CREDO

PERSONALISED WEALTH MANAGEMENT

# BEST IDEAS PORTFOLIO

## Monthly Spotlight

PRIVATE & CONFIDENTIAL

February 2013

# CREDO CAPITAL PLC

Best Ideas Portfolio

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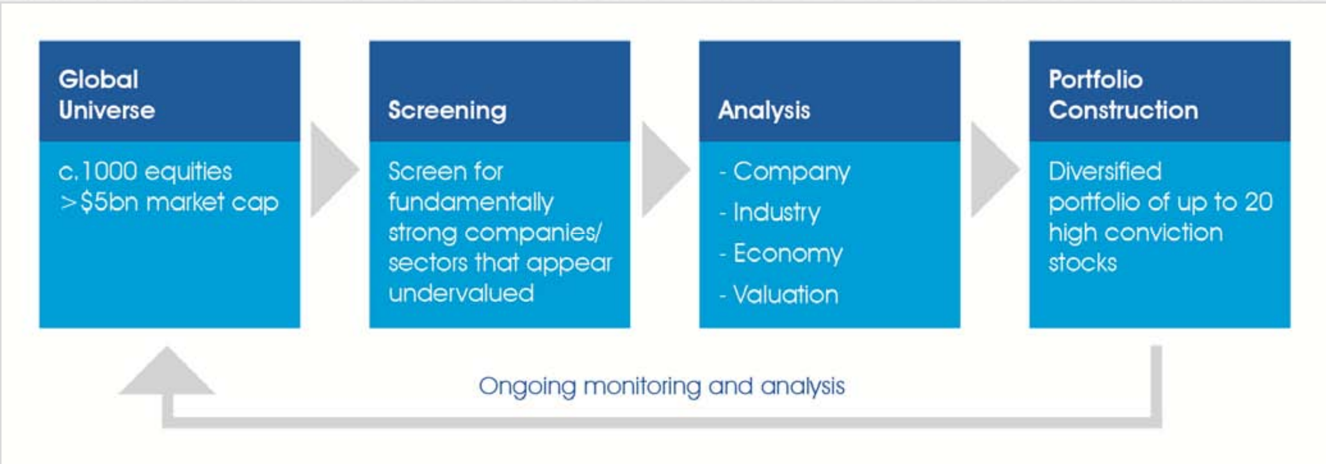
## Description

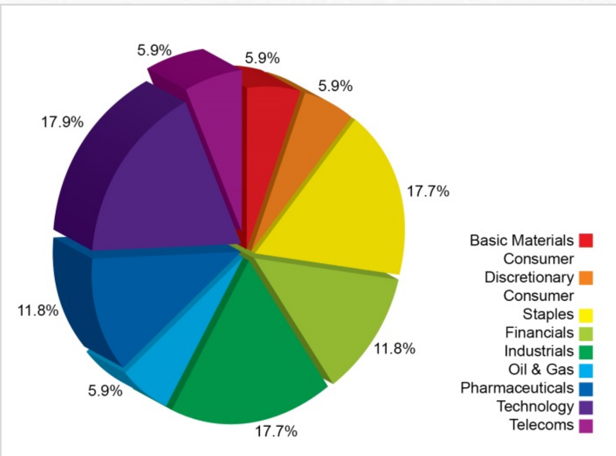
The Credo Best Ideas Portfolio is a diversified portfolio (not a fund) of global equities which we believe to be well-positioned to outperform the wider equity market over the longer term. The portfolio has a bias towards developed market, large capitalisation stocks.

Our aim is to generate sustainable excess returns versus global market indices through careful stock selection.

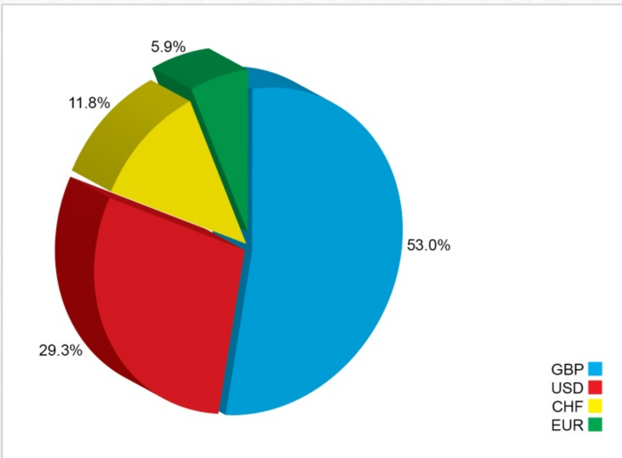
## Investment Process




## Sector Allocation




## Currency Allocation




## Performance / Stats[1]

| | Current P/E | Forward P/E | Dividend Yield | Return Since Inception (14/04/2011)[2] |
|---|---|---|---|---|
| **Best Ideas Portfolio** | **13.1x** | **12.2x** | **3.3%** | **22.2%** |
| **MSCI World Index** | **16.6x** | **13.6x** | **2.7%** | **12.0%** |

*(1) Source: Bloomberg pricing as of 31/12/2012 close*

*(2) Performance figures are based on a notional portfolio, denominated in pound sterling, designed to track the holdings of the Credo Best Ideas Portfolio. All stocks are held in equal weights. Portfolio incorporates all additions and removals. Portfolio may not be fully invested at a point in time and therefore can hold a portion of assets in cash. Performance is calculated before any fees (which can vary depending on the level of service) but includes gross dividends, not reinvested.*

On January 24th, 1984, Apple mastermind Steve Jobs announced the launch of the first ever Apple Macintosh computer. It was an instant sensation. As the first personal computer to feature a mouse and graphical user interface, it revolutionized the way consumers would interact with computer devices.

Fast forward 29 years to the exact same spot in Cupertino, California, and Apple's now acting CEO, Tim Cook delivered an equally engaging broadcast; a presentation of the company's financial performance for the preceding three months. But on this occasion, there was no mention of a revolutionary new product, nor did investors leave the presentation with the same degree of optimism.

Despite results that were broadly in line with expectations, profits grew at the slowest pace since 2003, reigniting fears that rising development costs and competition may stifle growth at the world's largest publicly traded company. To add to uncertainties, group CFO Peter Oppenheimer announced disappointing revenue guidance for the March quarter, which happened to be almost 10% below original consensus expectations. Of greater focus was the language he used to deliver this statement. Oppenheimer admitted to historically issuing conservative guidance, but to increase transparency, Apple now intends to project guidance that they are likely to achieve, setting a lower bar for consensus expectations. The subsequent reaction sent shares tumbling, closing the day more than 12 per cent lower and increased speculation that Apple's "beat and raise" reporting culture had reached an abrupt end. The sell side community hasn't been any more forgiving, with some analyst slashing their price targets by as much as 25%.

But given the extent of downgrades, surely there must be something fundamentally broken in Apple's business model to justify such a rapid realignment of opinions? Or is this just another case of a sell side community that remains distinctly behind the curve?

Expectations going into results were already rather subdued. Commentators and analysts alike have been voicing their concerns about the company's health for some time. Many are worried that sales of the company's flagship iPhone are losing momentum and that the threat of commoditization will pressure margins. Some believe that Apple lacks a credible emerging market strategy and that the company's premium pricing model will drive consumers to cheaper alternatives. However one of the more pressing issues is whether Apple's key innovation engine has stalled. An unsuccessful venture into maps hasn't exactly helped to alleviate any of these concerns.

Despite what some headlines may suggest, Apple's performance during the quarter was actually very strong, for which it has received very little merit. The company sold 47.8 million iPhones which was a whole 30 per cent more than Apple sold in the same period a year ago. According to estimates by Kantar Worldpanel Comtech, its market share in the US grew from 45 per cent to 51 per cent year on year. Shipments of iPads were also robust, up 60 per cent against a market which grew by 56 per cent based on IDC estimates. With global smartphone penetration still hovering at around 50 per cent, in our view it's unlikely at this stage that sales growth will wane. Even more significant is Apple's opportunity in tablets, which Cook believes will one day ultimately be larger than the PC market today. Unsurprisingly, competition has eaten into Apple's dominant market share, but it still remains a key beneficiary of the secular migration from traditional desktop PC's to mobile computing.

What surprisingly received little consideration from the investment community was Apple's impressive performance in China, where iPhone sales grew by triple digits year on year and overall sales were up 67 per cent during the same period. The world's largest telecoms market remains a holy grail for technology companies, where smartphone adoption is still in its early stages (3G penetration currently stands at a meagre 20 per cent). Furthermore Apple is yet to roll out its new flagship phone on the country's largest mobile network, China mobile, which boasts a subscriber base of over 1 billion people. In recent interviews, Cook suggested that eventually, China will generate more revenue for Apple than the United States. Apple has even established a new operating segment of Greater China given the very significant contribution of that region to its overall business.

In other emerging markets, Apple's presence is less prominent and its strategy in the region is yet to be defined. Whilst the pricing of its current product line up may deter the more value conscious of consumers, widely reported speculation of a mini iPhone launch later this year should help to bridge the gap with market leader Samsung. Although the low-mid tier segments of the market offer a sizeable opportunity, many are concerned that it will naturally come at the expense of margins. Just how large the margin impact will be at this stage is unknown, if at all. A recent report by Goldman Sachs estimated that margins on a mini iPhone would be in line with those of the devices bigger brother. Nevertheless, accelerating rates of wealth creation and the recent launch of its iPhone 5 in over 100 countries are likely to increase its penetration in some of the faster growing corners of the world, with or without the addition of a cheaper alternative.

Whilst Apple has undoubtedly created some of the world's most desirable computing devices, we do not believe that the company's success rests solely in its ability to design impressive hardware. Apple's operating system has long been at the forefront of software innovation. Adoption on desktop devices has been swift and Apple has a strong track record of outpacing growth in the overall PC market. With Microsoft controlling nearly 90% of the operating system market, the opportunity for Apple to build its market share is quite enormous. The adoption of its operating system on mobile devices is even more notable. Consumers have been attracted by an integrated platform that is incredibly user friendly. Value added services such as iTunes and the more recently launched iCloud have increased consumer switching costs and establish a more loyal and engaging user base. ITunes for instance had another record breaking quarter, with over two billion downloads in the month of December alone and iCloud continues to grow at a robust rate with 250 million accounts. Furthermore, it is estimated that a large percentage of users own more than one Apple device, which has enabled the company to create a unique and sticky ecosystem. It is this ecosystem that we believe will help insulate Apple from the threat of commoditization.

Though a suite of popular gadgets and a sticky ecosystem may relieve Apple of some of its competitive pressures, is it enough to sustain the remarkable growth rates that investors have become so accustomed to? Peers Nokia and RIM have set a near perfect example of the challenges facing companies in a rapidly evolving technology landscape. Under Job's stewardship we saw Apple revolutionize the music industry and the way we consume media. With Cook having been at the company's helm for almost two years now, investors are yet to see such a moment of brilliance. Apart from the iPad mini, Apple hasn't launched a new line of products in almost three years. The creativity lull has some investors raising red flags. Yet although management at the Cupertino Company are offering few clues as to what lies in their innovation pipeline, Apple bears could be left bitterly disappointed. Sources from manufacturing supply chains in the Far East point to a range of new products, including an Apple TV. Even during this quarter's earnings call, Cook stated that televisions are an intense area of interest for Apple. A ballooning R&D budget and growing partnership with display giant Sharp have further fuelled speculation. Just how the company would differentiate itself in this highly competitive market is up for debate, but in light of its history of creating revolutionary products that deliver an exceptional consumer experience, it's fair to say that we should expect nothing less.

Remarkably, Apple is one of the few companies of its size with an abundance of liquid capital to fund such ambitious growth plans. During the past quarter alone, Apple generated $23bn of operating cash flows. After allocating nearly $7bn to fund CAPEX, dividends and share buybacks, the company still managed to add another $16bn of cash to its $110bn war chest, leaving Apple with a wealth of opportunities to deploy its excess capital. One of these opportunities could be to mimic the success of Samsung by acquiring component manufacturers and become more vertically integrated. This would enable Apple to exert more control over the supply chain and better manage its margin profile. Alternatively, Apple could explore the potential of returning more cash to shareholders, which is a move that would be welcomed by most income orientated investors. In any case, on a dividend yield of only 2.4% it appears there is increasing scope for Apple's to reward shareholders over the long term.

There remains some uncertainty over which path Apple's growth profile will follow over the years to come. Much does depend on its ability to continue revolutionizing the way consumers interact with computer devices and remaining at the forefront of innovation. Yet what is more certain in our view is that as the world's largest publicly traded company (at the time of writing), Apple will inevitably succumb to the law of large numbers. We accept that in its current form Apple cannot grow its sales at record rates into perpetuity. However we also believe that Apple is still well positioned to capitalize on the proliferation of mobile computing devices, by creating innovative products and services that consumers want and need. We also welcome reported changes to the company's guidance that have been the centre of investor attention for all the wrong reasons. Apple should now be much better positioned to manage expectations, which of late have been excessive to say the least. Furthermore on a forward P/E multiple of only 10x based on the most recent consensus numbers, the company is hardly priced for a flawless future, which should help limit downside from these already depressed levels (in comparison to the high of $702 in September last year). If one strips out the cash of $137bn this multiple contracts even further to 7x. With expectations so low and an abundance of growth drivers we believe that shares continue to offer a highly compelling investment opportunity for long term investors. In our opinion Apple's business model is anything but broken.

## How to Invest

If you wish to make an investment in the Best Ideas Portfolio please contact one of our Relationship Managers.

## Important Notice

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