

Global Equity Observer

Building Resilience with Quality Capital Allocation

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In the play *Richard II*, William Shakespeare referenced the strength of the moat: “This precious stone set in the silver sea, Which serves it in the office of a wall, Or as a moat defensive to a house...”. And celebrated investor Warren Buffett is well known for using the moat analogy: “In business, I look for economic castles protected by unbreachable moats.”

As a team, the high quality companies we look for exhibit deep, wide and well-managed economic moats. These moats bring long-term, sustainable competitive advantages, helping to protect and grow market share, sustain or improve profitability, and potentially deliver attractive long-term returns.

But maintaining these moats requires effective and sustained investment by management in the unique attributes of the company’s offerings, ranging from brand recognition and pricing power, to patented technologies, high switching costs, network effects and scale and reach. Whether investment is in advertising and promotion, research and development (R&D) or other areas, we like it to be made through the profit and loss statement rather than via acquisitions—with a few notable exceptions.

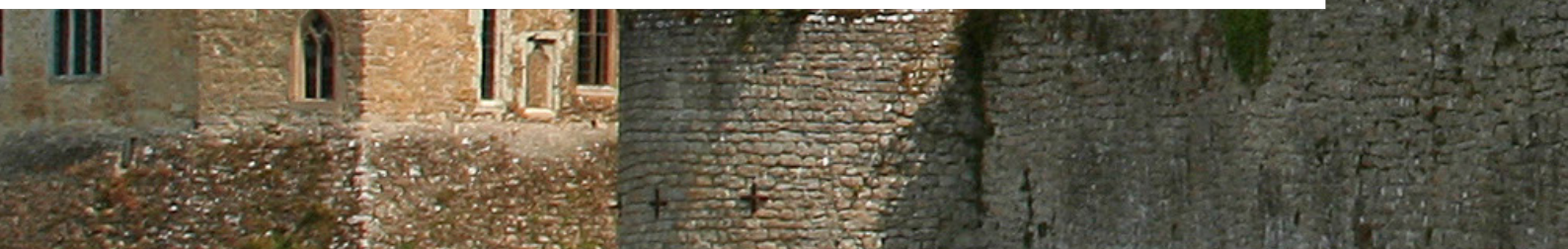
The last few years have been especially challenging for all companies, high quality or not, given the large bumps in the road due to COVID-19, war in Europe, supply chain disruption, rampant inflation and tighter monetary policy. But through this, we’ve seen remarkable resilience in our holdings, along with continued investment to drive onward growth. In fact, we would argue that it is precisely because of the effective investments by management that we’ve seen this resilience play through, as they help their companies to successfully navigate the variety of cycles and events the market throws at them.

AUTHOR



**ALISTAIR
CORDEN-LLOYD**
Executive Director

“The last few years have been especially challenging for all companies... But through this, we’ve seen remarkable resilience in our holdings”



Strengthening the moat through investment

Consider our consumer staples holdings; COVID-19 appeared particularly punitive for them. Lockdowns basically closed half the distribution channel for beverage companies as bars, hotels and restaurants shuttered. Beauty companies saw traditional retail and duty-free grind to a halt, while household and personal care items on shop shelves faced lower footfall from housebound populations. However, having invested in digital capabilities ahead of time, our staples companies were able to sustain their brand recognition and connect directly with their customer base around the world.

For example, during 2020, thanks to its strength in digital and e-commerce, which increased considerably during the crisis, our French-based global beauty holding was able to maintain a close relationship with its consumers and compensate to a large extent for the pandemic-driven closure of points of sale. E-commerce sales that year grew 60%, and today they stand at 28% of group sales. Advertising and promotion spend increased from €8.7 billion in 2020 to €12 billion in 2022. This has helped drive sales growth at twice the market growth rate, all while managing selling, general and administrative costs down from 20.3% of sales in 2019 to 18.3% of sales in 2022, leading to operating margin expansion.¹

Our Dutch-based global brewer is significantly investing in scale, ramping up capacity investments in Vietnam, Brazil and Mexico, along with investing in efficiency through its global business-to-business (B2B) and Connected Brewery programme (spending as much in the next three years as it spent in the last five). Furthermore, it is increasing investments in sustainability via solar power and biogas, along with wastewater treatment investments. During the pandemic, it benefited from its shift to digital (thanks to investment made prior to 2020), with its e-commerce platform showing strong growth. Meanwhile, its business-to-consumer platform Beerwulf had more than three million visitors in 2020, half of them new. Today, its active digital customer base is 40% ahead of pre-pandemic levels, despite the traditional retail channel reopening. And its B2B digital platform, available in 24 countries at the time, connected to 60,000 business customers. Today, the platform has grown to over 430,000 customers, selling products with merchandised value of €6 billion in 2022 versus €1.5 billion in 2020, with an aim to reach €15 billion in 2025.²

Health care is another key sector for us, especially in life sciences and medical technology, where we typically find the highest quality names. Here, building out the moat means directing capital to innovation (R&D) and increasing scale (production capital expenditure [capex]). Last year, one of

our highly diversified, U.S.-listed names invested in building out its mass-spectrometry platform to bring high-resolution analysis to toxicology and metabolomics (the large-scale study of small-scale molecules in cells, tissues and organisms). It launched its innovative new DualBeam scanning electron microscope to support the development of increasingly smaller and more complex semiconductors, and in genetic sciences it introduced a new system to help testing laboratories advance molecular diagnostics. To increase scale, it expanded capacity in China and Singapore, and in South Korea it launched innovation centres to support the semiconductor and biotech industry. Overall, the company invested \$2.5 billion in capex across its businesses to strengthen partnerships and accelerate growth.³

In the information technology sector, investment has been—and continues to be—extremely strong. COVID-19 brought forward a rapid adoption and need for technology as businesses raced to digitise and connect. At the heart of this is our world-leading technology consulting business, with 9,000 clients and more than 75% of the Fortune Global 500 as customers. It spent \$2.2 billion on R&D and training (nearly 4% of sales) last year. Since 2020, its investment in people has equated to a 40% increase in headcount in order to match demand. Its return on invested capital barely moved at all during the challenges of 2020, and has steadily risen since 2019, highlighting the resilience of the business.⁴

We also hold the world's largest software company in our global and American portfolios. This company, with a software platform—or network—that is the heartbeat of most people's work-place computing lives, brings together technologies and products that deliver experiences and solutions in an ecosystem of partners and customers. This is something exceptionally hard for any competitor to replicate and is arguably impossibly expensive to dislodge. The scale of its annual investments is eye-watering. At \$24 billion last year, the company's capex spend is close to 70% of the whole of the MSCI World software industry spend put together.⁵ Its strategy to build the intelligent cloud and intelligent edge platforms requires continued investment in data centres and technology infrastructure to support the services it offers, and by doing so it makes its moat deeper and wider. The company's scale brings efficiency. Its huge data centres deploy computational resources at lower cost per unit than smaller ones. Its vast cloud scale coordinates and aggregates diverse customer, geographic and application demands, and this scale improves the utilisation of computing, storage and network resources. There are environmental benefits too. Its cloud and artificial intelligence services and data centres help businesses cut energy consumption, reduce physical footprints and design sustainable products.

¹ Data taken from L'Oréal company reports

² Example not applicable to portfolios which feature alcohol exclusions. Source: Data taken from Heineken company reports

³ Data taken from Thermo Fisher company reports

⁴ Data taken from Accenture company reports

⁵ FactSet

The above are a few isolated examples of our holdings investing in sustaining and building their competitive advantages and refining their relevance to their clients. We are always looking for this focused allocation of capital when we engage with the management teams we meet. While this commitment of capital isn't likely to change the next quarter's

or even next year's results, what it will do is enhance the long-term prospects of the franchise. It will keep the moat deep and wide, which in turn should keep the fundamental compounding of earnings and cash flows steadily growing over the long term—which is exactly what we want to see.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect global franchise companies and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. **Stocks of small- and mid-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

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