Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Back to Basics

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Growing $10,000 at an annualised rate of 8% a year would become $14,693 in five years, $21,589 in 10 years, and be worth more than four times as much in 20 years at $46,610—a strong real appreciation of capital.[1] This compounding is fundamental to successful long-term investing, as long as you have the patience for it.

AUTHOR

WILLIAM LOCK
Head of the International Equity Team

While the rate of compounding matters, the key lies in the ability to keep doing it. This is why we look to hold companies with high and sustainable returns on operating capital, since these companies exhibit the best compounding characteristics, in our experience.

The things that matter

There are a few key attributes essential to achieve these high and sustainable returns: pricing power, hard-to-replicate intangible assets with high barriers to entry, and a leading presence in industries and categories with strong, long-term opportunities for growth. Also vital is a management team able to allocate capital effectively, to drive this growth and navigate the ever disruptive sea of change—you can't compound if you're not growing.

"While the rate of compounding matters, the key lies in the ability to keep doing it"

Pricing power matters for two reasons. First, it may protect you in both inflationary and deflationary conditions; you can pass on input cost inflation to the end consumer if your costs of goods rise, and you can uphold your pricing if these

[1] The example shown is for illustrative purposes only and does not represent actual market returns. The data has been chosen to convey the concept of compounding. Results are hypothetical.

commodity-driven costs decline. Second, it means you could have better control over your gross profit margin—you can keep it stable. A high gross margin (our global portfolios average 50% compared with the broader market of 26%) is the signal of pricing power. By definition, if you are not able to offset inflationary or deflationary conditions, you would not be able to maintain a high gross margin.

High gross margins help support sustainable growth. As an example, take a leading French beauty company. Its gross margin is 70% and its operating margin is 20%. This means 50% of its sales are operating costs (70% minus 20%). These operating costs are the engine room of innovation, sales, marketing and research and development. It means the company can, and does, spend 30% of its revenues on marketing alone, supporting and building its world-leading brands. The average company simply can't compete, given the average company has a gross margin of 26%. If the average company spent 30% of revenues on marketing, it would make an immediate loss. So high gross margins do two things: they help support high barriers to entry, and they underpin stable profits.

Hard-to-replicate intangible assets are powerful because they enjoy high barriers to entry and durability. Favourite consumer brands, from sports shoes to shampoo, typically have many, many years of investment crafting and positioning the brand, tuning it to changing tastes, keeping it relevant, keeping it desirable, and ensuring ready access in-store and online. Leading global technology software franchises have built such strong platforms—entwined in the heart of all we do at work and at home—that switching costs deter us from moving to an alternative. Why take the risk? Why invite the cost? And who is there to switch to anyway? As long as the provider supplies us with what works and they innovate to keep relevant, then there's no switch to be had. Sure, disruptors come along, especially in technology, but typically the disruption helps lift the boats for the most powerful franchises. New digital payment players use the incumbent rails of the established debit and credit card companies—new players benefit from the existing infrastructure. Games, app and social media developers write for the incumbent desktop and mobile operating system suppliers; they need them.

We invest in companies with the ability to grow sustainably over the long term, where this growth is rooted in sound fundamentals at justified prices. We don't engage in the risk of very high expectations for growth, regardless of price, or in exciting businesses on the cusp of discovery with a distant prospect of turning a profit, or the promise of a new way. We want to ensure the industries and categories our companies are in, or are developing, have a genuine road map for long-term growth. For example, attractive opportunities in digital payments, enterprise-wide networks, beauty and personal care, medical technology, financial and business software, health and hygiene as well as environmental solutions are all reflected in our portfolio—all backed by world-leading, well-established franchises.

And the things that can't be ignored

Further safeguarding the potential for compounding, throughout our investment process, we consider the material risks and opportunities that ESG issues may pose to the sustainability of returns. Ignoring, for example, the impact of climate change and the need to decarbonise could impair a company's competitive advantage and reputation all at once. Failing to develop brand equity that speaks to consumers wanting, for example, natural provenance, recyclable packaging, lower carbon footprints or informative labelling, is failing to safeguard the franchise. Not investing in an appropriate framework to confront cybersecurity risk could significantly compromise operations and profits. Not optimising a talented corporate culture by neglecting to foster diversity and inclusion signals further risks to the franchise. We bring these conversations to the table through engagement with the company rather than forming an opinion using only third-party scores or data points.

Where can it go wrong? The returns will not remain high and sustainable if the management teams in control of allocating shareholder capital do so unwisely. Highly profitable businesses that require limited capital—because they're driven by their intangible assets—produce significant levels of free cash flow and have powerful balance sheets to deploy. This financial capacity could be a risk in the wrong hands. In essence, a lot of money can be spent very quickly at the wrong price for the wrong assets for the wrong reasons. Management might be trying to mask slowing organic growth, they might be accelerating short-term earnings growth (if they're incentivised to do so), or they might have captured the right asset, but at a very high cost.

How can we control for this? Through fundamental analysis and engagement. We look to understand if their incentive structure risks short-term behaviour. When we can, we meet with management to understand how they think about the allocation of capital (where, how and why) and how they've allocated it in the past, and come to our own conclusion as to the risk or opportunity. Being long-term holders with very low portfolio turnover facilitates this ongoing dialogue.

In a world where daily financial chatter looks to dot plots, talking about talking about tapering, non-farm payrolls, the crypto helter-skelter, the stimulus tap, hydrogen or lithium ion, transitory or persistent inflation, commercial space travel, bad news is good news, good news is bad news, it's easy to get distracted from what drives the core of long-term returns; the power of compounding. That's what we relentlessly focus on owning and checking and checking again, and then again: that we have a portfolio of those rare companies with the ability to compound at a high and sustainable return on their operating capital.

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

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).

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