May 2024

Opportunities in a new era

—
Investing for a
world of change

Clyde Rossouw
Head of Quality

The fast view

— Investors have been pursuing themes and chasing shares with momentum, resulting in large stocks being the biggest gainers.

— The market has become increasingly concentrated, with the top seven stocks now comprising nearly a fifth of the total.

— We argue that this can't last forever without an underlying earnings evolution.

— The market should start focusing less on the 'story' component of investment cases, shifting attention back to quality companies' earnings streams.

— We expect our holdings in the Ninety One Global Franchise Fund to continue compounding earnings faster than the market and estimate that our portfolio will deliver earnings growth of 10% per annum over the next 5 years.

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

We started the year with an environment that looked positive for global growth. Investors pinned their hopes on three big tailwinds likely to bolster equity markets in 2024: earnings, a more supportive interest rate environment and strong thematic drivers, largely focused on Artificial Intelligence and its impact on the investment landscape.

A few months into the year, and cracks are starting to show.

It is no longer clear that we have unreserved interest rate support, given the market has revised its outlook for rates. The liquidity environment has become less favourable, with rates potentially 'higher for longer', which impacts the earnings picture.

We have also seen signs of the market tempering its exuberance over AI. Investors have become more selective, which is starting to be reflected in the performance of some stocks.

If you look below the surface and unpack performance across different parts of the market, it is clear that large companies have delivered the bulk of growth outperformance. But when you adjust for market cap on an equal-weighted basis, the performance picture is very different. The average technology stock, for example, has only delivered a marginally positive return, and the broader market, as measured by the MSCI All Country World Index (ACWI), was up only 2% in the first quarter. A very different story to the perceived more than 8% return at index level.

Most of the returns have been driven by large stocks and those that have rampant price momentum. Investors have been pursuing themes and chasing stocks with momentum. There is a lot of passive money floating about. We would caution that just because something has gone up in the short term, it doesn't mean that the market is necessarily right. Chasing themes that are going up works very well, until it doesn't.

We have also seen signs of the market tempering its exuberance over AI.

Given these moves, the market has become increasingly concentrated, with the top seven stocks now comprising nearly a fifth of the total. The combined market cap of these stocks was $1.5 trillion 10 years ago. Today, they account for roughly $13 trillion in market cap, with almost all these stocks surpassing $1.5 trillion individually. As far as mega cap rallies go, they have been practically unparalleled in their outperformance. They have strung together a series of market-beating performances over the last 10 years, with 2022 being the single year in which they didn't beat the index. The more investors have chased that story, the stronger the share price performance has been. We argue that this can't last forever without an underlying earnings evolution.

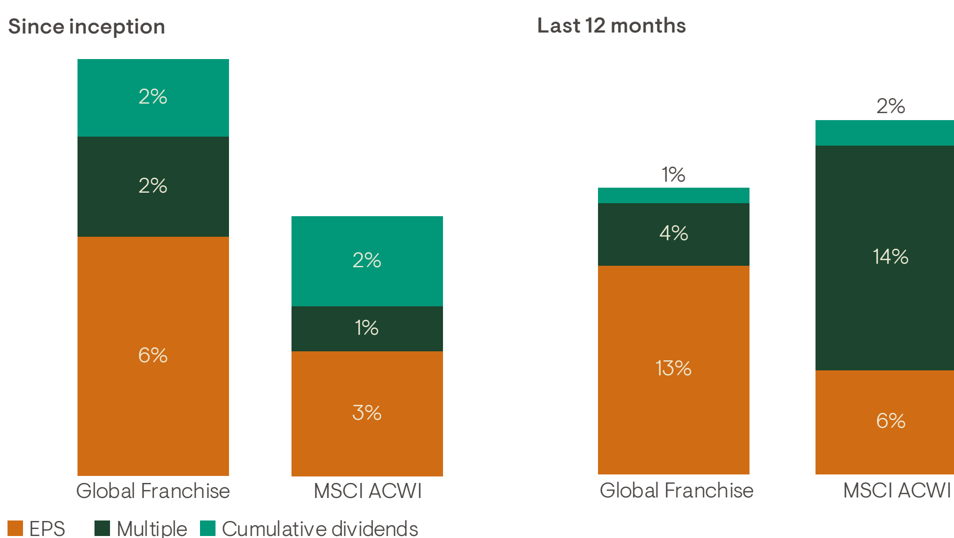
The importance of earnings growth

Earnings growth is the primary driver of returns over time. Historically, that is what has driven the outperformance of the Ninety One Global Franchise Fund over the course of nearly 17 years of investing through different market cycles. Since inception, the Fund has delivered earnings growth of 6% per annum against the market's 3% per annum, as shown in Figure 1. That relative difference is the clear driver of long-term alpha, despite the shares we own becoming marginally more expensive than the broader market – as expressed by multiple expansion.

More recently, however, markets have been driven by multiple expansion – in other words, they've become more expensive. Companies have been rewarded for a future yet to materialise. On average, the valuation of stocks has risen faster than their fundamental value in this highly distorted market. As can be seen from Figure 1, over the last 12 months, nearly two-thirds of the MSCI ACWI's total return of 22.2% has been driven by a rerating (multiple component = 14%). While earnings per share growth has been a solid 6% for the MSCI ACWI over the last 12 months, it speaks to the point that the market has been more excited about themes than the actual earnings delivery. The Ninety One Global Franchise Fund has again delivered double the earnings growth over the last 12 months, despite recent underperformance.

We believe that the drivers of stock market performance are the fundamentals – it is about earnings growth rather than a rerating. That's encouraging and highlights the opportunity. The fundamentals we look for include enduring competitive advantages, dominant market positions, strong balance sheets, lower cyclicality, low capital intensity, sustainable cash generation and disciplined capital allocation.

Figure 1: Total shareholder decomposition – earnings growth the primary driver of returns for the Ninety One Global Franchise Fund

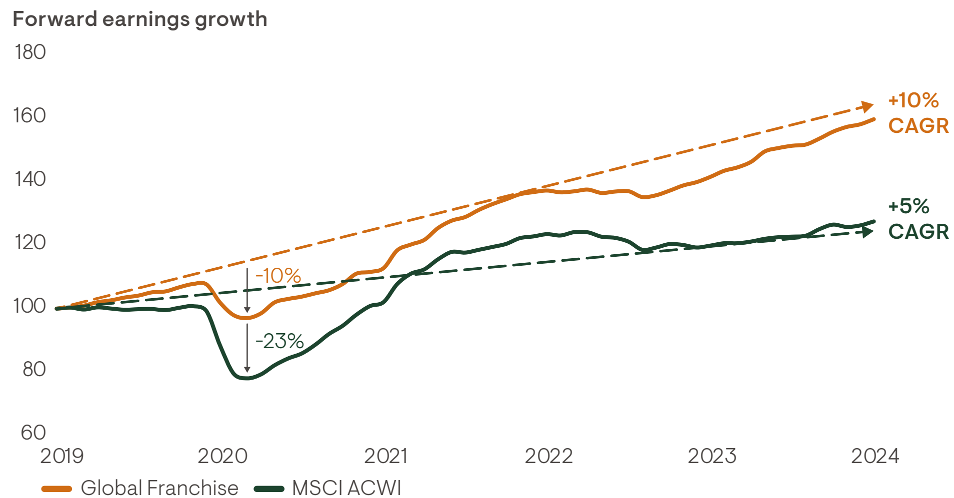


Past performance is not a reliable indicator of future results, losses may be made. Source: Ninety One, FactSet, Bloomberg, 31 March 2024, based to 100 at April 2007. Weighting based on GSF vehicle. Earnings based on blended 12 month forward. Rating based on 12 month forward PE. Performance is derived from portfolio constituent through time and is based on the weighted average aggregation of EPS growth, rating change and dividend yield; hence, it does not take account of fees and trading costs and will differ from reported fund performance. Based on a related portfolio with substantially similar objectives as those of the services being offered.

Over time, our portfolio has successfully compounded earnings faster than the broader market, shown less cyclicality and been more resilient during economic drawdowns. The Fund has grown earnings by 10% per annum, double the rate of the market over the last 5 years. This is the primary way the Fund has managed to deliver alpha, not through market timing or macro views.

Importantly, the companies we own are still well-positioned to be able to deliver good growth on a forward-looking basis. We expect our holdings to continue compounding earnings faster than the market and estimate that our portfolio will deliver earnings growth of 10% per annum over the next 5 years.

Figure 2: Compounding of earnings



Past performance is not a reliable indicator of future results, losses may be made.
Source: Ninety One, Bloomberg, 31 March 2024, based to 100 at March 2019. Weighting based on GSF vehicle. Earnings based on blended 12 month forward.

Thoughts on valuation

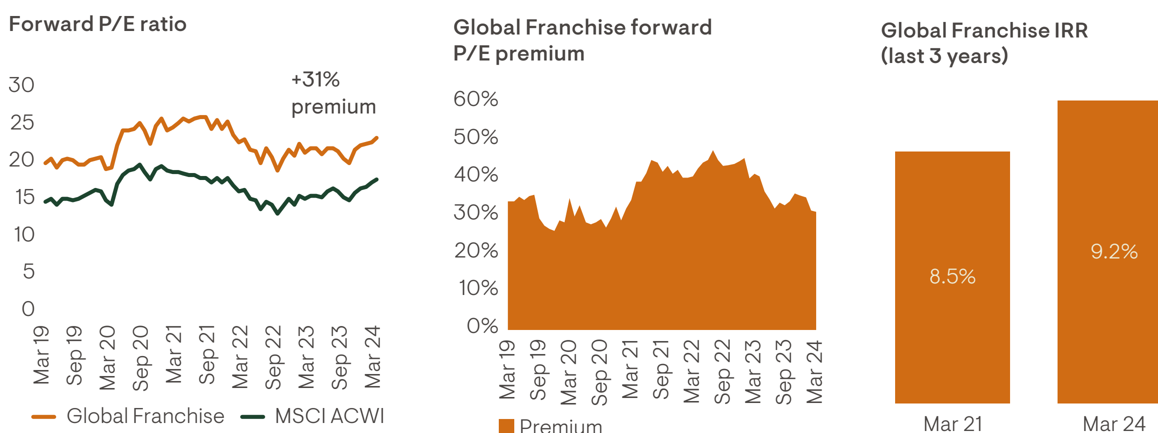
Looking at the value proposition, investors are often concerned about the price earnings (P/E) multiples for quality stocks. We believe the P/E valuation premium is reasonable given the quality and growth characteristics of the Fund. If you look at the premium of our portfolio over the market in the last 5 years, it is roughly the same. But this metric ignores factors like cash conversion and balance sheets, which we argue are particularly important.

Although commonly used, we believe that the P/E 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. 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.

We believe the most robust way to calibrate the valuation of our Quality portfolios is to use an internal rate of return (IRR) calculation, which looks at the expected return given starting valuations and forecasts of future cash flows (near term and longer term). It captures the time value of money and is a simple and directly comparable metric that is calculated bottom-up, based on our own individual company analysis.

The IRR for Global Franchise is currently 9.2%. This compares to 8.5% 3 years ago, as shown in Figure 3.

Figure 3: The valuation premium is reasonable



Past performance does not predict future returns; losses may be made.
Source: Ninety One, Bloomberg, FactSet, 31 March 2024.

As our numbers reveal, we have a more compelling bottom-up aggregated return forecast from the companies we own than we had 3 years ago, which excites us.

Conclusion

As we move into the year, many developed economies have proved to be resilient. While global equity markets have rallied this year, market volatility reflects an uncertain outlook. Short-term shocks have continued to rattle markets, including the growth and earnings outlook, China's property crisis, volatile commodity prices, turmoil in bond markets and heightened tensions in the Middle East.

Against this backdrop, we believe that investors will reward robust business fundamentals. The market should start focusing less on the 'story' component of investment cases, shifting attention back to quality companies' earnings streams, which have proved to be sustainable over time.

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 www.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, May 2024.

36 Hans Strijdom Avenue
Foreshore, Cape Town 8001
Telephone: +27 (0)21 901 1000
Client service support: 0860 500 100
Email: comcentre@ninetyone.com

—

www.ninetyone.com
Follow us on Twitter @ninetyone_sa

CS_606_MACS17340 05/2024