

2fold: Take Stock podcast
Zehrid Osmani, Martin Currie

CAROLINE GURNEY: I'd like to begin by acknowledging the Traditional Owners of the land on which we meet today and recognize their continuing connection to lands, waters and communities. We pay our respects to Elders past and present.

ZEHRID OSMANI: We believe that corporates will be spending increasingly more on AI as they realize that AI makes them more productive and or more creative and ultimately therefore makes them more competitive. And corporates want to be either more competitive or stay competitive. We always say that you don't get competed away by AI, you get competed away by another corporate using AI faster and better than you do.

CAROLINE GURNEY: Hello and welcome to Take Stock, a podcast by Future Generation (ASX: FGX and ASX: FGG). In this series, we get a backstage pass into the minds of leading fund managers and work out how and why they make the stock choices they do. I'm Caroline Gurney, the CEO of Future Generation. We're Australia's first listed investment group to deliver both social and investment returns by harnessing the generosity of our leading fund managers. So far we've donated more than 75 million to not-for-profits that improve the lives of young Australians. And we can do this because of people like Zehrid Osmani from Martin Currie. They charge zero management or performance fees for managing Future Generation's money. Zehrid's here with me in the studio today, all the way from Edinburgh, so Zehrid, welcome. It's great to have you in Sydney.

ZEHRID OSMANI: Good morning, Caroline. Great to be here.

CAROLINE GURNEY: Thank you very much for taking the time out of what I know is a very busy schedule. I have a lot of questions to get through, but I really wanted to ask you about NVIDIA because you are a very big believer, you're a big holder of the company. In fact, I think it is your biggest holding. Nvidia (NASDAQ: NVDA) was the star of the U. S. reporting season, Sales group of 265 per cent 265 per cent I mean, it recently became the only, well, I think it's the third company in history to achieve a market cap of \$2 trillion. So how much further can that stock run? Tell us.

ZEHRID OSMANI: Well, it's a question that many investors probably are wondering. So for us, when we look at a company like Nvidia, we are assessing the market potential, the market growth and then in the case of artificial intelligence (AI), which is what Nvidia is capturing, it's actually the shape of that growth in the market. So for us, there is various scenarios that we run. But when we're looking at the AI potential, we believe that we're really just at the foothill of that potential, or at the bottom of the S curve, if you will. What we've seen so far in 2023 is probably the tip of the iceberg. We believe there's going to be acceleration in take up. And it's going to come from multiple strands. Firstly, the cloud providers upgrading their cloud infrastructure to make it AI ready. So the hyperscalers like Amazon, like Microsoft, like Google, and then the

corporate spend. We believe that corporates will be spending increasingly more on AI, as they realize that AI makes them more productive and or more creative and ultimately, therefore, makes them more competitive and corporates want to be either more competitive or stay competitive.

We always say that you don't get competed away by AI. You get competed away by another corporate using AI faster and better than you do. So that will be critical. And then, when you listen to the Nvidia earnings call, the CEO is also flagging 'sovereign AI', so AI deployed by governments, and that will be probably the next leg of growth, All to say, that there's a lot of scenarios that need to be run about the potential. But what we see is still a very long runway of growth. So then when we look at Nvidia, we're looking at a company that can grow its top line at over 20 per cent annualised, and its earnings at over 30 per cent annualised over the next five years, and this is a company with a very high return on invested capital. We estimate over 100 per cent return on invested capital last year, and as a result, we can see that the company still has a nice compounding characteristic, high growth, high return, and therefore, that's one of the reasons why we're keeping it as one of the largest, in fact, as you said, the largest position in our strategy.

CAROLINE GURNEY: I mean, it's an amazing stock in terms of it's come from nowhere it seems, and now it's run and I want to ask you more about artificial intelligence. But first as the CEO for Future Generation, you know we deal with more than 30 leading fund managers and I'm really fascinated to find out how you go about selecting a stock. How did you select the stock of Nvidia in the first place? How do you look at the whole investable universe and then narrow it down to such a small number of stocks? If you can tell us how many you manage, that would be fantastic. And then take me through the process and maybe use Nvidia as an example, if you can.

ZEHRID OSMANI: Yeah, definitely. So when we look at, a stock, we deploy our investment process. It's a three-step process. The first step is idea generation, the screening, as you mentioned. The second step is the in depth fundamental research. And the third step is portfolio construction. And portfolio construction is then harnessing the best ideas that come out in depth fundamental research and putting them in this high conviction concentrated strategies that we run, but with no unintended risk exposures. So when we start with a screening for us, we're focusing on companies that have high returns on invested capital and an attractive gross profile. And that gives us that quality gross profile in the way we define it. And then we look at a few other aspects like strong balance sheets. We also like companies that grow organically rather than through acquisition. So we focus on goodwill on the balance sheet. Our ROI calculations include goodwill. And so in the case of Nvidia, this was a stock that we purchased in March 2021, but that's after months of research and it came through the screening from it's high returns and attractive gross profile characteristics. We decided to move it into step two, in depth fundamental research, which took months to generate. And that's where some of the assessment is across four fields, industry risks, company risks, governance and sustainability risks and the portfolio reset that stock would bring to the portfolio on industry risks. We always like good industry dynamics when we focus on companies. We always remember the old adage that Warren Buffett once said, 'If good management meets bad

industry, it's a bad industry reputation that stays intact.' So we like good industry dynamics. And when we looked at Nvidia and the industry, we could see that there was high barriers to entry, which was driven by the high technological content of what they do - the importance of research and development (R&D). Therefore, the competition risk was low. This was a company that was really well established as a quasi-monopoly in the GPU space at this stage. So it's a bit like where SML was 10 to 15 years ago. And so for us, it was an interesting dynamic. It gave the company very strong pricing power and in technology, you always have disruption risk.

So we do focus on that. But we also could conclude that Nvidia is very innovative and will remain innovative. So if you look at the R&D intensity of the company and the scale that it's achieved compared to one of its competitor, Advanced Micro Devices (NASDAQ: AMD), it's actually outspending that company by two to three times in terms of dollar amount channelled in R&D for the specifics of GPUs. So we believe that it can sustain its competitive advantage. In fact, recently, it's actually accelerated its innovation cycle. So it just shows you that the company can really sustain its competitive advantage. And as we keep building that fundamental research, we also look at the gross potential of the market, but also therefore of the company, the profitability and returns potential, the cash flow generation. We forecast over 20 years. And that's important to highlight, Caroline, because for us, the reason we forecast over 20 years is to capture the whole sustainable period of excess returns. And then we feed that into a structured valuation framework, a discipline valuation framework, and valuation discipline is always critical. And our valuation tools are long term. From that comes a conclusion about both the upside potential of the stock, risk profiles of the stock, which gets us to be able to conclude whether the risks are captured in the current share price, whether we are comfortable running those risks effectively, and a conclusion about whether a stock is attractive.

CAROLINE GURNEY: So let's go a little bit further. I mean, obviously you've become an expert now in AI, artificial intelligence. Many are actually saying that the theme is maybe a little frothy now. You've talked about 20 years, but when would it be time to sell out if you were, you know, a Mum and dad shareholder? And the other question I wanted to ask you is, how can an Australian, besides buying Future Generation shares, get access to the AI market?

ZEHRID OSMANI: Two good questions. So valuation discipline is always critical. We mentioned that just with the previous question. And in this instance, just as much, we always focus on thematic opportunities and artificial intelligence, we highlight as one of the important eight themes that we focus on. It's actually capturing four of the eight themes. And I'll come back to that to list them in a moment. But critically, we don't invest in attractive themes.

We invest in attractively priced, attractive themes. And so valuation discipline is critical. There are times in the market when themes get ahead of themselves, get frothy and get disconnected from fundamentals. It goes back to the previous discussion, which is you have to have fundamental forecasts of market potential growth, returns, cashflow characteristics of the businesses you look at, and a discipline valuation framework to be able to tell whether a company still has upside potential - that's the important aspect to mention.

When we look at Nvidia and other stocks in the AI space, we can see that there's potential for froth. If we give you a few examples, we look at over 50 stocks in the AI basket, and over the past 12 months, they have gone up by roughly around 60 per cent in terms of share price. Their sales estimates have not moved and their earnings estimates have only increased by seven per cent. When you look at a company like Nvidia, that company's share price has gone up by over 280 per cent over the last 12 months, but its earnings estimates have increased by over 380 per cent. So in this instance, Nvidia has actually seen multiple contractions. So yes, the share price, when you look at it on its own, has increased significantly. But the earnings estimates have increased even more. And that's really the importance of it. So when we look at AI, we look at companies that can monetise the AI opportunity. And that will be critical over the next 12 to 24 months after this initial AI froth that we might have seen, it'll be about which companies can monetise, which companies are genuinely seeing the earnings upgrades and which ones aren't, and therefore might just be exposed to the AI theme, but will struggle to monetise. So that's really the focus for us is stick to companies that can monetise, which to us typically are the enablers, the enablers of the AI opportunity and so companies like Nvidia. It's the largest position in our strategies, companies in semiconductor space, but ultimately the enabler of the semiconductor industry as a company that provides the tools for the semiconductor manufacturers, or companies like Microsoft (NASDAQ: MSFT). Microsoft is an interesting name because it has the opportunity to monetise across three fields. Firstly, it's 49 per cent stake in OpenAI. Secondly, as a cloud provider, and thirdly, as an enterprise software company. So the fact that it's got its channels to corporates, and as we mentioned earlier, corporates are most likely to spend on AI at this stage.

CAROLINE GURNEY: So that's two more stocks that you've given us. So thank you very much for that. More broadly, you know, what, what's your outlook for markets? What's going to happen in the coming year?

ZEHRID OSMANI: So for us, when we wrote the outlook for 2024, we mentioned a few things. Firstly, inflation will be stickier and longer lasting. That's because we can see that wage inflation remains elevated and the largest potential for inflation to stay high comes from wage inflation. And it's something that central bankers like Christine Lagarde (President of the European Central Bank) are actually highlighting, that second round inflationary pressure coming from wage inflation. As a result, we believe that whilst rates will be cut in 2024, it will be backend-loaded. So monetary policies will pivot towards cuts, but not until the second half. We're welcoming the fact that the market has now adjusted to that expectation. But initially, there was expectations of a March cut for the Fed, and we felt that that was premature. The other aspect that we highlight is on the economic side. As we look at the leading indicators, we are of the view that both the UK and Europe will remain in stagflation. The US and China will be slowing down, so you have a global cycle that is in slowdown. As a result, when we look at the corporate earnings cycle, we believe that the corporate earnings will remain in recession.

So you're facing either no growth or very little growth across geographies and as a result, we believe that growth will be scarce. So focusing on quality growth will be important. But ultimately, in this environment, we like to focus on companies with resilient earnings because there's still risk of earnings downgrades. We believe consensus is too high. Secondly,

companies with pricing power because of the higher inflation. Companies that have pricing power will be able to protect their margins more efficiently. Thirdly, companies with strong balance sheets, in case of economic slowdown leading to potential higher risk of recession. And fourth, companies with exposure to structural growth opportunities because of the lack of growth. But ultimately, to come back to the high level, the expectations of rates getting cut in the second half of the year should be supportive for equity markets and notably for the quality growth style.

CAROLINE GURNEY: As a global fund manager, you know there's around 60 global elections going to happen this year. You've got the US you've got India, you've got the UK, you've got the European Parliament. What impact do you think that might have on global markets? And is that something you'll factor in? And then we're going to turn to China.

ZEHRID OSMANI: Yeah, the geopolitical risk is always something to bear in mind. And elections do provide an element of geopolitical risk, certainly uncertainty in terms of policies post-election. So the two that we're focusing on are the European ones and the US presidential elections. On the European ones, we believe that there could be a momentum towards anti-European parties, and therefore you could have a bit of a tougher reform agenda coming through. Nothing that will be overly concerning, but you could have, just a move closer towards an anti-centralised EU approach. On the US, it will be interesting to just see how the polls amount, but at this stage, what the polls are telling us is that Trump might be back in the White House. What might mean for markets is possibly less unpredictable than the first time around. So Trump is a known entity this time around. There might be changes in policies, but ultimately what we've seen previously is that Trump seems to be very focused on economic growth and therefore it could be supportive to the economic momentum of the US and ultimately to the stock market.

CAROLINE GURNEY: I think everybody's going to be watching the US elections. I know I certainly am. But let's turn to your investment style. You've talked through how you actually pick a stock, but you're unconstrained, which means you're high conviction. Is your portfolio more risky? And how do you mitigate that risk?

ZEHRID OSMANI: Our portfolios are very focused 20 to 30 stock portfolios at typically 25 stocks as a mid-point. You could, therefore, see them as being more volatile, because in any given month or quarter, if one or two stocks moves in an outsized manner, it creates that volatility. But we believe that over the long term, focusing on finding the 25 best ideas actually leads to a better outcome than going with a 50 stock portfolio. Warren Buffett once said that, 'Risk comes from not knowing what you are doing.' The reason why many investors might have more stocks, it's to mitigate that risk. And what we find is that by focusing on 25 stocks, we have more focus on a small number of stocks that we therefore know better. And we can do more in depth research, go deeper into understanding their business models and all the threats that their models are facing and therefore be comfortable with that. So that's one aspect. But secondly, in terms of mitigating the risk, we have an innovative approach to risk assessments. And the reason we highlight it as being innovative is it's away from the traditional risk tools, which we already have and we deploy. We complement that with assessments of

fundamental risk exposures. So in these 25 stocks or so, we're able to assess how do they generate their revenues, profit and production basis in terms of geographic exposures. How do they, which exposure do they have in terms of end markets, in terms of thematic exposures. And we're able to then constitute a picture at the portfolio level that is more accurate by geographic risk exposures, thematic risk exposures, and use of marketing risk exposures, all of which helps us achieve better diversification and ultimately attend to risk clear ups more efficiently.

CAROLINE GURNEY: And where do you get your ideas? Like, you know, what do you read? What do you listen to? You obviously know what you're doing. So tell us, tell us one of your secrets about when it comes to investing. Is it gut instinct or is it data driven? Give us some help for us everyday investors out there.

ZHRID OSMANI: Yeah, we're very much focused on fundamental data. So very intensive on the data side to make sure that we have a good picture of growth potential, returns potential, cash flow characteristics, all of which feeding into a detailed and structured valuation framework, as we discussed. But in terms of what I'm reading, it's a combination of reading the press, which I try and vary between European, American, and global press on a daily basis, and that gives it me various angles, but also a source of idea generation. And then secondly reading the research that's out there is also important. And then in terms of books I like the trilogy from Clayton Christensen, The Innovator's Dilemma, The Innovator's Solution, and Seeing What's Next. That's three books that I always highlight as a must read.

CAROLINE GURNEY: So tell us, what do most investors get wrong? You know, what are the main pitfalls for retail investors that you see out there?

ZHRID OSMANI: So in terms of investors like me one of the things that I've come to realise is behavioural biases are not necessarily a big focus by traditional investors and actually every investor has behavioural biases.

So if you're not aware of them, you're more likely to be victim of those behavioural biases. So what we've done is we've put in place a framework to assess our behavioural biases and to really watch out for any such risks. The typical risks are risk of groupthink, risk of overconfidence or loss aversion, risk of affinity bias or confirmation bias when you're looking at an opportunity and trying to find confirmatory evidence why you're right and the rest of the market is wrong. So the same pitfalls that an investor like ourselves face can actually be equity in the retail investing. So don't be overconfident, but also don't watch out for loss aversion. It's actually a good opportunity to put some money to work when there's a lot of loss aversion around and equally, when you're looking at investing, don't be scared by investors that might have underperformed because that might be the best time to pick some of those up. You have to do your homework in terms of deciding which investors you want to back and every investor will go through a period of underperformance, but if you believe in their investment process, in their approach, in their investment philosophy, that might be just the right time to pick them up after a period of underperformance.

CAROLINE GURNEY: That's great advice. I mean, you've mentioned Warren Buffett, but what other investors do you admire?

ZEHRID OSMANI: In the contemporary investors that I like people like Bill Ackman for his very focused approach on turning around businesses that might be underperforming for reasons that are more cyclical rather than structural and therefore that provides a good source of alpha. Investors like George Soros, who I think in the past has shown an ability to really focus on a few parameters and, and then really put his conviction behind it. Companies closer to home like James Anderson, who was ex-Baillie Gifford, who actually has done a good job of being early investor in Tesla and then exiting at a time when Tesla became a more mainstream investment and a head of competitive intensities accelerating in the auto industry.

CAROLINE GURNEY: All fabulous names. We are incredibly grateful to you because we need our pro bono fund managers, but why do you manage our shareholders money and don't charge?

ZEHRID OSMANI: Well, we're very excited about the initiative that Future Generation's running, the focus on making an impact. Social impact in particular is very much aligned with our way of investing and our way off assessing sustainability risks in businesses. And within that, we look at environmental risks and therefore environmental impact that corporates have, but also social risks and therefore social impact. So for us, we could see that there was good alignment philosophically with that side of our analysis. And therefore we're really excited to be part of this.

CAROLINE GURNEY: Thank you Zehrid. I've really, really enjoyed this chat and getting also an insight into your investment process. So thank you for your time today and your busy trip and for the work that you do and Martin Currie to ensure that Future Generation can keep on giving. Thank you.

ZEHRID OSMANI: Thank you, Caroline.

CAROLINE GURNEY: We hope you enjoyed today's episode. Please join the Future Generation family, Australia's first listed investment companies provide investment and social returns. We are proud to have given more than 75 million to Australian not for profits. You can be part of this and gain investment returns while contributing to improve the lives of young Australians. For more information about Future Generation, please visit our website www.futuregeninvest.com.au. Thank you.

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