shortage of housing. If the house builders bought a lot of land cheap after the financial crisis then actually maybe margins and returns on capital can go through a period where they exceed the peaks of the previous crisis. When the margins were peaking in 2007 that was on the back of land which they had bought relatively expensively after a prolonged boom. It's a tough call I think.

HF: I agree with you entirely. On the land issue the government's making it a lot easier to get planning permission so we're in a fairly unique situation where land prices are actually not rising as much as house prices, there's plenty of land available. In the UK the industry as a whole is rational. They're operating in their own areas, the government wants them to compete heavily but they don't, so over whole cycles they make very good returns.

Question: Despite the fact that you say there's excess demand they're not looking to grow very fast are they?

HF: Apart from Bovis, the management are incentivised not to grow too much but to return capital back to shareholders through dividends, which determines their compensation. The industry is now built to not break down like the supermarkets did.

Question: Speaking of toxic corner could you say a bit about E.ON?

AG: The share price of E.ON has gone from around €45 to around €8 ½ today. One of the key drivers has been concerns about nuclear liabilities. In stark contrast to Japan, in Germany they've had to decommission all of their nuclear fleet and there's been a big debate about the size of the liabilities, which offered us the opportunity. We had to spend a lot of time getting comfortable with those liabilities. We looked at international comparisons, at precisely what they were doing with the decommissioning, we spoke to several industry experts that had experience of decommissioning to make estimates and we've come to a figure of around €16 billion. This is in line with the company's guidance, which is roughly twice the level of the US liabilities on a pro rata basis.

The fear around the liabilities has obscured where we see the real value which is in their transmission and distribution business. These are highly desirable and valuable assets in the market, infrastructure assets, which are highly regulated, with very stable, predictable cash flows. Within New E.ON, about 80% of its value comes from the transmission and distribution business. So you get basically almost everything else for free in E.ON. which is one of the largest power generators. We put very little value to the generation assets because power prices have come right down, particularly in Germany, but if we see a rebound that could drive value. There's also an E&P business, a renewables business, there's hydro, that's very valuable still today. So we see a lot of value in the sum of the parts which have been obscured by this nuclear issue. There may be news coming from Germany, there have been hints and press reports, that we might see a solution in terms of the government taking some of these liabilities, particularly in terms of disposing of nuclear waste, which is being left to the government ultimately. If we see a fund created that will cap those liabilities, that could be a great catalyst for E.ON's valuation.

Question: Are you looking at other commodity stocks? It's very difficult to tell where we are in terms of the cycle, but does it really matter where we are in terms of the cycle? These things are probably quite cheap anyway?

RO: We are looking at other commodity stocks, we're interested in oil but we've got three oil stocks already and that's probably all we're going to have. We're interested in copper particularly, but it's difficult to find pure copper producers without a lot of debt. We do not predict exactly where we are in the cycle, what matters to us is that the companies should be deeply unfashionable because then you get low valuations and non-producing assets entirely ignored. With Rio Tinto we feel that a large part of their un-producing reserves are not being valued at all. It's an area of great interest, yes.

Question: What kind of iron ore price do you use and how did you come up with that for valuing Rio?

RO: We used $55 and we assume a 45% margin which in fact is a lot lower than the historic average. Rio's iron ore, because it is so very low cost, has always been extremely profitable. Iron ore is regarded as a high volume/low margin metal but in practice Rio Tinto has been extremely high margin. They are on the left (lowest) side of the cost curve, they're producing iron ore in Australia at $16, that's $25 including freight and delivery to China, which means that, as my colleague Harry Fraser puts it, it's inconceivable that Rio Tinto would not make money from iron ore.

Thank you all very much for attending.