CQS | NEW CITY EQUITY

Interview with Raphael Pitoun

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What makes a company really exceptional?
There are two main characteristics. First, the company needs to be innovation-centric. This is the key attribute behind a company's ability to develop the right products and services to clients. It is built around a well-defined mission to serve a specific market in the best possible way. Second, is a company's internal organisation, primarily corporate governance, which should be oriented towards the long-term execution of the *mission*, and be reflected in a progressive management of human capital and leadership across all levels of the organisation. We believe that to drive innovation, a company needs business managers who behave like internal activists. Moreover, high levels of employee satisfaction, limited employee turnover and the right incentives towards the business' long term objectives are often important to maintain market leadership. The Chairman's letter in the annual report is essential reading. That's where, year-after-year, you can get an understanding of a company's DNA and whether the strategy of delivering on its mission statement is consistently implemented.

What kind of business models do you prefer?
Fundamentally, four business models are relevant to our strategy:

- First, we seek companies that sell *highly differentiated products and services*. They bring a significant advantage to their clients in terms of productivity, maintenance, reliability, after sales service or overall results versus competing firms. Most companies in that category invest heavily in research & development in order to maintain market leadership and drive pricing power.

- Second, we favour companies whose business is based on *platforms*. These companies grow on the back of a positive and sustainable network effect: the larger the platform, the better the value proposition to the user. These businesses typically combine different competitive advantages which are difficult to replicate.

- Third we also like *non-core but mission critical* companies. These companies are positioned to benefit from the economic rationale of their clients to outsource essential but non-strategic tasks which it would be inefficient to handle internally given the investment they require. Often, these companies are leaders in small markets with limited competition.

- Finally, we invest in *dual mandate* companies. These companies deliver a range of products and services which benefit clients in complementary ways. The first leg of the mandate is to enable the client to implement cost cutting, improve efficiency and ultimately free financial resources. The second leg of the mandate is to help the same client boost innovation, launch new products or invest in technologies.

How relevant is the strength of branding?
A brand is an important asset, but is a consequence rather than a cause of a good business. This is especially true as marketing-based barriers to entry are significantly lower nowadays. Only some exceptional brands that combine other competitive advantages make sense for us to invest in. Fashion-driven brands in luxury and most consumer staples do not qualify.

Do you only invest in companies which are leaders in their respective industry?
Market share is important, not only because it is often positively correlated with margins but also because size enables a deep interaction with a company's market. When unmet needs or new demands emerge, scale enables a company to identify and address a client need successfully. Strong competitive positions are all the more valuable as client and market knowledge become increasingly important.

How do you consider sector exposure?
We often find companies which, despite their innovation and good governance, do not meet our expectations in terms of potential investor returns. For our strategy, companies need to be in the right industry and that's why we exclude many sectors from our portfolio. For example, the resources and airlines sectors include some good quality businesses but for us their success is too reliant upon external factors. Other sectors, such as pharmaceuticals, are excluded because they are not predictable enough or because they do not provide sufficient structural growth, such as the utilities, real estate and telecoms sectors. Finally, some sectors do not provide sufficient transparency to investors. Broadly-speaking, this is the case for the banks and insurance companies. A point that's important to highlight is that investors should not be scared by technology. Every growth story requires some level of technology and, after thorough diligence, we have identified great opportunities with sustainable, long term returns in the technology and other sectors. No sector is immune to disruption; look at the oil sector which, with the emergence of shale gas, has experienced one of the most painful disruptions among all industries over the last thirty years.

Do these exceptional companies all make good investments? How do you think about valuation?
Valuation is a key tenet of the process and the message here is to urge investors not to oversimplify this topic. We believe that, given the increasing importance of intangibles, some classic and still commonly used financial metrics are flawed and an undifferentiated approach is dangerous. For example, most companies we analyse have a limited need for tangible capital, so using ROCE is meaningless. Likewise, the price earnings ratio relies on accounting principles that are arguably dated; this makes us sceptical of this valuation measure as a guide to successful stock selection. Finally, the free cash flow yield is too simplistic and fails to capture the company's investment dynamics.

The reality is that there is no magic bullet. Our approach is to be forensic in our analysis and combine these orthodox metrics with progressive valuation models. Before completing the valuation of a business, one has to conclude a deep understanding of the company's model, strategy and financial statements to derive its long term earnings power.

The strategy is highly ESG friendly. How do you incorporate ESG considerations into the investment process?
ESG is a natural component of the strategy and a performance tool. Environment (E) can be less relevant given our sector exposure; that said, Social (S) and Governance (G) are critical to choosing the right investments. ESG considerations accompany us during the entire investment process from initial sector exclusion to deep dive analysis and valuation. This is not to follow any kind of 'trendy' investment style – we are agnostic to these kinds of fashions. It is because of the way we envisage ESG through the inclusion of non-financial metrics to deliver better returns to investors. With predictability in mind, we seek to avoid companies with exposure to major sources of risks that could unfold over the longer term.

Why is the portfolio so concentrated?
Over the last 90 years in the US market, 50 companies represented 40% of the returns, while 96% of listed companies destroyed value versus the government bond yield.[1] Our objective is to identify those few listed equities that deliver the bulk of stock market returns and invest in these companies. This is consistent with the size of our Top50 list. Ultimately the portfolio includes between 20 and 25 positions as the relative value within the Top50 changes.

Why does it make sense to develop this strategy at CQS?
First, it provides autonomy to portfolio managers. Second, our investment philosophy is aligned with CQS' DNA, given its focus on fundamental research and the search for long term value. Interestingly, the credit markets often lead equity markets which will support the optimisation of our portfolio. Of course we also benefit from CQS' well-established infrastructure platform.

Source: Do Stocks Outperform Treasury Bills? Hendrik Bessembinder, Department of Finance at the W.P. Carey School of Business, Arizona State University, February 2017.

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