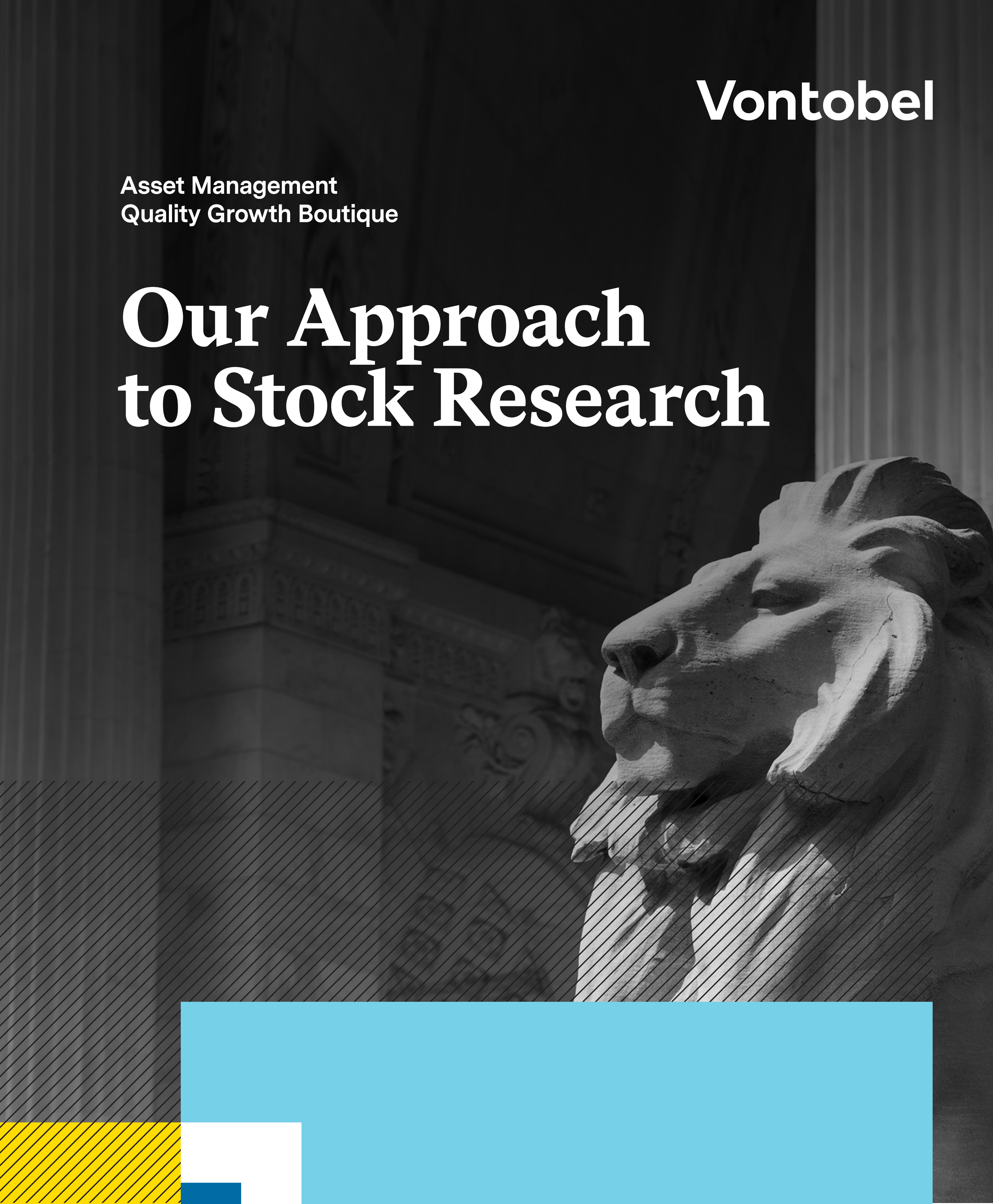
Vontobel

Asset Management
Quality Growth Boutique

Our Approach to Stock Research



November 2019

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Patience and Fortitude

Two majestic marble lions guard the entrance to the New York Public Library in Manhattan, a place they have occupied for more than a century. They were known by many different nicknames in the early years until, in the 1930s, then Mayor Fiorello LaGuardia gave them names that stuck. He called them Patience and Fortitude to embody the qualities he felt New Yorkers would need to survive the great economic depression. The city has been shaken by many crises since, yet the two lions remain potent symbols of resilience in the face of uncertainty and adversity.

A few short blocks away from the New York Public Library, at the Vontobel Quality Growth Boutique, patience and fortitude are qualities that guide the investment decisions we make on behalf of our clients every day. We do not know when the next downturn will hit, how severe it will be, or how long it will last. That is why we think successful equity investing requires a long-term perspective, courage in our convictions and consistent discipline to weather any environment.

Putting the Vontobel Research and Investing Strategy to Work

"We believe our investment approach is in-line with the end goals of our clients as it can help produce growth with lower levels of volatility and preserve capital in difficult markets."

Separating the Great Companies from the Mediocre Ones

As an active manager, one of the most important characteristics we look for in a company is consistent earnings growth. Earnings growth underpins wealth creation. That growth, of course, is driven by the fundamentals of a business – durable strengths such as pricing power, a strong balance sheet and high return on invested capital (ROIC).

Stock values, on the other hand, are a derivative of earnings. Sometimes stocks reflect a true picture of a company's earnings potential and underlying fundamentals; often they do not. In the words of legendary investor Benjamin Graham, "the market is a voting machine, whereon countless individuals register choices which are the product partly of reason and partly of emotion." The investor focused on fundamentals patiently waits until reason prevails.

We buy a particular stock because, after rigorous analysis, we determine that it is a high quality company with sustainable growth potential for the long term. We look for four essential characteristics:

1. Competitive Advantage
2. Solid Management
3. Sustainability of Growth
4. Sensible Valuation

Once we find those businesses, we stick with them in seeking to let the power of compounded earnings unfold.

We entrench ESG criteria into our focus on these key traits. ESG is important to the maximization of long-term value, providing better visibility into the governance and operations of the companies in which we invest. One of our core aims is to invest in companies where ESG risks are understood and mitigated.

1. Competitive Advantage

> **"Of course, some competitive advantages are enduring, while others are shorter lived. We constantly test that the underlying competitive strength of a company is still intact."**

Building a Wide Moat

Competitive advantages allow a firm to deliver a product or service that is superior to its peers, or produce a similar product at a lower price. Thus, competitive advantages enable a company to deliver good value for the customer and profits for itself. Both shareholders and customers benefit.

A company's competitive advantage is a critical determinant of its long-term results, but it is often the most difficult factor to assess. In order to understand the competitive moat around a business, our analysts ask questions like: How strong is the brand? Is the company's pricing power sustainable?

Let's consider sportswear brand **Nike**, which has tremendous brand strength globally. It has credibility in many sports and customers have an emotional attachment to the "swoosh" that many other brands can only dream of replicating. Nike uses its substantial scale in revenue and profitability to spend significantly more than its competition on marketing and sponsorships, which is crucial to ensuring that its brand continues to resonate with consumers – all around the world. For example, even in the face of the trade war, which has had negative repercussions for many US companies operating in China, Nike recorded growth of over 20% (in the first 10 months of 2019). Moreover, its brand strength enables it to continue to create and sell higher-priced, more innovative products that can boost the top line, at the same time as it focuses on manufacturing efficiencies that can improve margins and the bottom line.

Beyond brand strength, several other factors can make a moat wider. Economies of scale leads to a cost advantage as bigger companies spread fixed costs across a larger number of units and benefit from greater buying power. Another factor is to achieve a network effect by building valuable platforms on which buyers and sellers, or traders and users, achieve critical mass by transacting with each other. Think derivatives exchanges like CME Group, or e-commerce platforms, such as Alibaba, or the payments networks of Visa and Mastercard.

Visa and **Mastercard** operate in an industry in which we see strong long-term secular growth – there is still a significant amount of cash to be displaced by digital payments, particularly in emerging markets where the majority of transactions are in cash. Other positive drivers include rising consumer and merchant acceptance and the increased penetration of e-commerce. Further, there is a vast untapped opportunity in the business-to-business (B2B) payments segment, in which cards remain grossly underpenetrated.

But not all payments companies will benefit from this industry growth. As the two dominant global payment networks, Visa and Mastercard play a uniquely indispensable role in the payment ecosystem, which is all but impossible for other payments groups to match. For example, Visa can be used in more than 50 million stores and other merchant locations worldwide and has affiliations with some 16,000 financial institution clients globally. Scale brings proven pricing power when set against their fragmented merchant and institutional customer base. As a result, both companies have enjoyed operating margins in excess of 50% and ROE over 20% for the last five years. Their positions give them an advantage in the growing e-commerce space too, with the likes of PayPal and Apple Pay relying on their networks for their services.

Ultimately, we believe these quality companies can turn their competitive advantages into superior economics compared to the average business.

2. Solid Management

The Value in Visionaries

No investor would knowingly want to invest in a company that is managed poorly – investing alongside competent management is obvious. Yet distinguishing between good and bad management is not straightforward. When searching for a company with great management, we look at how they make decisions on capital allocation, how compensation is linked to shareholder value and how well they articulate their strategy and support it with a track record that demonstrates high returns and growth rates, financed with a conservative balance sheet.

A visionary CEO can successfully reset a company's strategic direction and transform a business. When Satya Nadella became CEO of **Microsoft** in 2014, he inherited an organization largely focused on extending the reach of its Windows operating system. As a result of concentrating on its historic crown jewel, Microsoft was becoming less relevant to customers and missed two major technological shifts: the internet and smartphones. However, Nadella recognized the significance of cloud and mobile and how this would change the business's approach to IT. In his very first memo to the company as CEO, Nadella framed Microsoft's core value as empowering users and organizations to "do more", regardless of their IT platforms, a far cry from the early days when the company's goal was to put a PC on every desk.

A strong CEO is also able to act decisively, make tough decisions and understand where to invest so that it can propel a company towards its targets. In Nadella's case, he quickly jettisoned the ill-fated Windows phone and released Microsoft applications for iOS and Android. This marked a more collaborative culture for Microsoft as it entered partnerships with other software companies and even embraced open-source software. Finally, Nadella oversaw Microsoft's push into cloud computing through which it aims to become a platform company for businesses and people everywhere. The efforts have recharged growth and broadened Microsoft's addressable IT markets by focusing on customer needs and emerging industry trends.

Vontobel Quality Growth ESG Mission Statement

In an interconnected society, the role of asset managers provides a vital link between savers, companies and employees. We take this responsibility very seriously.

The ESG mission of the Vontobel Quality Growth boutique is based on the enlightened self-interest of better returns relative to risk for our customers. This is accomplished by seeking to invest into companies able to sustain growth for many years through managing a strong franchise while benefiting from the stability generated from a healthy balance of stakeholder rewards.

We strongly believe that shareholder rewards are lifted with good ESG management and that sharing the earnings of the company with stakeholders is productive and not a zero sum game. We see ESG as important to the maximization of long-term value, providing better visibility into the governance and operations of the companies we invest in. One of our core aims is to invest in companies where ESG risks are understood and mitigated.

As an active asset manager, it is our responsibility to invest with conviction, underwritten by solid fundamental research that takes ESG aspects into account.

We believe ESG brings benefits to investors, employees, and our interconnected society as a whole.

Exceptional CEOs also tend to have a clear understanding of what customers want and how to deliver it. **Amazon** founder, CEO and president Jeff Bezos has consistently created outsized returns by ‘delighting the customer’ and taking a long-term approach. In Amazon’s e-commerce business, this means greater selection and faster shipping, the latter achieved by investing more in fulfillment centers and last-mile delivery than its rivals. And, when it comes to its cloud business, it means greater investment in server infrastructure and software services, as well as efficiencies that flow into lower pricing for customers.

Focusing on the customer has also resulted in a more balanced approach to margin expansion. Bezos has prioritized investing in the customer ahead of short-term profitability, which has driven customer retention and an increased share of customer spend across categories. This benefits shareholders too, as Amazon’s business is more predictable over the long term but still has significant headroom for growth across all its key businesses.

“Assessing a company’s management requires judgment and a deep understanding of the business.”

3. Sustainability of Growth

Fueling Long-Term Returns

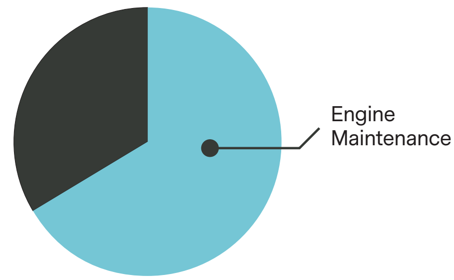
Return on invested capital (ROIC) is a metric that best encapsulates a business's profitability. It measures the amount of cash flow a business generates relative to the capital it invested. A high ROIC usually indicates that a company possesses competitive advantages, i.e., a moat. In addition, we believe many of our holdings also have the ability to deploy additional capital at attractive rates of return, which can help lead to earnings growth. For it is earnings growth that helps drive a stock's performance over the long term.

A case in point is **Safran**, a leading player in narrowbody engine manufacturing, which has delivered an average ROIC of 18% over the last five years. Engine maintenance is Safran's main driver of earnings, with its recurring revenue streams giving it long visibility on growth. For regulatory and safety reasons, engines must come in for maintenance every five to seven years (with roughly five visits over the lifespan of the engine.) Safran has a relatively young fleet – 60% of its engines made in a joint venture with GE have not come in for their first service, while another 30% have had only one shop visit. Maintenance revenues have historically grown at 8% annually over the last 12 years and we expect that to continue.

Demand for new engines is also strong and a source of growth. The backlog of narrowbody aircraft stretches out eight to nine years, supported by traffic growth of 5% to 6% and the structural growth in the low-cost airline space. Put that all together and we expect maintenance to drive overall aftermarket growth at a high, single-digit rate through 2029 – visibility that is difficult to find in almost any business.

Figure 1: Safran: Maintenance Helps Drive Profitability

Earnings



Historic Revenue Growth from Maintenance: 8% annual rate over the past 12 years

Source: Vontobel estimates, Company reports, 2019

Recurring revenue streams that result from regulatory requirements are one driver of growth. Other factors can provide equally powerful undercurrents, like the penetration of a new technology, expansion of market share or the rise of a middle class. We continue to find great long-term growth opportunities in companies that are benefiting from the secular demand growth among the middle classes in emerging markets (EM) with large populations.

As consumers earn more, they are more able to buy more and better consumer staples products. **Unilever**, whose brands are used by 2.5 billion people every day, derives 60% of its sales from EM, and generates at least €500 million from 16 different EM countries. We expect Unilever's growth, driven by EM, to continue to expand dramatically for many years to come.

> **"Over the long run, a high quality business can create more value for shareholders by reinvesting in the business than returning cash to shareholders, even if it is trading at a reasonable valuation."**

4. Sensible Valuation

> **"Investing at a reasonable price is just as important as finding the right businesses."**

Setting a Sensible Price

We understand that great businesses do not come cheap, and we are willing to pay a fair and "sensible" price for them, which makes the analysis of what constitutes sensible of critical importance. Our view is that a sensible price yields a return on our investment above the market's return through the cycle. We do not have a specific target, it depends on the quality of the business, its market and its liquidity, among other qualifiers. For businesses in which we have a high degree of confidence, we take a longer-view. For businesses that are more mature or cyclical, we use conservative assumptions.

Our philosophy is to "think like an owner". In other words, we view the investment as if we owned 100% of the company. When we invest in a company, we are looking for wealth creation from earnings accumulation and income from dividends and share buybacks. In fact, when valuing a business, we actually assume that multiples will gradually decline as the business matures. At a fair multiple, we expect that earnings growth will more than offset declining multiples, so we can earn a fair return on the investment.

For example, **HDFC Bank** – the largest private bank in India – has compounded earnings growth at approximately 28% per year over the past 20 years, even though the Indian economy has been through both good and bad times. During the global financial crisis, HDFC Bank compounded earnings at 20% year-over-year. HDFC Bank's competitive advantage comes from being more efficient than the large state-owned banks. It lends at market rates, yet has funding costs and expense ratios well below its competitors. That means the bank generates a high return on equity (ROE) and reinvests most of the profits back into expanding market share. In the last 20 years, HDFC Bank's market share has increased from less than 1% to 8% and it continues to grow.

If we could go back to 1997, how should we have determined the fair value of HDFC Bank, one that would give us enough margin of safety? Once we have established our view that it is a high quality business, we can then reverse the question: What is the maximum multiple we should pay for the stock to clear a minimum investment hurdle rate of, let's say, 13% per year. Using the actual data, earnings per share compounded at 28% per year. It would have taken a P/E compression of more than 90% to bring down the return below our hurdle rate. In reality, because HDFC was such a resilient business, the multiple actually expanded. The compounding of earnings over a long period of time is such a powerful force that it partly mitigates the initial valuation risk.

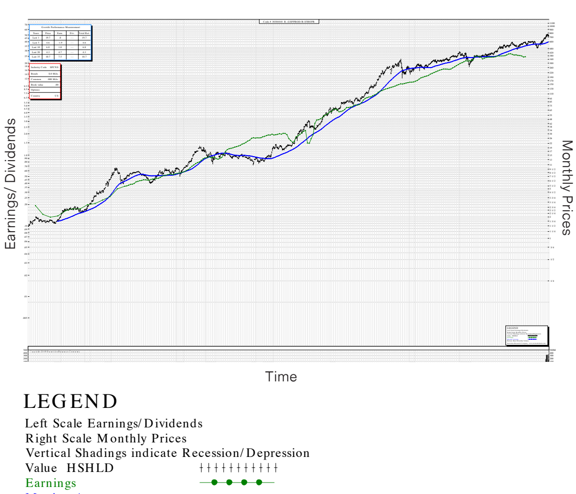
Patience and the Power of Compounded Earnings

One of Warren Buffett's guiding investment principles is, "if the business does well, the stock eventually follows." We could not agree more. It implies a high degree of patience and conviction (or fortitude) to concentrate on the long-term potential rather than the short-term bumps in the road. Investors with both a longer-term horizon and a focus on the four fundamental investment characteristics outlined in this paper more closely resemble business owners than stock speculators. We buy a stock because we see a great business with superior return potential for the long run.

The power of compounded earnings is crucially significant. Quality businesses can compound earnings at a faster rate than commoditized ones. Look at the performance of US stocks in the steel industry versus the household products industry since the 1980s. Despite the fact that demand for both industries grew at a similar pace during this period, stock performance could not be more different. Why? Prices are correlated strongly to earnings per share (EPS) and dividend growth. While the total return of household companies compounded at 10.7% per year for the last 35 years, steel companies compounded at only 4.3% per year.

Figure 2: Price return and earnings trend of a basket of US equity securities in the steel and household products industries; 35 years ending October 2019

Household products industry



Steel industry

Source: Securities Research Company. Universe is defined as US companies in respective industries, as defined by Securities Research Company, publicly-traded for the last 35 years.

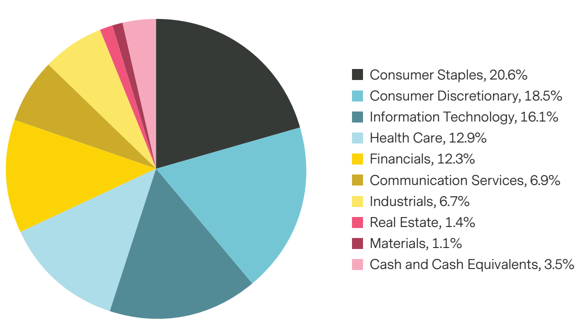
Standing the Test of Time

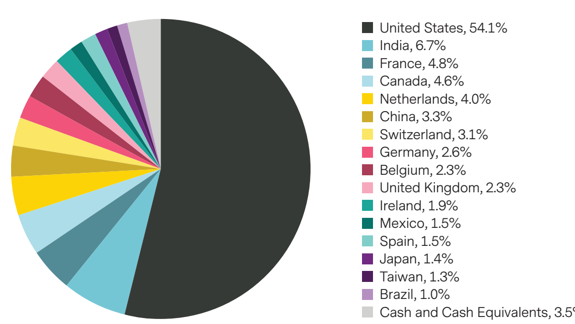
The trust that our clients place in us to manage money on their behalf is our main asset. This is a tremendous responsibility and we are mindful that delivering on their expectations can nurture this trust. In this paper, we describe our process of quality investing. However, the values that our organization embodies and the deep intellectual capital of our team is what enables us to carry out this process with consistency. It is only with a clear understanding of our mission – to aim to outperform the market over the cycle with less volatility – that we can consistently invest with discipline, otherwise we will hesitate when the market goes against us.

The culture of an organization demonstrates the values that binds its people. At Vontobel, we believe in a team approach. A concentrated portfolio requires a deep knowledge that we believe only a team approach can deliver. A culture of teamwork is organic; it takes many years to crystalize. Our senior investment team has been working together, on average, for more than a decade and we have now started to invest in the new generation of analysts. The process only works if the team works together – information is the raw material of our investment process and it needs to flow seamlessly inside the organization. This is our most important intangible asset. Like patience and fortitude, the two lions that guard the New York Public Library, we expect our organization will also endure the test of time.

We remain committed to helping ensure we have a strong and diverse portfolio – covering many sectors and countries – that can preserve as well as grow capital for our investors in periods of economic expansion and downturns alike.

Figure 3: Vontobel Global Equity Strategy Diversified by Country and Sector





Sector and country allocations are as of as of September 30, 2019 and based on representative portfolio. The basis for which the representative portfolio was selected is that the portfolio is the oldest and most representative account.

Performance Disclosure

Any investments discussed in this presentation are for illustrative purposes only and there is no assurance that the adviser will make any investments with the same or similar characteristics as any investments presented. The investments are presented for discussion purposes only and are not a reliable indicator of the performance or investment profile of any composite or client account. Further, the reader should not assume that any investments identified were or will be profitable or that any investment recommendations or that investment decisions we make in the future will be profitable.

Past performance is not indicative of future results. Any companies described in this commentary may or may not currently represent a position in our client portfolios. Any projections, forecasts or estimates contained in this commentary are based on a variety of estimates and assumptions. There can be no assurance that the estimates or assumptions made will prove accurate, and actual results may differ materially. The inclusion of projections or forecasts should not be regarded as an indication that Vontobel considers the projections or forecasts to be reliable predictors of future events, and they should not be relied upon as such.

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