Global equities

Buy franchise stocks like Nestlé, Microsoft, Visa, Unilever, says Morgan Stanley's Paulson

| BY ASSIF SHAMEEN |

It is a pretty nerve-wracking time for investors. The US Federal Reserve is poised to raise interest rates for the first time in nearly a decade, equity valuations are looking a bit stretched, corporate earnings growth is slowing to a trickle as the long-running margin expansion story reaches the tail end and now, there are mounting geopolitical concerns following last month's terrorist attacks in Paris. Veteran portfolio manager Bruno Paulson, who runs Morgan Stanley Investment Management's Global Franchise Fund, is unfazed. Paulson believes there is still money to be made in equities, particularly in high quality brand name global franchises that are able to compound shareholder wealth at attractive rates of return over time.

While Paulson concedes that the US Fed will raise rates later this month, he argues that it won't go very far in the rate cycle. "We still think it's a pretty deflationary world," he says. "The December rate increase has been pretty well telegraphed and we don't think the US economy is strong enough to bear much," he tells *The Edge Singapore* in a phone interview from London. "The Fed is desperate to get off zero and normalise rates because they are worried about the impact that a long period of low rates has on asset prices."

The way he sees it, global franchise stocks are a sanctuary in the current challenging times. "We only invest in very high quality companies with high return on unleveraged capital," he notes. "We think these high quality franchise stocks will hold up through the cycle because they have recurring revenues, strong balance sheets and pricing power."

But aren't high quality global brand name companies subjected to the same economic and financial conditions as other listed firms? They are, but Paulson argues that the subset of high quality companies are less sensitive. "They won't grow spectacularly because they never grow spectacularly," he says, noting they are well run and have strong brands and pricing power so they can continue to grow even in more challenging times.

A good example is a company like Swiss food and beverage giant **Nestlé**, which his fund has owned for years and through cycles. "It has been growing around 5% a year, give or take 1%," Paulson notes. Even at the height of the global financial crisis, Nestlé grew at 4% and its margins actually increased 10 basis points.

To be sure, the Global Franchise Fund is focused on the quality of earnings rather than perceived brand value. So luxury stocks such as **Prada** (down 68% from its 2013 peak) or **Michael Kors Holdings** (down 56% from its peak last year) have no place in his portfolio, while Nestlé and **Unilever**, which supply milk powder and soap, are among his top picks. Neither is the fund focused on dividends. "There are five sectors we basically avoid: utilities, energy, materials, telcos and financials," he says. The reason: "Companies in those sectors are mostly cyclical, low-return, highly levered price-takers."

So the fund looks mainly for investments with moderate but steady earnings growth as well as the ability to maintain or grow margins, allowing them to harness the power of compounding. "We mainly pick and choose within consumer staples, IT services and software names," Paulson says. Those high quality stocks continue to compound, growing steadily and delivering high returns.

Compounding is achieved through combining steady growth with cash generation. "So, a company may be growing around 5% and have strong cash generation," he explains. "If you also have a management team that is doing the right things with that cash, a lot of that should come back to shareholders. If you can do that, you could be delivering a 9% to 10% return over the long run." That's an excellent absolute return at a time when large global companies are struggling to eke out any growth at all in dollar terms. Indeed, the strength of the US dollar has been a significant headwind for one company in his portfolio — **British American Tobacco** (BAT), which sells mainly in emerging markets.

Consumer stocks the fund owns aside from BAT and Nestlé include Anglo-Dutch giant Unilever, Cadbury chocolate maker **Mondelez International** as well as **Reckitt Benckiser Group**, which owns health, hygiene and home product brands such as antiseptic Dettol and throat lozenges Strepsil. "We believe in a world where things are rapidly commoditised, companies that have strong brand equity and pricing power will continue to do well through cycles," Paulson argues. But a great franchise does not translate into an attractive stock. Take **McDonald's** and **Wal-Mart Stores**, which have size, scale and a to-die-for franchise.

"We have been ambivalent about McDonald's because we are focused on returns on operating capital employed and they own a lot of their property," he says. Wal-Mart is a great company but in a poor industry. "We regard retailers like Wal-Mart as very unattractive as they offer low margins and are a low return on cash business. In luxury, Morgan Stanley has owned **LVMH Louis Vuitton Moet Hennessy** in the past. However, it was never big on it. Of course, now everyone is worried about China demand, and LVMH's margins, like those of other luxury retailers, have been under pressure.

Tech picks

Global Franchise Fund also owns shares in **Microsoft**, **Visa** and **Accenture** in the tech sector, which makes up over 20% of the portfolio, but not in **Apple** or the high-flying so-called FANG stocks — **Facebook**, **Amazon.com**, **Netflix** and **Google**. "Facebook is a great company, but just too expensive for us," Paulson says. "We believe there are only two ways of losing money in stocks — either the earnings go away or the multiple goes away. Facebook is a perfectly valid growth investment, but we are not really a growth investor." With a high valuation multiple, it is also vulnerable. "If Facebook hits a bump with a bad earnings number, the stock could fall fairly sharply," he says. Amazon.com, which sells for nearly 800 times forward earnings, is slightly different, he argues. "It could make a lot more money if it chose to." Right now, Amazon is investing almost everything it earns.

SAMUEL ISAAC CHUA/THE EDGE SINGAPORE

Paulson: We mainly pick and choose within consumer staples, IT services and software names

Paulson is also less sanguine about Apple, the world's largest company. "Apple is a great company, very attractive from a valuation standpoint, but we worry about the sustainability of its earnings," says the veteran portfolio manager. "It has 13% or 14% of the global smartphone market, but makes over 2% of the total profits of the MSCI World Index," he notes. "My fear is that by the time we get to the iPhone 9, smartphones will go the way of the laptop." He would rather be in Microsoft because CEO Satya Nadella, who took over two years ago from Steve Ballmer, has done well in refocusing the company towards enterprise, cloud services and mobility. "While the consumer Windows business is less robust than it used to be, their enterprise Windows business is doing fine and Microsoft's Office franchise is fantastic. In volume terms, they are the No 1 provider of software in servers and No 1 provider of software for databases."

Paulson's fund does not have big exposure to the high growth pharmaceutical and biotech sector that has had a great run over the past three years. "We like healthcare because it is clearly miles ahead of telcos, utilities, financials or materials," he says. "The trouble is that pharmaceutical companies' main assets are drugs under patents that are fading assets because you are running out of time to sell them and as an investor, you are betting on their ability to develop or find new drugs. If they can spot the right drug and keep growing their pipeline, then that's brilliant, but how many companies can keep doing that?"

Big exposure to media

The Morgan Stanley Global Franchise Fund has big exposure to the media sector. "We own three stocks in the media space — **Time Warner**, **Walt Disney** and **21st Century Fox** — because we believe they are the highest-quality names, with content like ESPN, Disney and HBO, for which there is strong demand," he says. "We fully understand that advertising, particularly non-sports advertising, is in trouble." Even when people are viewing non-sports channels, Paulson notes, "they are viewing it time-delayed on their iPads or iPhones rather than on TV," he says. "But whichever way you watch ESPN or HBO, the money is coming to Disney or Time Warner." The bulk of their income comes from the cable companies in affiliate fees, rather than advertising. Content providers are able to use their power to do deals with cable companies, which are well above annual inflation."

While Paulson concedes that the unbundling of media content will cause disruptions as subscribers cut the cord with cable operators, he is in no rush to load up on high-flying streaming play Netflix soon. The stock is up 1,532% since July 2012 and trades at over 250 times next year's projected earnings. "Netflix has been very successful and has built up a base of tens of millions of subscribers," he notes. The company faces several headwinds, though. For one, competitors like Amazon, Google and Apple are gunning for a slice of its business. "Netflix and Amazon are making some of their own shows but they do not have a big library of content, so they would need to buy content from Time Warner, Disney or Fox," he says. "The mistake many of the content providers made is that they gave Netflix too much of their content and have since made it very clear that they don't want to keep doing that," he says. The Disneys and Time Warners have learnt from the music industry, which gave away too much to Apple's iTunes and, as such, are much more careful now, Paulson points out.

One of his favourite stocks is payment processing firm Visa, which recently bought privately held Visa Europe, previously not part of the US listed firm. "There is a lot of noise about all these new electronic payment systems like ApplePay or GooglePay taking business away," he says. "Apple cannot replace Visa or **MasterCard**. Every potential threat that we have looked at for Visa in the last few years, has turned out not to be too severe," he points out. "The good news about Visa is that it is an incredibly lucrative business with very high margins and they are collecting a very small portion of the total transaction." E

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Reckitt Benckiser Group	7.1
Microsoft	8.4
Visa	4.2
Accenture	4.7
Time Warner	3.4
Walt Disney	3.7

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