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Purist approach to quality investing “well suited to current conditions and for uncertain times ahead”

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The fast view

- Wider adoption of ‘quality’ as a term and investment approach has led to both inconsistency and impurity in the definition of ‘quality’ being used.
- Our purist quality approach leads us to favour certain stocks over others, even in seemingly similar parts of the market. We also find quality even in unexpected low-quality parts of the market.
- We don’t have exposure to any of the ‘FAANGs’; our preference in the Big Tech space is Microsoft. We typically prefer our technology-focused businesses to have subscription rather than transaction-based revenue models.
- In financials, we have historically avoided banks, preferring businesses that exhibit capital-light business models, highly differentiated competitive positions, structural tailwinds, or preferably a combination of these traits. We therefore have exposure to Moody’s and Charles Schwab.
- Specialised software players can provide attractive exposure to some end markets that themselves tend to be lower quality, such as construction. For example, specialised software provider Autodesk – while exposed to the architectural, engineering and construction industries – displays many of the characteristics we seek.
- Warning lights are beginning to flash on certain excesses in the market. Caution is clearly required.
- Looking beyond short-term sentiment, we do not believe the environment has changed the fundamentals of the companies we own.

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'Quality' is a term and an investment approach that has been increasingly adopted by investors in recent years given the proven long-term track record of this style of investing. However, wider adoption has also led to both inconsistency and impurity in the definition of 'quality' being used. In particular, the lines have become blurred with growth investing, as growth has outperformed other styles in recent years.

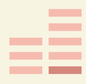
Ninety One's Global Franchise Strategy reflects a purer and more consistent expression of quality that is focused solely on what we believe to be attractively valued best-of-breed 'Franchise' companies with the following key attributes:

Hard-to-replicate enduring competitive advantages

Dominant market positions in stable growing industries

Low sensitivity to the economic and market cycle

Healthy balance sheets and low capital intensity



Sustainable cash generation and effective capital allocation

In this article we provide some stock examples to demonstrate how our purist quality approach leads us to favour certain stocks over others, even in seemingly similar parts of the market, and also how we can still find quality even in unexpected low-quality parts of the market. We then finish with why we maintain strong conviction in the long-term outlook for this focused investment approach.

Quality in Big Tech

We are often asked why we do not own any of the 'FAANG' stocks, when these companies seemingly display many of the quality attributes we seek, such as enduring competitive advantages and dominant market positions. The strength of these businesses is evident in the strength of their share prices but that does not necessarily make them right for our investment approach. We typically prefer our technology-focused businesses to have subscription rather than transaction-based revenue models, as these are more consistent, dependable and less cyclical. We also seek high and consistent conversion of profits into cash, strong balance sheets, and exemplary capital allocation. In addition, we are mindful of business tail risks such as platform obsolescence, and regulatory risks around data privacy, antitrust legislation and taxation. Finally, even the best businesses don't make the best investment cases as valuation is also a critical consideration.

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One or more of the above issues currently prevents us from allocating to any of the FAANG stocks in Global Franchise. Instead, our approach favours another Big Tech company not captured in the FAANG acronym. Recurring revenue streams from its subscription-based cloud offering; dominant market position in enterprise software with an entrenched global user base; over $50 billion of net cash on the balance sheet; and sustainable cash flow generation from its platform that can be scaled and monetised for many years to come. The company is Microsoft and the summary table (Figure 1) below highlights why we believe it stands out as the best fit for our approach in the Big Tech space:

Figure 1: Microsoft is the best fit for Quality in the Big Tech space

	Revenue model	Cash generation	Credit rating	Regulatory risk	Capital allocation	FCF yield
Microsoft	Subscription (Office + Azure)	Good and improving	AAA	Lower	Excellent	3.0%
Facebook	Transactional (advertising)	Good	N/A*	Higher	Good	3.9%
Apple	Transactional (product cycles) and subscription (services)	Excellent	AA+	Higher	Excellent	4.7%
Amazon	Transactional (ecommerce) and subscription (AWS + Prime)	Good	AA-	Higher	Good	2.6%
Netflix	Subscription	Negligible but improving	BB-	Lower	Unknown**	0.1%
Alphabet	Transactional (advertising) and subscription (cloud, YouTube***)	OK and improving	AA+	Higher	OK and improving	3.7%

* Facebook has no debt (aside from capitalised lease liabilities) and therefore is not rated by the rating agencies.
** Netflix is yet to generate significant organic positive cash flow through its life due to heavy investment in media content.
*** YouTube users monetized via paid subscriptions rather than advertising.

Quality in Financials

We think it is important to delve into the specific stock exposure we hold within financials given the very distinct groups of business models that exist within this sector. We have historically avoided banks for a number of reasons. Firstly, these businesses typically exhibit low returns on capital, predominantly earning money through the spread between short-term deposit rates and longer-term loans, with equity returns magnified through leverage. With this model, exogenous forces such as interest rates and the broader health of the economy become key determinants of profitability. Differentiation in core banking is difficult to exhibit, hence the limits to supernormal profitability and more commoditised profit profiles. Insurance companies exhibit similar challenges for a quality investment process, and hence we have avoided this industry within the Global Franchise strategy.

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We become more interested in businesses in the financials sector when they exhibit capital-light business models, highly differentiated competitive positions, structural tailwinds, or preferably a combination of these traits. For that reason, we have held Moody's for many years, a dominant player in the oligopolistic market for credit ratings, where brand recognition and trust are almost insurmountable barriers to new entrants. The market for independent credit ratings has benefited from a structural tailwind since the GFC, as banks around the world have de-levered and debt financing has incrementally shifted from bank loans to capital markets.

Charles Schwab is another financial stock held in the portfolio (since 2018). We admire the customer-centric way in which Schwab manages its business. This approach, and the continuous reinvestment in the customer experience has led to significant growth, and Schwab now offers brokerage and asset management (among other investment services) to millions of customers, boasting over $7 trillion in client assets. They earn money from this system through net interest, not unlike a bank. However, Schwab benefits from a structurally lower cost of funding due to the exemplary service it offers clients, who worry little about the interest rate received on cash deposits. This allows the company to take almost no credit risk in its investment portfolio, investing the majority of its assets in government backed securities.

We admire the customer-centric way in which Schwab manages its business.

Quality in low-quality end markets

Technology, and more specifically software, is often treated as a monolith within global equity markets. Beneath these labels there exists a diverse array of business models, with varying drivers of value, and we think it is interesting to consider how specialised software players can provide attractive exposure to some end markets that themselves tend to be lower quality.

Construction for example, tends to be a cyclical industry, with both residential and commercial property cycles driven by the economic environment, financial conditions and nuanced, local supply and demand drivers within markets. These characteristics combined with largely commoditised offerings tend to make construction firms, building materials businesses and commodity players low return on capital propositions, not suitable for our quality approach.

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We have found that specialised software provider Autodesk – while exposed to the architectural, engineering and construction industries – displays many of the characteristics we seek. Autodesk has a leading position in a number of Computer Aided Design (CAD) software categories for commercial and industrial use cases. Its de facto position in these professions and interoperability across users and projects, results in an enduring competitive position. Following a cloud transition, Autodesk's software is predominantly subscription based, resulting in less sensitivity to economic and construction cycles. We believe the company has a long and profitable runway of growth in the years ahead, underpinned by the positive environmental and regulatory tailwinds. The business is highly cash generative, has a strong balance sheet, and a sensible approach to capital allocation. Our assessment of these attractive characteristics led us to initiate a position in 2020.

Outlook

As we stand, equity markets are pricing in further bond yield increases, driven by higher inflation expectations. This has resulted in a rotation away from growth and defensive stocks, towards value, cyclicals and recovery stocks. Against this backdrop, one risk worth considering is that the current pro-cyclical shape of the equity market could reflect a 'self-limiting' force in the economy. Inflationary forces limit the real wealth effect of stimulus measures, higher oil prices hit consumers at the pump, effectively taxing consumers' income, and steepening yield curves lead to tightening financial conditions for corporates, households and governments. Finally, while the Fed has made their dovish stance clear, more fiscally hawkish tones are emerging from the US, particularly around taxation, given the sizeable deficits that need reining in. Overall, there are a number of risks to the consensus view that stimulus driven demand will underpin a strong economic recovery.

By definition, 'growth' has been the hardest hit by the rotation towards more value equities. Long dated earnings are being discounted back at higher discount rates (as yields on bonds have risen), hence the relative de-rating, especially the businesses that trade on high multiples of revenues, with as-yet-undetermined earnings profiles.

> The current pro-cyclical shape of the equity market could reflect a 'self-limiting' force in the economy.

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More cyclical industries appear supported, but it should be noted these shares have already experienced a significant re-rating and many of the value sectors are now beginning to price in quite robust fundamentals from here, as well as significantly higher bond yields. This is illustrated in Figures 2 and 3 below, which show the increasing divergence of cyclicals outperformance and copper outperformance from US 10-year rates:

Figure 2: Message from the equity markets: Pricing in higher 10-year rates

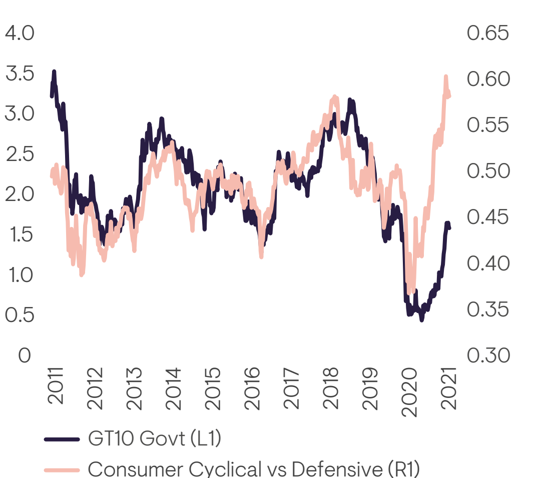
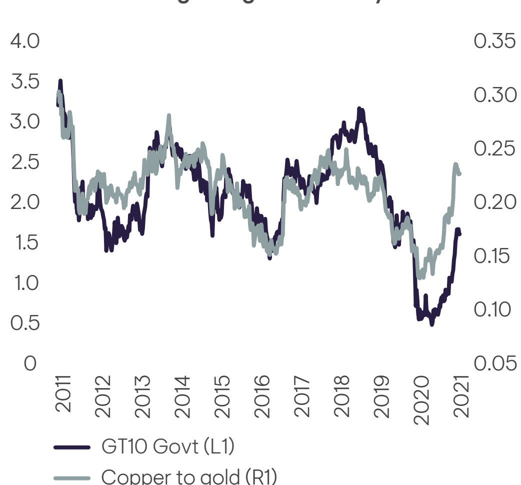


Figure 3: Message from the commodity markets: Pricing in higher US 10-year rates



Source: Ninety One, Bloomberg as of 12 April 2021. Charts show growing disconnect between both cyclical equities and commodities versus the US 10-year Treasury yield.

Some warning lights are beginning to flash on certain excesses in the market.

Additionally, investors would be wise to question the conventional wisdom that asset-heavy businesses are best placed to weather rising prices. This could be wrong in cases where inflated maintenance costs on already significant capital bases swallow excess cash. Conversely, capital light businesses can see their intangible assets restated as prices rise, without incremental capital.

Finally, we would also note that some warning lights are beginning to flash on certain excesses in the market. US broker Charles Schwab recently noted that their clients are holding less cash as a percentage of total assets than ever before (i.e. they are more fully invested), while both inflows and new user growth, as well as trading activity, are all at record highs. Caution is clearly required.

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Looking beyond short-term sentiment, we do not believe the environment has changed the fundamentals of the companies we own. As shown in Figures 4 and 5, the companies in the Global Franchise portfolio are still generating far superior returns on capital, but today are valued at a discount to the broader market not seen for 10 years.

Figure 4: Global Franchise PE premium to MSCI ACWI

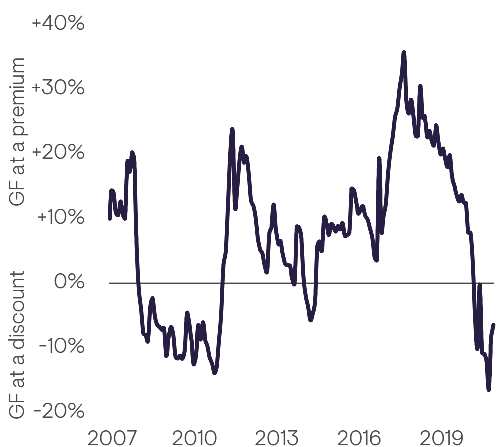
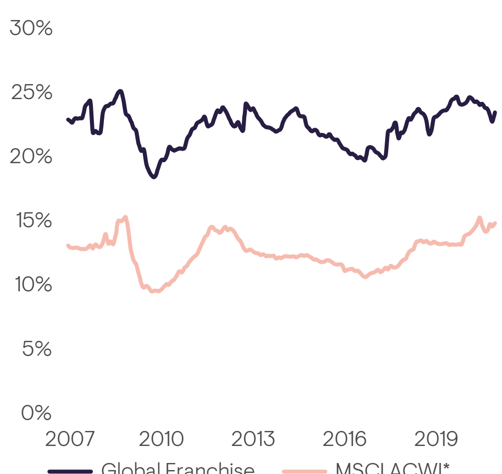


Figure 5: Global Franchise ROIC vs MSCI ACWI



Source: FactSet, Ninety One, 31 March 2021. *Index: MSCI AC World NDR (pre Oct-11, MSCI World NDR). The portfolio may change significantly over a short period of time. The above reflects the portfolio characteristics reweighted excluding cash and cash equivalents. Based on the I Acc share class. Inception date: 10 April 2007.

If we do see more prolonged inflationary pressures, we are comfortable that the businesses we own have significant pricing power given their strong competitive positions, backed by intangible assets. As noted above, intangible assets will not require significant incremental capital in an inflationary environment, unlike capital intensive businesses. Finally, quality companies have very low levels of debt relative to the broad market, which will be an enviable position if financing costs do continue to increase.

Our disciplined approach to valuation means portfolio companies are less sensitive to higher yields than some higher multiple, growthier approaches. Meanwhile, the stable – often recurring – nature of the business models in which we invest enable these high-quality companies to grow with far less reliance on macroeconomic conditions.

Conclusion

We believe that our consistent purist approach to quality investing – captured in stocks such as Microsoft, Moody’s, Schwab and Autodesk – can continue to compound intrinsic value and therefore shareholder wealth, and this approach is well suited to both current conditions and for uncertain times ahead.

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