“What is true quality really worth?”

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2 An active Quality equity approach for long-term sustainable growth

SUMMARY: Clyde Rossouw, Simon Brazier and Neil Finlay discuss the unique characteristics of an active Quality approach and its suitability for long horizon investors. Strategic thinking, active ownership, stakeholder awareness and engagement will be important drivers of long-term performance. Implemented through a high conviction, focused, low-turnover portfolio, an active Quality approach is well-placed to deliver long-term sustainable growth, development and value creation.

"Short-termism can lead to insufficient investment in the sources of a company's competitive advantage, and capital allocation decisions that are value destructive and misaligned with the long-term needs of investors" Clyde Rossouw – co-head of Quality, Investec Asset Management

The Quality approach to long-term sustainable investing

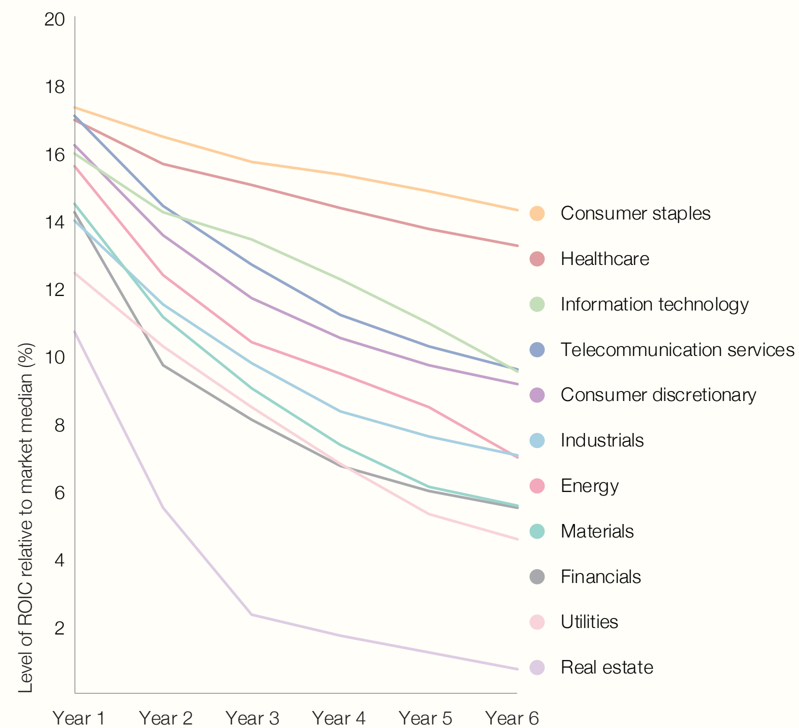
Before assessing its suitability to long-term investing, we first need to define what we mean by 'Quality'. Quality companies have hard-to-replicate, enduring competitive advantages, typically derived from intangible assets, such as brands, patents, copyrights, licenses and distribution networks. These competitive advantages create barriers to entry that allow such companies to sustain high levels of profitability, as measured by both return on invested capital (ROIC) and margins. Quality companies often have dominant market positions, operating in stable, growing industries, with low sensitivity to the economic and market cycle. With a focus on intangible rather than physical assets, they are capital light, financially strong and highly cash generative.

These unique attributes are ideally suited to long-term investing. The Willis Towers Watson (WTW) Thinking Ahead Institute[1] highlights a number of building blocks of value creation via long-term investing, which can be broadly summarised under two headings: 'long-horizon return opportunities'; and 'cost-reduction and loss-mitigation strategies'.

Long-horizon return opportunities – ROIC and margin sustainability

We have studied the extent to which companies with high ROIC experience mean reversion or a decay in those returns over time. We analysed the top quartile of companies in each MSCI ACWI sector, as measured by ROIC, and calculated the average fade rate over rolling five-year periods between 1988 and 2016[2]. We found that certain sectors not only started with higher levels of profitability (ROIC), but also did better at sustaining those profits over time. As illustrated in Figure 1, the sectors achieving this have been consumer staples, healthcare and information technology; where Quality companies and enduring competitive advantages are most prevalent.

Figure 1: Significant divergence in ROIC decay profiles by sector for companies with Q1 ROIC

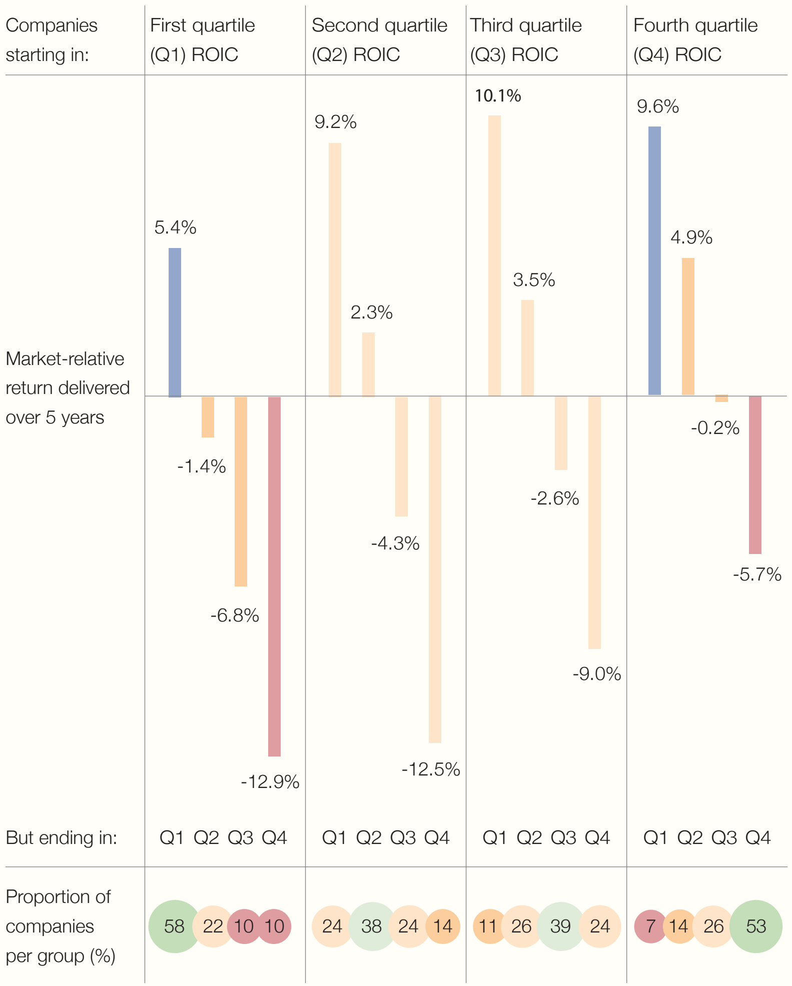


Source: Investec Asset Management, FactSet, 1988-2016

Our research also revealed that investing in companies with top-quartile ROIC has been most likely to deliver strong long-term shareholder returns. Over the analysis period, 58% of companies that started with top-quartile ROIC were able to maintain that over a rolling five-year period. These Quality companies delivered outperformance of 5.4% p.a. on average versus the market, as illustrated in Figure 2 on the following page.

[1] Willis Towers Watson Thinking Ahead Institute: https://www.towerswatson.com/en-GB/Services/Services/Thinking-Ahead-Institute
[2] Please refer to our 2016 paper 'Equity investing the Quality way' for the full methodology.

Figure 2: Investing in companies with Q1 ROIC is most likely to provide strong returns after five years



Source: Investec Asset Management analysis of Factset and MSCI data.
Note: Quarters are cumulative as at 31.12.16.

[3] We have used the operating profit (EBIT) margin rather than the gross profit margin as this is more comparable across companies and industries. For certain businesses the gross margin is either irrelevant or not reported by the company. The operating profit margin is often referred to as the earnings before interest & tax (EBIT) margin.

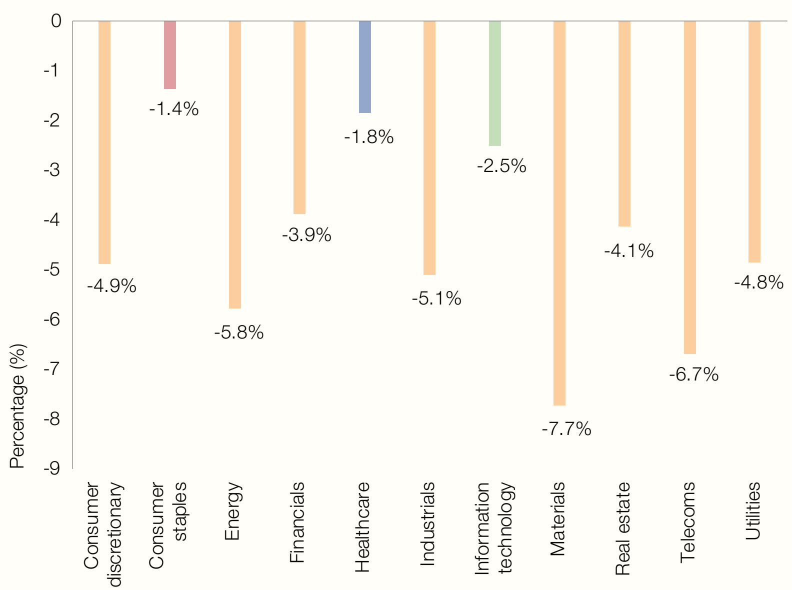
As a company's ROIC is partly a function of its margin profile, the logical next step is to examine profit margin sustainability, here represented by the operating profit margin[3]. A decline in a company's ROIC can be caused by a variety of factors. However, at a high level it is typically a function of: 1) declining sales, 2) an inflating asset base without a corresponding rise in profits, 3) falling profit margins. Therefore, in order to better understand ROIC convergence, we must also understand the likelihood for margins to mean revert.

Margins can fall for a number of reasons. Cyclical pressures on overall company volumes can result in declining sales, creating reverse operational leverage from the fixed cost base. Rising expenses, such as the price of inputs used to manufacture a product, may not be recouped by passing on the cost to end customers. Alternatively, newly introduced regulations can push up the cost of doing business for market participants and limit the potential for future price increases. Most worrying, perhaps, competitive forces can incite pricing pressure on goods and services, resulting in falling margins. While margin pressure from cyclical forces will typically vary through time, competition can be a more perpetual force. This is why the durability of a company's competitive advantage is so important.

Similar to our prior work (*Equity Investing the Quality Way*, May 2016), we examined the extent to which top-quartile (Q1) margins (i.e. companies with margins in the top 25% of the universe) fall over a rolling five-year period between 1988 and 2016, breaking the universe down into its respective GICS sectors[4]. Figure 3 shows the average total decline for Q1 margins by sector. In line with our work on ROIC, high margins have also shown a tendency to erode over time and mean revert to the market average. Again, however, consumer staples, healthcare and information technology sectors have demonstrated much greater resilience than other sectors.

[4] The universe base for the purposes of this analysis is the MSCI ACWI, with measurement of margin movements on rolling forward five-year periods from 1988 to 2016. Companies with negative profit margins at the start of the five-year measurement period are excluded, as are those with unsustainably high margins greater than 100% (i.e. above annual sales generated). Furthermore, any companies not classified within the GICS Sector/Industry framework are also excluded.

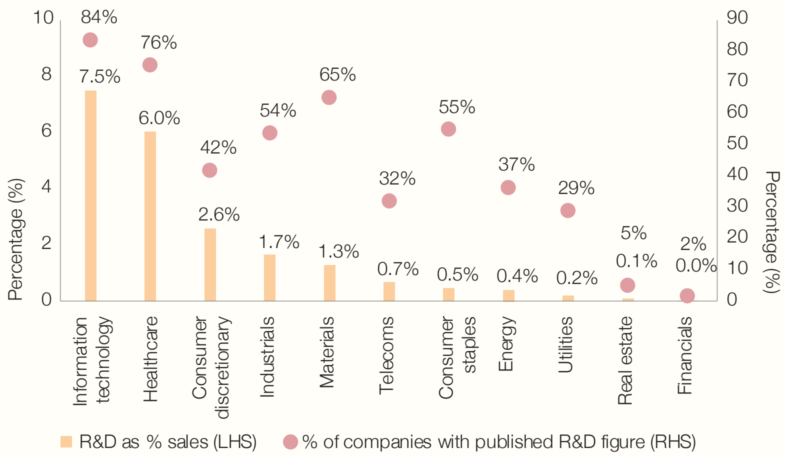
Figure 3: Significant divergence in margin decay profiles by sector for companies with Q1 margins for the period between 1988 and 2016



Source: Investec Asset Management, FactSet, 1988-2016

Significant research and development (R&D) investment has been key to the sustainable growth, ROIC and margin of Quality sectors. R&D investment helps drive product innovation and improves brand awareness and loyalty. This not only contributes to self-funded future growth and employment, but also strengthens barriers to entry and protects companies from disruption and competitive threats. As illustrated in Figure 4, given their consistent cash generation, capital light Quality sectors have typically been able to invest more heavily in R&D as a percentage of sales. The figure for consumer staples is artificially depressed because it includes the food and staples retailing sector, which has low levels of R&D spend and is typically avoided by Quality investors, and also because it excludes advertising and promotion (A&P), which is a significant expenditure for consumer staples companies to support their brands.

Figure 4: R&D investment drives innovation and helps sustain a company's competitive advantage



Source: Investec Asset Management, FactSet, 31.03.17

Overall, investment in the sources of a company's competitive advantage, through R&D and A&P, is a key factor in its ability to sustain ROIC and margins and, as a result, deliver long-term value creation.

Long-horizon return opportunities – active ownership and stakeholder relationships

As typically long-term shareholders, Quality investors are ideally placed to engage actively with company management and ensure that capital allocation is fully aligned with the long-term interests of shareholders. Active ownership and engagement helps to assess, and raise if appropriate, governance issues such as risk management, board balance, audit, remuneration, and shareholder rights. Importantly, this can also be extended under a Quality approach to capture stakeholder, as well as simply shareholder value.

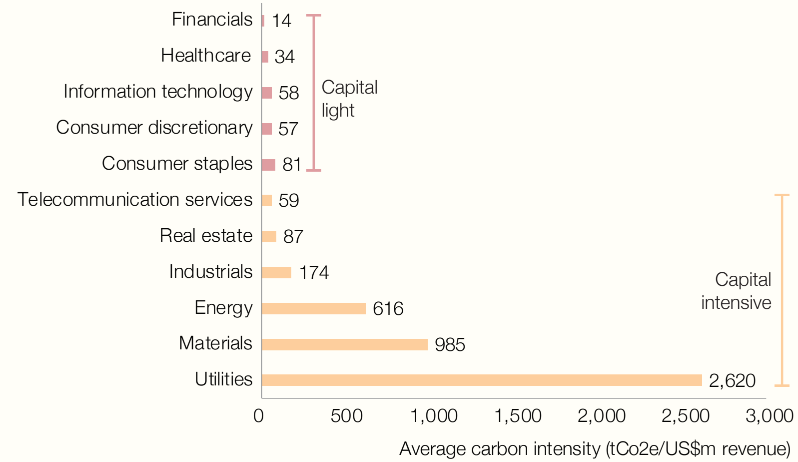
The think-tank, SustainAbility, defines a stakeholder as "any individual or group that may affect or be affected by a company's activities".

A non-exhaustive list of stakeholders includes not just management teams and shareholders, but also governments, regulators, society, employees, customers, competitors and suppliers. The 2006 Companies Act in the UK is explicit on the role the board of directors must play to promote the success of a company. Directors must consider the long-term consequences of the decisions they take, and the interests of the company's 'members as a whole'. In the 2012 *Kay Review of UK Equity Markets and Long-Term Decision Making* Kay argues, "long-run business success depends both on the relationships that companies enjoy with their stakeholders, broadly defined; and on the legitimacy and sustainability of the market economy in which they operate".

A company's business practices and capital allocation decisions need to foster strong and sustainable relationships with all key stakeholders. The range and importance of stakeholders will vary by company, but in all cases these relationships are not just a matter of corporate social responsibility, but a prerequisite for delivering growth and sustainable development. Successful engagement with stakeholders can provide important business and customer intelligence, open new markets, reduce risk, improve supply-chain efficiency, build brand loyalty and reputation, and support creativity and innovation. It can lead to improved employee satisfaction, which itself can lead to enhanced productivity, as well as talent retention and attraction. Companies with sustainable business models, and business practices that support the society and environment in which they operate, can enhance their returns and cashflow, and lower their risk and cost of capital. Building and sustaining strong stakeholder relationships can itself be a key competitive advantage, supporting long-term value creation. Gaining a deeper insight into a company's suppliers, customers and competitors can help to generate new investment ideas for Quality investors.

One important example where Quality companies are well-aligned with stakeholders is climate change. Quality investing avoids the most capital intensive areas of the market, with typically the worst CO_2 emissions, such as energy, materials and utility stocks. Many Quality companies are also actively increasing their focus on sustainable business practice – in some cases, with clear carbon footprint targets. Using MSCI analysis and 2015 data from the Carbon Disclosure Project, Figure 5 shows the significant differences in carbon intensity between companies in capital light versus capital intensive sectors of the market (as measured by tonnes of CO_2 equivalent per million US dollars of revenue). The average carbon intensity is significantly lower in capital light Quality sectors.

Figure 5: Average carbon intensity significantly lower in capital light Quality sectors



Source: MSCI ESG research, 2015

Long-horizon return opportunities – capturing systematic mispricing

As described, the market undervalues the ability of Quality companies with enduring competitive advantages, disciplined capital allocation and a focus on sustainability, to deliver persistently high ROIC and margins. This, in itself, is a systematic mispricing of quality stocks on a long-term view, of which the patient active quality investor can take advantage.

A quantitative Quality approach, alone, does not capture the full extent of the long-term mispricing. Active qualitative research is essential to fully assess the sustainability of a company's business model, competitive advantage and stakeholder relationships. Commonplace headline

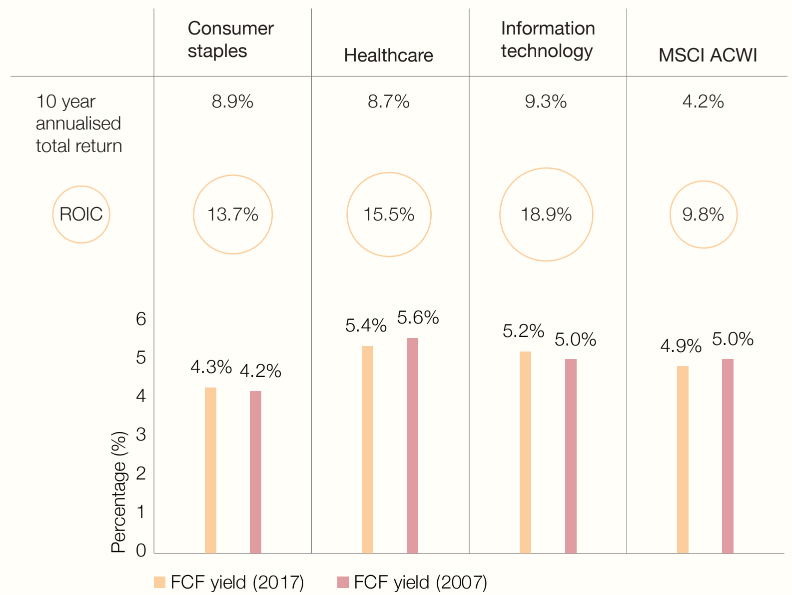
Quality metrics may not by themselves show, for example, how strong a company's competitive positioning and market share really is, the impact of short-term currency movements, its dependence on the economic cycle, its relationships with key stakeholders, or business tail risks, such as regulatory risk or over-reliance on a single product, market or customer. Aggressive accounting and financial engineering can distort earnings-based metrics, giving a false picture of the actual health of a company, and even fairly reported figures can be misleading. For example, high margins may reflect under-investment rather than pricing power or cost efficiency. Overall, different levels of disclosure, accounting treatments and calculation methodologies, as well as corporate activity leading to one-off gains or losses, all make cross-company comparisons difficult using solely a passive or quantitative-based approach. In-depth proprietary company research can exploit the long-term pricing inefficiencies not captured by a pure passive or quantitative approach.

An understanding of valuation is important, as how much the market is willing to pay for a company's earnings and cashflows is a key determinant of long-term performance, not just the earnings and cashflows themselves. Here, however, the right valuation approach is required. Although commonly used by investors, we believe that the price earnings (PE) ratio as a valuation measure is a blunt tool. The metric takes no account of how much debt a company holds and, therefore, how risky its balance sheet is. As a result, it unfairly penalises unlevered businesses, especially in an environment where debt servicing costs are low. The earnings figure is based on accrual accounting, which can be influenced by a variety of factors that obscure the underlying operating performance of the business. Furthermore, no account is made of the quality of those earnings, and whether they represent a high or a low return on the capital invested in the business. This does not necessarily mean that one should ignore PE valuations, but we believe there are other measures, such as enterprise value to operating profit and free cashflow (FCF) yield that better determine whether a stock is expensive or cheap.

The enterprise value includes the net debt, as well as the market capitalisation of a company. It therefore accounts for the use of leverage and is more reliable when comparing companies with different corporate structures and different accounting or tax regimes. This is critical in an increasingly cross-border and global investment environment. The FCF yield accounts for the price paid for a stock relative to the level of free cash the company generates (its operating cashflow minus capital expenditure). FCF yield captures the actual tangible cash-generating power of the business. It also better reflects the available cash that can be used to reinvest in the business for growth, or to service debt, or be returned to investors through dividends and share repurchases.

In Figure 6, our preferred sectors – consumer staples, healthcare and information technology – have outperformed over the last 10 years. However, this performance has not come from a re-rating; with FCF yields in line with history. Additionally, these sectors continue to exhibit ROIC significantly in excess of the wider market.

Figure 6: Relative valuations remain attractive for Quality stocks



Source: Investec Asset Management, as at 31.05.17

Again, an active approach is key, ensuring valuation methodologies used are appropriate and consistently applied, and crucially that valuations are put into context, for example: longer-term history; valuations of competitors; the wider equity market and other asset classes; a company's stage in the cycle; and the quality, growth and risk characteristics being paid for. If one business is of far higher quality, exhibiting a consistently high ROIC, with defensible market positions in a growing market, investors should be willing to pay a differentiated valuation versus a structurally challenged, commoditised, ex growth business. When put into context, we do not believe that current valuations of Quality stocks are overly stretched.

Cost reduction and loss mitigation – minimising transaction costs and avoiding permanent capital loss

Finally, as well as achieving gains, equally important to long-term returns is avoiding losses and unnecessary transaction costs. The effect of compounding is as powerful on costs as it is on returns, so that even seemingly small transaction costs, from excessive trading, can prove meaningful over the long term. The tangible costs associated with short-term trading are unavoidable, creating a headwind to performance. Potentially more damaging, however, is the cost caused by futile attempts to time the market or chase short-term performance, often leading to significant 'buy-high sell-low' errors.

With regards to risk management, we believe investor attention should not be focused on benchmark risk or tracking error, particularly when the index itself carries inherent risks. The defensive characteristics of Quality companies mean they may lag strongly rising markets, but what is most important is the ability to avoid permanent capital loss. In other words, provide downside protection and avoid losses that are never subsequently recovered. This is essential to benefit fully from the power of compounding.

Again, Quality companies are a natural fit. Defensive recurring revenues, often driven by repeat purchases of low-ticket everyday items, together with barriers to entry created by enduring competitive advantages, reduce business and operational risk. Healthy balance sheets and strong consistent cash generation reduce financial risk, as self-funded cash generative businesses are less dependent on capital markets for liquidity,

which makes them more likely to survive market downturns when capital may be in short supply. Capable experienced management teams, aligned with shareholders and other key stakeholders, reduce capital allocation risk. Together with valuation risk, these are the absolute risks that, if not appropriately managed, can lead to permanent capital loss, jeopardising long-term performance.

Bringing it all together

In his assessment of the asset management industry, Andrew Haldane, executive director of financial stability at the Bank of England, concluded in his speech on 'The age of asset management?', given at the London Business School in 2014, that "Capital that can afford to be patient, should be patient". There are number of ways in which a portfolio's risk and return profile can be improved through long-term investing. An active Quality approach, driven by in-depth proprietary fundamental analysis, and implemented through a high-conviction, focused, low-turnover portfolio, is well placed to capture the benefits of long-term investing, and deliver strong performance with below average levels of risk.