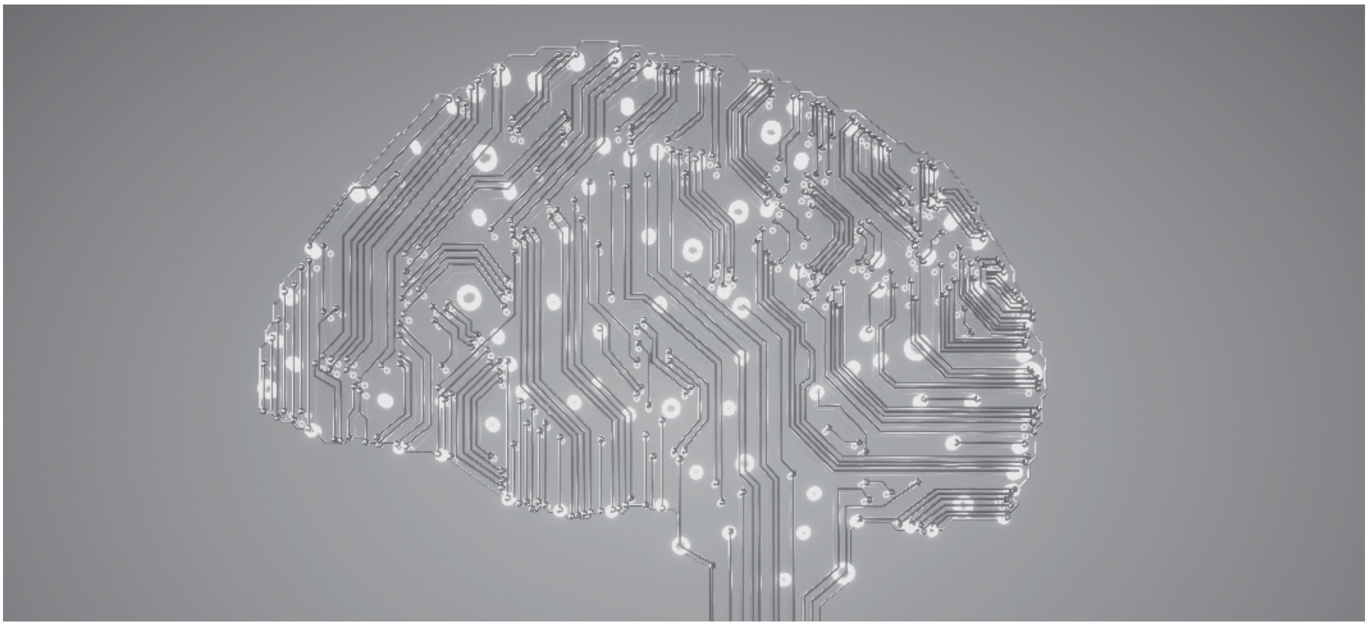


Why the best stories often don't make good investments

Clyde Rossouw

A handful of global companies have provided outsized returns this year, creating both risks and opportunities. Sometimes, the best businesses don't make the best investment cases.

Markets have been hostile this year. There has been a material increase in the cost of capital on the back of the rapid rise in interest rates globally. We have also seen an extreme narrowness of the market. Investors have grown accustomed to the fact that technology has become a dominant driver. A handful of companies have provided outsized returns this year, largely generated by the 'Magnificent 7': Apple, Microsoft, Alphabet (Google)[1], Tesla, Amazon, Nvidia and Meta (Facebook)[1]. A lot has been written about these goliaths and their link to the hype surrounding artificial intelligence and the way in which it will change everything.

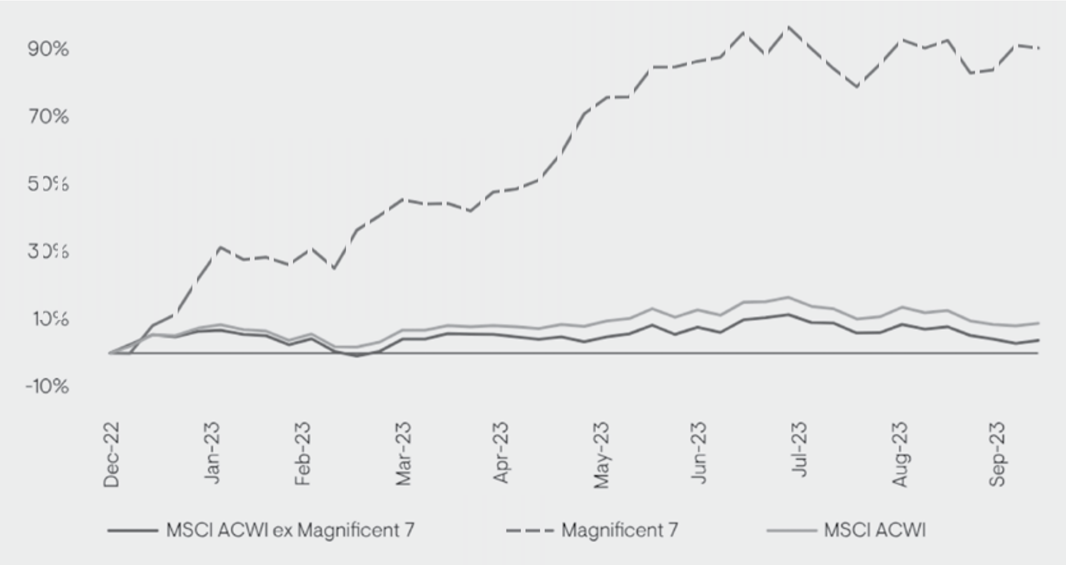
While the market is up 10% this year, nearly two-thirds of that total return is directly attributable to these seven stocks, up on average by 84%. Owning anything outside of these names, therefore, has been a challenge for many portfolios.

> Global equity markets have been challenging, as investors have grappled with a tension between increases in the cost of capital and returns driven by a narrow subset of stocks.
>
> This narrowness has created both risks and opportunities—the opportunity set is wider than the handful of shares that have benefited this year.
>
> However, investors need to be increasingly discerning about the companies they own, as markets question the growth outlook, valuation, and quality of these businesses.
>
> Despite these risks, high-quality businesses with strong fundamentals and reasonable valuations are well-placed to navigate this complexity.

Artificial intelligence or artificial valuation?

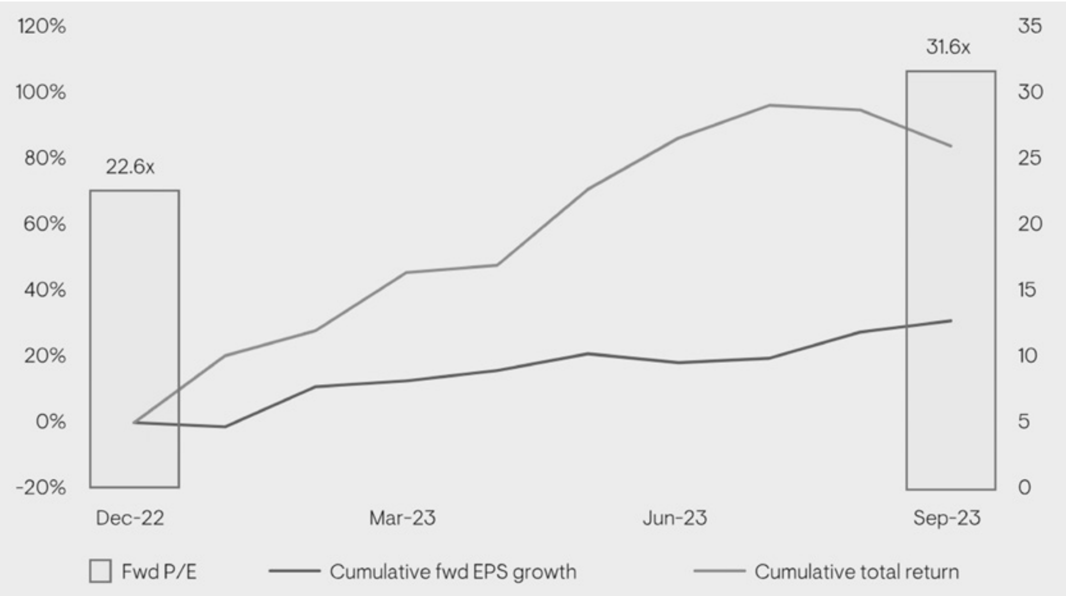
Most of the top performers' returns have come from a re-rating, with the result that investors are paying more for the prospective expectations of returns rather than the actual earnings growth they have delivered, even though the earnings for those stocks are up an impressive 31% on average. These shares have, therefore, become more expensive in the context of the broader market. Simply measured on a forward price/earnings basis, they are 40% more expensive than they were at the start of the year. If that is the case, you must be confident that the growth is going to come through. However, it is hard to see how trillion-dollar-plus market cap companies will be able to compound at the same rates of return they have done historically. How much revenue are they going to have to continue to generate when the starting point is more than $100 billion dollars a year?

Figure 1: A narrow market for investors



Source: Ninety One, Bloomberg, 30 September 2023.
For further information on indices, please see the Important Information section.

Figure 2: Bloomberg Magnificent 7 Index YTD



Source: Ninety One, Bloomberg, 30 September 2023.
For further information on indices, please see the Important Information section.

Some of these companies seemingly display the quality attributes we seek, such as enduring competitive advantages and dominant market positions. But sometimes the best businesses do not make the best investment cases. Valuation is a critical determinant of outcome and essential in our consideration. As such, we only own two of these shares within the Ninety One Global Franchise strategy, namely Microsoft and Alphabet (Google), where we can get behind the longevity of the business model and their valuation.

Beating the fade

Investors understand that most businesses' growth rates will fade over time. New competitors, shifts in spending

Clyde Rossouw, Ninety One

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The quote

While the market is up 10% this year, nearly two-thirds of that total return is directly attributable to seven stocks, up on average by 84%.

Figure 3: Return on invested capital (ROIC)

Source: Ninety One, FactSet Bloomberg, 30 September 2023.
**Comparative index changed from MSCI World from 1 October 2011. Based on a related portfolio with substantially similar objectives as those of the services being offered.*

habits and poor management decisions test the lifespan of all companies. Technology has the potential to disrupt and upend the futures of supposedly undisputable business models.

How do we avoid these companies at risk? Long-term market outperformance is generated by owning stocks in growing companies that generate high and/or rising returns on invested capital (ROIC), at fair valuations.

Very simply, return on invested capital demonstrates how effectively successive management teams have historically deployed cash into the business. The companies that we invest in typically have—and maintain—consistently high ROIC, as management teams pursue strategies that generate returns above the cost of capital, increasing shareholder value as the business expands. These companies invest in products and services that enable future growth, while also creating barriers to entry to new competitors. Consequently, they can return more cash to shareholders, in the form of dividends and share repurchases, without negative knock-on effects to future growth. The businesses we own within the portfolio have, on average, generated ROIC at consistently higher levels than the average company. This is a critical underpin to quality businesses.

Markets often undervalue these types of companies because they assume that their returns will fade over time when, in fact, their returns compound for far longer than many investors anticipate. This opportunity does not just exist in technology businesses, despite the acute focus that investors have placed on this theme. There is a wide cross-section of opportunities that span sectors and themes.

What gets us excited

Our job is to find differentiated assets that have exceptional fundamentals at reasonable valuations—ones that you cannot simply access through an index. We find companies that can sustain these high returns longer than markets expect. The stocks we own are up mid-single digits on average this year and yet the 'free cash flow' (FCF) performance is comfortably up by double digits in US dollars. That gets us excited, as our shares have effectively become relatively cheaper in the broader market context. FCF yield is the anchor point of valuation because it is a tangible measure of economic productivity. Importantly, through this measure, the portfolio trades in line with its own valuation history and below the market as a whole. That said, the broader market is distorted by several factors and so you need to be mindful of extrapolating answers from an index valuation.

While the businesses we own have done reasonably well, they have materially lagged a narrow subset of stocks. These are great businesses, where the share prices are not yet reflecting their potential and importantly, you are not overpaying for the opportunity. In short, they are great businesses at reasonable valuations.

Take a company like Beiersdorf, which owns a collection of beauty and personal care brands across the full spectrum of price points: mass (NIVEA), derma (Eucerin), super-premium (La Prairie) and healthcare (Elastoplast). The company's different brands hold strong positions in their niches, helping it to generate attractive organic growth over the long term. Within the business, there is a margin opportunity, which is a significant differentiator versus the wider large cap staples peer group. We believe this is not priced into the share. The business also has a considerable cash balance of almost €5 billion, which creates optionality if attractive assets come up for sale.

That makes us optimistic about what we own, and importantly, confident on what we do not own, given some of the valuations and risks building in certain parts of the market. If we are correct on the cash flow evolution, we should see double-digit annualised returns in US dollars on a medium- to long-term basis, without allowing for any re-rating. In other words, we are not looking for those shares to become more expensive. We recognise that the environment is not one where the market is going to pay for higher ratings, so there is conservatism built into that outlook.

Squaring the circle

The market loves a theme and a narrative; however, no matter how good management's story is, ultimately the FCF and the earnings evolution must match that story. Where that is the case, we are happy to invest, because we are positive on those prospects. But where shares run ahead of those expectations, that is obviously where you must be more cautious and start asking questions about how you are going to make returns from here.

As a result, the market is becoming far more discerning about the types of companies in which investors should invest. The cost of doing business is higher, so too the cost of growth, and demand is waning as economies come under pressure. The market is starting to differentiate between companies that can sustain a high ROIC and those that cannot, which tends to favour quality businesses. Quality businesses are those that can compound cash earnings per share through a market cycle. They have deep moats, dominant competitive positions, healthy balance sheets and FCF generation that can fund their own growth, so they do not have to rely on external capital providers. As such, they are more resilient in these challenging market conditions. **FS**

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[1]Microsoft and Alphabet are the two Magnificent Seven constituents that are in the portfolio and Beiersdorf is a top 10 holding. This is not a buy, sell or hold recommendation for any particular security. These securities are not extracted from a related portfolio. For further information on specific portfolio names, please see the Important information.

The quote

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