Stewart Investors
Sustainable Funds Group

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Quality & Patience

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Today, asset owners have an unprecedented range of options of where to invest and an even greater number of well-argued reasons for why each of these will be the most attractive home for their capital. Aggressive, untested monetary policy has helped fuel years of above-average equity returns, encouraging many of those who run these strategies to predict handsome returns for investors.

Years of strong returns have also intensified the tolerance for risk. The substitution of capital loss with relative return, as a definition of downside, has become worryingly common, as has the fear of missing out on the attractive returns generated by popular names of the day. These behaviours distract from the importance of capital preservation for the long-term growth of capital.

These distractions are present whether you believe that long-term protection and growth of capital is best served by an active manager, 'Smart' beta strategy or passive fund.

Owning a passive fund heavily weighted to expensive, large and popular companies due to its relative cost or because the definition of risk has regressed from the protection of capital to volatility from a benchmark, means that capital preservation is no longer regarded as central.

Smart beta has become an increasingly popular option for asset owners. Proponents of these strategies argue it offers exposure to the best of both active and passive worlds – offering factors which have explained historic 'excess' returns at a cheaper fee than their active counterparts. Popular factors are typically size, value, momentum, quality and low volatility.

We are quality investors, so we are naturally interested to understand what is in a Quality Index[1]. The definition of quality varies, depending on who is providing the index. The MSCI Asia ex Japan Quality Index, for example, defines Quality as a company with high returns on equity[2], low levels of debt and low levels of earnings variability.

We would argue this is not quality investing but rather 'high return on equity, low debt and low earnings volatility' investing. This is a mere subset of quality. Instead, we look for quality in terms of people, franchise, financials and sustainability.

These quality factor portfolios are created looking in the rear view mirror and importantly lack any scepticism of the fundamentals. Consequently, there is a high chance they end up owning the quality companies of yesterday. They assume that historically attractive returns on assets will be translated into similar returns on future investments and, other than (historic) consistency of earnings growth, there is no insight similar to what we would look for in quality of earnings such as: are earnings being turned into cash or, even better, free cash flow? Are high returns the result of underinvestment in the business? Have they proven themselves resilient through times of stress? What are the trends driving growth and are they sustainable?

We would not own a number of the largest companies in the MSCI Asia ex Japan Quality Index, either due to sustainability headwinds facing earnings (tobacco and fast food franchises) or the hit-driven nature of their businesses (online games).

1 An index made up of companies that are regarded as 'quality' ones.
2 Return on equity is a measure of the profitability of a company.

Any consideration of valuation is also absent. High quality businesses tend not to translate into high quality investments if valuations are unjustifiable - a situation very common today. An Indian consumer company with a market cap[3] of USD45bn is the fifth largest in the MSCI Asia ex Japan Quality Index. Despite being run by high quality management and owning some of India's strongest brands, we do not own it for clients due to its high valuations.

Viewing quality through a purely quantitative lens will also miss those companies investing in long-term capabilities at the expense of short-term profitability. We have found such companies, when operated by competent management teams who are owners or at least think like owners, have been lucrative long-term holdings for clients. These management teams tend to be more interested in the long-term creation of wealth rather than satisfying value-destroying distractions like quarterly expectations or reducing the volatility of earnings.

This ability to think and act like an owner is one factor that our qualitative philosophy emphasises. Gaining comfort in the stewardship and thought process of the allocator of a companies' capital is very difficult to distil into an algorithm, as is collecting evidence that a company has cultivated a time horizon and culture capable of leveraging and preserving the strength of a franchise, a characteristic central to incorporating sustainability challenges into their thinking. One of our family-owned companies puts it like this: 'we pay attention to not only the what we do, but the how we do it'. We have found these factors have a strong bearing on a company's long-term success.

Although sounding simple, owning a company for the long-term is not easy. Constant news flow and short-term volatility in share prices conspire to pull on our many behavioural flaws. Persevering through these shorter term pressures requires values that a smart beta strategy cannot offer: patience, scepticism and trust.

Within our investment philosophy, trust is a critical factor when investing clients' capital. We must believe that the people at the company are suitably aligned with our time horizon, values and objectives - that they will not expropriate our clients' capital, either through malicious behaviour or incompetent capital allocation. Studying and understanding the decisions and outcomes that have been made in the past, in the good times and more crucially the bad, increases our ability to trust in the decisions they will make in the future.

Why is this important? The longer a company is held, the more important the quality of people becomes. Over short time periods, market noise dominates returns, while over longer periods, the resilience of the business, return on investment and earnings growth drive returns – outcomes of quality decision making. In contrast, we believe investing alongside poor quality people is the surest way to destroy capital permanently and we will sell our position if trust has been lost, even if the company is earning high returns on equity, has low levels of debt and high historic earnings growth.

As patience is the capacity to delay reward, it requires that you believe there is something worth holding out for. For an investor, being able to stay invested through the tough as well as the good times, is key to the long-term compounding of capital[4]. A lack of patience also tends to lead to chasing 'game-changing' companies of the hour. Owning these companies provides the sense of security that comes with being part of a crowd, but results in paying valuations that reflect their popularity. Such behaviour conspires to destroy capital and obstruct the power of compounding.

Discipline to stick with an idea or stay on the side-lines and buy at more attractive valuations sounds simple but is not easy. Factor portfolios are by their very nature impatient. They are constantly rebalanced to reflect the new quality companies of today which increases trading costs, reduces returns and again gets in the way of long-term compounding of returns.

3 Market cap is the value of a company on the stock market.
4 Compounding refers to the increasing value due to interest earned on both principal and accumulated interest.

We have found that the best quality management teams also tend to be the most patient. Often turning this skill into a competitive advantage, world class businesses are not built in a day and the best are constantly evolving. Again, trusting in a management team or a steward makes holding on far easier than if a portfolio is seen as a collection of a stock prices or Bloomberg tickers.

When owning a quality factor-based portfolio, the asset owner is trusting that the index provider has distilled quality into a few, easily measurable metrics and, most importantly, that the future will resemble the past. This is an important consideration given it is unlikely the provider has their own capital invested alongside its clients, a consequence of the strategy's creation having more to do with the profitability of the provider's business than conviction in the ability to protect and grow capital. Lower fees tend to mean more assets. Historically this has proven destructive to client returns.

If performance of the index runs into trouble as most strategies do at some point, what is to stop the investor questioning its legitimacy, running out of patience and moving onto the next 'winning' factor? We believe there is very little. It is a strategy which makes the preservation of capital even harder than it already is.

Our long-term philosophy requires clients to trust us not to deviate from identifying and owning high quality businesses run and owned by high quality people. It also requires that they trust us to act as if their money was our own.

The reciprocation of trust and patience between clients, investment team and companies held on behalf of clients, should allow us all to stay focused on what is important - the long-term preservation and growth of capital.

It is a simple notion but one that is increasingly rare today.

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Contact details

Edinburgh
Stewart Investors
23 St Andrew Square
Edinburgh EH2 1BB
United Kingdom
e. info@stewartinvestors.com
t. +44 (0) 131 473 2900
stewartinvestors.com

London
Stewart Investors
Finsbury Circus House
15 Finsbury Circus
London EC2M 7EB
United Kingdom
e. info@stewartinvestors.com
t. +44 (0) 207 332 6500
stewartinvestors.com

Singapore
Stewart Investors
58 Duxton Road
2nd & 3rd Floor
Singapore 089522
e. info@stewartinvestors.com
t. +65 680 59670
stewartinvestors.com

Sydney
Stewart Investors
Suite 10, Level 3
13 Hickson Road
Dawes Point
Sydney NSW 2000
e. info@stewartinvestors.com
t. +61 2 8274 8000
stewartinvestors.com

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