Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Finding Diamonds in the Rough? Searching for Quality in Financials

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For many in the market, being a quality investor within financials might seem like a contradiction in terms; financials is a value sector, they may argue—typically cheap and quite frequently not so cheerful. While that is certainly true of some parts of the sector, we believe that select high quality companies within financials do exist and that we can identify them for the benefit of our clients. However, this relies on a rigorous process to separate the wheat from the chaff.

A good place to start is to ask why, in general, financials may be considered low quality. A key aspect is their dependence on macroeconomic factors such as interest rates and the outlook for equity and credit markets, which means that their operational fate is often not in their own hands—a bank is a prime example. Just look at the recent earnings upgrades in the banking sector: For many bank stocks, this was driven by higher interest rates, the direction of which is both difficult to forecast and impossible for management to influence. In addition, many financials companies are highly cyclical, often driven by macro factors, be it the state of the overall economy or the health of asset markets, driving assets under management. We do not need to revisit the Global Financial Crisis to find examples of this; in early 2023, the collapse of a few small to medium-sized U.S. regional banks in the face of surging interest rates triggered the largest banking failure since 2008-09. All this adds up to relatively opaque business models with numerous share price drivers—macroeconomic and fundamental combined.

The presence of sustainably high returns on operating capital is one of the hallmarks of our team's definition of quality. Within financials broadly, however, the balance sheet heavy nature of many business models tends to weigh on returns, leaving them struggling to make our quality grade. Quality companies, as we have been defining them for more than 20 years, have (among other things) sustainably high returns on unlevered operating capital, robust balance sheets and the ability to fund their growth mostly out of the existing cash flow—things that banks, for instance, generally do

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not have or are unable to do. A typical bank could have an unleveraged return on assets of less than 1%, and this before leverage of typically more than 10x. Balance sheet requirements are of course determined by regulators and changes can be difficult to anticipate, with regulatory intervention—and its impact on balance sheets and earnings—often coming out of left field. As a result, we can never own banks in our pure quality portfolios.

While banks do not meet our high quality criteria, we believe that select high quality companies can be found elsewhere within the financials sector and make excellent candidates for our portfolios. Well-managed companies with strong intangible assets in balance sheet light subsectors such as exchanges, niches in the insurance industry and payment companies can achieve the combination of high returns, moderate cyclicality and recurring revenues that we favour in quality companies.

The relative scarcity of suitable portfolio candidates within financials is less of an impediment for a well-resourced team managing high conviction portfolios where index weights do not determine investment decisions. In addition, disconnects regularly develop between share prices and the value of the underlying franchises, which can offer good opportunities for stock pickers with a bottom-up approach. Admittedly, they require effort and expertise to unearth; a discounted valuation can signal either opportunity or balance sheet distress. With the strength of our team working on financials—which includes Anton Kryachok and myself alongside Bruno Paulson, Alex Gabriele and Richard Perrott in coverage of the sector—we have been able to identify promising investments on behalf of our clients.

Examples of some relatively new additions to our portfolios may highlight our stock picking process within this space better than a theoretical description.

A U.S.-based insurance broker

Within financials, the insurance broking industry is a fertile hunting ground for us; this is a capital-light industry which is highly concentrated at the large company end and provides good opportunities to roll up smaller brokers in the SME (small and medium-sized enterprises) segment. The brokers help their clients buy insurance at a good price and also structure it for them, as well as giving advice in areas such as risk management, regulatory requirements and capital management. We consider insurance brokers to be diversified professional service providers with a good revenue growth outlook, supported by structural drivers of higher insurance premiums, such as climate change, cybersecurity risks and rising court judgements. We selected this particular company, rather than its peers, for two reasons. First of all, it has implemented a unified operating platform that has helped both to drive a significant expansion of its EBITDA margin (from below 20% in 2013 to almost 32% in 2022) and break down barriers between siloed subdivisions to improve the client offering. Secondly, in our assessment, it has a strong management team with a history of shrewd capital allocation for the benefit of shareholders. In essence, it is a capital-light company with structurally high—and improving—returns, negligible macro gearing and a shareholder-friendly management team, which fits the bill for our quality portfolios perfectly. Just as importantly, at the time of purchase the company was trading materially below its intrinsic value.

Two leading exchanges

Another good example is illustrated by two exchanges, one based in the U.S. and the other in Europe, where high returns on the modest amount of capital employed, recurring revenues and modest cyclicality coupled with an attractive valuation have allowed us to build positions in select global portfolios. Diversified revenue streams and high barriers to entry by virtue of a combination of network effects, brands and sticky software, combined with strong management, have helped these two names stand out from their peers.

A U.S.-based payment company

High barriers to entry and strong intangibles help to protect the exchanges' profitability and growth outlook, which is also part of what attracted us to a U.S.-based payment company held in select global portfolios. This leading e-wallet solution provider boasts a constantly growing user base and broadening merchant acceptance, which create a positive flywheel effect where its larger network and additional functionality make it more valuable to consumers and merchants alike. Payments are not a new area for us: we have owned a leading global provider since 2010, and it holds a top 10 position in our global portfolios.

While we typically find the greatest proportion of high quality compounders in the consumer staples, information technology and health care sectors, our bottom-up investment approach enables us to identify those niches of quality that exist within other sectors. Financials is a good example of this, and our exposure to investments in financials as a percentage of the overall portfolio has increased over time. The recent MSCI Global Industry Classification Standard update, which shifted a couple of payments stocks from the information technology sector to financials in early 2023, has certainly contributed to this. But perhaps more significantly, the breadth of investment expertise on our portfolio management team has allowed us to, in the words of Peter Lynch, turn over more stones and find the odd diamond in the rough to add to our portfolios.

Risk Considerations

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

DEFINITIONS

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

Leverage is the degree to which a company uses fixed-income securities such as debt and preferred equity. The more debt financing a company uses, the higher its financial leverage. A high degree of financial leverage means high interest payments, which negatively affect the company's bottom-line earnings per share.

Return On Assets (ROA) indicates how profitable a company is relative to its total assets. It is calculated by dividing a company's annual earnings by its total assets.

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).

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