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INVESTMENT MANAGEMENT

GLOBAL EQUITY OBSERVER

A Collection of Quality Insights

VOLUME 1

International Equity Team

GLOBAL FRANCHISE/BRANDS | GLOBAL QUALITY | GLOBAL SUSTAIN

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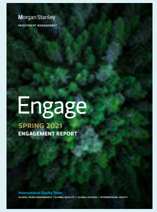

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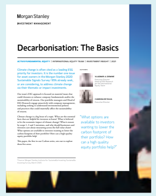

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Tackling Plastics in Consumer Staples

Dear reader,

This May, the International Equity team celebrated the publication of its 50th Global Equity Observer (GEO) – our monthly series of investment insights through the lens of our high quality investment approach.

Since the release of our first GEO 'The Value of Predictability' over four years ago, there has been a tremendous amount of *unpredictability* in world events and markets – particularly in the last 18 months. Few might have foreseen the unleashing of a global pandemic, leading to a brief but dramatic collapse in world markets, national lockdowns, extraordinary amounts of government intervention and subsequent market exuberance off the back of vaccine development and rollout. While there is renewed optimism in economic recovery, the future is anything but certain.

We have also seen higher standards demanded by regulators and asset owners on environmental and social matters. Corporates have had to step up to the challenge and, as long-term shareholders with an owner's mindset, ESG-focused engagements form a fundamental part of our analysis and thinking.

Against this backdrop, we remain steadfast in our conviction in high quality, high return on operating capital compounders with a strong ESG profile and the ability to grow earnings steadily over time – a belief you will see re-iterated in our monthly publications. These companies' pricing power and recurring revenues allow them to grow earnings across cycles, making them far more resilient in unpredictable times. We're delighted to share with you this selection of articles from our GEO series, covering topics from healthcare in a pandemic to the low carbon transition challenge.

As always, we invite you to engage with us.

William Lock
Managing Director
Head of International Equity team

August 2021

THE SECOND MOUNTAIN

JANUARY 2020

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"Today's environmental and social challenges offer businesses ample opportunity to focus on purpose as well as profit"

In his recent book, David Brooks argues that as we mature, we need to move beyond 'the first mountain', the one we think we're meant to climb, beyond self-gratification and individual goals, to climb the second mountain, where we find fulfilment in helping others or addressing a common good. It's not difficult to extrapolate this argument beyond the individual to corporations (and even fund managers), where today's environmental and social challenges offer businesses ample opportunity to focus on purpose as well as profit.

It is now 50 years, half a century, since the economist Milton Friedman argued that the sole purpose of business was to generate profits for shareholders. He did have a greater good in mind—that successful companies would pay taxes which would benefit society—but this second notion didn't gain as much currency as the first, particularly among the business community. This thinking has appeared a somewhat immutable truth over the past five decades. However, last year's announcement by the U.S. Business Roundtable, made up of some of the world's leading companies, including many world class multinationals we own in our portfolios, provided a watershed moment that it was perhaps time to reframe Friedman's argument. Might sustainability or durability—for these companies and the world—in fact depend on a more holistic perspective? In particular the signatories made commitments to their customers, employees, suppliers and communities, alongside the promise of generating long-term value for their shareholders.

As long-term investors in high quality companies, this just strikes us as good business practice and even common sense. Dealing briefly with the four stakeholders the Business Roundtable mentioned, there are obvious examples of why each of these matter:

- **CONSUMERS:** It is becoming increasingly clear in the world of consumer staples that to be successful companies have to deliver 'performance' products, which actually deliver benefits, not least because social media helps consumers become far savvier.
- **EMPLOYEES:** In many sectors dependent on highly skilled workers, most obviously software & IT services, the ability to recruit, motivate and retain staff is a crucial source of competitive advantage.
- **SUPPLIERS:** Companies are increasingly being held responsible for their whole supply chain, be it around worker safety or environmental impacts.
- **COMMUNITIES:** Aside from the obvious point that communities are generally consumers, companies now have to deal with a tougher political and regulatory environment, for instance around trade, tax, anti-trust, data privacy and the environment.

"Our portfolios are designed for performance not impact, but it is increasingly true that impact will affect performance over time"

To us there is no trade-off between 'doing the right thing' and long-term success. Long-term success requires that companies 'do the right thing'. We have been clear from the start that our portfolios are designed for performance not impact, but it is increasingly true that impact will affect performance over time, as companies are becoming increasingly responsible for the externalities they create, be they carbon, plastic waste or the loss of privacy.

Being more positive, the new Zeitgeist presents opportunities as well as risks, as purpose-led brands or those that stay on the right side of employees and regulators, can drive financial opportunity. This may be in the form of market share gains, pricing or an engaged workforce respectful of the regulatory environment. As Unilever's CEO Alan Jope argues it is "not about purpose instead of profit but rather profit through purpose"—in other words, customers are more likely to purchase brands that clearly signal values with which they are aligned.

"Environmental and social factors have become ever more important to the companies we invest in given the climate crisis, social media, and less predictable political environments"

As investors in compounders, we have always been focussed on the long term. The companies we own tend to be less cyclical than the index, and have strong strategic positions. As such, it has always been implicit that ESG-type factors were towards the top of the list of threats to sustaining high returns, hence our historic focus on governance. Over the last few years, the environmental and social factors have become ever more important to our companies, given the climate crisis, prevalence of social media and the less predictable political environments. Our response has been to become more systematic around ESG considerations. As a result, as an investment team we are climbing what at times feels like our own second mountain, grappling with what are often difficult to quantify ESG risks and opportunities.

In some cases, it is relatively easy to get to the familiar comfort of numbers, for instance in accounting for the likely incremental costs of around 30 bps per year to consumer staples companies paying the 40% premium for fully recycled plastic (or cutting the growth rates for those who fail to adapt). Equally, the risk from higher corporate taxes can be measured by comparing the company's current tax rate with the revenue weighted average of tax rates where the company operates. It is even possible to model the impact of a $100/tonne tax on CO_2 emissions; fortunately this is manageable for the companies in our global portfolios, as the carbon intensity is 87-89% lower than that of the index, based on tonnes of CO_2 per $million sales.[1]

Other issues are not so easily reduced to numbers, and these have given rise to fascinating conversations within the team. For instance:

- How to think about tail-risks—low probability events with major potential costs, such as a data breach?
- Which risks are sufficiently material for us to change a company's cost of capital or terminal growth rate in our model?
- What value do we put on diversity, and what cost on its absence? More broadly, culture is crucial, but is it measurable?

It is within this context that we have been working on developing a proprietary ESG scorecard for our companies which will focus not only on material stock specific issues and controversies, but also on attaching metrics to pressing "universal" issues such as environment threatening carbon emissions, safety, data, regulation and diversity, whether risks or opportunities. Where these are significant enough, there will be an explicit adjustment to either our modelled numbers, our valuation methodology or to the position sizes in our portfolios.

As ever, we remain pragmatists, artists as well as scientists, recognizing that issues are seldom clear-cut. As bottom-up fundamental investors, we seek greater understanding of our investments in an ever more complex world. We are striving to arrive at a reasonably objective assessment of the net effect of our companies' positive and negative activities on their return potential. We openly admit we do not have all the answers yet, and almost certainly never will! What we can offer is a genuinely long-term perspective, a commitment to confront these issues within the team rather than outsourcing them elsewhere, a history of thorough engagement with the companies we own, and the deep sector and company expertise to isolate and analyse the key issues. We look forward to climbing the second mountain together with you.

"We don't have all the answers yet, but what we offer is a commitment to confront these issues within the team rather than outsourcing, and a history of thorough engagement with the companies we own"

[1] Source: MSCI, Morgan Stanley Investment Management, as at 31 December 2019.

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THE COVID-19 ACCELERATOR

MAY 2020

"COVID-19 has brought to the forefront existing tensions between global power blocs"

In years to come, when we look back at the impact COVID-19 has had globally, William Hague (the former leader of the Conservative Party in the U.K.) may well turn out to have been right when he said that COVID-19 was a great accelerator to existing forces and trends.

Take its impact on the global power blocs. In the European Union, the health crisis has brought to the forefront existing tensions over whether the Northern Europe states should pay off Southern Europe's debts. At the same time, the American-Chinese rivalry has further intensified and with it all of the associated implications for trade/globalisation and the future role of the U.S. dollar as the global reserve currency. COVID-19's economic impact is accelerating Asia's global ascendancy, as a quick lockdown and rapid implementation of effective testing and tracing means the region's economies appear far less damaged than the West's. Political tensions may rise as COVID-19 leaves tens of millions without jobs, leading to deepening inequality, raising debt burdens and increasing state power. This is pushing to the fore policies such as Modern Monetary Theory, debt write-offs, harmonisation of corporate tax rates, basic incomes provided by the state, and corporates demonstrating wider responsibility to all their stakeholders (less debt/buybacks more on-shoring/tax). And then there is the question of who owns data about each of us and how that information may be used, setting up a debate on where the new boundary exists between the state and the individual.

As stock pickers we focus on the impact these trends have on individual stocks and industry-specific trends (namely, the high-quality, high-return sectors we own) and the effects on our stocks.

> **"COVID-19 has resulted in 'two years of digital transformation in two months' "**

The accelerator effect is particularly clear around technology. Satya Nadella, CEO of the large American technology company we own in our global portfolios, claims that COVID-19 has resulted in "two years of digital transformation in two months", as corporates shift to home working. In enterprise technology this technology company, given its communication and collaboration platform and cloud services, is a winner from this shift to the home. COVID-19 is accelerating existing trends, just as the growth of e-commerce and fear of transmission is boosting the shift from cash to cards, helping payments companies in the long run, even if the collapse in cross-border transactions is a temporary headwind. While these COVID-19-boosted shifts will likely help the economic dominance of the oligopolistic tech giants, be it in hyper-scale cloud services or social media networks, the parallel rise in concerns about inequality, government debt and privacy means that the political and regulatory risks to these tech companies will need to be watched carefully over the next few years.

COVID-19 has obviously shown the importance of health care as an industry and shone a light on whether health care systems are robust enough generally or whether better infrastructure is needed. If more funding is required, those who can provide savings will likely do well. For our med tech names, COVID-19 highlights the importance of data –not only using it but also, critically, having it. We believe this provides favourable tailwinds for diagnostics and testing equipment companies, especially when you consider 70% of medical decisions are informed by diagnostics, which amount to less than 2% of costs.[1] Recognising that the avoidance of unnecessary trips to the hospital is a way of saving health care systems unnecessary costs could lead to the acceleration of at-home treatments via remote monitoring and telemedicine, e.g. home dialysis.

For consumer staples companies, COVID-19 has shown big brands matter. Retailers are aggressively rationalising their shelves of mid-tier brands and the long tail of small niche brands as consumers in the developed world focus on affordability and known, trusted brands. It reminds CEOs that trust is the most powerful attribute a brand has, and must be treated with the greatest of respect. This will accelerate the shift in brands' communication, from marketing to consumers to mattering to them, pushing purpose to the fore whether in product superiority or in their social and environmental impact.

> **"Trust is the most powerful attribute a brand has, and must be treated with the greatest of respect"**

Social distancing and lockdowns have given all age groups a crash course in e-commerce. Once shopping lists are set up online, consumers are unlikely to return to walking the retail aisles. Companies whose management teams invested early in their digital capabilities will likely emerge from COVID-19 stronger than their peers. A French beauty company and a British consumer goods company we own already generate 20% and 10%, respectively, of sales from e-commerce, with margins and market shares at or above their offline ones.

In all cases, it is the quality of the management team that drives the resilience of the company and prospects for its success in coming through this crisis, whether through investing in innovation to remain relevant with customers or understanding and responding to the demands of stakeholders. We have always emphasised the importance of capable management teams in quality investing, which becomes even more obvious in the face of a global crisis.

[1] Source: Point of Care Testing, Abbott Laboratories.

FINANCING CLIMATE CHANGE

FEBRUARY 2020

Bank regulation may force the economy to shift towards a less carbon intensive model more quickly than expected. Some enterprises will flourish in this environment and others will fade, potentially leading to material shifts within the indices. As the market does not currently price for this, a solidly embedded environmental, social and governance (ESG) approach, as we believe we have in our strategies, may become a crucial differentiator for long-term performance.

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If Google Trends is to be believed, interest in ESG investing has increased tenfold since 2017. In Europe, the share of ESG funds has almost doubled to 7%.[1] This rapid development has overshadowed another major ESG-driven shift in financial markets, one that may have an even more significant and more imminent impact on the behaviour of companies and their share prices.

In December 2019 the European Commission announced its 'Green Deal'. The Commission states that 'the private sector will be key to financing the green transition', and that 'long-term signals are needed to direct financial and capital flows to green investment and to avoid stranded assets'.[2] Amongst other things they say that 'climate and environmental risks will be managed and integrated into the financial system. This means better integrating such risks into the European Union (EU) prudential framework and assessing the suitability of the existing capital requirements for green assets.'

When put simply, what these cryptic words mean is that banks will have to integrate ESG risk in general, and climate change risk in particular, into their risk management processes. For example, banks will have to assess the flood risk of a property in their mortgage risk assessment, under the assumption that worldwide temperatures rise by 2°, 3° or 4° centigrade. Even more difficult than these physical risks are the transitional risks, such as the risk that certain carbon intensive assets such as coal-fired power stations, cement plants or gas pipelines,

> "Banks will have to integrate ESG risks in general, and climate change risk in particular, into their risk management process"

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[1] Source: Bank of America
[2] Source: European Commission, 'The European Green Deal', 12 November 2019, available at https://ec.europa.eu/info/sites/info/files/european-green-deal-communication_en.pdf

"The European Banking Authority is developing a dedicated climate change stress test to quantify vulnerability to climate change risk"

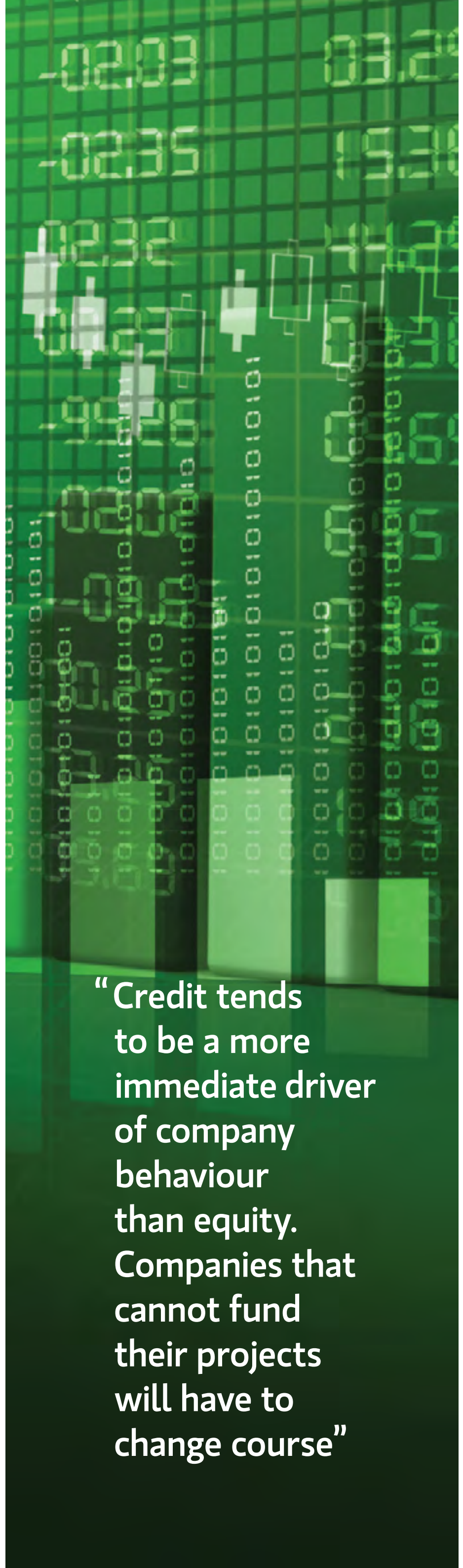
have to be written down due to regulatory change. On the flipside, migrating towards a carbon neutral economy by 2050 will require material investments, most of which relates to reducing carbon emissions from buildings (e.g., insulation, heating/cooling, construction materials etc.).[3] In the recent calculation based on the EU taxonomy of environmentally sustainable activities, the investment gap is about €270 billion annually or €2.7 trillion over the next 10 years, equal to 15% of EU GDP.

The European Banking Authority (EBA), which manages the banking stress test in Europe, will run a sensitivity analysis for climate change with a number of volunteer banks in the second half of 2020. The EBA will develop a dedicated climate change stress test to quantify the vulnerability to climate change risk[4] at a not yet specified date. Christine Lagarde recently suggested this could be as early as 2021. The stress test is likely to feed into the assessment of the individual banks' capital requirements set by the regulators, namely the European Central Bank.

Europe is not alone. The Network for Greening the Financial System (NGFS) was founded in December 2017. This global network of supervisors and central banks includes amongst others the People's Bank of China, the Bank of Japan and the Bank of England. It aims to mobilise the financial system to manage climate and environment-related risks and scale up green finance to support the transition towards a sustainable economy. In its first comprehensive report, published in April 2019, the NGFS called for collective action and reasserted climate change as a source of financial risk.

As banks recognise the physical and transitional risks in their calculations for probability of default, valuation of collateral and capital ratios, they will have to materially increase capital allocations to 'brown' loans (i.e. non-green loans). At the very least this would lead to an increase in the pricing for these facilities, but given risk limits and the impact on the overall capital ratio, it may mean that banks will simply have to refuse credit entirely. For instance, there are already a number of banks who have a blanket ban on the funding of coal mining and coal-based electricity generation.

The Commission has recently published a further draft of its Taxonomy, which is a detailed list of economic activities that help mitigate carbon emissions. Going forward there are



"Credit tends to be a more immediate driver of company behaviour than equity. Companies that cannot fund their projects will have to change course"

suggestions to apply capital relief to those activities considered helpful while applying higher capital requirements on activities considered detrimental. If implemented this would create a double whammy for the financing of 'brown' activities as the banks would apply both higher risk weighted assets and higher capital ratios to these loans. Such a direct intervention in capital flows has more than a faint echo of the dirigiste planned economy models of the 1970s.

So why is that relevant for our portfolios which have either no position in banks at all or usually a material underweight? The point is that credit tends to be a much more immediate driver of company behaviour than equity. As companies only rarely tap the equity markets to fund their strategic priorities, CEOs can, and many do, ignore ESG-focused equity investors for a long time, in particular when more and more of their shareholders are passive funds. It is very different when it comes to loans and bonds however, meaning companies that cannot fund their projects at a reasonable price or worse, cannot access credit at all, will have to change course.

With credit capital drying up for carbon-intensive industries and flows directed towards activities that either generate positive carbon outcomes or are carbon neutral, earnings and capital returns will shift, leading to a rebalancing of the economy and the equity indices. Staying abreast of these developments requires an active and ESG-focused approach.

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[3] Source: EU Technical Expert Group on Sustainable Finance, 'Taxonomy Technical Report', June 2019, available at https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-taxonomy_en.pdf
[4] Source: EBA Action Plan on Sustainable Finance, 6 December 2019

PAYING UP

JULY 2020

AUTHOR

ALEX GABRIELE
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The payments industry is gradually emerging as one of the most attractive parts of the financial technology (Fintech) world. Prior to COVID-19, approximately 50% of transactions globally were done in cash.[1] COVID-19 has forced many in-person transactions online, where cash is not a practical way to pay. Furthermore it is likely physical money is a vector for the transfer of the virus.

Once consumers are habituated to using more convenient digital payments, the shift away from cash should remain structurally higher in the post-COVID-19 world; digital payment volume growth is expected to be in excess of 12% per annum in the medium term, an attractive tailwind for the sector.[2]

The payments universe is complicated and there are a range of players with differing roles and value propositions. Broadly speaking there are three main categories—Card Issuers, Card Networks and Merchant Acquirers. Card Issuers are mostly banks and credit card companies who issue credit and debit cards to retail or wholesale customers. Card Networks provide the infrastructure and the rulebook for the exchange of authorisations and funds. Merchant Acquirers provide the connection between the shops or websites that accept the payment and the Card Networks.

> **"With consumers now in the habit of using digital payments, the shift away from cash should remain structurally higher in the post-COVID-19 world"**

For instance if customers swipe their cards to pay for their fully loaded COVID-19 shopping trolleys at the local supermarket, the device sends a message to the Merchant Acquirer asking for authorisation of the payment. The Merchant Acquirer sends the message through the Card Network, which forwards it to the Card Issuer. If the Card Issuer confirms the card to be good for payment, the authorisation is conveyed back through the Card Network to the Merchant Acquirer and finally to the supermarket. Depending on the card used and geography, for every $100 shopping basket the consumer buys, the supermarket receives approximately $98.00 to $99.00 whilst the Merchant Acquirer gets a $0.10 to $0.20 fee, the Card Network collects a fee of around $0.20 and the Card Issuer gets generally $0.60 to $1.30.[3] Optically it looks like Card Issuers are making the most money, but in reality they pass some of the fee back to consumers in the form of incentives like air miles, cash-back or reduced foreign exchange fees.

Card Networks – the resilient part of the system

Traditionally the two pure card networks, Visa and MasterCard, have been the most attractive bottleneck in the ecosystem. They have a strong set of three overlapping moats—a network of consumers, a network

[1,2] Source: Capgemini World Payments Report 2019

[3] Source: Adyen, Nexi, Visa and Morgan Stanley Analaysis

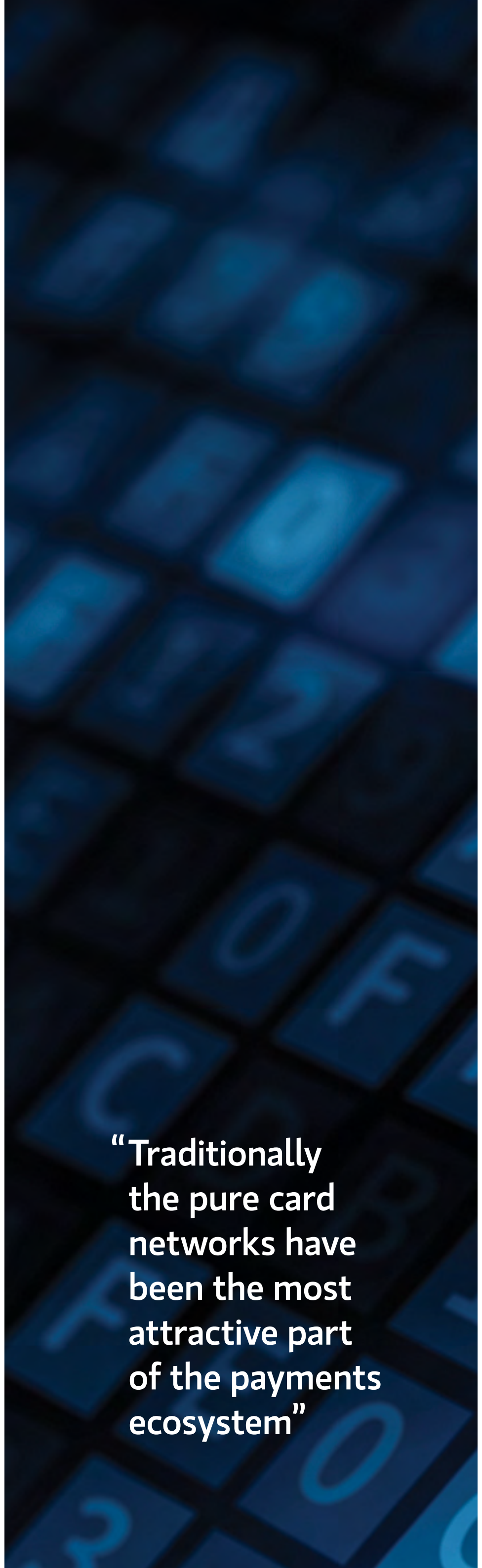
of merchants and a network of financial institutions. These overlapping moats have proven very difficult to break. There are some vertically integrated operators, domestic card networks and new emerging electronic payment providers, but without the help of government regulation tilting the playing field, and extensive capital, it has proven very hard to compete; the majority of these alternatives lack the scale of investment, international reach or service quality to compete with Visa or MasterCard. That has allowed Visa and MasterCard to maintain stable and often dominant market shares in a growing market, with the persistent global move from cash to card.

Merchant Acquirers – making progress

Most merchant acquiring activity is still done by banks, particularly in Europe. Historically it was a part of commercial banking services that banks provided to their clients. Over time the inherent economies of scale in this business have resulted in the emergence of initially bank-owned utilities and now independent commercial operators that provide processing and merchant acquiring services. These companies pursue one of two strategies. Either they consolidate the existing merchant banking infrastructure under one roof and create synergies from streamlining systems and cost, or they operate one unified technology stack and acquire customers organically. Players like Adyen, Stripe and PayPal have pursued the second strategy and saw very strong growth at highly attractive economics resulting in elevated valuations. At the same time some of the consolidators that trade at more digestible multiples are making good progress based on sensible pricing of deals and improving integration skills.

Card Issuers – buried in the banks and credit companies

Most issuing activity sits within banks and credit card companies. They sometimes



outsource the processing part to gain economies of scale but tend to hold on to the core issuing activity, which gives access to the interchange fee. Whilst card issuing produces very attractive returns, with some variance depending on how much they have to give away in direct or indirect incentives, these activities are rarely big enough to drive the economics of the organisations where they occur.

Data – the next frontier

The current investment case rests on the benefit of consolidating what is by nature a largely fixed cost business. Beyond this, the payments industry provides an unrivalled treasure trove of data on which to build value-added services.

> **"Ultimate success will be determined by who can generate the highest quality data"**

For example, fast food restaurants are putting up kiosks in their restaurants where you can order food to pick up at the counter. Customers tend to order more or higher value items at the kiosk, maybe because they feel less under pressure from the people waiting in the queue behind them. A similar trend is happening with the use of apps. Creating a tool that helps fast food restaurants project the return on investment for the kiosk, based on their existing customer base, could be of material value.

Ultimate success in this industry will be determined by who will be able to generate the highest quality data. Some of the large banks who have both issuing and acquiring under one roof should, in theory, be best equipped. However, this requires integration across often separate divisions (retail and commercial banking) and a material upgrade and integration of existing systems. Historically banks, in particular incumbent banks, have struggled with these kind of challenges. Card Networks have by far the deepest set of data. However, their role at the centre of card payments is not just one of processing, but also to be the arbiter and rule maker between acquirers and issuers. It will be difficult to remain a referee whilst competing with the contestants on data.

Some of the Merchant Acquirers are positioning themselves in value-added services. Similar to the banks, the system architecture will be critical to success, favouring the single technology stack players. Recently established digital wallets like ApplePay and GooglePay are also in a strong position assuming they can integrate the payments data with their other databases.

Implications

From an ESG perspective, the shift to digital payments away from cash may lead to the financial exclusion of people without access to the banking system, especially in emerging markets. Visa is acutely aware of this and has been helping unbanked individuals access electronic payments accounts, with the aim of meeting 500 million people by 2020. The shift to digital also raises payment security issues. Visa has been investing heavily in data security. They received the highest rating in the sector from Gartner Consulting during their 2019 cybersecurity program review, and also prevented approximately $25 billion in fraud using artificial intelligence.

As quality investors with a focus on downside protection we have always been drawn to the Card Networks given the robustness of their business model and scale economics. Banks and pure credit card companies are out of bounds for our global portfolios due to low returns and high leverage. Merchant Acquiring is more interesting, although valuations are very elevated for players with single technology stacks.

HEALTH CARE IN A PANDEMIC

SEPTEMBER 2020

AUTHOR

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In a previous GEO (Compounding in Health Care, September 2019), we wrote about some of the virtues of the health care industry; one being the predictability of the sector. Selling essential, non-discretionary products means that health care companies are relatively immune to economic turbulence in a way that most companies are not.

The current crisis has tested conventional wisdom in all manner of ways, including what to expect of health care companies. On aggregate the sector has proved resilient, particularly in a relative sense. Indeed, consensus 2020 earnings for the sector are down only 3.8% since the beginning of March, versus -26.7% for the MSCI World Index. However, beneath the headline numbers are some unusually large variations. Some companies have proved fairly predictable, while others have recently reported results that were scarcely imaginable just a few months ago, both to the upside and the downside.

Short-term hurdles from social distancing measures offset by some opportunities

The major negative for the sector has been that hospitals and doctors' surgeries have been avoided for all but the most urgent and essential procedures. The result has been a particularly tough environment for medical device producers. For traditionally predictable businesses selling, for example, joint replacements, having 30% chopped from their 2020 earnings estimates is, surprisingly, not unusual. Even product categories that one would have previously considered as not at all discretionary, such as pacemakers, have proved vulnerable to declining sales (one leading company's division was down 25.7% organically in the second quarter). Hospitals have also been clearly impacted by this dynamic, as well as companies providing diagnostic tests. Furthermore, life science companies have suffered as researchers have been away from their benches and social distancing has limited the ability to install new equipment.

> "Selling essential, non-discretionary products means that health care companies are relatively immune to economic turbulence"

Pharmaceutical businesses have generally fared better, although certain products that need to be administered by doctors have suffered. Generally, the story of the year so far has been very strong demand in the first quarter as people panicked about the availability of medicines, followed by a weaker second quarter driven by destocking as the panic proved a little excessive.

The crisis has also served as a reminder of the purpose of health

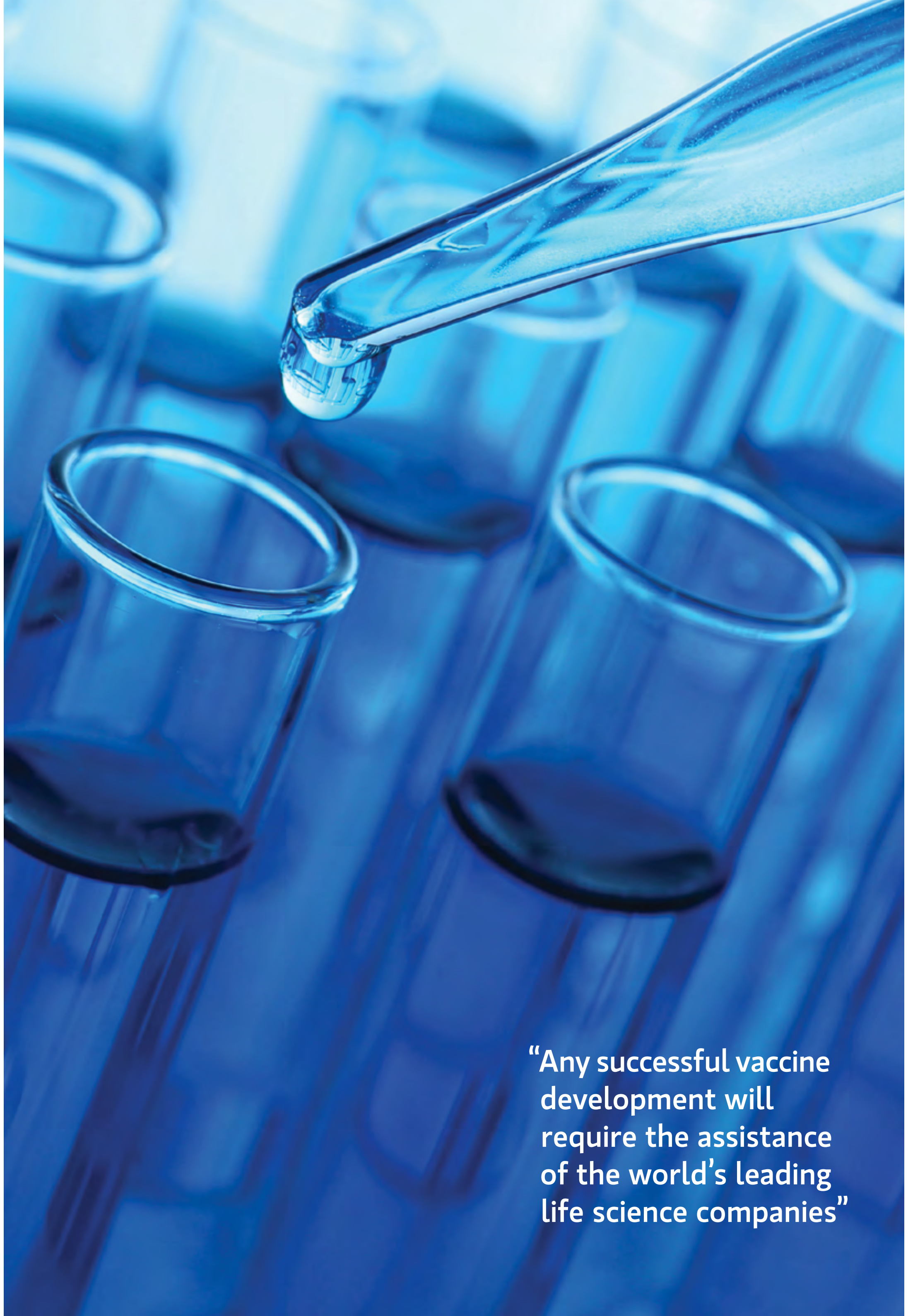
care companies. While the sector is frequently criticised by politicians, especially in the build-up to elections, and analysts are quick to point out environmental, social and governance risks, it sometimes seems to be forgotten that these companies provide life-enhancing and often life-saving products and services. It is these companies that are at the forefront of finding solutions to the current crisis. Time will tell whether the political winds become any more favourable, but a few highly innovative companies are already benefitting from these dynamics, particularly those able to provide accurate COVID-19 tests, as well as those in a position to help pharmaceutical companies research and develop treatments and vaccines. One of the team's health care holdings provided initial guidance for its second-quarter results of flat to -15% organic growth, and in the end reported +11% while guiding for 15% growth in the third quarter.

> "The sector has proved resilient, particularly in a relative sense"

Looking ahead

Ultimately, the questions we are asking ourselves are whether those companies that have been negatively impacted by COVID-19 have had any permanent impairment to their earnings, or whether 2020 will turn out to be an aberration. For those that are benefitting from COVID-19-related developments, we are trying to establish how enduring these new revenues will prove.

As to if/when there will be a successful treatment or vaccine,



and which companies will benefit the most, we generally find these types of predictions fraught with risk. We are, however, reasonably confident that our portfolios' companies will participate, given any successful development will require the assistance of the world's leading life science companies and likely the world's leading needle and syringe manufacturer. Also, given the difficulty of manufacturing vaccines at scale, it is not outrageous to suggest that the world's two leading vaccine manufacturers, may have a part to play.

Impact on our portfolios

Overall, we cannot claim the health care portion of our global portfolios has proved entirely protected from the negative consequences of the pandemic, but certain parts have benefitted materially, and on aggregate we feel it is providing the resilience we aim for; consensus 2020 earnings for our health care holdings are down 2-6% for our global portfolios since March, compared to -4% for the MSCI World Health Care Index, and -27% for the MSCI World Index;[1] this despite minimal exposure to the particularly defensive but lower quality pharmaceutical and biotech sub-sectors. Crucially, given the essential nature of the products and services the portfolio's companies provide, we feel confident that the more affected areas will bounce back relatively quickly—such that there is no material impact to the long-term earnings or compounding these companies can deliver.

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[1] Source: FactSet, August 2020. The MSCI World Health Care Index measures the performance of large- and mid-cap health care stocks across 23 developed market countries.

THE YEAR AHEAD: THE ROARING 20S OR THE SCARY 20S?

DECEMBER 2020

AUTHOR

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Managing Director

> "Vaccines can open up the genuine prospect of a world returning to something like normal in the second half of 2021"

November was a spectacular month for markets. The 13% rise in the MSCI World Index was the best monthly result since January 1975. There was some spectacular news though, with three vaccines achieving efficacy way in excess of the 50% that was deemed the minimum viable level. This opens up the genuine prospect of a world returning to something like "normal" in the second half of 2021, potentially ending the ominous cycles of flare-ups and lockdowns which had returned for the U.S. and Europe in the Northern Hemisphere's autumn. In addition, the world breathed a sigh of relief that the U.S. seems on track for a peaceful transition of power, with the added bonus that the absence of a clear Democratic "Blue Sweep" makes significant corporate tax rises or radical regulation less likely, which may protect U.S. corporate profitability, particularly for the tech giants.

While the news was clearly positive in the month, the issue is whether the market has moved too far too soon. The MSCI World Index was roughly flat year-to-date (YTD) at the end of October, before the "month of miracles", and is now up over 50% from its lows in March, bringing us to a 12% annualized return through the end of November—a higher-than-average annual return. This would seem to imply that the long-run outlook for corporate profits is better than at the start of the year, despite the impact of the pandemic, which is forecast to shrink global gross domestic product (GDP) by 4.4% this year according to the International Monetary Fund, and has driven forward earnings down 9% YTD.

It is important to point out that this is not a market that was remotely cheap at the start of the year, on the back of a market rise of 26% in 2019, all of which was rerating, as earnings fell slightly. This has left the MSCI World Index's current multiple of the next 12 months' forward earnings above 20x, a metric that had never been above 17x before this year, in a history going back to 2005. Allowing another year of earnings recovery, the two years' forward multiple is 17.7x, still 15% above the pre-2020 high of 15.4x. Risk definitely seems to be "on".

Even if we assume that the direct effects of the pandemic, the lockdowns and the voluntary self-isolations have faded by the second half of next year as the vaccination spreads across populations, COVID-19 will still have left a major legacy. This can be seen in the acceleration of three major existing trends.

> "COVID-19 will still have left a major legacy, as seen in the acceleration of three existing trends: technology, government intervention and the growth of debt"

The first is the step change in the adoption of technology. E-commerce has surged, along with remote working, while cash spending has shifted to cards and corporates are shifting their on-premise technology infrastructure to the cloud. This march of technology clearly creates winners and may give corporates in general the opportunity to cut some costs on a permanent basis, for instance, around office space or sourcing newly remote labour from cheaper locations. But it also exposes losers, be it traditional retail without a unique selling proposition, real estate plays or IT services companies that manage on-premise infrastructure.

The second is the growth in government intervention. The unprecedented scale of support during the pandemic is likely to have added to governments' already growing taste for involvement in the economy. The era where economies were run for the benefit of large corporates already seemed to be coming to an end, given the attacks on free trade, the revival of anti-trust activity, pushes to raise corporate taxation and the start of moves to rebalance the relationship between labour and capital, for instance, through raising minimum wage levels. The action on climate change may be the most important shift, with moves towards pricing carbon and constraining polluting activities. Optimists will point to the probable gridlock in the U.S., and even the potential for a wave of lucrative green infrastructure investment. But on the downside, much of the carbon-heavy status quo may become uneconomic or even forbidden.

The final trend that has been boosted is the growth of debt. Admittedly, the personal sector savings rate has risen sharply, given the large transfer payments by governments and the suppression of social consumption, be it holidays or eating out. The same is not true of the corporate sector, which has seen a further step up in leverage. Moody's estimates that investment grade debt issuance will be up 60% this year, and even high yield is expected to see a 25% increase. This is dwarfed, though, by the increase in government debt given the actions to shield economies from the pandemic. The U.S. alone has seen a $4 trillion increase in its national debt so far this year, which has now reached 107% of GDP.[1] Again, there is an optimistic scenario, where newly freed consumers spend heavily in 2021 and 2022, reducing their high savings rates, while governments continue to support demand by running heavy deficits, helped by accommodating central banks and the relaxed attitudes of bond markets so far. Growth would therefore bounce back strongly, but hopefully without the significant rises in inflation or interest rates that might spook the markets. The less positive scenarios are either side of this Goldilocks outcome: either too cold, because of consumer caution or government cutbacks, or too hot, with the recovery driving up inflation and rates.

> "Action on climate change may be the most important shift"

There are positive potential pay-offs from all three trends: corporates become more efficient, green infrastructure investment offers a boost and low interest rates allow governments to continue to spend. Along with the potential for consumers to spend their savings, the more ebullient of commentators suggest that this can set off a second "Roaring '20s", presumably unworried by what happened at the end of the '20s the last time round. All these positive scenarios are possible, and some may even be probable, but the issue is that the current 20x plus multiple of earnings may be effectively taking them as a given. Given how much can go wrong, we see this multiple as the "Scary 20s". Equally, growth investors may well be looking to the benefits of the acceleration of technological disruption to justify elevated valuations, without worrying about the potential curbs on the tech giants, while value players may be looking forward to the imminent reflation without taking sufficient account of the disruptive or environmental challenges.

In this "risk-on" world, after the spectacular market rises over the last eight months, we would argue that investors should now be looking to preserve capital, or to keep the lights on, rather than attempting to shoot the lights out. To quote Warren Buffett, "Be fearful when others are greedy." As such, we would be advocating the benefits of compounders. The idea is that these companies' pricing power and recurring revenues allow them to grow earnings across cycles, making them far more resilient in tough times like 2020.

Our global portfolios have indeed managed to deliver this resilience, growing forward earnings by 3-5% so far in 2020, on the back of 8%-11% growth in 2019—a sharp contrast to the -9% and -1% that the MSCI World Index managed in 2020 and 2019, respectively. Interestingly, this 22-27% relative gain in earnings over the two years has not resulted in any significant outperformance over the period, given the violence of the recent value rally. As a result, the portfolios have sharply derated versus the index and are now only on a 9%-16% forward earnings premium to the MSCI World Index—a premium that vanishes in free cash flow terms, despite the massive gap in terms of quality, making compounders a relatively cheap insurance policy.

> "Ebullient commentators suggest a second 'Roaring '20s' may be the result; we would argue that investors should now be looking to preserve capital"

[1] Source: U.S. Department of the Treasury.

AVOIDING LOSING MONEY IN EQUITIES

AUTHOR

BRUNO PAULSON
Managing Director

JANUARY 2021

One of the benefits of compounders is that they are robust in tough times. Their recurring revenues help preserve their sales, while their pricing power protects margins. 2020 was certainly tough times, with world gross domestic product estimated to be down 4.4%, and advanced economies faring even worse, down 5.8%.[1]

"The Information Technology sector alone delivered 60% of the MSCI World Index's 2020 return"

[1] Source: International Monetary Fund

The idiosyncratic nature of the crisis did affect some of the companies we typically prefer, with beverage companies hit by the closure of bars and restaurants; payments companies' lucrative cross-border businesses severely affected by the collapse in travel; and some health care players affected by the cancellation of routine operations and the logistical challenges of the pandemic. Despite pockets of local difficulty, the earnings of high quality global stocks generally held up well.

This is in stark contrast to the MSCI World Index as a whole. Its forward earnings fell 7%, despite all the government support for corporates. This meant that more than 100% of the overall index return of 16% was accounted for by the major 23% rerating. This repeated the pattern of 2019, when the index returned 27%, despite a 1% fall in forward earnings, with rerating driving the performance. Across the two years of 2019 and 2020, the index has rerated by 55% from 13.4x to 20.7x NTM earnings. It is also at an elevated 17.9x on a 24-month forward basis. Our high quality global stocks have also rerated but at least half the returns have come from the compounding earnings, up 18%, and dividends.

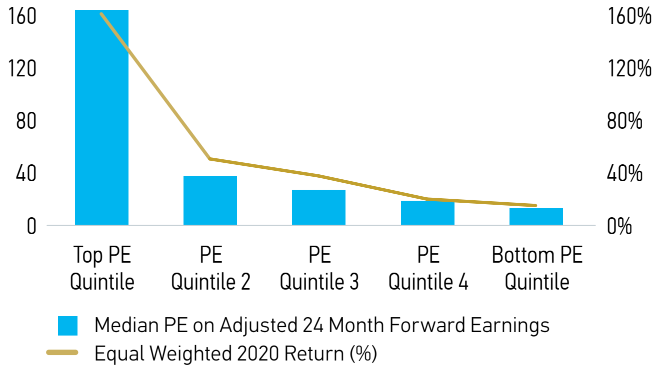
Apart from the cyclical/value rally of Q4, the key issue to note in 2020 was the dominance of technology in the market's returns. The information technology sector alone delivered 60% of the MSCI World Index's 16% 2020 return, and adding in certain household names in e-commerce, streaming, electric vehicles, and social media—regarded by most people, if not MSCI, as technology companies—takes the share to 89%, meaning that the rest of the market only delivered 11% of the index performance. Another way of looking at it is that over half the total MSCI World Index performance was delivered by only five companies, and 78% by the top 25, of which only one is listed outside the U.S.

While our global portfolio managers favour a strong weighting in information technology particularly software in addition to staples and healthcare, the IT sector's hot pace bears noting. The team's valuation discipline meant that our global quality portfolios did not get the benefit of the year's massive growth boom.

2020 saw a spectacular 480 initial public offerings, amongst which there were 248 SPACs (special purpose acquisition companies), also known as "shell" or "blank cheque" companies. The euphoria in the growthier end of the market can be seen in the information technology returns. Splitting the sector into five quintiles by adjusted 24-month forward earnings shows, as in the chart below, the seeming exuberance. The top quintile has a median price-to-earnings ratio (P/E) of 166 times adjusted earnings. This (P/E) is arguably being generous, as using pure GAAP/IFRS numbers, i.e., deducting share-based compensation,

DISPLAY 1

2020 Return by Information Technology Valuation Quintiles



Source: FactSet and Morgan Stanley Investment Management.

takes the majority of this quintile into loss, even two years ahead. This elevated valuation was helped by the group's average 2020 return of 163%. Even the relatively sober second quintile, with adjusted P/Es from 33 to 56 times, saw a return of over 50%. Our valuation discipline has limited us to the third quintile and below (quality concerns kept us out of the bottom quintile), meaning that we missed out on much of the excitement.

There are only two ways of losing money in equities: either the earnings go away or the valuation goes away. Our quality-obsessed investment philosophy looks to minimise the former, and we have also looked to reduce the risk of the latter, in the face of the market's 20x forward multiple. Not only have we continued to avoid the more boisterous quintiles of the information technology sector, but we have shown discipline within our global portfolios' existing holdings shifting from companies with top-line growth of 6% or above to those with sub-6% growth. This shift to cheaper stocks has been to the detriment of performance, given the continued progress for growthier names, but should support the portfolios' resilience in the future.

We don't suggest that high quality global equity is cheap in absolute terms but relative earnings multiples look far more defensible. Now more than ever, it is time to focus on keeping the lights on, rather than attempting to shoot them out, and reasonably priced compounders seem a reasonable way of avoiding a plunge into darkness.

Source for all earnings and valuations within the document: FactSet and Morgan Stanley Investment Management.

INSTA-ENGAGEMENT

FEBRUARY 2021

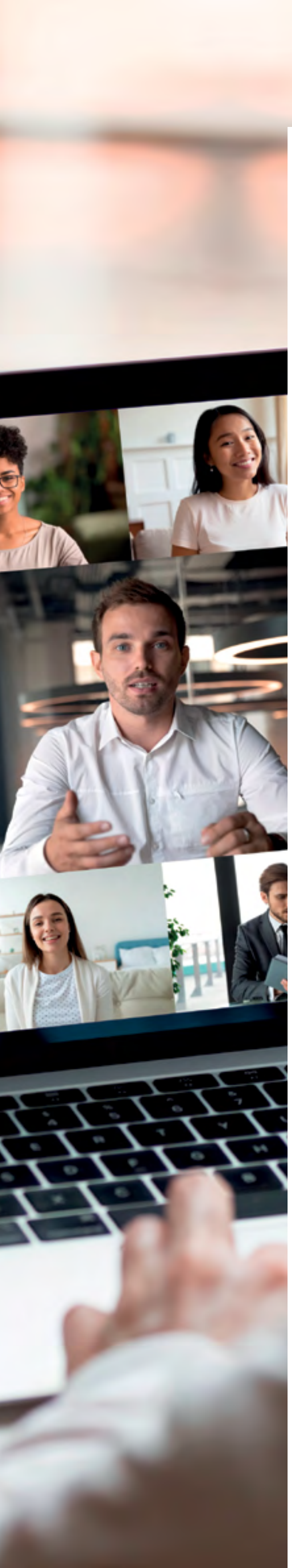
AUTHORS

LAURA BOTTEGA
Managing Director

BRUNO PAULSON
Managing Director

Effective engagement needs time. Expecting instant results from an engagement is as senseless as expecting instant alpha. Just as we look for steady and consistent growth in the companies we own, we value steady and consistent improvement in their approach to environmental, social and governance (ESG) issues over zigzagging in policy to satisfy short-term appetites and box-ticking.

As a team, we have engaged with company managements and their boards for over 20 years. In recent years, we have become more structured about our engagements, focusing on dual discussions with the C-suite as well as sustainability representatives of our investee



companies. These engagements have provided useful insights, especially regarding company responses to and priorities during the pandemic. We have also become more systematic about the crucial area of management incentives, creating our proprietary Pay X-Ray scoring framework. This has enabled us to better compare and discuss company pay plans and inform our voting approach. In 2020 we voted against management on 30% of say-on-pay resolutions. In the bulk of these cases our stance was in disagreement with ISS, which supported management.

"Our efforts to engage are helped by our long-term holdings of significant stakes in companies"

Our efforts to engage are helped by our long-term holdings of significant stakes in companies. The resulting access makes us less dependent on news presented at public annual general meetings or investor relations events. We reserve our hardest questions for private meetings, not the podium or the press. We believe the right questions asked in the right way can garner thoughtful consideration of our position and drive the agenda of future engagements. However, we are not afraid to vote against management, as was demonstrated by the 68% of the 2020 shareholder proposals that we supported.

Remote working has meant that both asset managers and companies have had to get used to digital and video-conferenced engagement. We found, in the main, that companies were responsive to our requests during lockdown. We held some 369 meetings in 2020, and 205 of those specifically included an ESG engagement on topics ranging from decarbonisation, diversity and data security to supply chain questions from fast fashion to semiconductors. That said, we are looking forward to meeting companies face-to-face again whenever this becomes possible.

Discussions with companies in the fourth quarter of 2020 included carbon emissions targets, deforestation, diversity and inclusion, board risk controls and safety. For example:

- With Reckitt Benckiser, we probed how their recent pledge to be **net zero carbon** by 2040 can be achieved. We were encouraged by their policies and actions around **palm oil**.
- We had a very detailed discussion on **deforestation** with Procter & Gamble, to understand their initiatives in sustainable paper product sourcing. They have taken a number of concrete actions, but we voted for the shareholder resolution to improve disclosure.
- Our discussions with Baxter International centred on **product safety**, given past concerns. They aim to be in the top quartile on safety among global companies and have achieved a good reduction in product complaints through improvement to their inspections. We also examined their **diversity and inclusion** measures and encouraged them to disclose their gender pay gap. We believe Baxter is making progress and will continue to monitor them.

We encourage you to learn more about these and our other engagements through our Engage newsletter, published semi-annually, available at **www.morganstanley.com/im**.

The question of "whose opinion matters?" has never been more germane. Ultimately, while all stakeholders matter, the top line starts with the customer. Any major concerns relevant to the customer should be high on the agenda of company management. In this context, it is important to be clear about one's own principles, priorities and values. For our carbon-light, high-quality global portfolios, we pay particular attention to companies' efforts to meet low or net zero carbon targets.

We're also pragmatists. We recognise that universal problems may require collaborative solutions to hasten progress. MSIM's support of the One Planet Summit asset manager initiative since January 2020, which aims to advance the understanding of climate-related risks and opportunities in long-term investment portfolios, is an excellent example. In the United Nations Principles for Responsible Investment 2020 Annual Report, MSIM scored "A" across modules and "A+" in Listed Equities for both Active Ownership and Incorporation, a result we are delighted with.

As companies look to emerge from the crisis, we will continue to ask the hard questions. Many of them are company or industry specific, be it around plastics for consumer staples, product safety for health care or data security for information technology, but there are some more universal themes coming out of the crisis:

- What are the main lessons from the pandemic? How have companies evolved their attitude to risk as a result of the crisis?
- Will the company's supply chain be the same as or different from before the pandemic? Has the company accepted that it is deemed responsible for its supply chain—from employee health and safety to resourcing?
- How will capital allocation and balance sheet decisions differ going forward?
- How have remuneration decisions been affected by the shock of the pandemic? Will the board take into account any capital raising, dividend cuts or take-up of government support?
- How is the company placed for the new era of greater government intervention? Is there significant exposure to potential new tax regimes?
- How does the company perceive the impact of remote working on innovation or product safety, or prioritise topics such as gender and racial diversity under tougher economic conditions?
- How are companies weighing up the balance between the ever-increasing demands for sustainability and their long-term returns on operating capital employed?

Globally, the call for greater transparency and disclosure of companies' and fund managers' activities, as well as in-depth portfolio reporting, is finding its way into industry bodies and regulation. As we navigate the ESG journey, we believe it pays to avoid faddy "tickboxery" and instead to maintain investment discipline, to focus on robust stocks and on relevant, meaningful long-term engagement.

AUTHOR

NIC SOCHOVSKY
Managing Director

"Our life experiences create our memories; our memories are based on our own encounters with brands"

WHY BIG BRANDS THRIVE IN A DIGITAL AGE

MARCH 2021

A mass-market brand aims to sell to all the buyers of the category. In fact, the typical buyer of a brand is a light buyer. Take a certain globally known soft drinks manufacturer: according to data from Kantar (a market research firm in the U.K.), the average consumer of its namesake beverage buys a can almost 12 times a year. However, this average is misleading.

The average buyer is not typical. At one end of the spectrum, there are people who consume 1,000 cans a year. This means that, in fact, the typical consumer purchases just one or two cans a year. This buying frequency is witnessed across all brands, small or large. Another way of showing this is to calculate what percentage of volumes is accounted for by the heaviest 20% of buyers. The empirical evidence shows it is a long way from the 80/20 rule; instead the heaviest 20% of buyers account for closer to just 50% of purchases.[1]

That means that in order to grow, brands need to target the other 80% as well—the millions of people who occasionally buy a can of this well-known fizzy drink, i.e., those who scarcely think about or buy it. These consumers could easily forget about it and not make their semi-annual or annual purchase. Advertising is needed to retain and prompt these buyers. If the advertisement works, it changes the probability of buying tomorrow from almost nothing (say, one chance in 300 days) to slightly more (two chances in 300 days). The change is so slight we'd hardly notice, but if every person exposed to the advertising increased purchases from once every 300 days to twice, sales of this carbonated beverage to its largest buying group would double.

So how do brands grow? They need to expand their mental and physical availability.

First let's break down "mental availability." One human brain operates largely in the same way as another—neurosurgeons don't need to know which country you are from to perform brain surgery. However, our life experiences create our memories, which means we all hold different ideas in our brains. Said another way, how a brand is encoded and stored in and retrieved from a buyer's memory is similar across buyers, but what our memories contain varies based on our own encounters with categories and brands.

Associative network theories are a commonly accepted group of theories of memory that share common foundations. One of these foundations is that memories consist of nodes, which when encountered together can form links (become associated). For example, if you see an advert

[1] Source: "How Brands Grow," by Byron Sharp.

"A brand's growth depends on deepening penetration … therefore, all marketing activities need to have reach"

featuring David Beckham and a certain sportswear brand, the two may become linked in your memory—such that the next time you see Beckham, there is a chance you may think of that sportswear brand.

In order to identify something to buy, we seek out a reason to buy something. This is referred to as a retrieval cue. What we (easily) think of largely determines what we buy. So, what determines what we (easily) think of in a particular instance? Let's take an example: If you feel tired (a cue), you might then look for a pick-me-up, and so options (soft drinks, coffee, caffeinated carbonated beverages) will pop into your brain. These common thoughts buyers use to locate options to buy are called "useful category entry points" (CEPs). And guess what? Large brands are linked to a broader range of CEPs than smaller brands. In other words, large brands have greater mental availability. For example, there are numerous CEPs for the reasons you'd want a soft drink—such as it's a warm day, the kids would enjoy it, to treat myself, it goes well with meals, etc.

Now let's turn to "physical availability." The key to physical availability is making the brand easy to find and buy. Without physical availability, investment in mental availability will be largely wasted, and vice versa.

Grocery buying is part of most people's day-to-day lives, with staple products in constant need of replenishment. And the penetration and importance of each channel varies across countries and between rural and urban areas. As more shopping options become available, people add them to their repertoire, rather than totally substituting one for another.

Multiple-channel shopping is normal regardless of the country. Accordingly, brands need to cover multiple retailers and channels as shoppers rarely only shop at one outlet. In a store, brands are surrounded by plenty of clutter. Mental availability and distinctive assets (logos, packaging), along with physical availability (premium shelf space), help a buyer find the brand. These factors help fortify the strength of large brands.

The Digital World

A brand's growth depends on deepening penetration and recruiting a greater proportion of light-category buyers. Therefore, all marketing activities need to have reach. "Reach" refers to the size of the audience exposed to a brand's marketing activity in a specific time period. Social media and digital advertising simply usher in more ways of reaching buyers. And critically, the more data a brand has on its consumers, the more targeted and effective the advertising becomes. Big brands have more consumers and more data, resulting in a return on advertising spend online that is two times higher than offline.[2]

Online (and mobile) shopping extends physical availability. Unsurprisingly, the internet is the fastest-growing distribution channel, where some argue there is a level playing field for brands large and small. The argument goes that within an e-retailer's shopping environment, physical availability evens out across brands, as bigger brands do not command the same shelf-space advantage that they typically do in-store, and a small brand has similar real estate to a large brand on the "infinite shelf." The reality does not back this up, however. Online shopping offers saveable shopping lists, with frequently bought brands popping up first on the list. Remember, we all want to spend less time shopping for essentials. On average, more than half of purchases are made in 13 seconds.

COVID-19 accelerated these digital trends and underpinned the relevance to consumers of big brands. For example, in 2020, the world's largest cosmetics company's e-commerce sales grew 62% and now account for 27% of sales, helping the group almost offset the hit to sales from the closure of department stores and travel retail channels, and resulting in full-year sales falling just 4%. An American multinational consumer goods company's e-commerce sales (14% of total sales) grew 50%, helping drive group sales growth of 8%. A British multinational consumer goods company's e-commerce sales (12% of total sales) grew 56%, with group sales growing 12%. As a result, we remain confident these 100-year-old (or more) corporations are adapting to the digital age and can continue to compound sales and profit whilst sustaining high returns in the coming years.

[2] Source: https://www.conagrabrands.com/files/cagny-2021

IS QUALITY NOW (RELATIVELY) ON SALE?

APRIL 2021

AUTHOR

BRUNO PAULSON
Managing Director

It has been a tough 12 months, in relative terms at least, for investing in quality, particularly for those who pay close attention to valuations. There has been a double whammy from the combination of the "value rally" and the "growth bubble," which has meant that reasonably priced compounders have significantly lagged the market, despite continuing to perform their core role of compounding their earnings far better than the index as a whole, over the cycle. In the shorter term, the relative picture is less clear, but there is at least some evidence that both the "value rally" and the "growth bubble" may be close to running their course.

It is unsurprising that value has done well from the March 2020 market trough. There has been a great deal of positive economic news. The massive level of government intervention—be it through stimulus packages, furloughing workers or central bank intervention to support markets and minimise the chances of corporate financial distress—has both mitigated the economic impacts of the crisis and limited the fallout on corporate earnings. The speed of vaccine development and, in some cases, vaccine rollouts, have also been a significant positive surprise. Given all this, the switch from "risk off" to "risk on" is understandable, and the sharp improvement in earnings expectations for cyclical sectors seems justified. Both of these factors naturally leave the higher, quality names in the shade, given they are seen as safe havens with less volatile revenues and lower operational leverage. Over the 12 months ended 31 March 2021, the consumer staples sector only returned 24% and health care 29%, as against 54% for the MSCI World Index as a whole,[1] more than giving up their significant relative gains of the first quarter of 2020.

[1] Source for all earnings and valuations data in this report: FactSet and Morgan Stanley Investment Managemen

In addition, there has been talk of reflation and rising rates, which has direct positive effects for financials, and also notionally makes cheaper, and thus shorter, duration equities more attractive versus higher, quality or faster, growing longer duration plays. While the U.S. 10-year rate has indeed risen by over 100 bps to 1.74% over the last year,[2] this impact seems less clear-cut. Not only does the German 10-year rate still languish at -0.29%, only 16 bps up from a year ago,[2] but the duration argument does not fit well with the exuberance in growth stocks. Our December 2020 piece "The Only Two Ways to Lose Money in Equities" discussed how the most expensive quintile of the MSCI World's information technology sector was trading on 160 times earnings two years forward, even excluding share-based compensation, and gained 160% during 2020, massively ahead of the duller, and cheaper, stocks from the third and fourth valuation quintiles that we invest in.

2020-21 has been the fourth significant, i.e. double-digit, relative drawdown in the last 25 years. The others came in 1998-99, during the tech-media-telecom (TMT) growth bubble; 2002-03 in the cyclical earnings rally; and 2012-13, as risk came back on post the euro crisis. The last year has arguably seen a perfect storm, as all three factors have played their part.

While the performance of high quality companies may have lagged over the last 12 months, this has not stopped them from performing what we believe to be their key function: compounding.

Looking backwards, it is clear that the relative performance of a portfolio with very high weights in the lagging quality defensive sectors of consumer staples and health care and that misses out on the growth exuberance within information technology will suffer. Looking forwards, it is far less clear. As the baseballer-philosopher Yogi Berra put it, "It's tough to make predictions, especially about the future," though we prefer William Goldman's "Nobody knows anything." Mind you, it is "inconceivable" that you will not love the William Goldman scripted masterpiece, "The Princess Bride," if you have not yet seen it.

While not at the same level of certainty as our film recommendations, we are confident about the path of high quality companies' earnings. The companies are compounders after all, with a proven ability to grow across cycles at a high return on operating capital, with resilience in tough times. Admittedly, there is a higher level of noise than usual at present. Beverages and medical devices should gain as social distancing eases, allowing visits to bars and routine operations in hospitals, while some of the portfolio's "bonus" earnings from hygiene products and COVID-19 testing may ease off. There may also be a headwind from rising corporate tax rates, already implemented in the U.K. and potentially looming in the U.S. However, beneath this short-term noise, the structural drivers of recurring revenues and pricing power are still in place.

As ever, there is much less clarity for the market's earnings. Progress depends on the extent and duration of the recovery. Earnings forecasts do lag, so there may well be more growth to come, but the pace of improvement seems to be slowing outside the commodity plays of energy and materials. The other nine sectors' earnings only rose 0.5% in March, versus the 2%-plus monthly progress since last June. Aside from the potential tax rise headwind, one area of concern is how effectively companies with limited pricing power will be able to pass on any rising input costs, be they from commodities or labour.

The larger risk for the market is multiples. The MSCI World Index's forward earnings multiple is still above 20x, only down 1% despite the 27% rise in the earnings denominator over the last nine months. This is defying the normal pattern of a falling multiple as earnings

[2] Source: Bloomberg L.P.

"Beneath this short-term noise, the structural drivers of recurring revenues and pricing power are still in place"

recover from a cyclical low. The current market valuation is a full six turns above the 2005-2018 average multiple and seems to imply further sharp earnings growth. The other worry is that macroeconomic forecasts are now extremely bullish, with Wall Street talking about U.S. gross domestic product growth reaching 8% by the end of the year,[3] with no Federal Reserve reaction expected until 2023 at the earliest. This may well turn out to be correct, but it does leave limited room for further macroeconomic surprises, or at least further positive macroeconomic surprises. The strength and speed of the recovery may also limit its duration and imply that the early part of the cycle—so favourable for value plays—may be nearing its end.

Multiples are a particular concern in the growthier extremes of the market, given the 2020 exuberance. Special purpose acquisition companies (SPACs) are still flooding onto the market, raising $88 billion in the first quarter of 2021, more than in the whole of 2020.[4] However, there are signs that the air is beginning to hiss out of this inflated area, with the most expensive quintile of information technology returning -9% in March, while the other four quintiles were up on average 3.6%, admittedly only a small dent in 2020's 160% top quintile return. The CNBC SPAC 50 Index, which covers the 50 largest SPACs, is now down for the year, having been up 20% in late February.

If a portfolio of high quality companies can indeed continue to compound its earnings, we believe it is a better medium- or long-term bet than the market, which remains at multiples not seen since the TMT bubble at the end of the last century. In the shorter term, market moves are more of a lottery, but there are reasons to believe that the growth bubble may have peaked and that the value rally is at least nearing its end.

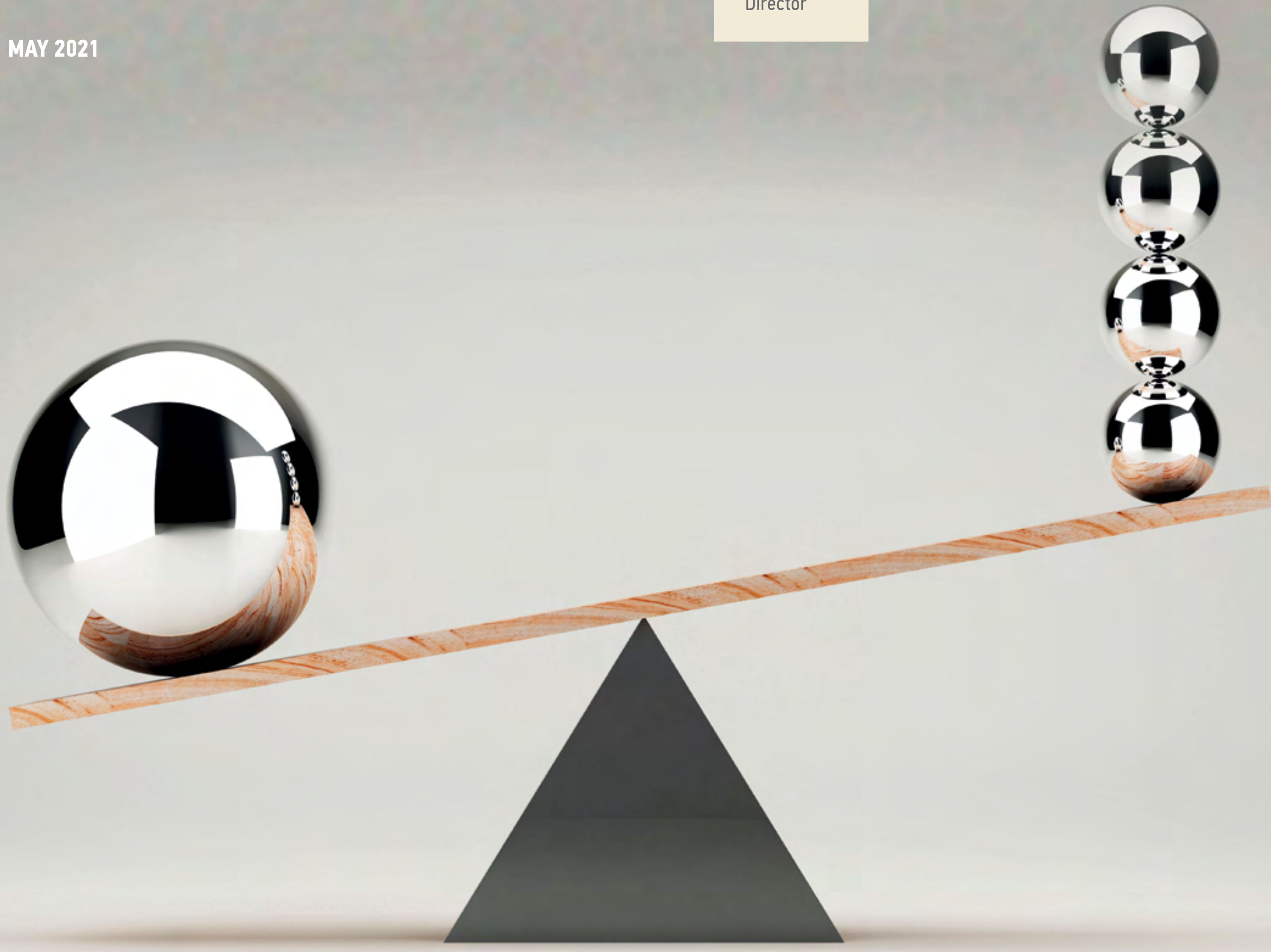
[3] Source: Goldman Sachs Q4 2021 vs Q4 2020
[4] Source: SPAC Research

SCALE AND DIVERSIFICATION

AUTHOR

MARCUS WATSON
Managing Director

MAY 2021

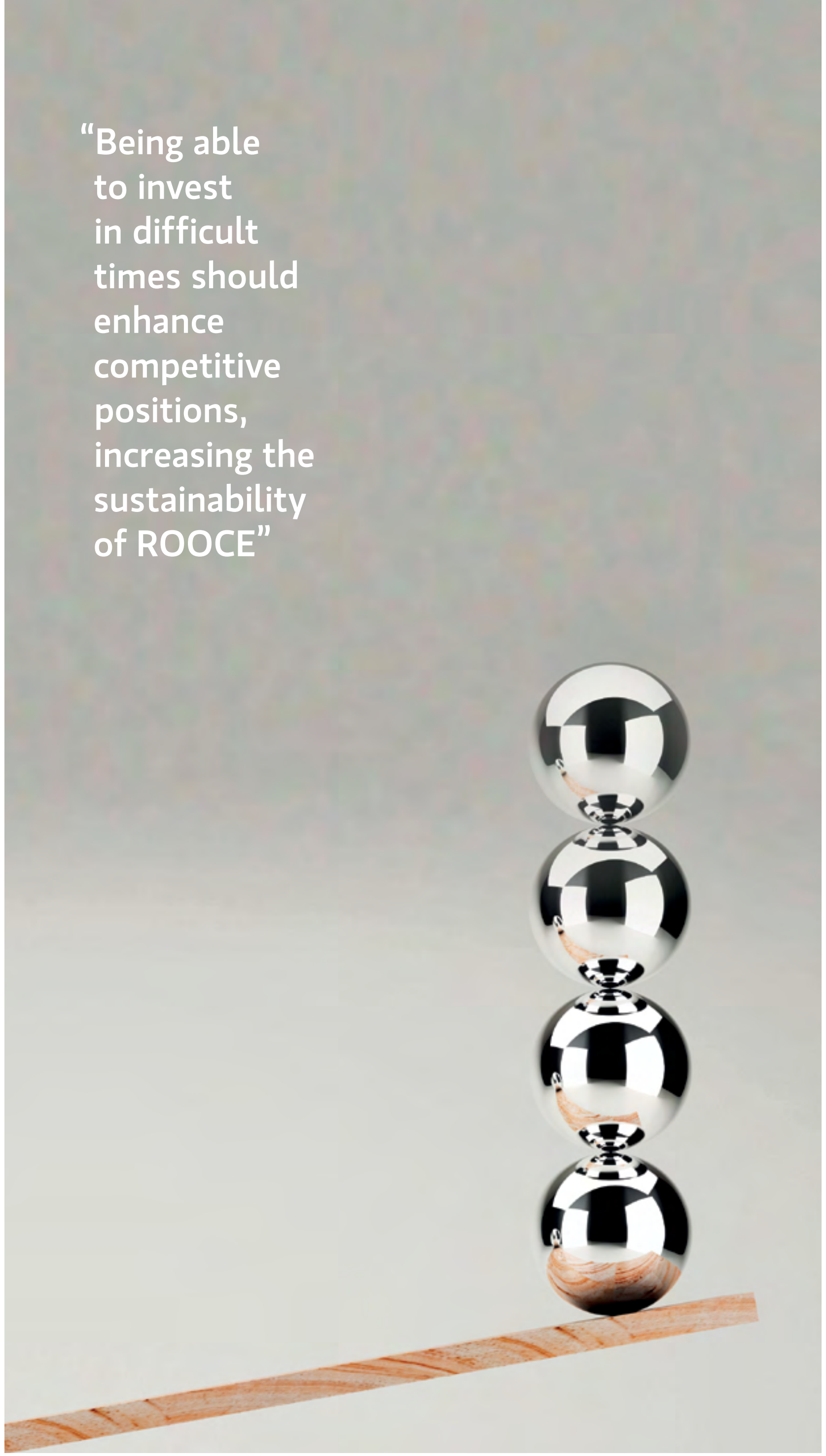


You may know that our favourite types of businesses are those that can generate a high, sustainable return on operating capital employed (ROOCE), while growing steadily and predictably over time. These high quality businesses often exhibit the twin virtues of scale and diversification. This makes sense: scale often lends itself to profitability and in turn a high ROOCE, while diversified revenue streams mean that potential mishaps in one business area or region need not have a significant impact on the company as a whole. This helps growth to be more predictable. Undoubtedly, the characteristics of scale and diversification have played a part in the superior earnings performance of the Portfolio compared with the index, both through the recent crisis and over time.

Winston Churchill observed that one should never let a good crisis go to waste. For corporates, this might mean investing when competitors are not able to, and taking market share as a result. Unfortunately for most companies, cash flows dry up during a crisis and investing is difficult or impossible. However, for those with scale and diversification, this need not be the case. Two leading global sportswear companies have effectively demonstrated the capacity and breadth of their capabilities to outperform and out-invest their peers. Over recent years, superior scale and profitability have allowed the two companies to grow their revenues at high single digits and invest meaningfully in digital capabilities, while maintaining pristine balance sheets in a way that was simply not possible for competitors.

Naturally when COVID-19 hit, store closures across the world meant that the entire industry suffered significantly. However, both companies made highly effective use of their capabilities and capacity to invest. One of these companies has a $3.5 billion marketing budget and launched a massive digital marketing campaign focused on remaining active during lockdown. It reported in June 2020 that its 'You can't stop us' campaign had generated over 2 billion views worldwide, driving powerful brand engagement, workout app downloads, enrollment in membership programmes, and ultimately a surge in already significant online sales: its e-commerce sales grew 54% in its most recent quarter. The company also benefited from being very well diversified geographically and was able to take lessons from China's lockdown to refine its strategy as other countries locked down later in the year. On top of this, neither company has stepped back on its sustainability, driving ever stronger brand loyalty and making an already dominant competitive position even more formidable. While both businesses were heavily impacted by the crisis, their ability to react nimbly means that their outlook is now far better than before the crisis hit.

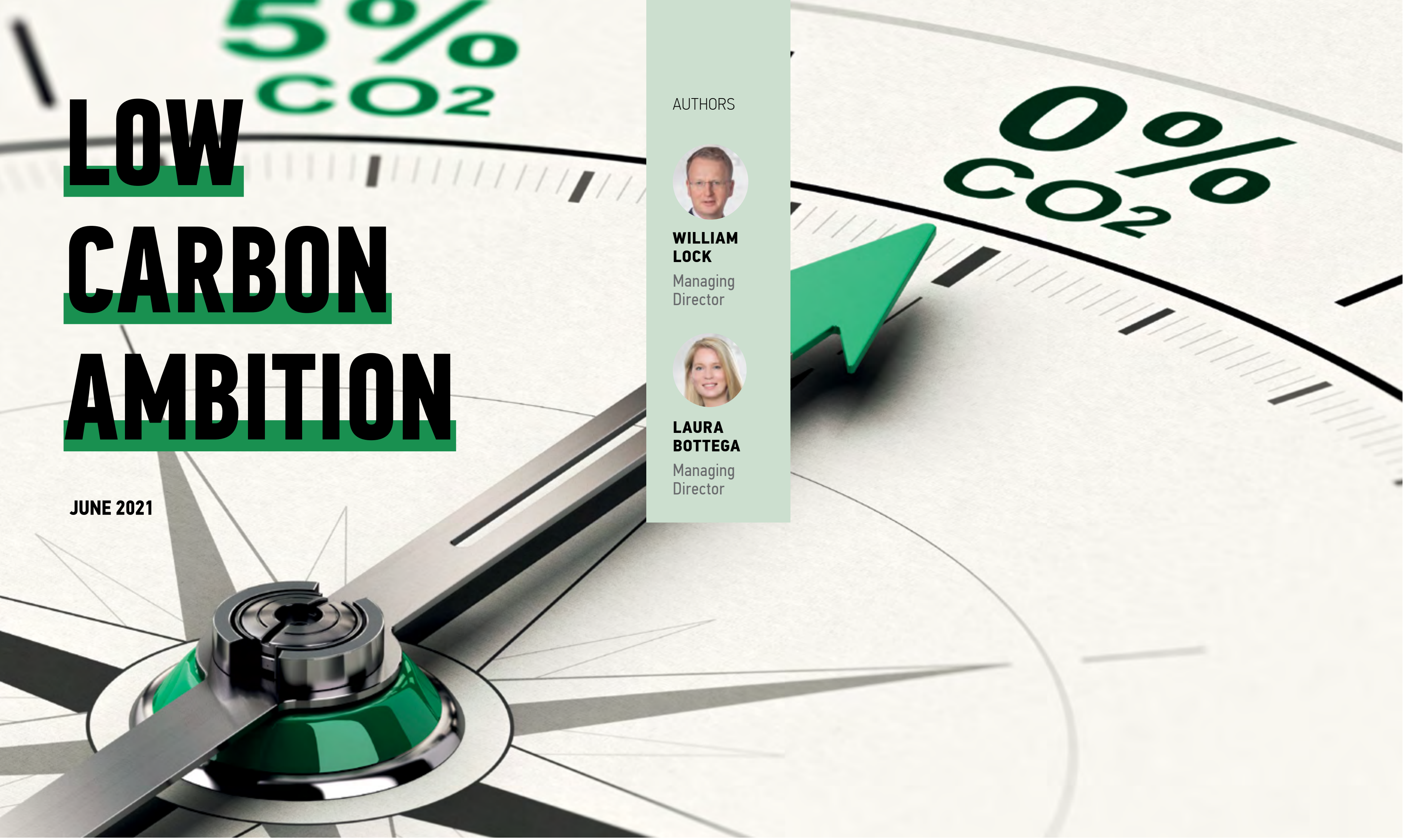
Turning to another sector, our diversified Health Care businesses have also shown



their mettle during the pandemic—despite the peculiar nature of the crisis affecting the industry more severely than would have been expected in a typical recession. We do not think it is a coincidence that many of these large businesses, with their impressive range of capabilities, were at the forefront of providing reliable COVID tests as well as supporting the development of vaccines. This has led to significant cash flows for the companies involved, exemplified by a medical devices company's free cash flows (FCF) growth of 135% in its most recent quarter. Given their enormous diversification, these companies have a variety of attractive areas in which to invest and are putting these cash flows to work. This will likely lead to stronger competitive positions and higher underlying growth rates than before the crisis.

Among our Information Technology holdings is a software business offering payroll and HR services to its customers who are mainly small- and medium-sized businesses. What distinguishes this company is that it backs up its impressive software offerings with a world-class service organisation. Without great scale or a wide range of product offerings, it would be difficult to justify or afford such service provisions, but it proved invaluable to its customers as companies had to adjust rapidly to lockdowns and working from home. The result is record high customer retention levels which have allowed it to continue to invest throughout the crisis, thereby improving its competitive position.

These examples are far from the only companies that have invested through the crisis. Ultimately, being able to invest in difficult times—even at the expense of short-term profitability—should enhance competitive positions, increasing the sustainability of ROOCE and driving the steady, predictable growth we look for. Happily, for many of our holdings, it is not something companies are easily able to do.



LOW CARBON AMBITION

JUNE 2021

AUTHORS

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"Companies' Scope 1 and 2 emissions are just first steps towards solving climate change"

Earth Day on April 22nd, with its theme of restoration, gave rise to a collection of new environmental pledges on the global stage.

President Biden, seeking to reclaim global leadership in the fight against global warming, unveiled the U.S. goal of cutting emissions 50% from 2005 levels by 2030. Prime Minister Yoshihide Suga raised Japan's target for cutting emissions to 46% by 2030, up from 26%, while Prime Minster Justin Trudeau raised Canada's goal to a cut of 40-45% by 2030 below 2005 levels, up from 30%. The recently agreed European Union (EU) Climate Law aims to reduce EU carbon emissions by at least 55% by 2030 compared with 1990 levels. Biden's move followed President Xi Jinping's emissions goal set last September with China seeking to achieve net zero emissions by 2060. There is hope that this will spur the next biggest emitters, India and Russia, towards improved pledges at COP26, the United Nations (UN) Climate Change Conference in November this year. Closer to home, Morgan Stanley has pledged[1] to mobilise $1 trillion in sustainable solutions globally that include helping prevent and mitigate climate change.

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[1] See: www.morganstanley.com/ideas/low-carbon-finance-1-trillion-dollar-pledge To reach the $1 trillion target, MS will work with corporations, governments and individuals to provide clean tech and renewable energy finance, green bonds and other transactions.

"The scale of the Scope 3 challenge suggests there is work to do"

Within our team's portfolios, our companies have been busy too, encouraging consumers—their customers—to live more sustainably. There is growing recognition that companies' Scope 1 (direct or controlled) emissions and Scope 2 emissions (indirect emissions from purchase of energy) are just first steps towards solving climate change. Greater focus on Scope 3 (everything beyond 1 and 2, including energy customers consume when using a product) has begun to work its way not only into the consciousness of CEOs but also their advertising campaigns. Household companies see a revenue opportunity in identifying for consumers which small changes at home can make big changes for the planet. Consulting firms argue that the pandemic has intensified interest in "conscious consumption". A U.S. multinational consumer goods corporation estimates that avoided emissions from low-energy laundry cycles since 2015 equals 15 million tons of CO_2 or the equivalent of 3 million cars off the road. For context, in 2020 this company's scope 1 and 2 emissions were 2.6 million tons.

Personal care companies now offer comprehensive sustainability programmes. Looking to accelerate already steady progress in its carbon footprint, the world's largest cosmetics company aims to reduce its carbon footprint by 50%, ensure 95% of its ingredients are from circular sourcing and invest €100 million in regenerating ecosystems. A German chemical and consumer goods company has launched a carbon footprint calculator to help consumers understand their personal CO_2 footprint and contribute to sustainability through personal lifestyle choices. The scale of the Scope 3 challenge suggests there is work to do. It aims to save its consumers, customers and suppliers 100 million tons of CO_2 cumulatively between 2016 and 2025. To date it has saved 50 million tons. Its 2020 Scope 1 and 2 emissions were 0.535 million tons.

One of the world's largest software companies takes the prize for ambition, pledging to go carbon negative by 2030 and to remove, by 2050, the entire historical carbon emissions of the company since it was founded in 1975. A global payments company has announced its commitment to reach net zero by 2040 and celebrated carbon neutrality achieved in its operations in 2020. This company signing up to the Climate Pledge and Climate Business Network offers further examples of companies recognising the importance of not only solving but also being seen to be part of the global solution to climate change.

Some companies, including a leading software and business solutions company, are seeking to spearhead the move towards a circular economy and a low carbon future with technology facilitating responsible design, sourcing, production, consumption, recovery and reuse. Consultants, already embedded in companies around the world, will play a key role in enabling other companies in the low carbon and energy transition. One consultant predicts (in "The Green Behind the Cloud") that migrations to the public cloud can reduce global carbon emissions by as much as 59 million tons of CO_2 annually. Earth Day's announcements indicated an extension of consultants and IT companies seeking to co-innovate and co-develop solutions for responsible production and design, empowering companies to decarbonise their supply chain and capture share in the circular economy. This follows similar consultant and IT company alliances of last year, joining with the UN Global Compact, to launch Sustainable Development Goals (SDG) Ambition Guidance, an SDG achievement accelerator.

We in the International Equity Team applaud these ambitions and actions, while recognising the challenges of achieving them, and we thought it would be helpful to articulate some of the steps we are taking in our team to accelerate positive change.

1. We recently enhanced the suitability criteria for our Global Sustain strategy. The Portfolio will seek to achieve attractive returns with significantly lower carbon emissions than the investment universe. We are working with our clients to join us in this objective where they see fit.

2. In order to achieve this objective for our Global Sustain strategy, we have introduced an explicit carbon screen to identify and filter out the highest carbon emitters in the universe.

3. Finally, we have introduced and have been executing for some months on a systematic engagement programme to question the companies we own on their sustainability initiatives, and how they intend to meet the goals they are setting.

Clients of our other strategies also benefit from this additional engagement with our investee companies given meaningful overlap in holdings across our strategies. Such conversations also offer insights to management quality, corporate agility and capital allocation in the face of new risks.

ESG integration today requires a facility not only with price and quality but with the third dimension of sustainability. We are conscious that there is always more to learn, but we believe our access and experience do give us an advantage in encouraging company managements towards a low carbon future. In this, as in everything we do, we remain ambitious.

"Earth Day's announcements indicated an extension of consultants and IT companies seeking solutions to empower companies to decarbonise their supply chain"

GEO BACK CATALOGUE

IN CHRONOLOGICAL ORDER SINCE 2017

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MARCUS WATSON
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ALEX GABRIELE, CFA
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Senior Associate

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Effective March 31, 2021, Dirk Hoffman-Becking has retired and is no longer serving as a portfolio manager for the Portfolio.

DEFINITIONS

Free cash flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. FCF represents the cash that a company is able generate after laying out the money required to maintain or expand its asset base. **Return On Operating Capital Employed (ROOCE)** is a ratio indicating the efficiency and profitability of a company's trade working capital. Calculated as: earnings before interest and taxes/property, plant and equipment plus trade working capital (ex-financials and excluding goodwill). The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto. The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The **MSCI World Health Care Index** is a capitalization weighted index that monitors the performance of health care stocks from developed market countries in North America, Europe and the Asia/Pacific Region. The index includes reinvestment of dividends, net of foreign withholding taxes.

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