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Oldfield Partners

# Global Equities Investor Day

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***Oldfield Partners (OP):*** *Richard Oldfield = RO, Nigel Waller = NW, Robert White = RW, Andrew Goodwin = AG, Sam Ziff = SZ, Harry Fraser = HF, Richard Garstang = RG*

RO: Good afternoon everyone, thank you all for coming. We will talk between us for 40 – 45 minutes, then move onto questions and at 5pm we will break for tea for 10 -15 minutes. Those who'd like to remain can go on questioning us after the break.

We'll begin with performance. This has been quite a rough year. We've made little progress, +1.7% in sterling terms, which is a little behind the MSCI World, and that follows a year in which we made little progress and the Index was up 12% (pg 2). The result of 2014 in particular means that we lag the Index by 0.8% annualised since we started.

The tumble in the summer was partly repaired by the strong market in October but at the end of September we saw valuations in the portfolio which were as strong as they had been at any time since March 2009. We wrote in the newsletter we sent at the very beginning of October about as vehemently enthusiastic for what we hold as we have ever written. The portfolio upside, based on our target valuations, by the end of September was about 70% (pg 3), the highest since we started tracking this . The only previous times it had been over 60% was in 2011 and in March 2009, both very good times to buy equities. I should say that for every stock we have a target valuation which is a combination of a multiple, such as a price to earnings multiple, a price to cash flow multiple, or a discount to assets, and a variable which is the earnings or the cash flow or the assets. That gives us an implied price from which we can calculate an upside to the target from the current share price. So for every stock at every moment there is an upside which changes as the share price changes and, less frequently, the variable changes. Of course there is a kind of spurious precision about all this, but the figures are indicative. What was interesting looking back to March 2009 was that the order of magnitude of our upsides in March 2009 was broadly right (pg 4). There are just a few which were outrageously wrong, so Mitsubishi UFJ the Japanese bank, Pulte which is a US home builder, Shinsei which is a Japanese bank – for those stocks we had 91%, 72% and 78% upside and actually what happened was MUFJ fell by 3%, Pulte by 26% and Shinsei was marginally up. At the other extreme, for eBay we had an upside of 30% and over the next two years it was up by 129%.

This exercise gave us a lot of comfort about our approach - valuing and investing in companies which we think are essentially sound and which have very low valuations. We can't ignore the macroeconomic context but we don't make detailed macro-economic predictions, we concentrate on the companies.

Over the very long term value investing tends to outperform growth investing (pg 5). It is well established that if you buy companies which have low valuations then even though at the time you buy them there may be extremely good reasons why they deserve very low valuations, over the next five to ten years you are likely to get the best returns through that method. Of course you can do it well or you can do it badly but the odds favour the value investor. We haven't chosen to be value investors because the odds favour that method, we are value investors because it is simply deep in the blood. I think you're either drawn in a kind of curmudgeonly way to companies with low valuations or (this is stylising it, it's not obviously quite as binary as this) or you're drawn to the excitement of very high growth and we are just all philosophically drawn to companies with low valuations.

However, there are periods when it simply doesn't work and of course there have to be because if it always worked the advantage would be immediately arbitraged away. We have just had about as long a period as there has ever been, the value portion of indices has underperformed growth from about 2006/2007. The only previous period in my 30-odd years of experience which begins to compare is the end of the 1990s when we had that very acute phase of tech, telecom and media boom. This is in fact now a longer period than that period and it's also slightly more severe now. There is no sacred law that says it reverses next week, next month or even next year, the trend could get even more exaggerated but the elastic is stretched very fully already. We feel that after eight years of relative famine we're due for seven years or so of relative feast. That's one reason why we are optimistic and believe that the valuations in the portfolio mean something.

This too gives us comfort (pg 6). This chart shows the performance of the US market compared with outside the US. It shows that the US has been a quite wonderful place to be, it's wonderfully resilient, you have policy action after the global financial crisis which was much quicker in the States than it has been in Europe or in Japan and you have a very low price of energy. You have all sorts of advantages in the States but this shows that they have been very fully reflected. Again there is no sacred law which says that this can't continue up and up and up, however, it is already very stretched. We haven't had a degree of outperformance of the US compared with the rest of the world as severe as this going back to 1969. We expect this too to reverse because valuations in the US are very high. We have some charts on this (pg 21) but you are probably all well acquainted with the expensiveness of the US market compared with Europe or Japan.

The Shiller P/E, which is today's share prices divided by the average of the last ten years earnings, for the US is 27 which is an extremely high figure. The Shiller P/E for Europe and Japan is close to half of that. It's no surprise that over the last three years or so we have found much more opportunity outside the States in Europe and in Japan than we have in the States. That seems likely to remain the case.

So that is the past. Nigel will now talk a bit about the future and then we'll get into the nitty gritty of the portfolio.

NW: We think the future looks very different from the past. When you think about the last seven years, we've had emergency levels of zero interest rates and we don't think that's what it will look like over the next seven years. December is likely to be the first of several rate rises, so we think the outlook is going to be very different from what we've been through in the last seven years, which is positive for our portfolio.

The other aspect of the current situation in the US which is unusual is the level of profitability - it's at record levels as you can see (pg 7). We think that several things are happening that could bring this back down to a more normal level. We are believers in reversion to the mean and this is unsustainably high. We've seen wage legislation now in several states in the US, California leading in terms of big rises in the minimum wage, so we see labour taking a greater share of revenue and therefore a lower share for corporate profit. Walmart's profit warning is likely the first of many in the States. So the outlook over the next seven years is very different from that which we've experienced in the last seven.

These (pg 8) are the portfolio's characteristics. We have a portfolio that is 12 times earnings, seven times price to cash flow and has a price to book of just over one. There is a slightly lower return on equity than the market, which is not unusual for us given the sort of stocks we invest in, which are often going through periods of difficulty. The interesting thing is to look at this in the context of the last column on the right hand side which is the net debt to equity. This is much, much lower than that of the World Index (and always is). The return on equity can obviously be influenced by the amount of debt that you take on in a business. The portfolio businesses have much less leverage but then that's a control of risk. We rarely want to combine operational and financial leverage in the same company because if you get it wrong it goes very badly wrong. You will always see our net debt to equity is much lower than the World Index.

On page 9 you can see the contributors to performance in 2015 to date. The first thing to point out is that the top five contributors in the portfolio are all Japanese. Lots of people don't like Japan and have a top down view that is very negative. We always look bottom up and find lots of value and my colleagues will talk about some of the individual companies shortly, but I think it's worth pointing out that this has been a year of Japan. As far as the detractors are concerned, we are going to talk about Staples and Hewlett Packard as they topped the detractors this year, but it is worth noting they topped the contributors last year.

In terms of activity, what have we been doing in the portfolio year to date? We have sold Renault, Japan Airlines, Arcelor, Nintendo and NTT and all but ArcelorMittal were at, or very close, to our fair value. That's what we aim to do. We aim to assess a fair value and watch the stock make progress until it reaches fair value when we sell it, which is what happened in those four cases. ArcelorMittal is different, this is a case of us realising that our original thesis was wrong, that we were too optimistic in terms of its likely cash generation given the deterioration of the situation in China and Russia and the amount of steel coming into the European market. We realised it was not going to produce the cash flow that we had originally thought, so although there was still upside at our new reduced level of EBITDA, it didn't provide us with enough potential return to make up for the much higher financial leverage. We're going to talk about some of the individual stocks, starting with Robert talking about NTT.

RW: We bought NTT in 2011. NTT is the largest telecommunications company in Japan as you no doubt know and is one third owned by the Government. The reason we bought it was because it had a lot of underlying assets, real estate assets, equity assets but also there was a lot of cash sitting in the mobile subsidiary, NTT Docomo. There was a change of management, a new President for the Group and President Unoura instituted a restructuring policy which targeted an increase in earnings per share over the coming four years of 60%. Initially that mainly came from share buy-backs but as the restructuring began to feed through it came from earnings as well. However, the buy-back programme and the increase in dividends, which we hadn't seen in this very sleepy company for a long time, began to work. The other thing that helped was very aggressive cost cutting. Cost cutting, particularly at the mobile subsidiary, but also at the fixed line companies, was helped by the very strong tailwind of demographics which are important in Japan. People talk negatively about the impact of demographics on the housing market and on consumption but actually the area where it helps most is in relation to employee costs given that it is a seniority-based employee system where the longest standing employees are generally paid the most. As they roll out of employment - and you can see this huge upside here of 60 year olds rolling out over the next few years (pg 11) – as they roll out the total wage bill falls even if wages for younger people are allowed to rise. This has been very important in helping to improve earnings and is true for a lot of other Japanese companies, which is one of the reasons that we think there is still upside in a lot of our stocks.

RG: I'm going to talk about Staples. As Nigel said, it has moved from the greatest contributor last year to the biggest detractor this year unfortunately. I'll give you a recap on what's happened. As many of you know Staples agreed to acquire Office Depot last year, the number 2 player in the office supplies market, and the share prices of both companies rallied strongly into the back end of last year. This year, the share price has slowly declined over concerns that the deal won't receive regulatory approval from the Federal Trade Commission. This obviously begs the question, what now?

We actually think the deal still has a chance of going through. However,, that chance has significantly diminished over the last year because of comments coming out of the FTC outlining their concerns. Recent reports indicate that both companies are looking at ways to make the deal happen, whether that's through the sale of assets or divesting contracts. As a recap to the deal, which is on the right hand side of this slide (page 12), on a stand-alone basis Staples generates around $800 million of free cash flow per year, and this equates to a fair value of around about $11-12 per share, which is around the current share price. So, for us, it doesn't seem to be pricing in much chance of the deal happening. However, should the deal happen there is $300 million in free cash flow from Office Depot and we estimate potential post tax cost savings from the deal to be nearly $900 million. This gives nearly $2 billion of free cash flow as a combined company and equates to a fair vale of around $25 per share - more than a 100% upside from today's level.

So at the moment you've got maybe 15-20% downside and over 100% upside. For us that risk/reward still looks very attractive. You have to bear in mind two things: firstly, they may have to divest some assets or contracts so the exact free cash flow may be a bit lower. But we still think the upside is still considerable. The second thing to consider is that over the last year or so the underlying business has deteriorated a little. The contract business is actually doing pretty well and the efforts they've put in over the last two or three years are starting to bear fruit: sales are increasing and margins are expanding.

However, the international business is still incurring problems and the strong US dollar is not helping. The US retail business is a mixed bag. The store-based part of that business, where they've had a large store closure programme, is starting to show some flickering of improvement but from a low base. The online business, which we were initially quite positive about, has been a significant disappointment with earnings growth starting to slow. So there is a question mark over whether that $800 million of free cash flow is fully sustainable. But we don't think the downside from this point is huge although one could imagine that, should the deal not gain regulatory approval, the share price could fall. At this level Staples is generating a 9% free cash flow yield, the dividend is 4% and as you can see from this graph (page 12) it has a history of generating high levels of free cash flow and the dividend has grown and is well covered by that free cash flow. We feel there is some protection to the dividend yield and the balance sheet is very strong. Should the deal not go through they have plenty of capacity to start some buy-backs which will help support earnings per share. The risk/reward at the moment still looks quite favourable.

HF: If you look up iron ore on Wikipedia you'll find a quote saying "mining iron ore is a high volume, low margin business" but, as you can see on this slide of Rio Tinto's iron ore margins in the Pilbara region (pg 13), Rio's iron ore business is not low margin at all. In fact, over 50 years, it's only just touched as low as 30% once and, other than that, it's been extremely high. If you look at the position on the cost curve (pg 14), if a quarter of the companies aren't making money, they're up at $60 cost per tonne and Rio is down at $25. It's almost impossible for Rio not to make money in iron ore. Today for example the price is at $44 per tonne so almost half the cost curve is losing money and still Rio is making margins at around the 50% mark.

We really like Rio because of its valuation. We know it will be profitable in iron ore, and with the investment phase completed, they no longer need to do large capex spending so the profits can be returned to shareholders. The balance sheet is strong, they don't need to pay down debt. We have a dividend yield of 7% and any free cash flow above that is being given back through share buy-backs. The valuation is now towards the bottom of their range over the last 20 years (pg 15). We think we should receive 7% in dividends per annum while we wait and we have the optionality on price improvement.

AG: Just to touch on Kansai Electric, we feel this is one of the best value contrarian opportunities in the global market today. In 2011 the disaster at Fukushima led to Japan progressively switching off all 48 of its nuclear reactors. So they ended up in a position in 2014 with the fuel costs at Kansai absolutely exploding. It was forced to run its thermal capacity 24/7 to make up for the loss of its 11 nuclear reactors. This led to a huge increase in fuel costs from around 350 billion yen to roughly 1.4 trillion and lots of red ink was printed in this sector.

International investors and domestic investors fled and at the start of this year you probably couldn't get a more hated or unloved part of the global market than a nuclear utility in Japan.

Also at about that stage, early this year, we started to see reports from METI and the Government about the restart of nuclear. Nuclear was a strategic priority for Japan and progressively these would all start to become switched on. Kansai itself is looking to restart 9 of its 11 reactors and is in final stages and pre-preparation for the switch on. Takahama 3 and 4 are having a final inspection from the nuclear regulatory authority and we expect these to be progressively returned to the market. This will transform the profitability and the valuation at Kansai. You can see here (pg 16) it fell to roughly low teens on a price to assets basis, where typically global utilities trade somewhere from 50% to 100%, and we see tremendous upside in Kansai. We will hopefully see the nuclear reactors come on stream in the next few months, not years, it's the next few months, and then we will see a transformation in profitability and the valuation.

SZ: E.On is our latest purchase, another utility company, a German company. As you can see here (pg 17) there's a large amount of upside to our fair value based on our assessment of the sum of the parts for E.On today. We've split the operating assets for E.On into two components, new E.On and Uniper. The company is going to split in the next 12 months. New E.On is effectively a combination of regulated assets, transmission and distribution much like National Grid, and then renewables assets. We believe that the company should be able to reinvest at very high rates within this business and it provides a very steady stream of regulated income over time.

Uniper is the commodity-related business and this has been suffering recently. Within Uniper there is the trading commodities business, conventional coal and gas generation, as well as oil and gas upstream assets. The company has effectively parked its commodity risk, oil and gas risk, within that business. As we move to the right of the chart we have the gross debt and the other liabilities, these are conventional liabilities with other liabilities (being the minorities and pension deficits) for the business. As we move further to the right we come towards the area that's caused most contention for E.On, which are the nuclear provisions. We got comfortable with these, effectively by comparing E.On to other operators around the world. It's got five times the provisions of the French nuclear company and almost 50% more than the US and Swiss operators.

The other point that gave us confidence with the nuclear provisions was the fact that within Germany itself they have decommissioned two plants already so they are able to execute a decommissioning process.

Finally, over the summer the German Government undertook a review of the provisions and confirmed that they were at a high enough level for the company over the coming 75 years. They also said that there are enough assets backing these provisions. So even if we increased the provisions to a higher level we still saw potential upside in the business and today the company is trading on about 10 times P/E and a 5 ½ % dividend yield, so we believe there's potentially a large amount of upside, almost 60% as the chart shows.

RO: Well that was a fairly quick tour of half a dozen stocks which does represent nearly a third of the portfolio. I'll just make some general comments about the portfolio and then open up to questions.

35% of the portfolio is invested in Japan at the moment. You've heard Robert talk about NTT, and Andrew talk about Kansai, two of the stocks that we have held. We're not in Japan because of Mr Abe, but Mr Abe is certainly a help. He's been a catalyst to the closure of the gap between price and value and as Nigel said, the scepticism about Japan is so entrenched, it's like the SS Queen Mary, it will a long, long time to turn around. We think what is going on in Japan is very exciting from a corporate governance point of view and this is not a quick trade, this is a multi-year position.

The emphasis on return on equity by Japanese companies comes both from above, from the authorities, from Abe, but also from the creation of the new Nikkei 400 Index where one of the main criteria for inclusion is a return on equity above a certain level. This is an index which matters because it's the index through which the Government pension plan and the Bank of Japan in the equity part of its quantitative easing programme get exposure to equities, so it matters and companies care about being included in it. Amada, the Japanese manufacturer, was excluded from the index initially but immediately announced a large share buy-back in order to boost their return on equity. Mitsui and other companies have done the same. There is pressure from above to improve return on equity and then there is also pressure from shareholders, most noticeably in the form of institutional shareholder services which is the global proxy voting service. Their recommendation to shareholders is to vote against the re-election of directors where the return on equity for the company in question has been less than 5% in each of the last five years. That is pretty aggressive stuff.

We see in our own involvement with companies we hold their sensitivity to return on equity which is entirely new. Incidentally, it is both ends of return on equity being targeted, an emphasis on profit return and on the balance sheet of equity.

We see it in the enormous growth in Japanese share buy-backs which reached 4 trillion yen last year, double the previous record. I may mis-remember these figures but roughly in 2014 the amount of US share buy-backs came to 130% of the net income of US companies. In other words, they were buying back shares by using borrowed money and I think that investors are rightly a little bit sceptical about that kind of financial jiggery pokery.

In Japan, in spite of the huge growth in share buy-backs the total volume of buy-backs was about 30% of the net income of Japanese companies, so just a portion of Japanese free cash flow was being devoted to share buy-backs. Moreover, Japanese companies have an enormous pile of cash, something which we have criticised them for over the decades, their extreme conservatism and indifference to shareholder returns. Now we're seeing pressure and we see this with the individual companies that we hold. Nintendo was totally indifferent to shareholders for years and years. They announced a year and a half ago that their strategy was not working, they were more or less the words of Mr Iwata the President of Nintendo and we assumed that would mean the strategy was likely to change. A year later it hadn't changed and we were beginning to despair when only six weeks after Robert and Juliet visited Nintendo the company announced that they would change their strategy by putting their games on other people's devices. That is exactly the monetisation of their intellectual property which we were hoping for. If they were to do that we had a share price target of 27,000 yen a share compared with the share price when we invested of 11,500 yen. So suddenly an emphasis on profit.

We've seen it with Fanuc, the robotics company, which we don't currently hold, but you may have seen it was in the portfolio in March 2009. It is a wonderful company, 40% profit margins, 20% market share across its businesses. In March 2009, we had only recently bought it at a time when the world was crumbling and we were able to buy it at less than 10 times earnings because the world was so depressed and it had an enormous pile of cash. Fanuc had been completely impervious to its shareholders. They produce the skimpiest of quarterly reports, two pages, of any Japanese company. They had no investor relations people. A US activist, Third Point, took a stake and about six weeks later the company made a statement in which they said they didn't really know whether Third Point had any shares or not but quite independently by the way they had decided they would buy back shares and increase their dividend.

We have in the portfolio Kyocera. Kyocera is the old Kyoto Ceramics. In its operating businesses in ceramics it is the leader in practically everything that you can think of from kitchen knives to mobile phone components to solar panels. Of those businesses, solar panels is under pressure because Government subsidies have come down and there is a over-supply, but most of the businesses are good. Their return on assets in their operations is 16% but their reported return on equity is only 4%. Why the difference? The reason is that 75% of their market cap is in cash and securities which yield almost nothing. One of those securities is Japan Airlines. Why does Kyocera, Kyoto Ceramics, own shares in Japan Airlines you might ask? Mr Inamori, the visionary founder of Kyoto Ceramics was asked by the Government to sort out Japan Airlines when it went bust, and as part of that process he thought it be nice if Kyocera owned some shares in Japan Airlines. But it has no business owning shares in Japan Airlines. Now in the old days, five years ago, we would have been pretty hesitant about Kyocera because although there is this big gap between price and value there is no obvious intention to close that gap on the part of the management and that broadly speaking remains the case, but the climate in Japan is now so different in terms of tolerance for very low returns on equity that we think we can afford to be a little more patient than we were. In every case the gap between price and value is quite wide but now there is a lot more emphasis on closing that gap, on realising the value, by management. So we're likely to be in Japanese companies for quite some time to come. As I say we now have 35% of the portfolio.

I won't say anything about any of the other stocks, we've covered some others but the portfolio is shown here (pg 18) so if you've got any questions when I stop then do ask.

I'll just finish with this chart (pg 19). What this chart shows is the cumulative total return of the MSCI World Value Index and also the MSCI World Growth Index in the various periods of three years after the first fed funds rise going back to 1974. There were six periods since 1974 in which fed funds interest rates have started to rise. As August and September show there is a general anxiety in markets about what the impact of rising interest rates will be. This chart shows that in practice in the six times in the past, average returns over the next three years have been very good. What is really striking is that the return for value has been very much better than the return for growth. So over the next three years you have plus 50% for value, whereas for growth you have 30%, which is roughly 9% a year, which is not a bad return so not a bad climate for equities generally. The 50% rise of value is similar to the average upside in our portfolio after a strong October.

Now why might that be so? Why is it that higher interest rates might be good for value and not so good for growth? We think there are two reasons. One is that higher interest rates mean higher discount rates on future cash flow. The companies where valuations are very dependent on the application of a discount rate are the longer term companies, the steady eddies, where you have to look out well into the future at cash flows in five, six, or ten years' time to justify the current valuation. You have to apply a discount rate and if the discount rate rises then the present value of that future cash flow comes down. I think that explains partly why rising interest rates tend to be less good for growth stocks than for value.

The second reason, and this is our own rationalisation, is that higher interest rates are associated with better economies and better economies are good for more cyclical companies. The value part of markets often tends to have quite a lot of cyclical companies in it. Our portfolio has a lot of cyclical exposure.

In March 2009 it was not clear what was going to pull the world out of the mess, but we had a pretty vehement view, based on valuations, that we could see a lot of upside. An exercise that I think is useful, when we see these very low valuations and high upside, is to say 'I what could happen over the next three years which would mean that we will look back and see very strong returns?' In March 2009 it was huge Chinese stimulus and large scale quantitative easing. Neither of those things is on the table again today, but if we look back in three years and see these returns have actually happened it might just be that the world economy is all right.

There was a headline in the FT a few weeks ago: 'Gloom stalks IMF finance ministers' meeting'. The article itself reported that the IMF, were expecting growth of 3.1% in world GDP for next year, which is not great but it's hardly a gloom-stalked forecast. In fact Christine Lagarde herself said not to get too over the top about the deceleration as we've still got more than 3% growth. They may be right, they may be wrong, but if it is more than 3%, at the moment it seems to us recession is built into the valuations of an awful lot of stocks that we own and if you don't get recession that is why we could see these sorts of returns.

So we finish as we started on an optimistic note, because that's what we are at the moment.

Q: If you look back in history wouldn't you normally find that interest rates start rising much earlier in the cycle than they have done this time round? The fact they haven't this time round is now the thing that makes it so different this time?

RO: Yes, but this simply shows empirically that interest rate rises have tended to be good. The future may be different from the past. The fact that we've had a protracted period of interest rates not rising, I'm not sure affects that point, but a slightly different point which may flow from your question, is that what would be bad for us is not interest rates rising but if they stay rock bottom. If the Fed funds rate does not rise in

December as people expect it to and does not rise next year, it won't rise because the economy is remaining extremely weak. If the economy is remaining weak then we're much more likely to have a problem than if interest rates rise. Have I missed your point?

Q: No. I suppose if this works this time it means that the economic cycle is going to be much, much longer than it has historically been.

RO: Yes absolutely, I do think that is completely the case. The economic cycle this time round is a very, very long economic cycle which means we could have a very long market cycle too.

Q: Can I ask a question about Rio Tinto? That 7% dividend is very attractive, how secure is that dividend? Is there much debt, what is the risk that Rio Tinto goes the way of Glencore with a rights offering and a suspension to deal with it?

HF: Rio did a rights issue a few years back but now they have a very strong balance sheet, it's about one times EBITDA. In terms of confidence on dividend, the first point is they're low on all the cost curves too. A very large proportion of commodity companies are now losing money. In iron ore as you saw, almost half of the industry is losing money. In aluminium about half are losing money. We don't know what prices are going to do near term but it feels like there is not much support for prices to remain where they are, and, even if they remain where they are, the dividend is covered. A week ago they bought back shares and you don't buy back shares unless you feel confident that you are already covering your dividend and then some. Of course if the commodity prices start going down further then we've got problems but I think if we're going down to very low levels then we'll see bankruptcies across the whole industry, the dividend will be cut, but we'll end up with a strong mining company that will be able to pick up assets at silly prices. We may end up with a better position but it will just be more painful to get there. As you can see it's our largest holding (pg 18). We think we are invested in a very, very unpopular space that provides us with protection, we are prepared to wait for the situation to improve while receiving a decent dividend.

RO: Just another word about this chart (pg 14) – it shows the cost per ton of producing iron ore and transporting it to China. Rio has a cost per ton of $16 before freight and other costs, which take it up to $28 or so. That's right at the low end. The current price of iron ore is $47. This here is the third quartile, this is a random point at which to draw a line but we say it seems likely that if there are pressures then at worst the top 25% in terms of cost will drop out of the market, because they're losing money. There are also Chinese producers who are producing iron ore at a cost of $120 a ton. That may have come down because the cost of production for all producers has come down with the fall in energy prices, but let's say $100 a ton. That compares with the current price of $47. So they're hugely loss making. Will they stop doing it? It doesn't seem very likely that they will stop in a hurry because there are strategic reasons to keep going particularly if they're making their steel just next to the iron ore mine. Also they have this tension that on the one hand they talk about a market economy and bringing their state owned enterprises into a more competitive world, but on the other hand they want to keep the economy going and they can't afford to cut production too quickly in an important area which would increase unemployment. However, they produce 500 million tons of iron ore which is a large percentage, about 25% of the world demand for iron ore.

In the last six months or so they've brought that down from 500 million to 450 million, so they are beginning to reduce production. This problem in iron ore could be resolved in a trice if the Chinese stop producing iron ore extremely unprofitably. If you're negative about iron ore then you have to believe that a very important participant in the market is going to go on acting completely irrationally.

Meanwhile we feel, and we feel this of other commodity companies too, that Rio is a pretty good each way bet. Ben van Beurden, CEO of Shell, the other day said that he thought the oil price was likely to recover in the short term because of the production cut backs that there have already been. And, he said, if it doesn't then there will be a medium term spike in the oil price, it'll go up a lot because there will be very sharp cut backs and then demand, if it remains steady, will result in supply being extremely short. We feel that at a time when this kind of company is deeply unfashionable the each way bet aspect is very attractive:, it either works in the short term or if it doesn't it is going to work in the medium term - as long as you have a company like Rio which has the very lowest cost of production in all its assets so will be the last man standing.

One more thing on Rio, between 2011 and 2013 they spent $42 billion in capital investment and they will have had a threshold return of around 15% for that. Most of those assets are still non-producing, they're not yet producing profits. The circumstances have changed so they won't be getting 15%, but if they get 7 ½% then that's $3 ½ billion of extra profit that they don't have at the moment. And that's on a market cap of about $65 billion.

Q: A question about Staples. As Richard knows I do a lot of work in the retail industry here and in the States. Something that has become absolutely a crescendo in recent months and certainly through this year is that most retailers, high end specialty and mass, are all talking about one thing and one thing above all and that is Amazon. Now it would seem to me that perhaps Staples is a perfect example of a mass merchant whose lunch is being gobbled up by Amazon. That's more of a remark about the decline of sales in the stores and possibly online. But in terms of value stocks in retail wouldn't Amazon be a better long term bet than almost any other because it seems to be relentlessly devouring pretty much every significant category of retail in the world?

RO: I'll answer the second part of the question and then Richard Garstang can talk about Staples. For Amazon we do look at its business model but as to valuation it just doesn't get anywhere near. They and a whole number of other companies have set about upending traditional business models in that they just don't bother about profits. Their shareholders are happy to encourage them - the whole of the unicorn sector of Silicon Valley, with billion dollar valuations for start up businesses in the private market, has thrived on shareholders pushing money into companies which don't show any profits and in many cases don't show any revenues. Of course Amazon has masses of revenue but it doesn't show very much profit and it isn't likely to show very much profit for years to come because they're taking a seven to ten year view, they just want to gobble up a big position in every market they possibly can and the pay off will be in seven to ten years time. They may be right. But we won't invest in any company, however wonderful it is, if the valuation is superficially high. All our experience is that if you invest in companies with low valuations then the prospects of a good return over the next five to ten years are very good. We might do well by the Amazons and others but you're in unchartered territory and we did see that in 1999/2000. It wasn't that all those ideas were wrong, there was a tech revolution, but the valuations went to extraordinary levels from which they had to come down. In 2000 I remember walking around with the prospectus for lastminute.com for two weeks in my briefcase because I couldn't believe they were spending a $100 of marketing expense for $10 of revenue. We're in that kind of a world again for a lot of the tech businesses.

At some point shareholders normally require a return on capital and that means that you have to put your prices up and increase your margins.

RG: I think it's fair to say that Amazon is probably the biggest concern for Staples and has been for a while now. It's particularly relevant to the consumer facing retail and online business. Whilst you can shop online at Staples (it's actually the fourth biggest online retailer in the world) it doesn't have the presence of Amazon and hence you're seeing loss of market share, pricing pressure, reduced sales and lower margins. So there is a big problem there.

The other side to the Staples business is the corporate contract side. These are contracts that small, medium and even some big companies have with the likes of Staples or Office Depot to provide office supplies. They typically last for three to five years, are quite sticky and have better pricing and delivery terms than you get on Amazon. You get loyalty points and the quality of service is actually better than you get from Amazon. This business is actually very good and that's where we get a large portion of the value from.

Equally, that's the point that the Federal Trade Commission is focusing on. If you bring Office Depot and Staples together, both of which have these contract businesses, you may suddenly have a company with a combined market share of 70% in this specific area. The FTC is not including Amazon as a competitor in the contract business. This appears to be because Amazon Business is not a major competitor at the moment. But we are concerned that this could change and we therefore need to keep a close eye on this part of the business

Q: The Tesco word didn't come up. Is Tesco almost as good as Rio?

NW: I wouldn't possibly compare them. Tesco is living by its logo, 'Every little helps', they've been doing things over the last year to improve their balance sheet. They've sold 13 sites that they decided they were no longer going to develop for £250million. They raised £3.6 billion from selling their Korean business which was in line with what we thought, in fact it would have been even more but they had a much larger tax bill than we expected, but it's basically what we thought was fair. That has repaired the balance sheet, with the sale of the land and despite buying back some leases from British Land we think they will end the year with net debt of about £5 billion, down from £9.4 billion in mid-year, so dramatic change. The pension fund has been shut, so that can allow them to start dealing with that liability. On the trading front they've been cutting prices. As a result they are seeing volume growth again and they maintain the volume market share which is very positive compared with where we were 12-18 months ago.

The other thing that's happened is that the impact of these price cuts has had quite a significant impact on the industry. You've seen Asda go through its worst trading period in its entire history in the UK, which is positive for Tesco. Walmart has also got its own problems and can't afford to help out so that's good to know.

Aldi and Lidl's growth has slowed dramatically. They're still growing market share but their like-for-like sales have gone from about 20% per annum which is ridiculously huge to somewhere between 0 and 5%, now 5 is lovely and 0 is not so great. That has all happened as a result of what Tesco has been doing over the last 12 months, so a lot is changing. The fair valuation as far as we're concerned has hardly changed so yes we are still very optimistic. We still think that somewhere between 3 and 4% margin in the UK is possible over the medium term.

Q: We heard about Amazon in relation to sales, what about in relation to UK supermarkets in general?

NW: Amazon has launched Amazon Fresh Direct, a very limited trial, first in Birmingham and now North London. They will deliver frozen goods and a small selection of every day goods within an hour. We don't have much detail. They have a similar product in the States for which they charge. The way you access that product is through an annual subscription of $200. That may catch on here but I'm not sure. Amazon will always be a threat but Tesco start from a 49% share, the market leader in the UK in terms of online delivery. So we're not too concerned about it, it's a very small part of Tesco's business at the moment. Grocery shopping is only about 7% of the market.

Q: Obviously you look bottom up at a whole range of different companies thinking about industries but over the last year or two presumably falling commodity prices and oil prices have an effect across your portfolio. It seems as though you've got fewer oil companies and miners than perhaps you did a year or two ago. Is that something you're focusing on or worrying about?

RO: We're very much focusing on that area. In fact we've got the same companies and slightly more of them than we had a year ago. We added to BP and Rio in August. We also own ENI the Italian company and Lukoil. It is a very difficult area because we can't forecast commodity prices with any confidence. Some investors therefore decide they are not going to bother with them and stay away. We don't take that view. We believe the one thing you know about iron ore is that it is always going to be wanted. We don't know the quantum exactly, and you don't therefore know exactly the price it's going to be wanted at any point in time but it'll always be in demand. That isn't true of a Nokia smart phone for example. So having made that sort of decision in principle, that we're perfectly prepared to invest in commodity companies, when do we invest? We have to invest when they are deeply unfashionable. When they're deeply unfashionable, the price of the commodity falls to the marginal cash cost of production, not to the marginal incentive cost of production. There are really two cost curves for every commodity, a curve which reflects the level of commodity price at which it makes sense to develop new producing assets and the level of commodity price at which it makes sense to continue to produce from existing assets.

In bad times, in unfashionable times, commodity prices tend to fall right down to the marginal cash cost, but not very much lower, and it's right about that marginal cash cost for a lot of commodities at the moment.

In good times it tends to rise towards or even beyond the incentive cash cost, so we want to buy when the commodity price is close to the marginal cash cost and that will also be a time when, with the falling commodity price, the share price is very weak. In order to be patient we've got to be sure that we've got a decent balance sheet. One of the things which concerned us about Arcelor was that the balance sheet was not strong and we couldn't therefore afford to be patient. We needed to see improvement quite quickly and when it became clear that the Chinese and Brazilians were dumping steel around the world and forcing down the price of steel our estimates for their cash flow fell from $10 billion in 2015 to $5-6 billion. We still had upside in the stock but not enough to compensate for the financial gearing. That's no longer true now, where you're very handsomely compensated for financial gearing in the current share price, so it's much more interesting now.

We only invest when they're deeply unfashionable. We have to be patient so we've got to have a strong balance sheet and we've got to have low cost producing assets. And both in oil and metals we are increasingly interested.

Q: And I assume you don't say well we won't have more than 30% of the portfolio?

RO: We do exactly that. We don't tend to have more than a third in any particular sector and we are unlikely to have more than a third in those two sectors (minerals and energy) combined.

Thank you for coming and we'll see you in the Spring.