July 2024

—
Investing for a
world of change

Future wealth creators – opportunities in a new era

Clyde Rossouw
Head of Quality

The market is currently dominated by a small group of well-resourced tech players: the Magnificent Seven and the companies that feed their ecosystem. As in the dot.com bubble, an impressive narrative supports these stocks, centred on how tech will change the shape of the market forever. But active investors should be careful about expecting the status quo to hold indefinitely.

An inflection point in the shape of the market?

Over the past three years, if you had bought anything with growth and a rising share price you would have done well. The old adage of 'buy low, sell high' has effectively become 'buy high and hold', on the basis that somebody will buy what you hold today at a higher price tomorrow. Put another way, today's market is very momentum driven. What has mattered less, to the stock market at least, has been the quality of companies. But the growth-and-momentum trade will stall at some point, and there will not be a warning bell. This is why it is important to be diversified – not just in sectors and regions, but also in equity styles.

This is the copyright of Ninety One and its contents may not be re-used without Ninety One's prior permission.

The inflection point may be approaching sooner than people think. Based on recent share prices, the Magnificent Seven have been whittled down to the Magnificent One: Nvidia. The Ninety One Global Franchise strategy does not own the company. Yes, we know its products are integral to gaming, data centres, language models and so on. But the market is pricing Nvidia as a monopoly almost into perpetuity, and that is a risk. At some point, rationality sets in. This is why we like to own businesses in the sweet spot of their life cycles, with a relevant product set and maybe not showing the most dramatic revenue growth, but still growing quite nicely.

> The market is pricing Nvidia as a monopoly almost into perpetuity, and that is a risk.

Changing interest rates

A crucial question for active investors is what will happen when interest rates come down and the market rotates out of cash into harder-working assets. The exclusive 'tech club' has shown thus far it can perform in both high- and low-interest rate environments. But for everyone else, rates are important, and what the stock market rewards may change.

A key focus in our Ninety One Global Franchise portfolio is earnings growth, but it does not appear to have mattered much to the market recently. For the past five years, despite achieving considerably better earnings and downside protection than the MSCI All Country World Index (ACWI), we have underperformed the global equity benchmark. Over this period, the ACWI delivered 5% earnings growth, and a -23% drawdown during COVID, vs. our 10% earnings growth and -10% drawdown in COVID. Over the last 12 months, the ACWI delivered 6% earnings growth, vs. our 13%. And since the inception of Global Franchise in 2007, the ACWI has delivered 3% earnings growth per annum, vs. our 6%.

> A key focus in our Ninety One Global Franchise portfolio is earnings growth.

This highlights that the biggest source of return for the ACWI in recent years has been from the market re-rating. But what if the market turns, and we see a de-rating over the next 12-24 months? Where will that leave investors in terms of overall total return? We believe our superior earnings growth vs. the market should stand us in good stead.

Valuations

What of valuations? Looking at price-to-earnings (PE) ratios as a measure, the Ninety One Global Franchise portfolio appears expensive vs. the market. But we prefer EV/EBIT (enterprise value to earnings before interest and taxes). In our view, this is a more genuine measure of the value of an underlying business, as it tells the story of the whole balance sheet and neutralises tax impacts in different countries. On this basis, our portfolio is roughly the same value as the market.

On a forward-looking basis, we are forecasting an internal rate of return (IRR) of 9%. Given our prospective low double-digit earnings growth, this means we are being deliberately cautious and building in valuation mean reversion to a lower level over time. But even if the shares do not de-rate, prospective returns could also be greater than what they are currently priced to deliver.

> Given our prospective low double-digit earnings growth, we are being deliberately cautious.

Recurring vs. non-recurring earnings

Another feature of our portfolio that is different from the market overall, and which the market again does not seem to place much importance on, is that over 60% of our companies' earnings are recurring. Where Nvidia must sell a product to make money, our companies will continue collecting from earlier sales, which equates to a higher quality of revenues.

The remainder of our earnings are non-recurring (one-off sales, product oriented or transaction based). We like this balance as it helps reduce earnings volatility over time, and we see it as a distinct advantage if the market environment changes, which at some point it will.

Portfolio positioning: defensive, durable and dynamic

Today, a big part of our portfolio is defensive, i.e., made up of companies that can grow their earnings no matter the stage of the market cycle. These shares have been the worst performing this year as the market is not pricing in a recession. However, we think investors should not rule out a recession as there is typically a lagged response to higher interest rates.

> Defensive shares have been the worst performing this year as the market is not pricing in a recession.

The core of the portfolio is made up of durable companies – those that can grow at a double-digit percentage rate, and that exhibit very little sensitivity to the economic cycle. Given these attributes, these stocks tend to trade at a premium to more defensive stocks.

A small part of the portfolio is what we call dynamic. The shape of the market today is all dynamic or high growth. We like select dynamic companies but do not believe that a portfolio should be entirely made up of these kinds of stocks, as this is where valuation risk is most acute. Our portfolio construction aims to take account of a wide range of potential outcomes. After all, nothing lasts forever – and that includes the magnificence of the Magnificent Seven.

Important information

All information provided is product related and is not intended to address the circumstances of any particular individual or entity. We are not acting and do not purport to act in any way as an advisor or in a fiduciary capacity. No one should act upon such information without appropriate professional advice after a thorough examination of a particular situation. This is not a recommendation to buy, sell or hold any particular security. Collective investment scheme funds are generally medium to long term investments and the manager, Ninety One Fund Managers SA (RF) (Pty) Ltd, gives no guarantee with respect to the capital or the return of the fund. Past performance is not necessarily a guide to future performance. The value of participatory interests (units) may go down as well as up. Funds are traded at ruling prices and can engage in borrowing and scrip lending. The fund may borrow up to 10% of its market value to bridge insufficient liquidity. A schedule of charges, fees and advisor fees is available on request from the manager which is registered under the Collective Investment Schemes Control Act. Additional advisor fees may be paid and if so, are subject to the relevant FAIS disclosure requirements. Performance shown is that of the fund and individual investor performance may differ as a result of initial fees, actual investment date, date of any subsequent reinvestment and any dividend withholding tax. There are different fee classes of units on the fund and the information presented is for the most expensive class. Indices 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. MSCI data is sourced from MSCI Inc. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, endorsed, reviewed or produced by MSCI. None of the MSCI data is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. This fund may be closed to new investors in order to be managed in accordance with the mandate. Fluctuations or movements in exchange rates may cause the value of underlying international investments to go up or down. Where the fund invests in the units of foreign collective investment schemes, these may levy additional charges which are included in the relevant Total Expense Ratio (TER). A higher TER does not necessarily imply a poor return, nor does a low TER imply a good return. The ratio does not include transaction costs. The current TER cannot be regarded as an indication of the future TERs. Additional information on the funds may be obtained, free of charge, at ww.ninetyone.com. The Manager, PO Box 1655, Cape Town, 8000, Tel: 0860 500 100. The scheme trustee is FirstRand Bank Limited, RMB, 3 Merchant Place, Ground Floor, Cnr. Fredman and Gwen Streets, Sandton, 2196, tel. (011) 301 6335. A feeder fund is a fund that, apart from assets in liquid form, consists solely of units in a single fund of a collective investment scheme which levies its own charges which could then result in a higher fee structure for the feeder fund. The fund is a sub-fund in the Ninety One Global Strategy Fund, 49 Avenue J.F. Kennedy, L-1855 Luxembourg, Grand Duchy of Luxembourg, and is approved under the Collective Investment Schemes Control Act. *The Fund is a sub-fund in the Ninety One Premier Funds PCC Ltd scheme managed by Ninety One Guernsey Limited and is approved under section 65 of the Collective Investment Schemes Control Act. Ninety One SA (Pty) Ltd is an authorised financial services provider. Ninety One SA (Pty) Ltd is a member of the Association for Savings and Investment SA (ASISA). The full details and basis of the award, affirmed on 14.03.24, are available on request. This communication is the copyright of Ninety One and its contents may not be re-used without Ninety One's prior permission. Ninety One Investment Platform (Pty) Ltd and Ninety One SA (Pty) Ltd are authorised financial services providers. Issued, July 2024

36 Hans Strijdom Avenue
Foreshore, Cape Town 8001

To reach our Ninety One unit trust team, please use
Telephone: 0860 500 900
Email: utclientservicessa@ninetyone.com

To reach our Ninety One Investment platform team, please use
Telephone: 0860 500 100
Email: comcentre@ninetyone.com

—

www.ninetyone.com
Follow us on X @ninetyone_sa

CS_648 07/2024