AORIS INVESTMENT MANAGEMENT

Investing abroad

Alan Kohler spoke to Stephen to find out more about how Aoris go about investing internationally and their approach to environmental, social and governance investing.

Stephen Arnold
Founder & CIO

READ TRANSCRIPT

Alan Kohler
The Constant Investor

AORIS INVESTMENT MANAGEMENT

Investing abroad

Alan Kohler, Jan 31, 2019 Fund Manager Interviews

This week's fund manager interview is with **Stephen Arnold**, the Chief Investment Officer of **Aoris Investment Management**. Alan Kohler spoke to Stephen to find out more about how they go about investing internationally and their approach to environmental, social and governance investing.

They only invest in global shares, not Australian, and we spoke to Stephen a year ago. We want to talk to him again because they've just put out a little report on investing in ESG, which stands for environmental social and governance. But there's some interesting stuff in his December quarterly which I wanted to bring out just about how they go about investing and what their criteria for investing is, which I thought you'd be very interested in hearing.

Here's **Stephen Arnold**, first to talk about how they go about investing and second, their approach to ESG investing.

Stephen, in your December quarterly you talked about the fact that you don't pay much tension to EPS (earnings per share) and actually, your approach is all about growth in business value. Explain to me how you achieve growth in business value if not through rising EPS?

Well, Alan, I think EPS is a useful accounting shortcut but it's only ever going to tell part of the picture, which is if an investor or interested party is trying to ascertain how profitable a business is and the rate at which their profit's growing. Then for us, what's more useful is the business becoming more valuable as investors – that's in essence what we want to be participants in, is the growth in value of the businesses that we own and that's distinct from buying, I guess, recovery situations or taking views on near-term events and catalysts. We want to be long term participants in the growth in corporate wealth creation.

Stephen Arnold
Founder & CIO

Alan Kohler
The Constant Investor

As it pertains to accounting standards, I think there's some important things that they don't tell you. One of which is what was reported as earnings, how much of that was generated in cash? For us, the cash earnings is far more important and the difference between the two really relates to how much investment the business needs to make in order to grow at a normal rate. Working capital, receivables and inventory of course, and many businesses have got to invest in their IT systems or warehouses and physical equipment which they may capitalise and the P&L doesn't tell you all about the reinvestment required in that side of the business.

You seem to focus on return on invested capital. Is it simply a matter of looking at their earnings as a percentage of capital versus the cost of the capital?

That's an important starting point. How capital intensive is this business and on the numerator what's the profit in relation to the amount of assets invested in the business. The second important part of that equation is, with the capital that the business generates, after the business has paid some of it out to the shareholders as dividends, after the company has invested some back into the business, into the receivables and inventory and so on to grow at a normal rate, then there's probably some left over. Then what return does the business get from that reinvested capital.

Splitting that return on invested equation into two, looking backwards, what is the business generating on the capital that supports the business? Then as the business reinvests to grow, how profitable are those reinvestment dollars? Clearly, the combination of those two in our view is what's going to drive the rate at which the businesses value changes. Hopefully positively, but not always so, and that's really where we focus as opposed to simply looking at EPS and working out whether it grew or declined year over year.

How does that go for you? I mean, you didn't have a great December quarter, but everyone went backwards. You sort of outperformed in the December quarter by 3%, 7.4% versus 10.4% for the MSCI. What was the main elements of your December quarter performance?

I think our outperformance versus our benchmark, if you like, or our opportunity set was quite pleasing and actually a combination of a couple of things. One is, just being mindful of where there are inflated expectations and there are some areas of technology which has delivered very outsized returns to investors over the last couple of years and where there's still a degree of enthusiasm or high expectations where the companies may not meet and where price to earnings ratios or some other valuation metric looks extended, that's number one.

Number two, is avoiding businesses that are very sensitive to externalities whether it's the trade conflict going on between the US and China, Brexit possibly or the oil price. Then thirdly, owning businesses with conservative capital structures. We know that in parts of the world, monetary conditions are tightening, businesses that have got a lot of debt, some will certainly pay more for that debt and some may struggle to refinance it, so owning businesses financed conservatively is very important.

And probably a fourth one I'd add is, owning these high quality, what we call all all-weather businesses that will continue to remain profitable. A wide variety of circumstances is really important to our definition of quality and we always look back at a business and say, "How did they go in 2009?" Let's pick the most economically stressed period in many decades and we only want to own businesses that remained very profitable and to your earlier point on return on capital, we want those that earned a return on capital well above their cost of capital in the most stressed conditions. That allows us to then say, well there's certainly plenty of things that can go wrong in the world, there's certainly plenty areas of risk, but we own businesses that prove resilient and profitable in periods of extreme stress.

How do you determine or calculate the cost of the company's capital?

It's a great point that you raise, but I think it's one where it's better to be approximately right than precisely wrong, so it's not something that we try and put decimal points against or a lot of precision. I think we use 8% as a reasonable proxy and we're never interested in owning businesses where we have to think too hard about risk. If there's a lot of financial risk, rather than saying, "Well, we'll increase our cost of capital for this particular business to compensate for this extra risk. We'd rather just not own the business altogether."

Are you saying that the cost of capital for all businesses is 8%, or is roughly 8%?

For the high-quality businesses that we want to own, then the cost of equity is going to be about that and then there's going to be some debt in the capital structure, so the finance theory would tell you that a weighted average of the two would probably produce a number in the order of 6-7%, and that's fine. We want some comfortable premium to that, so let's call it 8%. But what we don't do is look at lower quality businesses, riskier businesses, where other investors might say, "Well, I'm comfortable owning that but we'll factor those risks into cost of capital." For those types of businesses, of which there are many, then we're just not interested in owning them at all, it's quite constrained.

How much above 8% would a company need to be earning on its capital to justify you investing in it?

Well, for most of our businesses it's a significant premium to that and probably across the portfolio in the – call it 15%, so double that 8%. So, we're not looking for a marginal premium above whatever we deem to be the cost of capital. We're looking for a significant premium. Important for us to think through is the durability of any excess return. We're always mindful that whatever we see today reflects the rear-view mirror and we're mindful that many businesses that look excellent, look outstanding. It's very difficult to sustain for many, many years and in our quarterly we highlight a couple of categories of businesses like that, media businesses. 15-plus years ago, famous newspapers like the New York Times earned excellent returns on capital, but those industries have become progressively far more competitive and those returns have deteriorated significantly over time.

Durability of those returns on capital and then the choices management make about how they reinvest their free cash. And often times management are expansionary and make big acquisitions that dilute shareholder capital, they pay too much for businesses that they bought and then there's all sorts of integration challenges that come after on a big acquisition. Those are other dimensions that we're thinking about, not just is this a company that earns high returns on capital? How competitively resilient is it? How durable through time? Are we in the hands of conservative management who are going to act like owners and not be aggressive allocators of capital and destroy wealth.

Using your methods, what would have told you 15 years ago not to invest in newspaper companies?

Well, I never have done…

No, but as you say, at the time, 15 years ago, the newspaper companies like the New York Times and the Australian ones were earning really good returns on capital, but that was soon to come to an end. What would have told you that they were heading for trouble?

As a matter of fact, about 15 years ago I met with the management of Tribune Corporation in Chicago, a company that in the intervening years went bankrupt. The conversation I had with them was along the lines of how you are thinking about the diminishing advertising proposition that you represent to your advertisers. What you focus on as a newspaper company is circulation, but circulation doesn't tell you how many minutes each purchaser of the paper spends per day. I think it was just obvious that people are spending fewer minutes per day reading the newspaper and advertisers were going to wake up to the fact and pay less for it.

What I left the meeting with was a distinct impression that Tribune Corporation hadn't even thought about this. They had their head firmly in the sand. They were looking at these circulation figures that told them that the business was in good health, but it wasn't and I was struck by their detachment from reality and then as I said, ultimately the company went bankrupt.

What businesses/industries are in a similar position today? I'm thinking retailers, banks, those sort of things. You focused a little bit in your quarterly on banks and the fact that they're only just managing to earn cost of capital which is a problem. But where do you stand on those things now.

I think there are banks depending on where you are in the world. Most of them are failing to earn any sensible measurement of return on capital, European banks in particular. The returns on equity post the GFC have been woeful and things are not becoming easier and competition, the consumers are looking at alternative banks and regulatory capital standards are becoming more onerous. Banks is certainly one where the competitive moat, if you like, is shrinking. You no longer need to have a big branch network to be a competitive force, particularly with the younger bankers and consumers. I think another very relevant area is consumer packaged goods, the barriers to entry to create a new brand. Think about beverages, think about make-up and beauty, those competitive barriers to entry are lower, it's easier to create a brand profile through social media, it's easier to outsource the manufacturing to a third party and you can outsource the distribution. Retailers themselves want to allocate more of their shelf space to their own brands. They want to create interest to draw foot traffic into their store and so they want to have new brands so that they remain relevant to their customers.

I think for the Proctor & Gambles, the Coca-Colas, the Krafts, Kimberly Clarks, the Kellogg's, all of those types of businesses that were immensely powerful through the 1980s and 1990s, their businesses where it's far, far harder to earn the sorts of returns today and more importantly going forward than what they did a decade or two ago.

You've just made a big purchase or repurchase in Loreal. Why is that company different to what you've just been talking about?

Well, I think very impressively, they've been able to continue to gain share in the parts of their market that are seeing lower barriers to entry, the makeup area particularly that through 2016 and 17 grew very fast, and they themselves outgrew the market and took share and that's very impressive.

Also important for Loreal is that their business spans other important areas like skin cream, face cream, hair care, hair colour. They haven't seen the influx of new competition that makeup has and Loreal by and large has continued to gain share in those areas in most countries as well. It's also a business that I think has connected with its consumers in the way that consumers want to interact with it very effectively. They were very, very early among the multinationals in embracing online distribution, online communication. They do it in a very sophisticated way. I think their approach to the market and the results that they've generated have been very impressive and so for those reasons that we've purchased it for the portfolio.

Yeah, it seemed a bit unusual that you sold them and then bought again. I mean, you don't strike me as traders, why did you sell them and then buy back? In and out!

It's a good point. I think it's always important as an investor to have a flexible mindset, to be willing to re-evaluate information within a defined process and not that the process shouldn't change, but within that process to be willing to change your mind. I think if you're dogmatic and you sell a company never to buy back, or buy it and you never want to sell it, then you're going to get in trouble. We re-evaluated the results that Loreal's been generating over the last couple of quarters since we sold it, met with the company in Paris and have been impressed by the competitive resilience of the business and thought it was superior to a couple of other businesses that we had in the portfolio.

Just back to banks, do you own any banks?

No, and Alan, we never will, so that's a bit different from some investors who might say, I won't own banks except when it's the right time to own them. Our view is that we'll never know that and rather than make calls on economic cycles and central bank policy and regulatory policy and all of those things that seem to be important for banks. We're just going to take a path altogether, so we don't own them and never will own them. We don't spend mental energy thinking about those externalities that would matter to those people who do own banks.

When you look at the economic results that banks generate, they're pretty mediocre. Australia's had a pretty profitable banking system, it's becoming more challenged. But in most parts of the world, banks are entities that are very financially geared. They earn very low returns on assets, apply a great deal of debt against that and come up with a return on equity that might be 6%. In our view that's a pretty uninspiring end result of a business that by its nature is extremely risky.

AORIS INVESTMENT MANAGEMENT

You call yourself a value investor rather than a growth investor, explain to us the difference?

We like to think of ourselves as being a combination of the two, if you like. We call it quality-first value investing. Price always matters, it's not enough to identify outstanding businesses. The price you pay will matter a great deal to your end result as investors, but nor are we the breed of investor that says, "There's a price for anything, if it trades on a low enough PE, I'm in." We exclude huge parts of the market, including banks, that many other investors are comfortable to own. We won't own them at any price and from within a very defined and exacting set of criteria and relatively small part of the market that we consider to be our sweet spot, we're looking for those outstanding businesses, only when they trade at some discount to what we consider to be fair value. Price matters, but quality matters a great deal and it's a combination of the two that we're looking for.

Do you buy expensive companies because they're good?

Well, we may come at fair price in a different way than others. I think when many investors are thinking about the right multiple, let's call it price to earnings multiple. Then, what matters most is growth. For us, what matters most is quality, which is really a restatement of risk. We're willing to pay a significant premium to the market or for an average business, for businesses that we consider to be much higher quality or lower risk. When we think about the right multiple, we lean very heavily on risk and quality. I think others generally lean very heavily on growth and so it's for that reason we may have a view of what a business is worth that's quite different from others.

And does your definition of quality involve much more than return on invested capital?

I think that's a financial expression of other quality characteristics and the sorts of things we're looking for are the conservativism or quality of the capital structure, how is the business financed, number one. How relevant is it to its customers? Is it a business that keeps its customers for a long time or is it one where customers have got a lot of choices and change between suppliers a lot? Is it a business that can grow by innovating, creating more value for its customers? Or is it a business like, to pick an example, paid television in the United States, for many, many years the only way they grew was putting prices up by 10% every year, not adding any channels, just adding price.

We're also looking at management. Is management good stewards of the business's competitive moat or are they neglectful, perhaps arrogant, suffering from hubris, always wanting to get bigger rather than strengthen where they're already important and deepen the ways in which they're relevant to their customers? Just to pick an example to bring it to life, Accenture is an important stock in our portfolio. They keep their customers for many, many years. Their employees stay for many, many years. The top 5,000 employees have an average tenure of 15 years and they signed almost 200 deals last year with a value of more than $150 million dollars.

They're very relevant to their customers, their customers do a lot of business with them, these are deep, durable relationships and it produces a profitability that is then, I guess, a validation of what we're looking for in equality.

Tell us how ESG (environmental social and governance) fits into this? Because you've just put out a report on that, so are you kind of what you might call ethical investors, is that what you're saying?

I think it's a really important and multifaceted part of what we think about when we're thinking about business quality. I think the first thing to say is, we don't take the view that we can just tick boxes here or that we can apply some quantitative scoring, the number of independent directors – tick, number of some environmental metric – tick. In our view it requires a subjective assessment rather than an objective or box ticking assessment. It's not just environmental, it's not just how effectively a company uses natural resources, it's how well they treat their employees, how well they treat their customers.

Are they aggressive gouging their customers? And from a governance point of view, are the management team compensated on sensible metrics. Do they communicate to us as owners in ways that we think is transparent and fair, or are they opaque and aggressive management that get huge financial outcomes regardless of whether the business did a good job or a bad job? A lot of the types of businesses that we exclude tend to be the industries that have the poorest ESG outcomes. For instance, we won't own energy and mining companies ever, we don't like the cyclicality inherent in those businesses.

We mentioned we won't own banks. I think anybody reading the papers in Australia, including your columns, would be aware of the huge behavioural shortfalls that has been by the Australian banks and financial institutions, that's been brought to light over the last year or two. There's no one definition of ESG but I think applying a sensible criteria about, are they treating their customers fairly? Are they pricing the products fairly? Banks would fall short of that and not just in Australia, many other places in the world. Ultimately, good behaviour is good business and that good behaviour spans across how they treat the external environment, their customers and their employees.

What about diversity issues? Is there a number of women on a board that you need to have before you'll invest? A percentage, for example, are you looking at that? Will you invest in a company that's got no women on the board?

I think the answer to that is that there's no single quantitative metric that I think provides a sensible, yes/no, go/no-go, decision. I think it's more about whether the company hires on merit and whether they are inclusive in the opportunity set from which they draw people. Are they looking across the spectrum and not just on gender, on all sorts of metrics? Are they looking across geographies as well or only in one particular location? If they're hiring on merit, then the inputs into the equation, if you like, matter more than the outputs because there's no single metric of a minimum criteria that I think is going to produce the best outcome.

You may set a minimum criteria and it may mean that the company is excluding good people because they don't fit into that particular definition, which may then have behavioural disincentives. People feel like they're being passed over in order for the company to satisfy some external hurdle or criteria that they signed up for. That's really how we think about it.

What about environmental matters, are you screening companies in or screening them out on environment?

It's both and it's also recognising the impact that a company has on its environment may not be reflective in its own use of resources. A company may provide products that allows its customers to reduce waste and energy and more effectively use resources. Which is why looking up and down the supply chain is important and taking a subjective view, not using a particular scorecard. To give you one example, there's a business we own called Graco based in Minneapolis, and they are world leaders in equipment that's used to spray and dispense fluids. Their equipment would be used by professional paint sprayers, for instance – it's a wonderful business. I was walking through the factory floor a couple of yeas ago with their development head and he was explaining that they've created a product that allows them to electrostatically charge paint. An interesting application for that is when one of their customers is spray-painting railway rolling stock. Ordinarily a lot of the paint just gets sprayed into the air which wastes a lot of paint and has very negative environmental implications.

By electrostatically charging the paint it gets attracted to the metal and dramatically reduces those environmental negatives as well as saving the customer from wasting paint. That's a great example of how smart products can help their customers better use resources and which may not show up on their own balance sheet.

I think we'll leave it there, it's been great talking to you, Stephen, thank you.

Thanks so much, Alan.

That was Stephen Arnold, the Chief Investment Officer of Aoris Investment Management.