THE SCOTTISH Investment Trust

The CONTRARIAN

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ANALYSIS AND INSIGHT FROM **THE SCOTTISH INVESTMENT TRUST**

Another bubble?

Speculative asset bubbles have been reported since Roman times and doubtless go even further back. They stem from an intrinsic flaw in human nature: we like to think that we're onto a winner – and when we are, we don't like to consider that things could go wrong.

Investors' current infatuation with digital currencies looks like a bubble to us. The best-known of these is Bitcoin, although there are now more than 1,000 in circulation. Launched in 2009, Bitcoin has risen by more than 900% this year and more than 6,000% in the past five years*. The rate of the increase has accelerated sharply in recent months – a classic bubble warning. Indeed, the only investment to rival it is the Dutch tulip mania of the 17th century.

Ostensibly, Bitcoin offers several attractions. It's decentralised – and it's free of government control. It provides a degree of anonymity (which inevitably encourages its use in nefarious activities) but its main attractions are as a medium for speculation and a store of value.

Why should Bitcoin act as a store of value? In theory, it is free of the main risk associated with fiat currency – that a government will simply print more money to reduce its debt. Bitcoin's supply is supposedly limited, with only 21 million Bitcoins to be produced. Already, though, this store-of-value status looks shaky. Bitcoin has been subjected to two 'hard forks' this year – essentially creating a parallel currency to allow more to be produced. On each occasion, one branch of the fork (rebranded Bitcoin Cash or Bitcoin Gold) has fallen dramatically in value. So the promise of finite supply appears to have been broken already.

For the time being, however, speculators appear undeterred. But for those of us who worked through the dotcom bubble of the late 1990s, there are uncanny similarities with the digital-currency boom. Back then, bulletin boards were full of impassioned views on why things were different this time. Online advocates of Bitcoin are equally vocal today.

**As at 30 November 2017.*

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ABOUT

The Scottish Investment Trust

At The Scottish, our experienced team actively manages a high conviction, global investment portfolio with the aim of generating superior investment returns over the long term for our investors. Our contrarian approach is benchmark agnostic and provides profitable opportunities in any market environment. Founded in 1887, the trust has a long tradition of providing shareholders with an accessible, low cost way to invest in companies from around the world, whilst further boosting returns through the provision of a growing dividend. The Scottish has grown its regular dividend every year for the last 34 years. Our independently managed, closed-end fund structure allows us to be patient with our investments allowing them to mature profitability.

Looking for signs of a

Back in August, I spent some time in Brazil. My trip involved two days of corporate visits in São Paulo, the country's financial centre, and another two days of meetings with senior bureaucrats and politicians in Brasilia, the capital.

Ten years ago, Brazil was the darling of global investors. As one of the BRICs, it was a major destination for international investment flows. Much was made of its emerging middle class and its booming resources sector. What could possibly go wrong?

Too much cheap money, as it turned out. Brazil was a good fundamental story, but a credit bubble soon began to grow. The rot swiftly set in, with rampant corruption and spendthrift populist governments. The Brazilian economy was then dealt a double blow: not only did the credit bubble burst, but global conditions meant that demand for its resources collapsed and credit dried up altogether. There was an 8% real-term decline in the economy, and inflation rose as high as 11%.

Political change

So what's happening now? The most obvious recent development is political change. Following the impeachment of Dilma Rousseff last year, Michel Temer's administration is now in power and is pursuing a reform agenda. Temer's government has defended the currency and has refrained from just putting up wages – too often the Brazilian response to economic crises in the past.

There's a powerful case that the best time to invest in Latin America is when a country has moved from a left-wing government to a centre-right one that seeks to free up market forces and reduce the tax burden. Argentina provides a good recent example, and that's exactly where Brazil is now.

Corruption casts a huge shadow in Brazil, of course. The 'car wash' corruption scandal has threatened to engulf just about every Brazilian politician – and Temer is no exception. He is currently mired in graft allegations, and the future of his presidency is very much in doubt. But there is also a clear desire for corruption to be rooted out. All the bureaucrats that I met were adamant about what had to be done, and the country's judiciary appears to be in agreement – as the reach of the 'car wash' case is demonstrating.

Labour reforms

Meanwhile, Temer's government is pressing ahead with labour reforms. Laws put in place during the period of hyperinflation in the 1980s and 1990s are being repealed, and bizarre practices, such as that of paying workers for an eight-hour day but having them work only six hours, are being rolled back. Much-needed pension reform is also on the agenda.

Brazil also now has a relatively stable currency in the real. This is a significant step forward. When I lived in Brazil 30 years ago, the country had two currencies in two years. The real is weaker than in the boom days but hasn't collapsed despite all the economic turmoil. After a period of strength, its modest recent weakness has begun to make exports more competitive.

There are signs of clear improvement in the economy. Growth has returned this year, and inflation is falling rapidly. From over 11% at the start of 2016, the consumer price index has fallen

Upcoming EVENT AGM February 2018

Our 130th AGM will be held at 10.30am on Friday 2nd February 2018, at The Royal College of Physicians of Edinburgh, 9 Queen Street, Edinburgh EH2 1JQ.

The AGM will be preceded by a presentation from our Manager, Alasdair McKinnon, and followed by a Questions and Answers session.

All investors are welcome to attend. If your shares are held by your stockbroker or other platform nominee, please email info@thescottish.co.uk to reserve your place.

VOTING

If you hold your shares through AJ Bell Youinvest you can ask them to vote your shares. To do this you will need to log into your account and send them a secure message (not email) with your instructions for each resolution.

If you hold your shares through a stockbroker or other platform nominee you should contact them to make arrangements to vote.

You will not be able to vote at the meeting if your shares are held in a nominee.

turnaround in Brazil

BY ALASDAIR MCKINNON, MANAGER

to an 18-year low of 2.5%.

This has allowed the central bank to cut interest rates to 8.25% and gives it room to cut much more. Rates are expected to fall to 7.5% by the end of this year – and possibly lower than that in the foreseeable future. That has obvious implications for equities. There's a clear contrast here with the Western world, where interest rates can only really go up. Brazil's circumstances, then, should provide plenty of opportunities for investors.

Investment opportunities

Where might those opportunities lie? Growing consumer appetites offer one interesting avenue. When I lived in Brazil in the 1980s, what characterised it most was the stark divide between rich and poor. Last month, that gulf was still evident. But what had changed was the material wealth of everyone.

Take the favelas, for example. When I was living in Brazil, the houses in these shantytowns were literally built of rubbish: cardboard, scrap metal and scavenged lumber. Today, favela houses are built of brick and have running water. Another sign of progress was how widespread air conditioning now is. Virtually every building or car I was in last month offered climate control, so things have been changing for the better.

But there's still plenty of room for further improvement. Only around a quarter of households have flat-screen TVs, and only a similar number have microwaves. This means that there is a lot of scope for people to improve their lives through simple measures – and there is a lot of excitement about the future, as well as the energy and optimism needed to get there.

That's why consumer companies like Ambev, which we hold in our portfolio, see ample opportunities for growth. Lots of Brazilian people are still drinking cachaça, the local firewater. That gives beer companies like Ambev plenty of space to expand.

There are also opportunities in retail, where volumes are now recovering after the recession. Interestingly, e-commerce isn't as much of a game-changer in Brazil as elsewhere. Although the country now has broadband and adequate distribution networks, it currently lacks the capacity to allow online purchases to be returned easily. Also, for the poor, e-commerce is just not an option. In the relative lawlessness of the favelas, leaving packages with neighbours is not feasible. Shopping malls, however, are doing well; in Rio de Janeiro, they are seen as oases from the unrest on the streets.

Meanwhile, manufacturing companies, which suffered during the downturn, have had to cut costs to reflect realities. As economic conditions improve, these companies are in very good shape to exploit those better circumstances and the weaker real means that exports are growing again.

Although Brazil's equity market is still dominated by commodity companies, it also offers lots of infrastructure companies with big yields: toll-road operators and the like. These will become even more attractive as interest rates fall.

There are still risks

Finally, the country is taking steps to tackle the distortions posed by state-owned giants like Petrobras, the company at the centre of the 'car wash' scandal. It is currently restructuring to reduce its debt burden and render itself less vulnerable to the politically motivated fuel subsidies that caused much of that debt in the first place. The Temer administration is also moving to privatise the state-owned power company Electrobras.

There are risks, of course. The investigation into Temer could derail progress – not least because any successor is unlikely to be free of the taint of corruption. But the anti-corruption drive is clear evidence that there is the political and bureaucratic will to change things.

All in all, we see Brazil as an 'ugly duckling' market. It is currently unloved, and its opportunities are overlooked. But when the cycle turns – as it will – the investors who have taken those opportunities early on will stand to benefit the most.

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Another bubble?

Continued from: Front cover

Another uncanny echo comes in this year's explosion of initial coin offerings (ICOs). Essentially, investors subscribe to back start-up currencies, acquiring them to fund the new businesses. The hope for investors is that the 'tokens' they receive will rise in value as the businesses take off.

Whether these companies will flourish or flounder remains to be seen. But that hasn't stopped investors ploughing $257 million into Filecoin, or executives leaving high-powered jobs to work at ICOs – just as they flocked to dotcoms in the heady days of the 90s boom.

As with many of the ill-fated dotcoms, many of these ICOs have neither products nor proven business models. In yet another 90s parallel, we're seeing a perplexing rise in cash shells that simply invest in digital currencies and ICOs and – illogically – trade at a premium to these assets. As with their dotcom equivalents, these companies can only cite 'contacts' and 'knowhow' as reasons for giving them your money.

We should also remember that technology can be a curse as well as a blessing. A sobering warning for Bitcoin enthusiasts is the 2014 bankruptcy of Mt. Gox, a Japanese Bitcoin exchange. The company announced that it had lost about 7% of the Bitcoins in existence, probably because of hacking-based theft. So claims for the security may be overblown.

Of course, a bubble can keep inflating for some time. But to bank on that is to bet on the 'greater fool' theory – with the risk that you might be the greatest fool. Bitcoin's high volatility should be a warning too: the currency has experienced some dramatic one-day falls. For example, when the Chinese authorities imposed restrictions on digital currencies and ICOs in September Bitcoin's value dropped by $2,000 in a single day. Individual investors with large positions can also move the market with alarming ease.

The current enthusiasm for Bitcoin is part of a wider infatuation with the technology sector. The shares of the FANG stocks – Facebook, Amazon, Netflix and Google (Alphabet) have soared this year.

As with Bitcoin, investors appear unwilling to contemplate the possibility that the tech giants might be toppled. But everything is cyclical. Already, we are seeing fresh challenges to the supremacy of the FANGs through unhappy advertisers and regulatory pressure. More challenges may follow. Macroeconomic shifts and political or regulatory intervention could rapidly upset the current order, and disruptive new entrants could quickly eclipse the incumbents – just as Google overtook Yahoo and Netflix vanquished LoveFilm.

The dependence on key products could be an Achilles heel for the dominant technology companies. What happens to Apple if something else takes over from the iPhone? The swift evolution of technology means that challengers can arrive quickly and without fanfare.

What we do know is that the FANGs will lose their bite at some point. All businesses are subject to the cycle, and mean reversion always occurs. Nor should we forget that traditional companies in other sectors are adapting to the challenges of technology and adopting some of its methods. As highlighted before, Some high-street retail chains, for example, are responding to e-commerce and look well placed to resist its onslaught; those companies' valuations compare very favourably to the likes of Amazon.

The resilience of unfancied traditional competitors brings us back to Bitcoin. We find it interesting that Bitcoin's logo is a gold coin. In part, Bitcoin is an attempt to tackle a problem that already has a solution. If you want a stable store of value and a trusted medium of exchange, gold has been doing that job for centuries. Its supply is tightly constrained by geology: only around 2% is added to the amount in circulation each year. Unlike Bitcoin, more of it can't just be 'forked' into existence.

That's why we're increasingly interested in beaten-up gold miners such as Newcrest. Gold is cheaper than five years ago, and shares in companies that produce it have fallen as a result. But although it goes in and out of fashion, gold is always worth a meaningful sum. We think this age-old store of value is likely to prove its worth when the market eventually decides that Bitcoin was just a passing phase.

All sources SIT unless otherwise stated

Lend us your ear!

Your team at the Scottish like to keep their feet firmly on the ground, cutting to the core of ideas and posing the interesting, and potentially unpopular, questions. We'd like to give you access to more material that will enhance your thought process as an investor, a contrarian view that might stop you in your tracks, others that might provide a different perspective on our industry and some to keep you in touch with our current thinking on markets, amongst other things. We will be sharing and developing our ideas over the coming months and would love to be able to have you on board – watch out for more in our next newsletter and if you want to get ahead of the crowd then register your email on our website – rest assured we won't share it with anyone else.

www.thescottish.co.uk/subscribe

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