NCM Core Global and NCM Core International

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NCM Investments

COMMENTARY

Phil D'Iorio, CFA

Portfolio Manager

Cumberland Investment Counsel Inc.

Living in a World of Uncertainty

Global equity markets have been very weak and highly volatile thus far in 2022. Most of the major indices in the United States and Europe have fallen anywhere from 13-15% on a peak to trough basis. The reasons for this are well known. We are dealing with the highest level of inflation in 40 years, the U.S. Federal Reserve is tightening at a faster rate than the market was expecting just 3 months ago, and we are more than 2 months into the war between Russia and Ukraine.

In light of the challenging environment, we have made several changes to the NCM Core Global and Core International funds to make them more defensive. We believe the tail risks are higher than normal and so we have made these changes to dampen the volatility of our funds. Specifically, we have reduced our exposure to the Consumer Discretionary & Technology sectors. We have also increased exposure to the Consumer Staples & Healthcare sectors. As part of these changes, we have established a new position in Nestlé. And we have also increased our weight in Diageo, which is a long-standing holding. A description of each business follows.

Nestlé is one of the world's largest food & beverage companies with sales in nearly 200 countries with roots dating back to 1866. In terms of what we like about the company:

- First and foremost, Nestlé is a Consumer Staples company so it has stable end-markets that are less sensitive to the economic cycle which allows the company to generate robust free cash flow across the cycle
- Second, the company has very strong brands with leading market positions in attractive categories
- And finally, we are very pleased with the way the management team has reshaped the company's portfolio

Nestlé competes in large, fast-growing categories including Pet Care, Coffee, Health & Nutrition, and Premium Water. Nestlé is a dominant player in most of its categories with # 1 or #2 market share positions across 80% of its portfolio. In coffee the company owns Nescafe, Nespresso, and Starbucks. In Petcare it has the Purina brand which has several offerings in the premium and super premium categories. In water they sell premium brands such as San Pellegrino and Perrier. Finally, in Health & Nutrition they participate across several health & wellness categories including infant nutrition (Gerber Life), multi-vitamins (Nature's Bounty), and nutritional energy drinks (like Boost). Overall, Nestlé has a significant presence in premium categories, which gives it strong pricing power. This is an advantage in an inflationary environment because Nestlé can pass along rising input costs in the form of higher prices.

Nestle

We have a very favourable view of Nestlé's management team and we are particularly impressed with the changes they have made to their product portfolios. Since 2017 Nestlé has completed more than 75 acquisitions & divestitures, which is equivalent to nearly 20% of the company's total revenues. This portfolio transformation has increased its exposure to higher-growth, higher-margin categories. As part of this process, Nestlé has also divested slower growing, more commoditized businesses including parts of its water business (Poland Springs and Nestlé Pure Life), ice cream brands (Dreyer's), and portions of its U.S. confectionary business (Butterfinger and Baby Ruth). On the acquisition front, they have been buying companies in faster growing categories like plant-based foods, mineral water brands & healthy hydration products, and multivitamins where they acquired Nature's Bounty. Coffee is another area where they have acquired and it's a category where it has significant expertise as a global leader. In 2018 Nestlé acquired the perpetual rights to sell Starbucks' Consumer Packaged Goods products. So any time you're at the grocery store and you see Starbucks coffee pods or pouches of Starbucks beans to make drip coffee, it's sold by Nestlé. And the management has done a great job with this acquisition. During 2021, sales of Starbucks products reached 3.1 billion Swiss Francs, which is an increase of 17.1% versus 2020. More importantly this represents an increase of 48% from 2018, which is when the business was acquired. So in 3 years, they have increased sales of Starbucks products by nearly 50%. So we like Nestlé. It's a very stable, well-managed company. Let's move onto Diageo.

Diageo is the world's largest producer of Spirits with over 200 brands sold in more than 180 countries. The company has very strong brands across the largest categories in global spirits. As seen in the chart below, Diageo owns a large number of trophy brands in the spirits industry.

In Scotch they own Johnny Walker, in rum they have Captain Morgan, in vodka they have Smirnoff and Ketel One, in gin they have Tanqueray, in Canadian Whiskey (or rye as I like to call it) they own Crown Royal. They are also in tequila which I will expand on a bit later.

There are many reasons why I like Diageo but for the purposes of today, I am going to focus on the growth opportunities and the strong management team. In terms of growth:

- Diageo operates in a growing category. The Global Spirits category has been gaining market share from beer and wine over the last decade and this trend is expected to continue. Last year spirits accounted for about 39% of the total global alcoholic beverage market, which is up from 30% in 2010
- Every year more than 50 million consumers around the world reach the legal drinking age, which will support future growth
- And finally, Diageo has a significant presence in the premium & super premium categories which gives them strong pricing power which can help drive growth. Over the years the company has done a great job of building out premium offerings across its portfolio whether it be in Scotch, Canadian Whiskey, or Tequila.

We have a very positive view of Diageo's management team which has executed very well in terms of managing a well-diversified portfolio that can meet changes in consumer tastes. Over the years a key strength of theirs has been their ability to acquire and build brands to take advantage of opportunities in the market. Tequila is a great case study to emphasize this point. In this particular situation, Diageo's management team was able to identify a shift in consumer preferences at an early stage. In 2014, the company's exposure to the tequila category consisted of a 50% stake in Don Julio. At that time they believed that tequila was emerging as a big opportunity, especially in the higher-end tequilas, so they decided to acquire the other 50% stake in Don Julio that they didn't own. They followed this up with another deal in 2017 when they acquired Casamigos (founded by George Clooney). Since acquiring these brands, sales of Don Julio have increased seven-fold and sales of Casamigos have increased eleven-fold. With the help of these acquisitions, Tequila has significantly transformed Diageo's portfolio. In 2017 tequila accounted for 2% of total group sales but by 2021 this had risen to 9%, and today tequila accounts for more than 10% of total company revenue. Diageo's tequila sales have grown at an annual compound rate of 30% from 2015 to 2021. All of this to say, that we are very happy with the management team.

We view Diageo as a stable company that generates robust free cash flow and we believe there is room for more growth in the years ahead. Although Diageo is the largest global spirits producer, there is plenty of room to grow as Diageo has only 4% market share of the total global alcoholic beverage market.

The management team recently set a target to increase their market share by 50% by 2030, which would represent 6% of the total global alcoholic beverage market.

In conclusion, we are operating in an uncertain environment given elevated inflation and the war in Ukraine. We think the tail risks are higher than normal so we have made some changes to the NCM Core Global and Core International funds to make them more defensive. When we get into these environments where it feels like it's all doom & gloom, we like to ask ourselves...what can go right? And what might change the negative narrative that exists today? We think there are some things that could go right. We could get a resolution to the war in Ukraine. COVID could fade into the background and that would go a long way in alleviating bottlenecks in global supply chains, which in turn would help the inflation picture. That's what could go right. And probably will go right. But this could take time. And so that's why in the meantime, we decided to add a layer of conservatism to our portfolios. At the end of the day, we remain highly confident in our portfolios given the quality of the companies we own. The vast majority of the companies we own have very strong pricing power as illustrated with Nestlé and Diageo. Companies with strong pricing power are much better positioned in the current inflationary environment. If we remain in tougher markets for a longer period of time, we take great comfort in our belief that the companies we own will come out even stronger on the other side when we get to a better place.

CONTACT US

www.ncminvestments.com

NCM Investments

Calgary
Suite 1850, 333 - 7 Avenue SW
Calgary, Alberta T2P 2Z1

Toronto
310, 99 Yorkville Avenue
Toronto, Ontario M5R 3K5

FOLLOW US

403.531.2650 Phone
1.877.531.9355 Client Services
1.877.431.1407 Toll-Free
info@ncminvestments.com