October 2020

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Previously Investec
Asset Management

Navigating a volatile equity market ahead of the US election

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The fast view

- In our view, a bottom-up approach can combat elevated levels of volatility, specifically by selecting high-quality businesses that can withstand a changing political and economic landscape.
- A Biden presidency - the Democrat holds a steady lead in the polls - could mean healthcare reforms; American Franchise has highly selective exposure to niche, differentiated businesses.
- The 'big tech' FAANG stocks may face increased regulation; we attempt to mitigate this by seeking tech exposure through exciting structural trends such as digital payments and cloud computing.
- Trump's significant corporate tax cuts could be partially reversed; our greater exposure to international earnings should provide relative support to this headwind.
- Our strategy has a minimal carbon footprint, with no exposure to the carbon intensive sectors which may come under pressure should Biden become the 46th US president.

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Elevated volatility

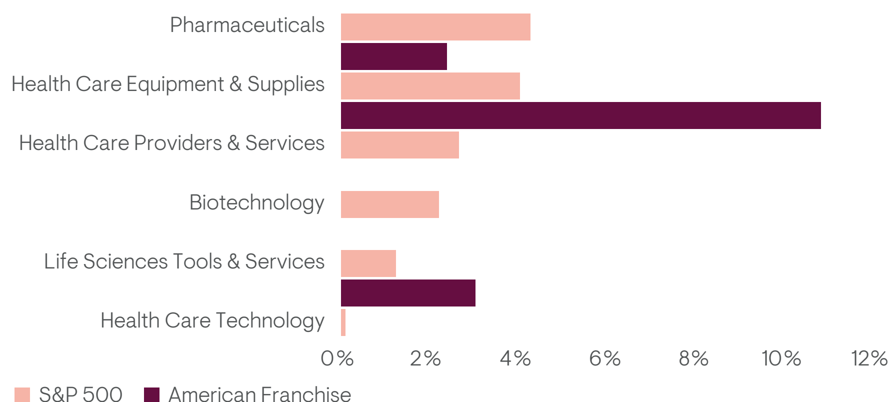
With the US election less than one month away, investor attention is increasingly turning to near-term opportunities and risk created by such a binary event. While US equity markets typically encounter elevated volatility both in the run-up to and immediate aftermath of an election, the outlook this year is even more uncertain as the world grapples with containing the ongoing COVID-19 virus.

At Ninety One, our Quality team believes that even in more stable market environments, investors are best off building their equity positioning from a bottom-up perspective. As such we focus on the individual merits of each company from a fundamental standpoint, rather than becoming fixated on difficult-to-forecast political or macro drivers. Underpinned by that philosophy, we seek to build portfolios of high-quality businesses which can withstand a changing political and economic landscape and compound shareholder value through the market cycle. With current polling – which is obviously subject to fluctuation – pointing towards a victory for the Democrat candidate Joe Biden, we shall provide an overview of the positioning in our American Franchise strategy in the context of some of the potential changes that might occur under a Biden presidency.

Highly selective healthcare exposure

As a key battleground in the US political landscape, the US healthcare system is likely to come under scrutiny in the event that Biden enters the White House. We have been concerned about the potential for reform for some time, particularly given the US spends a greater proportion of its GDP (17%) on healthcare than any other country in the world[1]. In our view, the entire US system is a myriad of skewed incentives which result in constant cost inflation in several key inputs, most notably pharmaceuticals. For this reason, we have long been highly selective in the healthcare exposure we allow into the portfolio. While currently overweight relative to the S&P 500 index (16% vs. 14%), this is composed of just six individual holdings – all with very different end market drivers. As a result, the portfolio's exposure is highly differentiated relative to the benchmark (Figure 1), with no exposure to traditional pharmaceutical companies, health insurers or managed care providers.

Figure 1: American Franchise's healthcare exposure is markedly different to the S&P 500



Source: Ninety One, as of 30 September 2020.

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1. Source: OECD, as of 1 July 2020.

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By its very design, the portfolio's exposure is to companies that receive a higher proportion of revenue directly from the patient, and are therefore shielded from large payers such as the US government and major health insurers. In the dental orthodontic market, for example, the patient settles a large portion of the bill in many cases. Within that space, Align Technology* is a good example of how being shielded from large payers can help generate repeatable cash flows through enduring competitive advantages. While the cost of Align's main Invisalign product – which uses technology to straighten teeth – is sizable at around US$5k per case, the majority of this sales price accrues to the dentist, who acts as a form of outsourced salesperson. Invisalign is priced similarly to traditional wire braces, but involves less dental visits, so while the total cost to the patient is the same, dentists have greater capacity to see more patients, thereby generating further revenues for Align.

In the event of sweeping reforms to the US healthcare system, we believe the US orthodontic industry should be relatively shielded given it is both niche and, at US$12 billion[2], very small when contrasted with the overall US healthcare spending of US$3.6 trillion[3] per year. Given the limited penetration of clear aligners in the broader orthodontic market, both in the US and internationally, we believe that the growth runway for this business remains strong, regardless of who sits in the Oval Office.

Another healthcare holding is the life sciences company Agilent Technologies; the company's liquid and gas chromatography tools – which separate components of a substance – are used in the testing of drugs as part of the manufacturing process. Agilent's customers are therefore the highly profitable pharmaceutical companies who tend to be less focused on the price of Agilent's tools and consumables, which represent a small proportion of the cost base. Agilent is a beneficiary of the increasing volume of pharmaceutical treatments - through testing of individual product batches – rather than the end cost to payers from the standpoint of drug pricing.

While there is a single 'Pharmaceutical' company held in the portfolio – as illustrated in Figure 1 – all is not what it seems at first glance. This exposure comes in the form of Zoetis, the largest pure play animal health company in the world, whose medicines and vaccinations for pets are sold via veterinarians. Needless to say, pricing concerns typically fall by the wayside when a beloved pet is unwell; a structural trend that can be observed in the 'humanisation' of the animals which live with many of us in our homes. With an exciting product pipeline across a range of therapeutic categories, including the much anticipated 'Simparica Trio' flea, tick and worm treatment for dogs, we believe the positive outlook for Zoetis should result in plenty of wagging tails.

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This is not a buy, sell or hold recommendation for any particular security. For further information on specific portfolio names, please see the important information section.

2. IBIS World's 'Orthodontists Industry in the US' report, May 2020.
3. US Centres for Medicare & Medicaid Services (CMS), December 2019.

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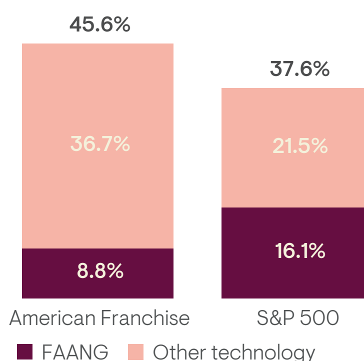
Threat of regulation underpins underweight FAANG position

Recently, the so-called 'big-tech' companies have encountered increasing scrutiny, with Facebook, Amazon, Apple and Google all facing questions in front of the US Congress over the course of the summer. Then, in early October, the House Judiciary Committee released the findings of its 16-month investigation in a lengthy report which detailed a wide ranging list of concerns. A point of particular focus was the increasing dominance of these companies over their respective value chains, and the harm potentially anti-competitive practices could have on the consumers they serve.
It is difficult, perhaps even impossible, to effectively manage a US equity portfolio while totally ignoring these so-called FAANG[4] stocks; after-all these are some of the most profitable businesses in the world. However, we choose to operate a sizable underweight position in FAANG stocks given that they account for more than 15% of the entire S&P 500, potentially tying up capital that could be allocated to more attractive opportunities.

Figure 2: The strategy is underweight FAANG stocks, freeing up capital for other technology[5]



Source: Ninety One, as of 30 September 2020.

To reiterate, this positioning does not result from a specific view on the outcome of the US election, yet we do envision an increasingly difficult regulatory environment for a number of these supersized tech businesses. Instead, we have allocated the portfolio's tech exposure to capitalise on some of the most exciting structural trends to develop within the sector over the past decade. Most notably, the rise of digital payments and cloud computing, through which we access via our positions in companies such as Microsoft*, Visa, Mastercard, Intuit and Autodesk. Importantly, the end customers/users of these companies are businesses, not consumers, which in our view reduces the risk of draconian intervention from a more liberal political administration.

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4. FAANG = Facebook, Apple, Amazon, Netflix and Google.
5. 'Other Technology' defined according to GICS classification system.

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Repeal of Tax Cuts and Jobs Act

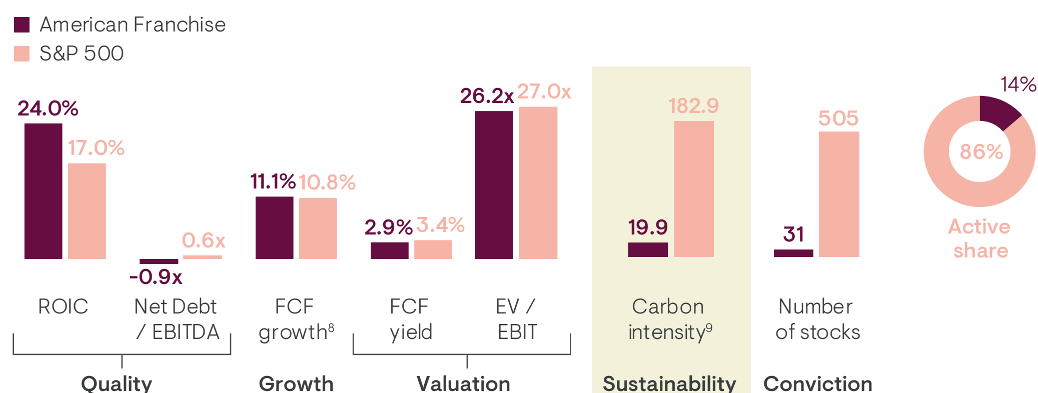
One of President Trump's most aggressive actions over the course of the past four years has been the enactment of the Tax Cuts and Jobs Act (TCJA). Introduced at the end of 2017, one of the many outcomes was to reduce the US statutory rate of corporate tax from 35% to 21%, with the hope that this would drive domestic investment. Fast forward to 2020 and Biden has been vocal in his intention to raise the corporate tax rate to 28%, in addition to introducing a minimum 15% tax on book profits – aimed at companies that reported net income of more than US$100 million in the US but paid zero or negative federal income taxes. Such a move would clearly create a one-time headwind for the year-on-year earnings progression of many US companies, particularly harmful for those with stuttering profitability and limited growth opportunities in the wake of the pandemic. In our view, the companies best placed to deal with such a change are those with high levels of profitability and multiple growth levers, where the headwind is likely to represent little more than a speedbump to long-term earnings progression.

Moreover, on our own estimates, we view the current portfolio position for American Franchise as slightly underweight US-based earnings, relative to the S&P 500 (~50%[6] vs. ~60%[7]). This makes sense given our preference for mature and dominant businesses who will have been more able to invest in the international growth opportunity. While measuring the prospective impact of such a complex change as re-working the entire US tax system is virtually impossible, we do believe our portfolio does at least have a positive relative skew given its international exposure.

Climate change may return to focus

Sadly, President Trump has been all too obvious in his scepticism toward the urgency of addressing the climate change crisis. The US withdrew from the Paris Climate Agreement in June 2017 and Trump has pursued a policy of energy independence based on the use of fossil fuels. In contrast, our investment philosophy results in a focus on carbon-light business models which have the potential for sustainable shareholder value creation over the long term. This positions the American Franchise strategy more in line with Biden's own thinking on climate change, one which could result in headwinds to carbon-heavy sectors within the S&P 500, to which we have no exposure.

Figure 3: American Franchise has a significantly lower carbon footprint than the S&P 500



Source: Factset, Ninety One, 30 June 2020. The portfolio may change significantly over a short period of time. The above reflects the portfolio characteristics reweighted excluding cash and cash equivalents.

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6. Source: Ninety One as of 30 September 2020.
7. Source: S&P Global, August 2019.
8 FCF calculation excludes companies classified in the Banks Industry Group according to GICS.
9. Carbon intensity measures the carbon efficiency of a portfolio and is defined as the total carbon emissions of the portfolio per $million of portfolio sales.

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Closing thoughts

As investors focused on companies that we believe are able to deliver robust earnings and free cash flow growth irrespective of the political backdrop, November's US election is a less meaningful event in the context of our 5 to 10-year time horizon. We will let other investors attempt to profit from shorter-term gyrations in markets pre and post the election outcome.

Our focus on long-term competitive moats, structural growth drivers and a generally defensive positioning means we are confident that the American Franchise portfolio is well placed, irrespective of the outcome of the battle for the White House.

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