

Dear Shareholder,

In absolute terms, the strategy achieved a *reasonable* return this year, delivering c.5% to investors, as underlying earnings grew 9% adding to the attractive valuation of our portfolio.

However, in *relative* terms, performance this year was poor. After two very strong years in 2021 and 2022, outperforming the market by 18%, it lagged the global equity market by 11% in 2023.

Year	Latitude Portfolio Earnings (EPS)	Latitude Portfolio NAV / Price
Nov 2016	£4.3	£100
Dec 2016	£4.7	£106
Dec 2017	£5.1	£118
Dec 2018	£6.0	£126
Dec 2019	£7.3	£145
Dec 2020	£7.9	£154
Dec 2021	£11.2	£197
Dec 2022	£13.0	£198
Dec 2023*	£14.2	£208
CAGR	18.4%	10.8%

Source: Latitude as of February 2024

*We report the portfolio level EPS each year, allowing investors to track the underlying growth in fundamental value. In last year's annual report, we reported £12.6 EPS for Dec 2022, which was our best estimate based on 75% of our businesses reporting results at the time. That figure has been revised in this report to £13 after the remaining companies finished reporting earlier this year. The estimated figure for 2023 is £14.2, we shall similarly update you in our next annual letter as to what the final number is - we don't expect it to differ materially.

Our earnings growth rate since inception has been 18% per year, *including* dividends reinvested. Over the long-term price follows value, and we focus our attention on delivering demonstrable value growth (through earnings and cash flow per share) within the portfolio. While we obviously like to see gains in both, we will focus predominantly on building operating earnings within the portfolio, paying less attention to short-term changes in price.

These earnings numbers are *unadjusted* GAAP figures reported by the companies. In many cases we believe that underlying earnings are higher, often substantially, although the transparency and comparability of showing unadjusted figures is likely of more benefit to shareholders. Over time, GAAP earnings should converge to our estimates of underlying earnings.

It's worth stating that GAAP EPS is one way to consider the underlying intrinsic value of a business. We always ensure that our portfolio is converting these earnings into actual cash flow, and often consider other financial attributes as superior when analysing individual companies. That said, GAAP EPS is a *reasonable* proxy to allow shareholders to track our performance over time and is the one we intend to show in the future.

Our businesses are, in general, investing for growth so the GAAP figures do not represent the maximal free cash flow they can generate today, rather the optimal (in the view of management whose opinion we trust) amount to balance the rewards of today while protecting and growing the rewards of tomorrow.

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The Year in Review:

We do not build portfolios with any reference to benchmark weights, believing this behaviour hampers original thought and that, ultimately, investment outcomes are weakened in the process.

This approach frequently puts us at odds with the prevailing consensus. In our view this is a necessary condition for long-term outperformance although it does result in periods of relative weakness, such as this year. This is the curse of comparison one encounters frequently in our industry, sent to test investors' mettle.

While relative performance is clearly an objective to be achieved over time, it's through keen focus on the actual performance (of both the companies, and their stocks) that we have accomplished this goal historically and aim to do so in the future.

For the past three years investing in the benchmark or, specifically, the go-go stocks of today has been like flying a kite through a hurricane. Price discovery has been suspended in the fog, as investors adjust to a rapidly changing environment. In such markets, when prices do adjust, they do so all at once. It's important to invest ahead of those moves, and critically to ensure it's worth the wait. With meaningful discounts to fair value, and a meaningful growth engine, our ship is the one we'd choose as the storms continue to rage.

As my Bermudian grandmother used to say, "life is about learning to dance in the rain, but you don't want to dance into a hurricane, that's plain stupid".

Investors in the Latitude ship have enjoyed ballast *and* propulsion in the form of high free cash flow yields and strong underlying growth trends. It's stood us in good stead for the past three years, in absolute *and* relative terms, and in the notes which follow we hope to compel you to see how this can continue for many years to come.

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Returning to our performance relative to the market, this year's underperformance was entirely attributable to two factors. Principally, our underweight position in the *Magnificent Seven* and also marginally due to our allocation to defensive growth businesses, most notably consumer staples companies.<sup>1</sup>

We started this year with around a quarter of the portfolio invested in consumer staples companies (**Tesco, Unilever, Diageo, Imperial Brands, Heineken, and Coca-Cola**). Between them they deliver an average dividend of c.4.2% and we expect buybacks to contribute a further 3% per year, implying a 7.2% return for shareholders *on top of* underlying earnings growth, and the potential for multiple rerating. We expect earnings growth of 5-10%, in some cases higher as margins expand following input costs pressures recently and, when this earnings growth comes through, we expect valuations to improve by 20-50%.

The sector currently trades at the lowest valuation relative to the market for the past 30 years, aside from the dot-com bubble, which presaged a very strong decade of future returns for the sector.<sup>2</sup> Such is the strength of the tide of opinion at present that a once in a decade valuation opportunity is presenting itself at a time when fundamentals for these companies are turning as well.

Emerging market exposure, which has been a drag on returns for the past decade (for example, it has cost Unilever and Diageo 1-2% of organic sales each year which, if reversed, would add 2-4% to the historic growth rates) looks likely to become a tailwind in the next decade.

Input cost pressures are easing across the board, which will lead to margins recovering from low levels post-Covid. Many of our companies have raised prices behind inflation, allowing them to capture market share from competitors and drive higher sales in the future as input price inflation normalises. Looking back over the year, our exposure to consumer staples was clearly the major source of underperformance for the portfolio contributing an average return of just 1%. This was despite the shares continuing to generate underlying earnings growth of 7.5% per year for the past two years. We have strong conviction that this valuation discrepancy will close, especially if we do see a weaker economic backdrop.

Tesco performed very well, and Diageo was the worst, while the other stocks' performance was, in aggregate, flat with a range of +9% to -6%.

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<sup>1</sup> Magnificent Seven refers to the largest 7 stocks by market capitalisation of the S&P500 – Amazon, Apple, Meta, NVIDIA, Tesla, Microsoft and Google

<sup>2</sup> S&P 500 Consumer Staples Sector relative to the S&P 500 Index

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**Tesco** returned +35% in 2023. Principally this was a much overdue reflection of the improved quality of the business, as the turnaround is complete, and the business is back on its throne as market leader. Compounding this strength, is the continued weakness of the competition. Most notably Asda and Morrisons are struggling under the debt burdens of their private equity buyouts, and do not have the financial flexibility to invest or fight for competitiveness by lowering prices.<sup>3</sup> Indeed, for the first time in many years Tesco has been *underinflating* the market, thus compounding its position as the best value for money. This reinvestment of potential profits in lower prices creates a strong fly wheel effect, driving more customers into the stores, and higher volumes. Their market share, which had been falling for a decade, has seen a strong recovery in the past two years, which we believe is likely to continue as Asda and Morrisons cede share. Given the high fixed cost nature of the supermarket business, it's critical to see sales densities and asset utilisation moving higher, and this has a geared impact on future returns. Other points to note are the likely sale of Tesco Bank, which should raise c.£1bn which we expect to be used to buy back shares in the company, complimenting the 4% dividend yield. At 12x PE (compared to international peers such as Walmart which trade on 24x) the stock remains an undiscovered jewel in the FTSE's crown.

The story was less positive for **Diageo**, which fell 20% last year, leaving the stock at the cheapest level versus the market for the past fifteen years. The cause of the fall was primarily their Latin American business, where excess inventories need to be drawn down, causing current sales to fall 20% short of expectations.<sup>4</sup> This division contributes around 11% of Diageo's group sales, implying a currency neutral impact of -2% to top line revenues. We expect wholesale inventory to return to normal levels early in 2024, and that this won't be repeated in other regions given the specific issues in Latin America. The company is doubling down, and their advertising spend in the US has almost doubled in the past three years as they invest behind their brands, as we would expect from a market leader looking to capitalise on difficult trading environments.

Within the portfolio, our changes this year were minimal. One new stock which we alluded to in the Q3 Global Fund Letter was **WEC Energy Group (WEC)**. WEC defies the common perception of utilities (especially if you are reading this in the UK or Europe) as it generates substantial growth, on top of its healthy 4% dividend.

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<sup>3</sup> <https://www.proactiveinvestors.co.uk/companies/news/1013637/tesco-in-pole-position-as-asda-and-morrisons-struggle-suggests-jp-morgan-1013637.html>

<sup>4</sup> Please see Diageo's Press Release - <https://www.diageo.com/en/news-and-media/press-releases/2023/diageo-issues-trading-update-due-to-a-weaker-performance-outlook-in-latin-america-and-caribbean-and-updated-medium-term-guidance-ahead-of-2023-capital-markets-event>

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This misconception creates opportunities where the market's habit of trading sectors as opposed to stocks leads to episodic opportunities, such as the one we saw last year when bond yields peaked. Utilities fell so far out of favour last year due to rising interest rates, that outside of Covid, their fall represented the largest drawdown in ten years.<sup>5</sup>

The utilities sector in the US is large and fragmented with many regional players. In our sector framework we believe there are only a handful of "good" utility companies. A good utility should have low physical risks (hurricanes, wildfires, earthquakes), low distributed energy risks (principally solar), high ratepayer bill affordability (allowing for attractive allowed returns) a long runway of reinvestment opportunities, and a strong track record of executing operationally and financially. WEC meets all these fundamental criteria and has delivered a remarkably steady 13% annual return over the past two decades producing roughly double the total return from the market.<sup>6</sup>

We believe the outlook is as bright as ever with the transition from coal to gas and renewables, and electrification requiring enormous investment in upgrading transmission and distribution networks. Consequently, the installed capital base (the "rate-base") is growing 7-8% with high visibility driving similar EPS growth and a 4% dividend yield.<sup>7</sup> This offers a prospective shareholder return of 11-12% per year from today's depressed valuations, with any multiple re-rating presenting incremental upside.

As a cherry on top, alongside the major investment in the energy transition and infrastructure upgrade plans, WEC is positively geared to the structural tailwinds of AI, and from the demands arising from the commensurate datacentre growth as well as the reshoring of manufacturing capacity. This year Microsoft commenced building datacentres in Wisconsin that alone will require an increase in state generation capacity of over 10%, and we expect more to come.<sup>8</sup>

The only other change made this year was minor, switching **Equinor** into **Shell**, primarily due to Equinor's higher exposure to European gas markets where we see potential price pressure, and also due to the fact it had outperformed Shell by some margin since 2021. We continue to believe the integrated energy sector is exiting a major downcycle and will produce exceptional returns for investors over the cycle to come.

<sup>5</sup> As measured by the maximum drawdown function on Bloomberg of the S&P500 Utilities GICS sector

<sup>6</sup> Total return includes dividend of 4% and EPS growth of 9%, as measured using TRA function on Bloomberg

<sup>7</sup> Please see WEC's latest Investor Presentation where they discuss this in more detail -

[https://s22.q4cdn.com/994559668/files/doc\\_presentations/2024/Jan/09/01-2024-january.pdf](https://s22.q4cdn.com/994559668/files/doc_presentations/2024/Jan/09/01-2024-january.pdf)

<sup>8</sup> Please see the announcement for a \$100m new datacentre to be built by WEC - <https://www.wpr.org/economy/we-energies-plans-100m-project-support-new-microsoft-data-center-law-passed-foxconn-may-exempt-it>

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Oil and gas supply and demand is measured in *barrels per day* “bpd” and, currently, supply and demand are roughly in balance at 102m bpd resulting in steady inventory levels across the industry.<sup>9</sup> This has been achieved principally by the US shale industry maxing out production to hit record volumes, 2m bpd higher than in 2021, and Saudi Arabia maintaining their production 2m bpd lower than full capacity while the residual growth in demand was met by steady increases in supply elsewhere.

Inventory levels have oscillated between 2.5bn and 3.25bn over the past decade, and small changes lead to large moves in oil prices.<sup>10</sup> It’s imprecise but a reasonable rule of thumb is that oil prices move roughly +\$10 for every 75m bpd fall in inventories. A 1m bpd deficit would clearly drive a 365m barrel draw on inventories over a year, causing oil prices to rise c. \$50, 75% higher than they are today. There are plenty of risks to the balance of supply and demand, although it’s worth remembering that Biden’s administration also had to release 230m barrels from government inventory in 2022, a trick that cannot be repeated.<sup>11</sup> Thus far his administration has only managed to buy back 14m barrels.

And what if investors disagree and don’t begin buying these stocks? Then the companies will likely continue buying themselves. BP and Shell have reduced their shares outstanding by 15% in the past two years, a rate which can continue given the extraordinarily high free cash flow if average oil prices are \$80 or above.<sup>12</sup>

On to the other existing holdings which, outside of the consumer stocks, fared very well.

Last year was a tale of two halves for **Sony** although one where the shares rebounded strongly, +35% in local currency. On the one hand, the multimedia company has had to battle a wildly depreciating currency, crosscurrents in their image sensing business and a demand slowdown for TVs as we have fully emerged from the pandemic. On the other, the strength of their media assets has shone through, with the PlayStation franchise, movies business and music streaming performing impressively.

The PlayStation business presents a huge growth opportunity given we are very early in the roll out of the PS5 console. Sony are on track to sell 25m units of their PS5s this year and there remains a long runway of growth ahead; in total, we think they can easily sell five times this number of units if it is anywhere near as popular as the PS4.<sup>13</sup> Next year Rockstar will release the next iteration of the Grand Theft Auto franchise, a ‘blockbuster’ game for PS5 players. The boon for Sony is the *razor blade* model

<sup>9</sup> Please see the December 2023 IEA report - <https://www.iea.org/reports/oil-market-report-december-2023>

<sup>10</sup> As measured by the OECD Commercial World Crude Oil & Liquid Fuels

<sup>11</sup> <https://www.reuters.com/markets/commodities/biden-administration-slowly-puts-oil-back-into-spr-emergency-stash-2024-01-04/>

<sup>12</sup> At \$80 oil we roughly estimate BP and Shell to trade on free cashflow yields of 15%+

<sup>13</sup> See Sony’s webcast at their last FY23 Q2 results where they disclose their unit sale forecast for the Financial Year 2023 (ending March 2024) [https://www.irwebmeeting.com/sony/vod/20231109/c5mxzn6e/202403\\_2q\\_02\\_en/index.html](https://www.irwebmeeting.com/sony/vod/20231109/c5mxzn6e/202403_2q_02_en/index.html)

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of growing an installed base of console customers, who are then drawn to buy more games and additional services which are high margin and accretive to profits (whereas the console is often sold at cost or even at a loss). Moreover, the prevalence of online gaming has created a powerful network effect in the form of their high margin online and digital platform, adding a layer of subscription revenue on top of the other one-off goods and services.

The music business also continues to go from strength to strength. Few end consumers are quite aware of the power of the back catalogue of songs Sony has with over 40 of the Spotify Global Top 100 belonging to their publishing label. Mega stars like Harry Styles, Beyoncé and Miley Cyrus belong to their roster of talent and you can tell the allure – their streaming growth has comfortably exceeded 20% this year.<sup>14</sup> With 70% of US listening coming from songs created over 8 years ago, the back catalogue compounds, becoming increasingly attractive over time, in our view.

When you account for the tremendous amount of cash on their balance sheet, and smaller minority companies they own, a PE multiple of 17x (or 6% yield) is an attractive valuation for a business that owns three of the most important multi-media assets in an increasingly digital age.

**McKesson** was a new addition to the portfolio in 2022 and performed well in 2023, rising 35% to an all-time high price of \$485 compared to our purchase price of \$353. The shares trade on 16x PE and offer prospective growth rates in line with the past of c.15% per year. On top of this, margins are trending towards the low end of their potential, and historic, ranges. Given the growth in their higher margin speciality businesses, as well as the potential growth in margin from the boom in GLP-1s, we expect margin expansion to add to this underlying growth rate over the coming years.

**AutoZone** continued to deliver strong performance. We have discussed it extensively in the past and recorded an hour-long podcast in 2021 which explores in depth our thesis for the business. Like many great investments, things only change slowly at AutoZone, so this podcast is as relevant now as it was then.<sup>15</sup>

The business continues to perform as expected, having grown EPS at 20% per year over the Covid period it's likely we see slight moderation, but the strong structural trends remain in place. The stock returned +5% last year although their competitor **Advance Auto Parts** fell heavily as it became clear that AutoZone's success in the commercial sector (selling to garages as opposed to individuals) has been at their expense, costing the fund 2% of performance this year when we exited our holding. Since inception the shares produced a modest positive contribution of 0.5%, alongside a reminder of the

<sup>14</sup> Please see linked article <https://themusicnetwork.com/sony-music-2020-market-share/>

<sup>15</sup> <https://www.joincolossus.com/episodes/58967817/lait-autozone-exemplary-capital-allocation?tab=transcript>

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risks when investing in anything but the strongest business models in an industry. Given our knowledge of the Auto Parts sector we felt the opportunity for Advance was there, although misjudged the strength of the competitive advantage enjoyed by AutoZone meaning that the town wasn't big enough for both of them.

Our financial stocks did very well this year. **JPMorgan** returned +31%, **Visa** +26%, **Goldman Sachs** +16% and even **Bank of America** produced a +5% return despite the market's concerns regarding their US treasury holdings (misplaced, in our view – see our Q1 2023 letter for full details).<sup>16</sup>

Most financial businesses generate *ad valorem* income. Visa charges a fixed percentage of all transactions processed on their network, while banks earn a spread on their deposits while charging value-based fees for their asset management, investment banking, and trading businesses. This offers high quality financial stocks, such as ours, an implicit inflation protection: higher inflation and a greater circulation of money go hand in hand, leading to higher profits.

While economic crises may be bad for financial businesses, the response to, and recovery from crises creates lasting value for the strongest franchises. Weaker competitors lose market share (payment startups, challenger banks etc) and central banks print their way to prosperity. This is precisely what we have seen following Covid and following the mini crisis with Silicon Valley Bank early last year, cementing our companies' market positions and competitive advantages. To the victor go the spoils, with JPMorgan acquiring the remnants of First Republic on highly attractive terms.

**Eiffage**, **Vinci** and **Air Liquide** had great years in 2023, delivering 9%, 27% and 36% returns respectively. Eiffage and Vinci are highly comparable, and little has changed in the businesses since last year. Cash flow remains robust and marginally ahead of our expectations and valuation remains highly attractive (9x and 12x PE respectively), especially when viewed through the lens of *private* infrastructure deals which are still being reported at cash flow multiples of 2-3x the market price for these stocks.

2023 was a good year for Air Liquide which remains the cheapest of the three large industrial gas businesses globally, with the highest potential upside in our view. They operate in virtual oligopolies in the local markets they serve with a diverse range of chemical, manufacturing, metal, energy and semiconductor customers. We believe the shares do not deserve to trade materially cheaper than its peers Linde and Air Products. Indeed, when you account for the differences in accounting (energy pass through costs) it is even less clear why there is such a difference.

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<sup>16</sup> [https://assets-global.website-files.com/5dc99409fd85fd74b0e70183/642eddc3e220973fe45ebaf\\_Q1%202023%20Investor%20Letter.pdf](https://assets-global.website-files.com/5dc99409fd85fd74b0e70183/642eddc3e220973fe45ebaf_Q1%202023%20Investor%20Letter.pdf)

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Organic sales growth has been 4% for the last four quarters, and we believe this strong secular growth will continue. The Industrial Merchant business progresses from strength to strength, as price increases continue to offset energy input inflation (c. 10%) and volumes increase in manufacturing, construction, and food. In Europe, where the bulk of Air Liquide's Large Industrial business is, revenues have slowed as the region grapples with an industrial slowdown caused, in large part, by the fall in competitiveness due to the energy crisis. What has been pleasing to see though, is that the strong decarbonisation trends in this region continue, with Air Liquide winning big contracts for carbon reduction with Verallia (the world's third largest glass producer), Holcim (a large cement company) and Total Energies (an energy company).<sup>17</sup>

The profits of the burgeoning Healthcare and Electronics businesses are also becoming more important as these higher growth verticals become a larger part of the mix. Ageing populations require more medical care over a longer period of time, which coupled with shortfalls in healthcare spending means there is a strong demand for as much outpatient care as possible. Outside of the French market, a focus on quality of supply rather than price competitiveness from the healthcare systems is bringing price increases back to the market which will also benefit Air Liquide long term.

Finally, we've held **Alphabet** since inception, and it had another strong year. Despite shares returning 58% last year they remain inexpensive in our view. We see Google Search as a major gatekeeper or, almost, a "master landlord" of the internet. As ecommerce continues to grow, online advertising is displacing rent (around 10% of retailers' sales) as a required cost to do business. There are risks to this view (although Microsoft's Bing isn't one of them) and the most notable of these would be Apple breaking their relationship with Google as their default search engine. That said, we estimate Google pay Apple \$18bn per year for this privilege which, if you capitalise at Alphabet's prevailing PE ratio of around 20x equates to \$360bn of gross savings, or 20% of market cap.<sup>18</sup> Their Deep Mind integration a few years ago puts them in a strong position if AI does become as dominant as market prices would have you believe. The good thing in our view is that at this price, you're not paying for it yet!

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<sup>17</sup> Please see Air Liquide's financial reporting in 2023 where they detail recent client wins - <https://www.airliquide.com/investors/documents-presentations>

<sup>18</sup> The estimate came out in a disclosure in court from University of Chicago this year. We had long estimated it to be around \$20bn. <https://www.cnbc.com/2023/11/14/google-pays-apple-36percent-of-safari-search-revenue-sundar-pichai.html>

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All told it was another solid year, with a couple of standout performers (in both directions), 75% of our stocks contributing positive total returns and strong levels of aggregated earnings growth across the board.

Thank you for reading and making it this far! We own a wonderful collection of businesses in a range of industries, with two things in common: they grow durably, and their stock prices are well below our estimate of a fair price.

The diversity of our exposure is an intrinsic strength, as we aren't tethered to the success of a single market environment or any one particular theme and can take advantage of major mispricing when it occurs.

It remains our contention that, over time, price follows value, which comes from growth. While noting the overall drop in valuation for our portfolio, it remains our opinion that this devaluation is temporary, due to the market's present obsession with popular stocks elsewhere. If our companies carry on performing as they have in the past, and we expect them to in the future, their valuations are likely to rise again to reflect this, and returns will be extraordinary for that period.

Our optimism about our future performance is tempered by the expectation that stock markets, particularly in the US, will do far less well in the next decade than they have in the period since 2009.

Despite the *relative* underperformance this year, we believe the defining characteristics of our portfolio make a remarkably compelling investment. We look forward to many strong years for our companies ahead, and even better performance of our stocks.



Freddie Lait

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