Bradfield Investments

Q1 report, 2019

Dear Partners,

Year to date our portfolio has returned 10.19%, and our annual return for the year ending 2018 was 15.39%. Comparatively, the S&P 500 has returned 17.75% YTD, but returned a whooping -4.85 for 2018.

We added to our positions in Reckitt Benckiser and Summerset, and maintained our position in Republic Services. We also added Apple to our portfolio when it dipped to $140 per share, a substantial discount to its intrinsic value.

My phone died last year, and I bought a Nokia. It'd do, I thought. It was black and shiny and well constructed, and also I couldn't deal with it. Android is a terrible OS, clunky and unintuitive. I ended up caving in and buying another iphone. Like so many other Apple devotees in the world, I realized just how hooked I was. The user experience is superior, and with something as sticky as phones (mine is stuck to my hand far too much) this cannot be underestimated.

We have started building up a cash portion of our portfolio. While we still think our companies sit undervalued, especially given their strengths, we consider the current spate of optimism in the market to be foolish with companies sitting at the prices they currently command. It can be tiresome to feel like chicken little, crying 'the sky is falling!' and waiting for the sky to fall when it never does. We note Australian household debt to GDP is still around the 120% mark. New Zealand is not much better, sitting at c.93%. As long as easy credit is available we cannot see this trend reversing. New Zealand currently has incredibly low interest rates -- I can go out and secure a mortgage for 4%, and so can you, which only increases the spate of borrowing. The danger is not first home buyers, but comfortable middle class baby boomers who borrow in larger and larger amounts. As Kida notes in a 'Financial vulnerability of mortgage indebted households in NZ'[1]

[1] https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Bulletins/2009/2009mar72-1kida.pdf

"…The median LVR tends to rise with income. In other words, higher-income households tend to be more highly geared.4 The distribution of LVR by income group (figure 6) also shows that highly geared households (LVRs above 80 percent) tend to have high incomes. The LVR indicator therefore suggests that high-income households are most exposed to risk from falling house prices…"

While the media has been busy demonising millennials for buying their coffee and avocado toast, the real threat is the affluent fat-around-the-middle baby boomers who have the large chunk of this wealth, and are thus the most highly geared. While the RBNZ concludes we are relatively safe from a shock, they have one caveat --

"...There is no formal estimate of mortgages relating to investment property. Informal estimates for 2007 suggest that as much as a third of aggregate household mortgage debt might be related to investment properties. Evidence from other countries suggests that mortgages relating to investment properties could be potentially associated with riskier forms of mortgage finance such as interest-only or no-deposit loans. By relying on the HES for information on household balance sheets, we are excluding this potentially sizeable and important portion of household debt from our analysis…"

If we assume a number of these high-income, highly leveraged households hold investments in investment properties, too -- a probable assumption given New Zealand's predisposition toward property investing, then it stands to reason that the risk becomes magnified once again - a leveraged house *and* a leveraged investment property(s)? That is a whole lotta leveragin'.

Magnify this again by the risks undertaken by Australian banks -- the main banks in New Zealand, as it so happens, and the risk becomes quite real. We consider holding cash to be a sane response to ever-growing pools of debt disguised as 'growth'.

We are exposed to New Zealand property through Summerset, however we note that Summerset essentially operates a interest-free float -- it has deposits from clients who will eventually be given their money back[2], factoring in depreciation. These, like the float of a insurance company, operate as an interest-free loan. As New Zealanders age more and more of us will require retirement homes. Summerset is uniquely positioned to take advantage of this. We anticipate a drop in property values

[2] They will be dead, probably.

which will impact Summerset's balance sheet short term, but the onslaught of grey-hairs continues regardless.

The largest positive impact on our performance has been Republic Services, who continue to excel in picking up trash. Reckitt Beckniser continues to be sorely undervalued despite its stellar consumer products business and market dominance in multiple areas. We find with large conglomerates analysts put too much pressure on how good the CEO is -- Rakesh Kapoor was once considered the golden boy of the condom world; RB's recent underperformance has seen him rebranded as a kind of weight on the company, a deadweight CEO. GE's Jack Welch was deified during his time at GE, yet his creation of GE's finance machine is arguably what caused so much pain in later years. Regardless of Kapoor's performance, Reckitt continues to have a large 'moat' around its products.

We continue to hold cash for two reasons: one, we do not see any stellar opportunities at present. Two, we consider cash highly liquid -- we can deploy it when we *do* see an opportunity. Warren Buffett was asked recently why Berkshire holds a massive pile of cash (100 billion or so, dear reader) when it would've earned more holding it in an index-- Charlie Munger answered that it wouldn't take a lot for Berkshire to spend it all on a big elephant. We consider this to be a sane answer. Here we are hunting small mice, though. We'll leave the big game to Charlie.

Yours faithfully,
Eden Bradfield
Principal