Long-term investing – an active Quality equity approach

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LONG-TERM INVESTING – AN ACTIVE QUALITY EQUITY APPROACH

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About Investec Asset Management

Investec Asset Management is a specialist investment manager, providing a premier range of products to institutional and individual investors. Employees are equity stakeholders in the firm. Established in 1991, the firm has been built from a small start-up into an international business managing approximately US$124 billion* on behalf of third party clients. We have grown from domestic roots in Southern Africa and the UK to a position where we proudly serve a growing international client base from the Americas, Europe, Asia, Australia, the Middle East and Africa. We employ 198 investment professionals. The firm seeks to create a profitable partnership between clients, shareholders and employees, and to exceed clients’ performance and service expectations. Investec Asset Management is a significant component and independently managed entity within the Investec Group, which is listed in London and Johannesburg.

*As at 30.06.17.
Executive summary

**The case for long-term investing**

- Most institutional and retail investors have long-term investment goals or needs. However, equity markets have been affected by a growing trend of short-termism in recent years, with large-scale ramifications for long-term shareholder value, economic growth and investment.

**Quality investing for the long term**

- Quality companies have hard-to-replicate enduring competitive advantages that create barriers to entry, enabling such companies to sustain high levels of profitability over the long term. They are capital light, financially strong and highly cash generative, with low sensitivity to economic and market cycles, making them ideally suited to long-term investing.

**Long horizon return opportunities**

- The market undervalues the ability of Quality companies with enduring competitive advantages, disciplined capital allocation and a focus on sustainability, to deliver persistently high returns on invested capital (ROIC) and margins.

- As 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 and other key stakeholders.

**Low cost and loss-mitigation strategies**

- The effect of compounding is equally as powerful on costs and losses as it is on returns. Avoiding permanent capital loss and minimising transaction costs is essential to deliver long-term value creation.

“Short-termism can lead to insufficient investment in the sources of a company’s competitive advantage, as well as capital allocation decisions that are value destructive and misaligned with the long-term needs of investors.”

*Clyde Rossouw* Co-head of Quality
The case for long-term active investment

"Asset managers have a fiduciary duty to meet investors’ needs, ensuring the efficient and appropriate allocation of capital to its most effective use."

Equity markets have been affected by a growing trend of short-termism in recent years. Developments in technology have led to a rapid advancement in the frequency, extent and accessibility of news, as well as the market’s speed of response to that news flow. It has given rise to significant growth in high-frequency trading strategies and electronic trading platforms, as well as an increasingly distant relationship between shareholders and management teams.

Remuneration and incentives at different stages of the investment chain are often more aligned to short-term activity than long-term value creation; from the corporate actions of company management to the commission-based volume and transactional activity of bankers, advisers and analysts. Regulatory and accounting changes across pension and insurance industries have also led to large scale ‘de-equitisation’, while an increasingly fragmented and passive shareholder base has resulted in a lack of ownership and engagement. Management teams are under greater pressure to deliver short-term financial results, as the ‘financialisation’ of companies has led to greater emphasis being placed on quarterly earnings, share price movements and market activity.

This has large scale ramifications for long-term shareholder value, economic growth and investment. Most institutional and retail investors have long-term investment goals or needs. Asset managers act as agents on behalf of investors, who are the ultimate shareholders and beneficial owners of a business. In doing so, asset managers have a fiduciary duty to meet investors’ needs, ensuring the efficient and appropriate allocation of capital to its most effective use. Short-termism can lead to insufficient investment in the sources of a company’s competitive advantage, as well as capital allocation decisions that are value destructive and misaligned with the ultimate long-term needs of investors.

A long-term active approach, with low portfolio turnover to minimise transaction costs, has clear tangible benefits for shareholders. One of the key recommendations of the 2012 ‘Kay Review of UK Equity Markets and Long-Term Decision Making’ was ‘to hold more concentrated portfolios judged on the basis of long-term absolute performance.’ The benefits of long-term active investment have also been laid bare in a 2014 paper by Cremers & Pareek, entitled ‘Patient Capital Outperformance’. Their analysis of retail and institutional equity fund performance in the US between 1986 and 2013 revealed that only high active share managers who trade infrequently outperform on average. According to their results, stocks held by patient and active institutions in general outperform by 2.22% p.a., with outperformance driven by ‘picking safe, Value and Quality stocks and holding on to those over relatively long periods.’

Long-term equity investing has wider benefits as well. As Andrew Haldane, Executive Director of Financial Stability at the Bank of England, argued in his speech on ‘The age of asset management?’ in 2014, shorter-term mandates and passive investing have been proven to increase asset correlations and amplify pro-cyclical swings, reducing risk-taking when it is already weak. The perpetual nature of equity should make it an ideal source of long-term financing to households, companies and governments. If executed effectively, a long-term active approach can play a key stabilising, counter-cyclical role in stressed economic and market conditions. In other words, long-term active investment can be beneficial not just for shareholders, but for the wider economy and society as well.

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The Quality approach to long-term sustainable investing

Before assessing its suitability for 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 attributes are ideally suited to long-term investing. In the remaining sections of this paper, we will assess how a Quality approach can benefit an asset owner's portfolio through value creation via long-term investing. This is broadly summarised under two headings: ‘long-horizon return opportunities’ and ‘low cost and loss-mitigation strategies’.

Long-horizon return opportunities – ROIC and margin sustainability

We have studied the extent to which high ROIC companies 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 2016⁴. We found that certain sectors not only started with higher levels of profitability (ROIC), but also did better at sustaining those profits over time. The sectors that have achieved this have been consumer staples, healthcare and information technology. This is where Quality companies and enduring competitive advantages are most prevalent. See Figure 1.

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. See Figure 2.

⁴Please refer to our March 2016 paper 'Equity investing the Quality way' for the full methodology.
Past performance is not a reliable indicator of future results.

Source: Investec Asset Management analysis of FactSet and MSCI data as at 31.12.16.
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\(^5\). 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 on ROIC, we also examined the extent to which high margin companies experience mean reversion or a decay in that margin over time, again looking at rolling five-year periods between 1988 and 2016, and breaking the universe down into its respective GICS sectors\(^6\). 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.

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\(^{5}\)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.

\(^{6}\)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.

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Figure 3: Significant divergence in margin decay profiles by sector for companies with Q1 margins

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Source: Investec Asset Management, FactSet, & MSCI, as at 30.04.17.
We can dig further into these three sectors and examine the Q1 margin trend by GICS Industry Group\(^7\), as illustrated in Figure 4.

**Figure 4: Significant divergence in margin decay profiles within sectors as well**

<table>
<thead>
<tr>
<th>Industry Group</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Household &amp; personal products</td>
<td>-1.2%</td>
</tr>
<tr>
<td>Food, beverage &amp; tobacco</td>
<td>-1.3%</td>
</tr>
<tr>
<td>Food &amp; staples selling</td>
<td>-2.5%</td>
</tr>
<tr>
<td>Pharmaceuticals, biotech &amp; life sciences</td>
<td>-1.4%</td>
</tr>
<tr>
<td>Health care equipment &amp; services</td>
<td>-3.6%</td>
</tr>
<tr>
<td>Software &amp; services</td>
<td>-0.5%</td>
</tr>
<tr>
<td>Semiconductors &amp; Semiconductor equipment</td>
<td>-1.4%</td>
</tr>
<tr>
<td>Technology hardware &amp; equipment</td>
<td>-4.6%</td>
</tr>
</tbody>
</table>

Source: Investec Asset Management, FactSet and MSCI, 31.12.16.

This evidences how all industries are not made equal, even within the same sectors. The most striking is the disparity within the information technology sector. The relative resilience of the software & services margins compares to a sizable collapse in technology hardware & equipment margins. This should come as no surprise. Hardware is well known to be in a state of perpetual price deflation, as we all experience day to day through the ever-tumbling prices of most basic consumer electronics. A successful software offering, on the other hand, has an ability to entrench its user base, whether that be consumers or enterprises, while the classic ‘build-once-sell-many-times’ model provides a cost structure with both exceptional margins and returns on capital if executed correctly. Strong pricing power is often an end result of an entrenched software offering, helping to future proof the company against inflationary increases in its primary expense line: employee costs.

\(^7\)Industry Group is the second level down within the four level GICS industry classification system.
It must be noted that the significance of the food & staples retailing grouping in Figure 4 is limited due to the small sample size. It is very difficult for any retailing business to generate a Q1 margin relative to a global universe set, given typically small mark-up achieved and high fixed cost base with only limited operational leverage. These businesses also typically hide significant financial leverage through their use of leases, something that will change in the near future as accounting rules bring these leases onto balance sheets. For these very reasons this particular industry group is less attractive to the Quality investor.

Within healthcare, pharmaceutical businesses have demonstrated better margin sustainability largely because of the patent protection provided on drugs. This protection allows companies to accrue strong margins while still spending heavily on research & development (R&D) to fuel future growth. Although some high quality businesses exist within the health care equipment & services industry, such as select medical device manufacturers, this grouping is heavily dominated by companies with commoditised offerings facing significant pressure from large payers within the worldwide healthcare system. This dynamic is again nicely reflected in the margin movements shown in Figure 4.

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 5, 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.

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.
For further information on indices and investment process, please see the important information section. Source: Investec Asset Management, FactSet, 30.06.17.
As 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, therefore, supporting long-term value creation. Equally 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. Through its commitment to responsible capital allocation, Quality investing avoids the most capital intensive areas of the market, with typically the worst CO₂ emissions, such as energy, materials and utility stocks. Many Quality companies are also actively increasing their focus on sustainable business practices – in some cases, with clear carbon footprint targets. Using MSCI analysis and 2015 data from the Carbon Disclosure Project, Figure 6 shows the significant differences in carbon intensity between companies in capital light versus capital intensive sectors of the market (as measured by tonnes of CO₂ equivalent per million US dollars of revenue). The average carbon intensity is significantly lower in capital light Quality sectors.
Figure 6: Average carbon intensity significantly lower in capital light Quality sectors

For further information on indices, please see the important information section.
Source: MSCI, Carbon Disclosure Project, data as at 31.12.15.
As described, we believe 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.

**Active qualitative research**

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

**A full understanding of valuation**

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 7, 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.
Again, an active approach is key, ensuring valuation methodologies used are appropriate and consistently applied, and crucially that valuations are put into context. Such context includes, 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 an attractive, 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.
Low cost and loss mitigation strategies

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 low turnover of the Investec Global Franchise Strategy relative to the average global equity fund (16.0% vs. 48.1% respectively), combined with exposure to highly liquid markets, helps to minimise the transaction cost drag on investment returns. This can be evidenced through average explicit transaction costs of 3bps for Global Franchise, compared to 14bps for the average global equity fund.8

Potentially more damaging, however, is the opportunity 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 long-term 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.

To test a Quality strategy’s ability to provide downside protection, we analysed the performance of the Investec Global Franchise Strategy, as a representative Quality portfolio, over its 10-year history to June 2017. As illustrated in Figure 8, Quality companies have consistently achieved better downside protection than the wider market, and the eVestment Global Large Cap Core peer group median, experiencing significantly smaller drawdowns in each of the five largest down markets over the analysis period.9

The defensive characteristics of Quality companies mean they may lag strongly rising markets. Figure 8 illustrates how important downside protection and minimising drawdowns has been, therefore, together with significantly shorter recovery periods, to the strong performance of Quality investing over the long term.

8Investec Global Franchise turnover average of three rolling 12 month periods to 30.06.15. Transaction costs calculated as an average over three financial years ending 31.12.16.
Average global equity fund data sourced from The Investment Association, based on three year data to June 2015. For more information on calculation methodology please see ‘The Investment Association: Investment costs and performance’ August 2016

9Investec Global Franchise Strategy composite performance, gross of fees, was compared with MSCI ACWI performance and the median strategy performance, gross of fees, of the eVestment Global Large Cap Core peer group, for each discrete period representing the five worst MSCI ACWI drawdown periods since inception of the Global Franchise composite on 31.03.07.
Past performance is not a reliable indicator of future results. Source: IAM, eVestment, Morningstar, 30.06.17. Drawdown periods as defined by MSCI ACWI five largest drawdowns since inception of Global Franchise. Data run monthly. Peer group median defined as median strategy return for defined drawdown time period.
Conclusion: Bringing it all together

Quality companies, by definition, operate in stable, growing industries, with low sensitivity to economic and market cycles. They are financially strong and can therefore sustain high levels of profitability. We have shown that Quality concentrated sectors such as consumer staples, healthcare and information technology have demonstrated much greater resilience than other sectors in sustaining those profits over time. Their consistent cash generation, enables capital light Quality sectors to be able to invest more heavily in R&D as a percentage of sales, driving product innovation and improving 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. From a valuation perspective, 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. Capturing systematic mispricing of quality stocks on a long-term view is an area where the patient active quality investor can take advantage. Quality investors are ideally placed to ensure capital allocation decisions are fully aligned with the long-term interests of shareholders and other key stakeholders. Gaining a deeper insight into a company’s suppliers, customers and competitors also helps to generate new investment ideas for Quality investors. Finally, managing business, financial, capital allocation and valuation risk can help to unlock the long-term power of compounding.

In his assessment of the asset management industry, Andrew Haldane concluded that “Capital that can afford to be patient, should be patient”. In this paper we have provided reasons why we believe Quality is a natural fit for the deployment of patient capital over the long term.
designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital
Investing. Further, the manager’s strategy may deploy investment techniques and instruments not used to generate Index performance. For this reason,
Indices available upon request.

Indicators are shown for illustrative purposes only, are unmanaged and do not take into account market conditions or the costs associated with
investing. Further, the manager’s strategy may deploy investment techniques and instruments not used to generate Index performance. For this reason,
the performance of the manager and the Indices are not directly comparable. The MSCI All Country World Index is a market capitalization weighted index
designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital
International, and is comprised of stocks from both developed and emerging markets.