Global Equity

TIME FOR QUALITY

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After a challenging year in 2022 for global stock markets, the future seems brighter for equity investors with quality growth stocks looking particularly attractive. Portfolio Managers Laure Negiar and Zak Smerczak of Comgest's Global Equity Investment Team discuss how their portfolio is well-positioned to capture the benefits of pricing power and sector trends that are currently driving growth.

Last year was one to forget for many equity investors, but ignoring the reasons behind the widespread underperformance across global indices would mean missing the reasons to be optimistic for better long-term returns.

2022 was characterised by rising inflation and the subsequent intervention by central banks to control prices by raising interest rates. The causes of inflation increases are well known; as the global economy recovered from its pandemic-related recession, there was increased demand for products and materials, while the conflict in Ukraine forced up commodity prices in the first half of the year.

Such an environment of rising inflation and interest rates is generally detrimental for valuations of growth companies because of their higher duration. Indeed, during the past year there was a clear style rotation away from growth investing towards value, which caused a subsequent downgrade for growth company valuations. However, we need to draw a distinction between 'quality growth' and 'growth' characteristics.

> — **Conditions may just be ripe again for our quality growth investment style to deliver attractive opportunities for long-term investors**
>
> *Zak Smerczak*

We believe such testing conditions may be short-lived, and it is more important than ever to look beyond the valuation multiples to find those companies that will not only withstand rising inflation and interest rates but have the potential to benefit over the longer term.

Laure Negiar, Portfolio Manager for Comgest's Global Equity Strategy, says: "When interest rates are rising there is a negative impact on the valuation of growth companies. But in times of rising inflation, quality companies see a relative benefit in revenue compared to the rest of the market."

She adds: "This is because quality growth companies have strong pricing power, little to no debt, strong cash generation, and they will also have sound balance sheets."

A quality portfolio

A quality growth portfolio should comprise companies with a low net debt to equity ratio since these are better placed during times of rising interest rates.

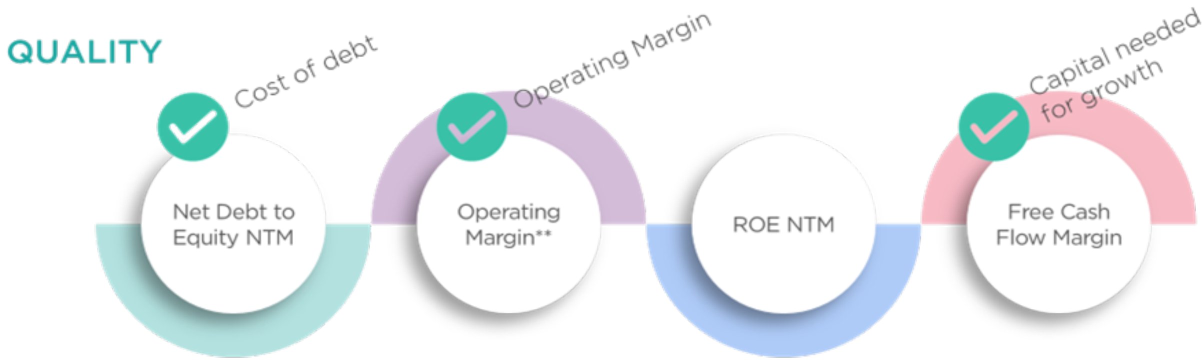
The Comgest Global Equity Strategy has zero debt with a net debt to equity ratio of -2.5% versus 29.4% for the MSCI All Companies World Index as at 31 March 2023 (*figure* 1).

Operating margin – or return on sales – is another important indicator of a quality growth company.

Negiar notes, "our strategy has an operating margin above 20% versus mid-teens for the index and it is worth remembering that in the tough times, typically this gap widens."

Quality growth companies also exhibit high levels of free cash flow, which means they are able to invest back into their own businesses irrespective of market conditions. This level of self-sufficiency is critical when capital is needed for growth during periods of rising or high interest rates when the cost of borrowing increases.

Figure 1. A quality portfolio



Rep. account	-2.5%	21.4%	18.8%	15.0%
Index	29.4%	15.7%	15.2%	7.8%

*Source: Source: Comgest / FactSet financial data and analytics, unless otherwise stated. Data as of 31-Mar-2023. The data shown is data of the representative account of the Global Equities Composite, managed in accordance with the Composite since the Composite's inception. Please refer to the important information section for more details on the representative account, its selection methodology and where to receive the GIPS compliant presentation of the composite. **12-month EBIT margin. Index: MSCI AC World - Net Return (MSCI AC World - Price Return until 01-Jan-2001). The index is used for comparative purposes only and the Fund does not seek to replicate the index.*

Pricing Power

Companies typically attempt to combat the corrosive force of inflation on their business by raising prices. However, Negiar states that while most companies can take this course of action once, only quality businesses have the luxury of raising prices repeatedly.

According to her, "Quality growth companies can raise prices while offering the exact same product or service without an adverse impact because what they offer is so compelling that consumers will continue to support it.

Comgest Global Equity Strategy comprises more than a third (37%)[1] companies with very strong pricing power including Microsoft, Linde and ASML.

Meanwhile, more than half (52%)[1] of the Comgest Global Equity Strategy is made up of companies with 'innovation-driven pricing power'. These include Eli Lilly and Johnson & Johnson, which are able to increase prices but must innovate to do so.

Negiar referred to Eli Lilly as an example of a company "able to increase prices for developing and marketing drugs that address a growing or new patient need."

Finally, there are companies whose business model is to provide value to end consumers, much like Costco. Their very edge is to provide affordable produce and products, notwithstanding this, they are still able to increase prices whilst maintaining margins due to their incredibly strong cost advantage (that being sourcing, scale and purchasing acumen). The catch, of course, is the membership model whereby consumers can only access these low-cost goods if they are willing to pay an annual membership fee, which also includes an element of pricing power, given the value on offer.

Strengthening sectoral trends

While growth stocks were unloved by investors in 2022, Negiar points out that the underlying sectoral trends behind their growth intensified during the year.

Sustainability, artificial intelligence, ecommerce, automation, and health care are among the sectors that boast opportunities for Comgest to find quality growth companies, and rather than suffering during the pandemic and the high interest and inflation rate environment, they have, on the whole, burgeoned.

"Automation grew stronger during the pandemic and post-pandemic period. The continuing rising cost of labour only serves to further that trend," Negiar says.

The trend to sustainability is also one that favours innovative, quality growth companies, and stocks that take ESG seriously are integral to the Comgest Global Equity Strategy.

Fellow Comgest Global Equity Portfolio Manager Zak Smerczak commented, "We have always invested in sustainable growth companies that protect and serve all stakeholders not just shareholders. We integrate an ESG assessment when researching our investments and there is clear evidence that our investee companies are making progress versus their targets across the portfolio."

For example, the strategy invests in Linde, a leading global industrial gases and engineering company with sales of $33 billion in 2022, which has exposure to electronics and healthcare, both of which play to the sectoral trends favouring growth companies, but it also benefits from the move to Net Zero carbon emissions.

"Linde[2] has identified $30 billion worth of projects, which translates to $10 billion sales and 25% additional EBIT from 2022 to 2030 because of its competencies in decarbonisation via carbon capture, utilisation and storage," reports Negiar.

A positive outlook

Growth stocks bore the brunt of market downturns during 2022 as a result of significant contractions in valuation multiples, but quality companies with strong fundamentals still delivered solid earnings growth last year.

As we look to the near term, we expect double-digit earnings growth for 2023 and 2024, which make the current valuation for growth companies based on last year's performance look attractive.

[1] Source: Comgest as at 31 March 2023.
[2] Source: Linde's annual report and website as of March 2023.

Negiar notes that "so far, the first quarter of the earnings season has been favourable for the strategy. Some of our names in the consumer space have been standouts in terms of beating expectations and have also expressed a positive outlook for 2023."

In the longer term, quality growth companies have proven resilient to the challenging economic conditions and are well placed to outperform benefiting from the sectoral trends that persist today and in the future.

Conclusion

In sum, Zak Smerczak reiterates Comgest's Global Investment Team view that "conditions may just be ripe again for our quality growth investment style to deliver attractive opportunities for long-term investors."

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- Emerging markets may be more volatile and less liquid than more developed markets and therefore may involve greater risks.
- Changes in exchange rates can negatively impact both the value of your investment and the level of income received.

Laure Négiar joined Comgest in 2010 and is an Analyst and Portfolio Manager specialising in Global equities. She is also a non-executive member of the Board of Partners. Laure co-manages Comgest's Global and EAFE (Global ex-US) strategies as well as the team's segregated accounts. Before joining Comgest, she worked at BNP Paribas Equities & Derivatives in Paris and London, and prior to that worked in several roles within the US government. Laure obtained a Bachelor's degree in Public Policy from Stanford University (with Honours and Phi Beta Kappa) before graduating on the Dean's list with an MSc in Management from the HEC business school in France. She is also a CFA® charterholder.

Zak Smerczak joined Comgest in 2016 and is an Analyst and Portfolio Manager specialising in Global equities. He is also a member of the Comgest Group's Investment Committee. Zak started his career in 2006 at Deloitte in London, initially in Assurance & Advisory Services before moving to Transaction Services where he was responsible for operational and financial due diligence. In 2011, Zak joined Mirabaud Asset Management where he worked as an Analyst covering global equities. In 2015, he moved to Polar Capital Holdings where he held the position of Analyst / Portfolio Manager for the firm's global multi-asset income strategy. Zak holds a Bachelor of Business Science Degree with Honours in Finance from the University of Cape Town. He is a CFA® charterholder and has been a member of the Institute of Chartered Accountants of Scotland since 2009.

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Data as of 31 March 2023, unless stated otherwise.

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