October 2021

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Investing for a
world of change

Fundamentals to the fore as market uncertainty rises

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The fast view

- Chinese regulatory fears, supply chain disruption, global growth concerns and worries over the US Federal Reserve tapering liquidity, have sparked market volatility.
- Given this backdrop, we believe fundamentals will be the critical factor in determining which companies outperform.
- We favour quality companies which we define as possessing enduring competitive advantages that enable them to deliver long-term structural growth. Typically, such companies are resilient during times of economic and market stress.
- The Ninety One Global Franchise portfolio has a track record of delivering durable, defensive and differentiated alpha. Crucially, the portfolio has exhibited good defensive characteristics in down markets and meaningful participation in rising markets.

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An uncertain backdrop

After an incredibly swift and sharp recovery post the lows of March 2020, global markets once again appear to be searching for direction. Volatility has come to the fore amid tension caused by Chinese regulatory fears, supply chain disruption and global growth concerns regarding the ability of economies to open up. Furthermore, the market has been put on notice that the US Federal Reserve will begin removing some of the liquidity support, which has been a significant driver of markets.

Despite this, equities still appear to be the go-to place where many believe they can capture positive returns. Against this uncertain backdrop, and given the relative unattractiveness of alternatives, our view is that investors should consider focusing on owning those companies that can navigate a world of geopolitical uncertainty, economic stress and structural change, while becoming even stronger in the process. After the growth and value rally last year, 2021 has seen a marked shift of emphasis to actual company results over sentiment and expectation.

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While global equity markets appear expensive looking at broad indices, we believe that there are still unique opportunities for active stock pickers. With uncertainty likely to continue, we believe the environment favours quality companies.

Not all quality companies are our quality companies

We define high-quality companies as those with enduring competitive advantages that are derived from intangible assets such as brand, intellectual property, unique content and networks. These exceptional qualities provide these companies with barriers to entry and pricing power, which in turn enable them to deliver long-term structural growth and compound cash flows at sustainably high levels of profitability, far beyond market expectations.

Lower economic sensitivity provides protection

Such attributes translate into these quality companies demonstrating significant resilience in times of economic and market stress. Revenues tend to be repeatable because they generally offer products and services that people need. These defensive characteristics have enabled quality companies to survive multiple economic cycles with their market position and competitive economics intact, while delivering returns to shareholders that have typically been not only stronger than the market but are also relatively defensive and uncorrelated.

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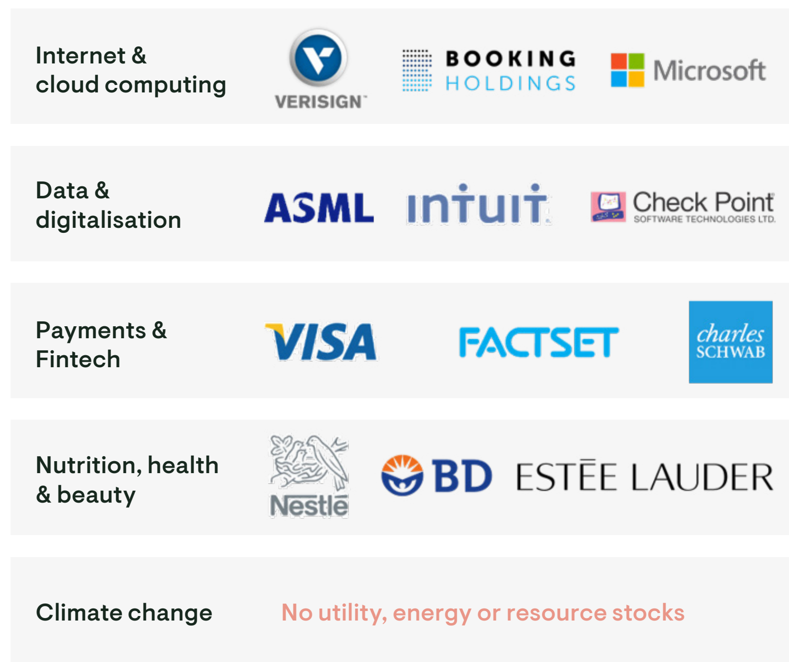
'Future-proofing' through R&D

As well as providing resilience in volatile markets, quality companies are also 'future-proofing' their businesses by continually investing in research and development (R&D). This investment helps drive product innovation, improves brand awareness and loyalty. In so doing, it not only contributes to self-funded future growth, but also strengthens barriers to entry and protects companies from disruption and competitive threats. In aggregate, companies in the Ninety One Global Franchise portfolio spend 8.2% of their revenue on R&D compared to just 2% for the wider market, and still generate far higher levels of profitability.

Successful R&D programmes obtain patent protection for new products, which provides another formidable barrier to entry by giving businesses extended periods over which to recoup their outlay. The more a company grows, the more effective the process can become – it can increase spending on R&D while at the same time its larger balance sheet can more easily absorb failures.

Similarly, technology companies spend a large amount on R&D to maintain their product advantage. Strong balance sheets also enable large incumbents to buy promising start-ups, which can also be viewed as a form of R&D investment. A strong financial model is critical to successfully navigating more challenging economic and market conditions, while positioning for the future. We favour companies with these attributes. Importantly, we do not have blinkers on and are open to opportunity, with exposure to key long-term themes.

Figure 1: Harnessing the power of change



Source: Ninety One, as at 31 August 2021.

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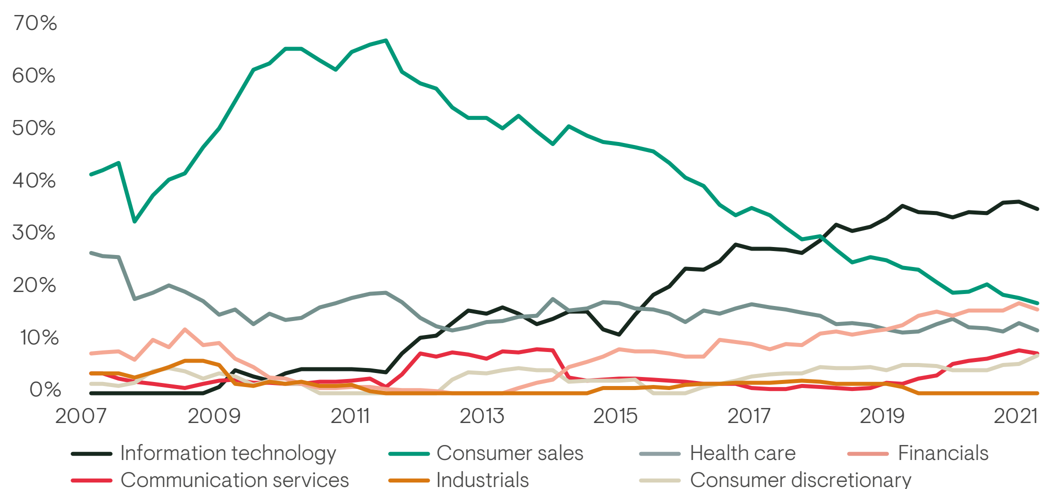
Survival of the fittest

A company's return on invested capital (ROIC) measures the profits that a company makes as a percentage of its invested capital – both debt and equity. In short, it demonstrates how effectively successive management teams have historically deployed cash into the business. The companies we invest in typically have – and maintain – consistently high ROIC, as the management teams pursue strategies that generate returns above the cost of capital, increasing shareholder value as the company expands. Such a company can invest in products and services that enable future growth while also creating barriers to entry to new competitors. The company needs to invest proportionally less compared to a low-return business for the same level of growth. Consequently, the company can return more cash to shareholders, in the form of dividends and share repurchases, without negative knock-on effects to future growth.

Over time, the universe of quality companies that can maintain top quartile ROIC has evolved into other sectors amid disruptive technological forces and structural changes to many industries. This is exemplified by the sector breakdown of the Ninety One Global Franchise portfolio, which has evolved significantly while staying true to our quality approach.

Figure 2: The Ninety One Global Franchise portfolio has evolved over time, embracing the changing market



Source: Ninety One, FactSet, 31 August 2021.

We have reduced exposure to consumer staples companies most impacted by threats such as private label penetration, brand proliferation, e-commerce and digital advertising. These disruptions are most acute in the US and in categories such as food and certain household products. Conversely, we have primarily increased our exposure to select, high-quality, attractively valued and cash-generative technology stocks.

One such example in the data and digitisation space is Dutch multinational ASML, a supplier of semiconductor capital equipment, focused on the most important step of the production process – lithography. If software is eating the world, then semiconductors provide the cutlery. Although ASML has long dominated this market, over the last decade it has perfected the use of a next-generation technology that utilises extreme ultraviolet light (EUV).

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Generating and harnessing EUV is an engineering feat – one that proved too demanding for competitors Canon and Nikon to even attempt. ASML's EUV machines – about the size of a single-decker bus, at a cost of close to R2 billion – have become precisely what chip makers need to print smaller circuits while increasing capacity and speed. Therefore, in the EUV era, ASML is no longer just a dominant supplier, but rather a monopoly, created through technological brilliance and innovation, as opposed to the more traditional mergers and acquisitions route.

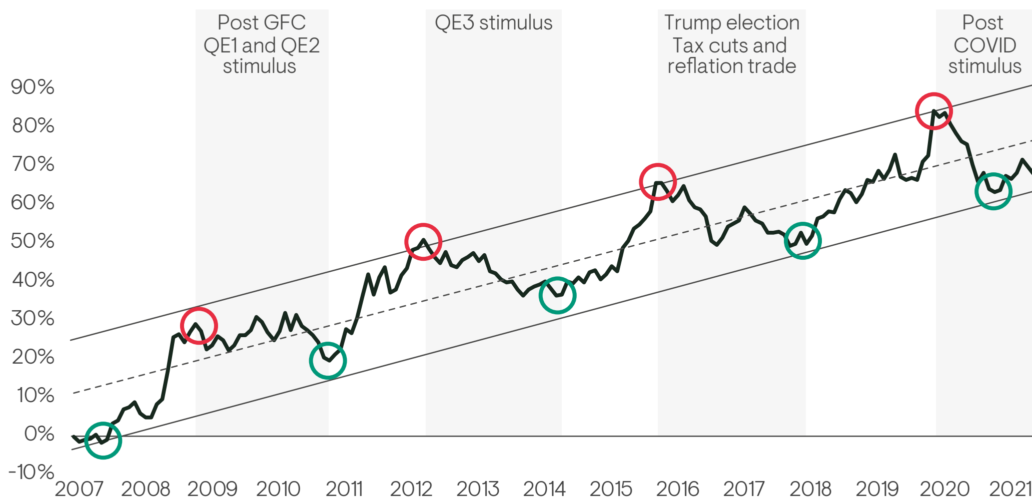
While the likes of Samsung and TSMC – ASML's largest clients – strive to maintain technology leadership in semiconductor manufacturing, other producers – notably those in China as it seeks technological independence - are endeavouring to play catch-up. The result is that ASML's importance in the supply chain has become further entrenched, evidenced by its order book stretching out to 2026. In the context of these exceptional growth and quality characteristics, this makes ASML a compelling investment proposition.

Market leadership

Given the backdrop, we believe fundamentals will be the critical factor in determining which companies outperform. Many of our portfolio holdings have delivered impressive results this year, ahead of estimates, and have been correspondingly rewarded by the market. With the possibility of rising inflation, quality companies with strong competitive positions and pricing power should be in a position of strength. We favour companies operating in structural growth areas, which are less reliant on overall economic dynamics.

There has been a change in market leadership. Quality is back in favour, and while cyclicals appear supported, value sectors have begun to lag as the strength of the recovery has been called into question. Consequently, we believe we are at an attractive point in the alpha cycle for the portfolio – suggesting relative outperformance may continue.

Figure 3: Cumulative (gross) outperformance since inception



Past performance is not a reliable indicator of future results, losses may be made.
Source: Ninety One, 30 September 2021. Performance is gross of fees (returns will be reduced by management fees and other expenses incurred), income reinvested, in USD. The periodic deduction of fees and expenses will have a compounding effect on performance. Example effect of management fees taken monthly over 10yrs on the value of a client's portfolio: Initial value = $100m, assumed return = 10% p.a., grows to $259m (no fees), grows to $241m (0.75% p.a. net fees). The annualised returns over 10yrs are 10% (gross of fees) and 9.18% (net of fees). *Global Franchise Equity Strategy inception date: 01 May 2007. Benchmark: MSCI AC World NDR (pre Oct-11, MSCI World NDR). For further information on indices please see the Important Information section.

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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.

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