

## Monthly Commentary 4<sup>th</sup> November 2015

October was a very strong month for risk assets - especially equities and high yield bonds. World equities were up close to 8%, as they retraced about half their losses from the April highs. US and UK government bonds were very weak, while European bonds held up relatively better. Commodities were slight gainers overall.

The large bounce in equities caught many investors off guard, and this is evident by the lacklustre performance of the long-short equity index. The HFRX Equity Hedge Index is supposed to have the best and brightest managers, but in October they were up less than a quarter of what equities did!

We were not caught off guard. You may recall in our monthly commentary two months ago, we noted:

*"While the short-term technical signals are ominous - pointing to possible further market drops - we view the ongoing falls as an excuse for a correction that the market needed to happen, and to shake off excesses that occur in a secular bull market. The fundamentals are actually quite OK, both in the US and Europe, and both economies are only slightly impacted by exports to China".*

As a result we did not even go underweight our equity allocation as we still believed that the risk reward was in favour of the bulls. We are still of the opinion that equity markets can still climb the walls of worry, and that equities are better positioned than bonds for performance going forward. What is less clear are bets on various sectors, so we are by and large more exposed to broad markets through either ETFs or top funds - mostly institutional. They have performed in line with expectations and we are happy to note that they all participated quite well in the bounce.

### **On Apple**

One equity that we almost universally hold across most of our portfolios, and have done so for a while, is Apple. The information attached on the last page lists some of the reasons we still like it, and why we did not sell it even as it fell as low as \$92 on August 24th. Since then, Apple has bounced back by almost 30%. We would also like to add some anecdotal evidence on Apple's strength as a brand. While visiting Hong Kong 3 weeks ago, we walked by one of the three Apple stores (in Causeway Bay). It was past 9pm and the store was buzzing with shoppers. This is nothing remarkable, as Apple stores generally attract big crowds in most cities. What was an eye-opener was the number of hawkers selling the brand new iPhone 6s on the sidewalk outside the Apple store. The store had run out and these enterprising individuals were selling them at a premium to what they could have been bought at the store only 3 meters away. Needless to say we witnessed quite a few Hong Kong dollars changing hands.



The Apple Store in Causeway Bay, Hong Kong at 9:30pm



One of many hawkkers outside the Apple store with three iPhone 6s on sale



# Why Apple?<sup>1</sup>

## Product sales surging...

| Net Sales by Product:  |                   |            |                   |           |                   |
|------------------------|-------------------|------------|-------------------|-----------|-------------------|
| iPhone (1)             | \$ 155,041        | 52%        | \$ 101,991        | 12%       | \$ 91,279         |
| iPad (1)               | 23,227            | (23)%      | 30,283            | (5)%      | 31,980            |
| Mac (1)                | 25,471            | 6%         | 24,079            | 12%       | 21,483            |
| Services (2)           | 19,909            | 10%        | 18,063            | 13%       | 16,051            |
| Other Products (1)(3)  | 10,067            | 20%        | 8,379             | (17)%     | 10,117            |
| <b>Total net sales</b> | <b>\$ 233,715</b> | <b>28%</b> | <b>\$ 182,795</b> | <b>7%</b> | <b>\$ 170,910</b> |

## Gross margins are growing in an unbelievably competitive environment...

### Gross Margin

Gross margin for 2015, 2014 and 2013 is as follows (dollars in millions):

|                         | 2015             | 2014             | 2013             |
|-------------------------|------------------|------------------|------------------|
| Net sales               | \$ 233,715       | \$ 182,795       | \$ 170,910       |
| Cost of sales           | 140,089          | 112,258          | 106,606          |
| <b>Gross margin</b>     | <b>\$ 93,626</b> | <b>\$ 70,537</b> | <b>\$ 64,304</b> |
| Gross margin percentage | 40.1%            | 38.6%            | 37.6%            |

## Dividend growing...

### Earnings per share:

|         |         |         |         |
|---------|---------|---------|---------|
| Basic   | \$ 9.28 | \$ 6.49 | \$ 5.72 |
| Diluted | \$ 9.22 | \$ 6.45 | \$ 5.68 |

### Shares used in computing earnings per share:

|         |           |           |           |
|---------|-----------|-----------|-----------|
| Basic   | 5,753,421 | 6,085,572 | 6,477,320 |
| Diluted | 5,793,069 | 6,122,663 | 6,521,634 |

|                                   |         |         |         |
|-----------------------------------|---------|---------|---------|
| Cash dividends declared per share | \$ 1.98 | \$ 1.82 | \$ 1.64 |
|-----------------------------------|---------|---------|---------|

## Shares outstanding are dropping due to aggressive share repurchasing...

The following table shows the computation of basic and diluted earnings per share for 2015, 2014 and 2013 (net income in millions and shares in thousands):

|  | 2015             | 2014             | 2013             |
|--|------------------|------------------|------------------|
| <b>Numerator:</b>                      |                  |                  |                  |
| Net income                             | \$ 53,394        | \$ 39,510        | \$ 37,037        |
| <b>Denominator:</b>                    |                  |                  |                  |
| Weighted-average shares outstanding    | 5,753,421        | 6,085,572        | 6,477,320        |
| Effect of dilutive securities          | 39,648           | 37,091           | 44,314           |
| <b>Weighted-average diluted shares</b> | <b>5,793,069</b> | <b>6,122,663</b> | <b>6,521,634</b> |
| Basic earnings per share               | \$ 9.28          | \$ 6.49          | \$ 5.72          |
| Diluted earnings per share             | \$ 9.22          | \$ 6.45          | \$ 5.68          |

## Performance vs major indices shines...

|   | September 2010 | September 2011 | September 2012 | September 2013 | September 2014 | September 2015 |
|---|----------------|----------------|----------------|----------------|----------------|----------------|
| Apple Inc.                                  | \$ 100         | \$ 138         | \$ 229         | \$ 170         | \$ 254         | \$ 294         |
| S&P 500 Index                               | \$ 100         | \$ 101         | \$ 132         | \$ 157         | \$ 188         | \$ 187         |
| S&P Information Technology Index            | \$ 100         | \$ 104         | \$ 137         | \$ 147         | \$ 190         | \$ 194         |
| Dow Jones U.S. Technology Supersector Index | \$ 100         | \$ 103         | \$ 134         | \$ 141         | \$ 183         | \$ 183         |

## These are some of the reasons why Elgin is invested in Apple Inc.

<sup>1</sup> All tables above are extracted from the companies latest 10-K filing with the SEC.



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