The realization that 7% of the world’s population participates in the global formal economy should strike you between the eyes. It certainly got my attention. I was at a conference in Bellagio, Italy last October having dinner with a man named Vijay – one of India’s leading venture capitalists. He casually dropped the factoid that 93% of the human capital in the world is not connected to the tax system, capital markets, or wage structures that most folks reading this assume apply to everyone. The reflex to these realizations is to define a “social” problem. Our job is to help investors see them as serial opportunities for outperformance.

What if “social” dislocations – like 93% of the world’s population being disconnected from the formal economy – could be structured as markets? Markets with common elements to their consumer demand and labor supply functions that can be met in the open market. This is how our team views people with disabilities.

Let’s assume that “social” can be articulated as a market. Let’s even assume that the right large scale adjustments to demand yield outperformance. Time horizon becomes a factor in this investment thesis. Clearly, this is not a high-frequency strategy. These types of fundamental macro adjustments take years – sometimes decades – to cycle through the economy. Quarterly EPS updates are less critical than robust long-term customer acquisition strategies that are monitored for signs of traction and long-term profits. Think innovation leap rather than marginal growth.

It takes an investor with an appreciation for the long-run to capture the bulk of these returns. These investors craft portfolios that “own the market” with corresponding liabilities tending to perpetuity. As institutional investors shift from “social” investing to non-traditional market investing over the next 10 years, long-term investors are best positioned with their ability to shift assets to the parts of the investable universe that lead and outperform. Their extended time horizons allow them the strategic view to both demand operational change and to be patient with results.

While the macroeconomic story for disability markets is impressive – 1.3 billion people influencing $8 trillion in annual disposable income – investors allocate to vehicles that reflect microeconomics. Investments flow to investible vehicles – stocks, bonds, and less liquid assets.
Revenues and costs create cash flows that increase or decrease the value of these investments. Finance professionals spend an incredible amount of time and treasure isolating and quantifying the factors that drive revenue and cost. The same analysis can be performed relative to non-traditional markets, through the lens of a specific firm or set of assets.

The Return on Disability Model contains the 30 factors that our team uses to observe corporate activity relative to disability markets. Via independent primary research, we analyze 1,500+ large cap public companies in the United States and Canada for those actions in disability markets that increase revenue and/or decrease cost. These factors encompass actions to delight customers, attract/engage the best talent, and maximize productive assets. Each firm receives a score based on these factors. The universe is then ranked based on their Return on Disability Score, with the top 100 US-based firms placed into an equal-weighted equity index.

Since January 1, 2012 the RoD US LargeCap ETN TR USD Index has returned 16.81% annually, with a beta to the S&P 500 Total Return Index of 1.06. The benchmark Index has an annual return over the same period of 15.09%. Investing in companies that act to create shareholder value in disability markets has yielded outperformance each year since inception ranging from 6.68% in 2013 to a minimum outperformance of 1.12% in 2014. The average annual outperformance since inception has been 2.53% above the S&P 500 TR Index.

A key question is: why do companies that act to create value in disability outperform their peers? We have found that companies that listen to and act to attract people with disabilities are highly responsive to their customer – maximizing revenue. Firms that seek out and engage the best talent that happen to have disabilities are in search of the best talent in general – driving costs down. Many firms have leveraged innovation from the way people with disabilities use things and environments to make their assets more

Historical Performance
Bloomberg Ticker – RODITR

Growth of $1,000

RODITR Index
SPXT Index
productive. In the short-run, specific actions in disability markets at a certain scale signal the existence of a great franchise. Great franchises act in ways that produce above average returns.

The long-run is more interesting for these companies. They are best positioned to capture excess returns as the global disability market matures over the next two decades. The catalysts are many, but the most interesting ones for us are aging Baby Boomers and the shifting importance of people with disabilities in China and India. According to the US Census, 52% of those aged 65+ have at least one disability. Baby Boomers – the wealthiest cohort in human history – will not retire like their parents did. They will remain active consumers well into their 90s and brands wishing to capture that spend must adapt to their functional demands.

While only 5% of our current LargeCap North American universe is acting on disability markets to add shareholder value – implying room for more companies to act – China and India extend that maturity model past the immediate horizon. Conservatively, there are 500mm people with disabilities in China and India who have begun to shape their identities. As they become part of their societies, a second wave of growth follows 10-15 years out.

The companies that outperform in disability markets tend to face an end consumer and are in constant search of growth. The best firms are concentrated in Discretionary, Financials, Health Care, and Technology. The top performers in terms of average monthly stock returns are in the Technology sector, which also score the highest on the Return on Disability model analysis. The worst performers on the Return on Disability model scores are Health Care firms.

We observe that most Health Care firms view disability as a clinical issue to be fixed as opposed to a set of Customer demands to be served. This is cemented by the fact that correlations between Return on Disability scores and stock returns are highest in Heath Care. Customer focus builds higher returns in Health Care over a
focus on clinical science.

Technology firms have adopted a disability focus at a faster rate than other firms. FAANG + MSFT stocks embody this business impact, particularly on the revenue side through product development. The “drive” to automated cars has disability at its core, with Waymo (formerly Google Car) putting users with vision issues at the “lead” of development. You can almost hear the R&D rallying cry – “Build a car that a blind guy can drive” – and that is what they did. Alphabet is the #1 ranked firm in our research universe of 1,500+ LargeCap public companies.

The key to this approach is to apply insights from the way people with disabilities experience products and environments to the core user experience. Apple would never make an iPhone Disability Version – simply because it would not sell. Apple does study how customers with disabilities consume data and information. They package those insights into the next refresh and improve the user experience for the core customer as well as people with disabilities. As investors realize the power of these innovations to drive revenue growth, stock premiums will be re-valued to reflect more than backward-looking sales growth and EPS surprises.

As this is my first investor letter, I lay the framework for our investment thesis that connecting non-traditional markets – beginning with disability – to revenue growth and cost reduction drives outperformance for investors. My view is that investors cannot effectively invest in “issues” for consistent risk-adjusted performance (I’m being diplomatic here). Once those “issues” are converted into market demand and supply, they can then be measured in transactions that generate revenues and costs. Revenues and costs can then be assessed for impact on shareholder value. In coming issues I will explore fundamental aspects of those impacts on shareholder value and review that period’s index results. I invite discussion and suggested topics.

Our firm believes that “Sustainable” investing must evolve to a market-based footing. While that starts with factors that drive returns – a major leap unto itself – other factors such as investability and management accountability must be a material part of the conversation. This is our challenge. Demand and the metrics that connect demand to revenue and cost are critical to delivering returns to investors. “Social” change occurs once that demand is fulfilled. “Social” change is a result of attracting, delighting and hiring the non-tradition market. The good news for investors? That change is aligned with material outperformance.

Respectfully,

Rich Donovan
CEO and Chief Research Officer
July 24, 2017

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