INVESTORS MUTUAL LTD

Investor Series: Why Holding Good Quality Stocks Matters

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Quality is one of the key aspects in Investors Mutual's investment decision-making process. In this article, we discuss why we focus on quality, the factors we consider, and provide examples of well-established quality companies which are cornerstone holdings in our investment portfolios.

Why Focus on Quality?

We have defined quality in the same way since our foundation in 1998. We look for companies that have a strong competitive advantage, generally the number one or two in their industry. We also look for companies with recurring, predictable earnings, run by experienced and capable management teams, and that can grow their earnings over the next three to five years. We also look for companies that based on our research are trading at a reasonable valuation.

We believe that quality companies are most likely to produce sustainable cashflows over the long term. These cashflows will be returned to shareholders either through dividends or buybacks, or retained for reinvestment to increase the value of the enterprise. Sustainable, reliable cashflows that can grow over time underpin valuations in both times of market volatility and relative stability. Companies which deliver steady and sustainable cashflows are also more defensive in times of market stress. Their reliable businesses and cashflows underpin their valuations, as was demonstrated in the March 2020 downturn and previous downturns.

Many quantitative metrics are available when assessing companies. Although these are useful lenses, identifying quality is more often reliant on judgement. Many aspects of quality are not easily captured numerically. Competitive position, management quality, accounting transparency, and environmental, social and governance (ESG) issues require experienced and considered judgement.

Competitive Position

While competitive position may appear to be captured by metrics such as return on equity (ROE) or margins, this is not necessarily the case. Mining companies will earn high ROE and strong margins in commodity price booms or during periodic shortages, but fundamentally have limited pricing power. For example, for several years the oil price hovered around $US100, and oil and liquefied natural gas producers generated strong margins and returns. More recently, many of these companies are not much above breakeven.

By contrast, **CSL** produces a commodity product, intravenous immunoglobin from blood plasma, and enjoys a very high margin on this product. CSL's competitive position is very strong because the company has invested well ahead of competitors in plasma collection centres, worked hard to enhance collection efficiency, and enjoys the lowest cost position in its industry. New competition is highly unlikely because of the regulatory hurdles in production of safe blood products, while price pressure is limited by the lack of new competition and relative inefficiency of competitors.

A strong competitive position such as a monopoly with long licences may not make high returns, but the returns will be much more sustainable than the average business. **Tabcorp**'s long duration lotteries and wagering licences are very valuable, but are not reflected in high returns. We believe that Tabcorp

can be better managed to take advantage of the amazing franchise its licences represent, and we are encouraged by recent developments on this front.

Management Quality

Experienced management teams with good track records are generally well-equipped to deal with cyclical shifts in demand and changing economic conditions. While management quality is often assessed by growth in earnings and share price performance, a deeper assessment is required to understand the sustainability of the business. Earnings may increase if management pushes prices hard, but this may be at the expense of future returns. Reducing expenses in research and development, information technology, safety, sales, and marketing and advertising are frequent tricks employed by private equity to dress up a business' earnings before a public offering. Cost-cutting measures can hurt a business' longer-term returns through a lack of investment for the future.

Capital deployment is one of the key functions of a company's management and board. Poor deployment of owners' assets is often clear in hindsight, but it is more useful to be able to make the assessment before the sorry results are obvious to all. **Fosters**' purchase of **Beringer Vineyards** and then **Southcorp Wines** diluted a very strong beer franchise in pursuit of building "a global alcoholic beverage giant". The wine business was later spun off after years of poor returns for the entire business. Similarly, **Boral**'s acquisition in 2016 of US fly-cash company **Headwaters** – on the grand vision of transforming Boral into a global construction materials and building products firm – seemed to us a poor decision at the time. This was vindicated by the impairment of the value of those assets, as it never earnt a reasonable return.

Accounting Transparency

There are many tricks that management can use to inflate short-term profits. These can include the use of provisions, the reclassification of maintenance costs as capital investment, the regular reliance on significant items, and the writing down of fixed assets, which lowers future depreciation. **Boral**, for example, impaired assets in its Australian construction division and claimed to have increased profits the following year when profits moved up much less than the decline in depreciation, and returns rose because the asset base after the writedowns was lower.

Environmental, Social and Governance Factors

Environmental, social and governance (ESG) issues are also often key influences on a company's value. As an active value manager with a long-term time horizon, our investment philosophy is based on the premise that a company's share price will eventually reflect its underlying value. This leads us to focus primarily on the longer-term underlying valuations of companies. We recognise that companies with good ESG records are likely to be beneficial for underpinning investment returns. Our analysts and portfolio managers rank their level of confidence in a company's current and future earnings. The earnings of companies with a good ESG record are likely to be less volatile and more predictable. A formulaic ESG assessment falls short of delivering a comprehensive view on the sustainability of the business and the durability of its social licence. Boards might tick the box on governance while presiding over a company culture and structure facilitating customer overcharging while also being economical with the truth when dealing with regulators, as was the case with **AMP**.

Conclusion

In these uncertain times, in our view a focus on owning good quality companies remains more important than ever. Many investors own or are chasing high-profile, high-growth companies such as those in the technology and medical technology sectors. This skew towards growth and momentum has left many good quality companies looking very attractively priced. A portfolio of these high-quality, well-established companies with sound fundamentals and strongly defensive characteristics, selected judiciously on the basis of quality and value criteria, will prove to be very effective in delivering long-term capital growth and tax-effective income in years to come.

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