

Head to Head: Global Franchise and Global Quality

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Portfolio Specialist Laura Bottega poses some topical questions to Portfolio Manager Bruno Paulson.

Laura Bottega (LB): Back to basics first. What are the key benefits that concentrated global equity portfolios Global Franchise/Brands and Global Quality offer to investors?

BRUNO PAULSON (BP): What they both offer is a collection of steadily compounding companies at reasonable valuations. The point is, these companies have earnings which have been really robust in tough times. For Global Franchise, the earnings for the holdings within the portfolio actually increased during the global financial crisis, a time when the earnings for the market halved.¹

Because these companies are able to compound even in tough times, we believe that over the whole cycle the companies (and therefore the portfolios) can compound well, better than the market. We believe that this is why, over the cycle, our strategies have delivered strong absolute and relative returns.

LB: So could you sum it up by saying that you believe the strategies offer capital growth, and earnings visibility?

BP: Yes, and a measure of downside protection, relative to the benchmark.

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¹Period covered: 31 October 2000 to 31 October 2017; market represented by the MSCI World Index. Source: FactSet, MSCI, Morgan Stanley Investment Management.



LB: How would you compare Global Franchise to Global Quality?

BP: I think the difference between them is relatively minor. Between the two portfolios there is about a 70% overlap, with the other 30% of Global Quality (GQ) also very high quality, so both portfolios are fairly defensive and move pretty similarly.

Of the 30%, half of it is in Health Care, mainly big diversified pharmaceutical and medical devices companies, and half of it is companies which may have more leverage or companies that don't pay a dividend and so don't qualify for Global Franchise.

At the margin, and it is at the margin, GQ is likely to be slightly higher beta, although the beta is likely to be significantly lower than the market and should still offer plenty of relative downside protection. The main difference is how the health care performs, and your view on that may influence your thoughts on the portfolios. I'd just point out that health care is pretty cheap right now, in a world where not much is.

GQ has Technology as the number one sector, but the overall weight in Technology is similar between the two portfolios. Longer-term, if and when this cycle finally ends, we have the optionality to buy Industrials within GQ. We don't own any real industrials at the moment and that is simply because of valuations – they are on peak multiples of peak earnings – but that is something we'd be looking to do when the time is right.

LB: Disruption has become a topical theme. What do you think are the key disruption threats?

BP: We're looking to own companies that have really strong intangible assets or as a lot of people call it, "moats", and that will help to keep their returns high. We want to avoid companies with fading returns on capital. Clearly, disruption threatens to weaken these intangible assets, or 'fill in' the moats, be it the rise of a certain e-commerce giant, either via retail or their cloud

hosting service, or the rise of streaming services.

Now to be clear, we're not growth investors and so we struggle to get past the multiples of these pure disruptors. What we look to own is either the incumbents who will be resilient in the face of disruption or who have some disrupting elements themselves.

In Media, we look for players with the best branded content, those that own or create the content that people want to watch such as live news or sport, and high quality drama. We believed there to be three really high quality providers but recent deal activity has narrowed the field. The industry has put a price on the assets we have long said are valuable, proving our investment thesis correct after some months of volatility.

In Technology we invest in companies that businesses rely on. That might be a market dominant technology company, with its cloud computing platform and its subscription-based offering or a global management consulting and professional services company which, as large corporates deal with disruptive change, is making a lot of money helping them.

Disruption is also occurring in quality "safe-haven" sectors; one area we point to is tobacco, where we bet on the disrupting incumbents who are the leaders in next generation heat not burn technology.

LB: Both portfolios have some 30% exposure to technology. Which technology names make sense for defensive portfolios?

BP: To be clear, we invest in "dull" tech and the companies tend to have valuations to match that. We don't do any hardware, just software and IT services. What we like about these companies is the recurring revenues. These may come from large corporates that find it impossible to survive without a particular consulting and professional services company who are deeply embedded in their company, or from software, where revenues continue to grow. One company we invest in

makes enterprise software for managing business operations and customer relations. The recurring revenues generated by the maintenance of the software was one of the things that attracted us to the company. Now, with the growth of cloud subscription and subscription driven revenue streams, this company is becoming even less dependent on more volatile initial software sales.

If the world does go wrong, we would expect to see the revenues and earnings of the technology companies we own holding up very strongly and actually holding up better than last time round.

LB: What about Consumer Staples? In the face of disruptive change, what makes you confident about the remaining Staples you own?

BP: Our Staples universe has shrunk a bit. Staples are still a crucial bit of the portfolio – over 40% in Franchise and 25% in Quality – but our exposure has come down over time.

I think there are four things that we think about with our Staples investments. One, *invest in the right categories*, the categories that are more insurgent proof (e.g. beauty, tobacco, alcohol) and not in food, because these are categories where either e-commerce is less viable for all sorts of reasons or the brands are actually more powerful and robust. And secondly, within categories you want to *be in the most powerful brands*. Particularly if we're moving towards a voice-led world - where you are not going to a supermarket, you're not even going online, you're just talking to this box in the middle of the table - you want to be the brand that is front of mind. Thirdly, you want *emerging markets exposure* because these disruptive threats aren't as strong there and there is stronger growth. And fourthly, you want an *entrepreneurial and decentralised management* that can react to threats and in particular, is fully invested. You have to spend a lot on advertising and promotion and not just cut it as soon as you face any threat plus, crucially, be *fully invested in digital*. If you look at

these four points you can see why over the last couple of years we've built a very large position in certain stocks and exited a very large position in another.

2017 was a strong year for both products given how well the markets did and that was down to the stock selection in Staples and the market, to an extent, recognising that we were on the right track.

LB: Finally, turning to the macro environment: how might interest rates impact the Global Franchise and Global Quality portfolios?

BP: It's a well-worn theory that higher interest rates/rising interest rates are bad for bond proxies, like Consumer Staples. You can show lovely correlations over long periods of time between Staples' relative performance versus the market and the 10-year rate. But we think that is a flawed analysis.

If you think about the performance of Franchise and Quality (and this applies across both of them) in the short-term, the performance is driven by risk-on/risk-off. So, the best time to buy our portfolios is when people are risk-on. Be scared when people are greedy. At the moment, the simplest proxy I look at is the relative multiple of Staples versus the market and it's near its post global financial crisis lows, so I don't think it's particularly controversial to say we are in a risk-on situation at the moment.

So that risk-on/interest rate effect is, if you like, already in there. And in the long-term, what matters is what do the earnings do? Do the earnings do better than the market? We still believe that these companies' earnings will compound better than the market.

The potential risk in relative terms is if the world turns out to be better than everyone thinks, if all of the risks go away, then some pretty terrible companies will probably do fairly well. And if that's your view of the world, and you can stomach the high valuations of these lower quality companies, then you should invest there.

But, at the moment, as I said you're not having to pay for taking less risk, you're not having to pay for high quality, I see this as a pretty attractive time to own two strategies with portfolios that own what we consider to be the highest quality companies that exist in the world.

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