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Global Equity Investing in an Uncertain Age

The Nikko AM Future Quality Approach to Global Equities

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Foreword

Welcome to our latest three-part investment guide where we detail our Future Quality investment approach to navigating turbulent times.

The three sections are outlined below, simply click to jump to the respective chapter.

To learn more about Future Quality investing, click here to watch our recently released webinar.

We hope the guide is helpful as you navigate the road ahead,

The Global Equity team at Nikko Asset Management

Part 1

Navigating the road ahead for global equities

Navigating the road ahead for global equities

In the first section of this investment guide, the Nikko AM Global Equity team explores how global equity investors can respond to the more challenging market conditions.

In recent times, the experience of investing in risk assets has been a rather miserable affair for everyone involved – particularly in some corners of the market where we have seen an utter collapse in share prices. We wonder, however, why this was so surprising for so many investors.

The evidence would suggest investors have become conditioned by the benign environment that had been prevalent for more than a decade, creating a smooth and clear road to higher prices for equities and indeed most financial assets. The world's key central banks had the specific goal of lower yields on financial assets since the great experiment of quantitative easing commenced. This post-financial crisis era has been less about investing capital and more about the 'great inflation' of financial assets.

This era even had its own language: SPAC, FAANG, meme, NFT, crypto, FOMO, and so on.[1] We live in a world where artificial intelligence is developing rapidly and is able to join the dots within larger data sets much better than humans can. We will, no doubt, underestimate the degree of future advances in this area. However, we should not underestimate the power of human thinking, as joining the dots on the wide array of evidence from different sources has been giving us valuable insights for some time.

As a global equity team, we are always discussing these observations and the insights they provide. In fact, they are instrumental both in directing our research towards the best new ideas and appraising our current investments. The valuation of companies has been a key area of focus, particularly since COVID-related monetary interventions pushed valuation disparities within equity markets to exceptional levels. In 2021, we wrote "These balloons… will not stay high in the sky…and the only debate will be the speed of descent". Then in early 2022, we wrote "Make no mistake, there are many aspects of this that have the trappings of a bubble". This is the human algorithm (or "Halgo[2]" for short) in action, and a good reminder to ourselves of the value of staying disciplined and bringing experience to the table. Being constructively critical is essential in today's turbulent world.

1 SPAC (special purpose acquisition company), FAANG (Facebook, Amazon, Apple, Netflix and Google), NFT (non-fungible tokens), FOMO (fear of missing out)

2 Halgo (human algorithm)

Source: Getty Images

All investors are now faced with a new and ongoing challenge. Policymakers no longer 'have our back', and inflation (rather than the price of risk assets) is now their number one priority. The road ahead is not going to be so easy for investors, but there are several useful steps they can choose to take.

THREE STEPS FOR THE NEW ROAD AHEAD

It may be easy to become gloomy in the turbulence of today, but there are plenty of reasons for investors to be optimistic about the prospects for compounding future capital from today's levels, provided the following three steps are taken into account.

1. Recognise that the road is rougher and more uncertain

As investors in individual companies or markets more broadly, we must constantly differentiate between volatility that is just short-term angst and a signal of change. Our approach is to always be open-minded to new information that could undermine a particular thesis. Our current thesis, however, is that we are experiencing a regime change. More specifically, given the scale of monetary creation over the last decade, inflationary trends are greater now than they were in the past.

In the shorter term, we expect a period of easing pressures as higher interest rates cool inflation (and result in lower growth) and supply chain pressures ease somewhat. However, on balance, structural energy undersupply, labour market constraints and military expenditures could all contribute to 'sticky' inflation at rates above the 2-3% ideal for central banks. Risk-free rates will therefore remain at higher levels for the foreseeable future.

Second, geopolitical uncertainty shows no signs of abating as the battles for technology hegemony between China and the US and Russia's struggle for military supremacy in Ukraine continues. The free flow of capital across borders can no longer be assumed, the cost of borrowing in the US dollar – the world's reserve currency – will likely stay high. Additionally, we need to be prepared for an increasing shift from China and other actors who intend to move away from the US dollar as the currency of external trade.

In short, we believe that growth in the broader economy will be less certain and more cyclical. As a result, we do not expect the cost of capital to return to the low levels seen in 2020–2021 any time soon.

Source: Getty Images

2. Realise that this new road may be best travelled with different vehicles

The good, albeit challenging, news for investors is that when there is a regime change, as the significant market correction seems to flag, there is a high probability that there will be new leaders in the race ahead.

We have done some work on prior periods of significant market corrections and what the probabilities are, with a clear caveat that the number of reference data points is modest in total.

As a reminder, the leaders over the last cycle were the Information Technology, Consumer Discretionary and Energy sectors. Assuming they will automatically return as market leaders is a brave call based on this work. Our team's view is that new leadership is likely to emerge this time, given the scale of surplus of capital that has just been allocated to those winners.

3. Improve probabilities by sticking to a few enduring principles

Invest in price makers versus price takers

It is not just the price for assets that has had favourable tailwinds over the last decade, but also profitability. Profit shares as a percentage of GDP have been at record levels in most economies, and this has conditioned investor behaviour, with recency bias leading many to assume this will remain the norm. Work by empirical research previously highlighted that in the decade prior to 2021, about half of the improvement in profit margins for US manufacturers was down due to lower interest costs and taxes. While lengthening of debt duration may dilute the impact of rising rates, there is now a clear headwind for interest costs while taxes similarly are heading upwards in many economies.

Gross margins are also being challenged by rising labour inflation (and availability), a shift to more local and higher cost supply chains, rising raw material input prices, and (particularly for those sectors previously benefitting from COVID-related revenue boosts) negative operating leverage as sales decline. On average, times are getting tougher for businesses, and franchise strength is being tested more fully. Where products and business models are unique, dominant or gaining share, the scope for passing on costs to customers and sustaining volume growth is greater.

Ensure capital funding is sustainable

The cost of debt is going up notably, and as is always the case, the availability of debt could become more irregular. The degree of change in debt costs in US dollars is much greater than in other currencies, and given its reserve currency status this raises the global cost of capital for many businesses. In our view, self-funding growth (high free cash flow) and balance sheets with appropriate and long duration debt will be better placed to keep investing through down cycles. Cash-burning, profitless business models likely won't pass the test.

Focus on justifiable valuations

We have learned, sometimes through bitter experience, that the penalty for investing at inflated prices and a lack of future cashflows is quite burdensome. Compounding of capital from levels that can be politely described as 'frothy' is really difficult. When the music stops, falls of 80-90% are common for the frothy crowd, and more often than not they stay down as profitability remains a dream rather than reality.

WHERE WE FIND THE 'FUTURE QUALITY' WINNERS

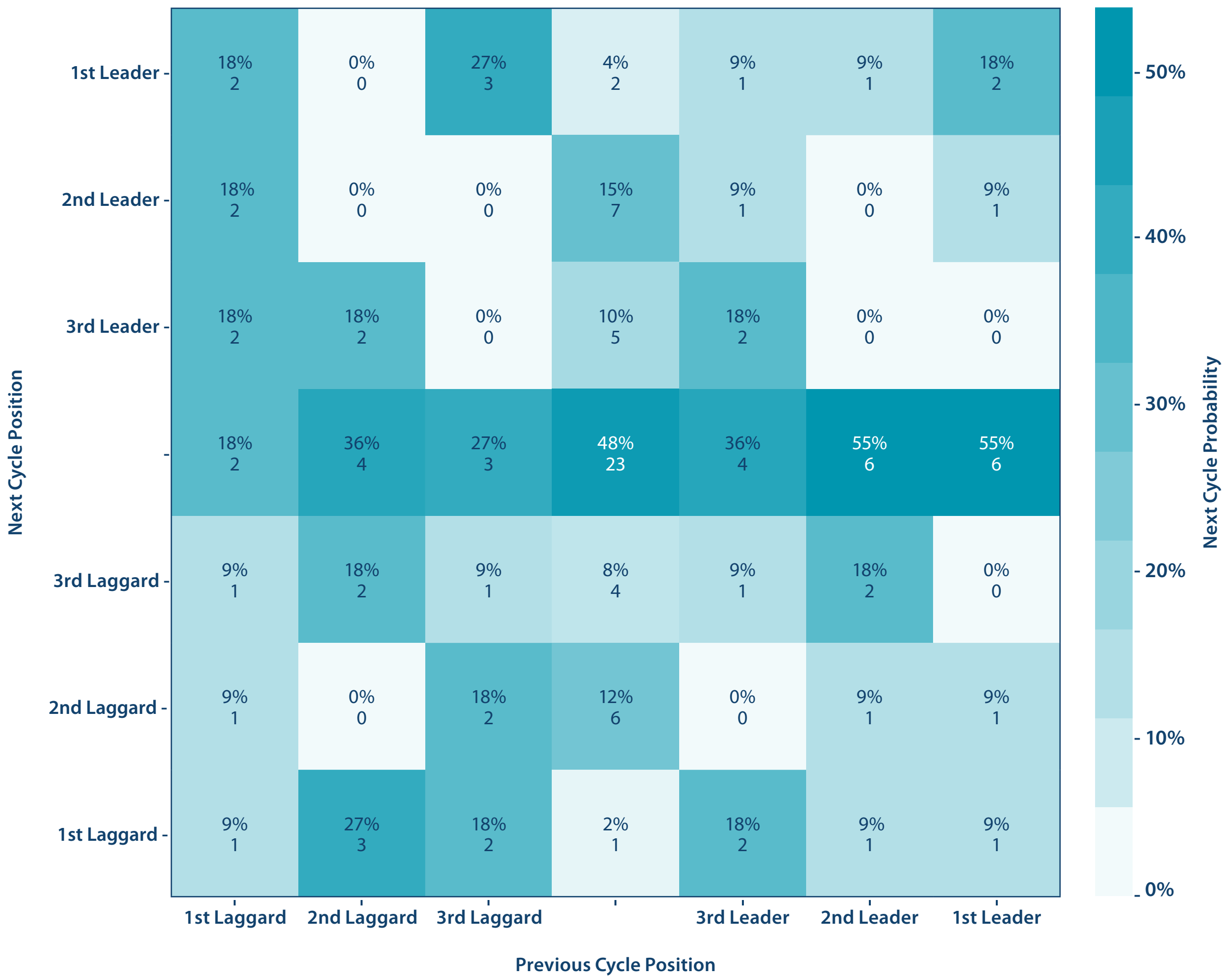
For more seasoned investors, none of the above should be particularly surprising. The next key question will likely be where to invest capital within global equities? In our view, companies on a unique journey of improvement that can attain and sustain high returns on invested capital over the next five years or more offer the best starting point. We call these 'Future Quality' companies, and they have been the foundation of our alpha generation for more than a decade. Here are the common traits shared by Future Quality companies:

Energy transition

Energy transitions take a long time. The first modern day energy revolution in the early 19th century, from wood to coal, fuelled great innovation that helped power the first railroads and ocean-going ships. The introduction of widespread electricity in the 1880s, led to inventions such as electric elevators, refrigerators and the mechanisation of agriculture. By the late 1920s, refined oil dominated the transport sector and reached a high point as a percentage share of all energy by 1973. Each transition required massive infrastructure spend before the benefits from adjacent technologies could be realised. These were 'system' changes, fighting incumbents and vested interests, and on average took 50 years before reaching maturation.

Figure 1

Probability of maintaining leadership after market drawdowns greater than 20% (1957-2022)



The above table looks at the probability of a sector in the equity market leading in the next market cycle having led in the previous one. We may all be familiar with the outsized gains made by the Technology sector in recent years, but after the 20% drawdown in markets in early 2022, what are the chances that a former market leader can repeat their outperformance in the next market advance?

This study ranks sectors for the US market back to 1957. It counts the bull cycle as the point of the price low after a 20% bear market to the subsequent price high before the next 20% drawdown. There were 11 such cycles in the last 65 years. The question "what is the probability of tech leading the market over the next five years or so" is answered in the top right of the table. The answer is just a 27% chance of tech being in the top two sectors for forward returns from here – in other words, it's possible but less likely than one might expect. In fact, the top left portion of the table shows a higher probability that the next cycle could be led by those sectors that have lagged the most. This study underlines the need for investors to keep an open mind as to where market leadership will emerge.

Source: RENMAC

We are optimistic about the fourth energy transition as an investment theme, and believe that an enduring cycle of rising investment is now upon. Societies must address the challenge of sustaining the still-needed fossil fuel production, increasing supply from more trusted regimes, improving energy efficiencies, reducing emissions and developing alternative energy sources further. The latter is key from a climate perspective, but also energy-intensive in its own right, creating a circular requirement for the other drivers. In short, the addressable market will grow and surprise investors, and profitability for many suppliers of the "picks and shovels" of the energy transition is on an improving trend. This is an increasing rarity in the current environment.

Enduring growth

Given the environment of higher interest rates, and continued pressures on household consumption, we are increasingly cautious on the growth outlook for many consumer-facing companies. We believe that the falling propensity to consume (due to greater spending on mortgage and utility costs) and prior COVID-led pulling forward of demand will be difficult and enduring problems to overcome.

Sustainable growth that is less impacted by consumer cyclicality is therefore preferable. Our long-standing overweight in the Healthcare sector highlights that we see the demand for better and more cost-effective solutions across ageing societies as being a long-term positive. Healthcare companies typically have less cyclicality in demand and, in many cases, have been indiscriminately derated in the reappraisal of higher growth companies. We keep finding more Future Quality picks here, where confidence in growth is higher compared to other sectors.

One final comment on enduring growth is that we are increasingly concerned about the prospects for digital advertising. Business start-ups and the costs of funding for newer business models have ballooned in recent years, as conducive capital markets have enabled initial public offerings (IPOs), SPACs and a flurry of activity in private equity funding. In 2021, start-up funding was estimated at $650 billion in the US (Source: Crunchbase), roughly double the level of prior years. Many of these were technology-related firms with limited customers and cashflow. We assume that 40% of this will end up in customer acquisition/digital marketing, with the majority going to key players such as Meta and Google. This level of spending may now normalise to more sustainable levels as we see new funding rounds dry up and many companies burn through cash reserves. This source of advertising spending will likely see a large drawdown, in turn prompting investors to reappraise their growth assumptions for the leading digital media players.
We therefore do not consider these companies as illustrative of the Future Quality theme; notable down-grades are not a key attribute for enduring growth, and therefore we have no exposure in this area.

Part 1 Summary

Within the Global Equity team, we believe 'Future Quality' companies should have long competitive advantage periods through which they can sustain high and/or improving cash returns. The challenge for investors is that only a fraction of companies within the global universe will display such characteristics.

In Part 2, we take a deeper look at the Future Quality concept, outlining the three fundamental principles that underpin our definition of Future Quality investments (value creation, long-term outperformance, and competitive advantages).

Part 2

'Future Quality' companies

'Future Quality' companies

The Nikko AM Global Equity team believes investing in 'Future Quality' companies will lead to outperformance over the long term. Part 2 draws on academic evidence to outline the three fundamental concepts underpinning our definition of 'Future Quality' investments.

First, we look at business value creation models. We assess the level of excess cash return on invested capital earned by firms – and the future sustainability of those returns – by assessing the firm's competitive advantage period.

Second, we analyse past stock market returns to highlight that it is not merely the level of excess cash return on invested capital earned by a company that drives shareholder returns. Rather, the market rewards companies that can allocate capital to improve cash returns on investment and maintain their competitive advantage.

And third, we assess the role of growth and its impact on shareholder returns for businesses with high, medium and low cash return on invested capital structures.

Drawing on this academic research, we explain in detail what we mean by 'Future Quality' and why we believe it leads to long-term outperformance. If an investor can anticipate a meaningful positive change in excess return (cash return on invested capital minus cost of capital), identify firms that have a longer competitive advantage period than the market anticipates, and can reinvest those excess returns into the business (growth), they should generate shareholder returns above the market. These are the characteristics of a Future Quality company.

Defining Future Quality

We define 'Future Quality' as a business that can generate sustained growth in cash flow and high and improving returns on invested capital at attractive valuations. Our portfolios only comprise companies that exhibit these characteristics and our research is devoted to unearthing companies that meet our criteria.

This concept underpins the Global Equity team's investment approach, and our analysis of a stock's 'Future Quality' characteristics determines whether a new investment opportunity merits inclusion in the portfolio or if an existing holding should be sold.

Future Quality companies are those that will *attain* and *sustain* high returns on investment.

Figure 2
Four pillars of Future Quality

Balance sheet

Growth is appropriately financed, not reliant on issuing significant debt or new shares

Valuation

Disciplined approach, paying too much for a high quality company can turn it into a low quality investment

Franchise

Lasting sustainable competitive advantage, protecting the high return on investment over the long term

Management

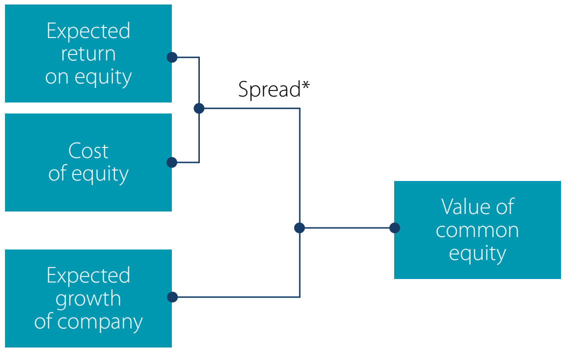
Sound strategic and capital allocation decisions, supporting high return growth opportunities

ESG is firmly embedded in our process

High, long-term returns cannot be sustained with unsustainable business practises.

Source: Nikko AM

Figure 3
The Value Creation Model



Source: Professor Enrique Arzac, Harvard Business Review
*Spread = Excess return on equity above cost of equity

When identifying 'Future Quality' companies, we analyse several variables including management quality, franchise quality and balance sheet quality. We then combine this analysis with a disciplined valuation approach.

Excess return and the competitive advantage period
A company creates value by generating a spread between its cash return on invested capital (CROIC) and the cost of capital. The length of time this spread or excess return can be earned by a company is known as its 'competitive advantage period'. Forecasting the sustainability of this spread (competitive advantage period), the magnitude (excess return) and the ability to reinvest the excess return into the business (growth) are key to determining Future Quality attributes.

Focusing on the sustainability of excess returns and improvements in CROIC is vital. The market rewards companies that can improve returns and maintain their competitive advantage. In his paper titled *'Do Your Business Units Create Shareholder Value?'*, Professor Enrique Arzac of the Columbia Business School described this concept as the Simple Value Creation Model.[3]

Arzac identified the importance of the sustainability of that excess return in valuation. Management's decision-making should focus on allocating capital to business units that can generate excess returns over the long term.

Similar studies have explored the concept of value creation over the years. Professor William Fruhan (Harvard Business School) in his book *'Financial Strategy: Studies in the Creation, Transfer, and Destruction of Shareholder Value'*[4] concludes that the only way to increase the value of an asset is to influence either the cash flow derived from that asset or the discount rate (weighted-average cost of capital). He further explains that the profitability of a firm is based on the capital intensity, profit margins and leverage and that the value of the firm is determined by the excess return, growth and the competitive advantage period. Hogan et al. (1999)[5] pointed out that shareholder value is created when a company invests in projects earning a return in excess of the cost of capital.

Value creation and share prices – are high returns on invested capital all that matter?
Buying the best or worst quality company based on historical returns is a poor investment strategy. Empirical evidence suggests high or low return businesses exhibit very little correlation to future shareholder returns. Michael Mauboussin and Dan Callahan[6] from Credit Suisse HOLT conducted a ten-year study of historical returns and forward share price returns. The universe (1,355 US companies excluding financials and utilities) was divided into quintiles based on HOLT's cash flow return on investments (CFROI) in 2002, with quintile 1 (Q1) being the best return businesses and quintile 5 (Q5) being the worst. Figure 4 shows the performance of each quintile over the subsequent ten-year period. This suggests that low quality companies (as defined by historical returns) perform well and even better than their high-quality counterparts; however, when risk is adjusted, there is no discernible pattern. The Sharpe ratios for Q1, Q2, Q3, Q4

3 Enrique R. Arzac, "Do Your Business Units Create Shareholder Value?" Harvard Business Review January/February 1986 pp. 123

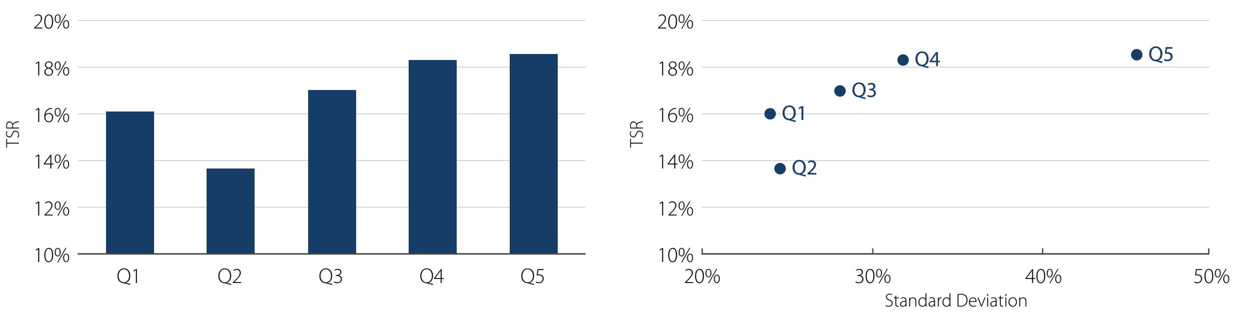
4 William E. Fruhan, Jr., Financial Strategy: Studies in the Creation, Transfer, and Destruction of Shareholder Value - Homewood 1979 pp. 7-15

5 James Hogan, Robert Neyland and Mark Greslee, "Creating Sharehol-der Value" – Electric Perspectives, September/October 1999 pp. 44-54

6 Michael J. Mauboussin and Dan Callahan, Economic returns, Reversion to the Mean and Total Shareholder Returns – Anticipating Change is Hard but Profitable, Credit Suisse Global Financial Strategies 2013 pp. 2-7

Figure 4

Total shareholder returns (2003-2012) by quintile based on 2002 CFROI ranking



Source: Credit Suisse HOLT and FactSet

and Q5 were 0.45, 0.34, 0.42, 0.41 and 0.29, respectively. **However, improving future returns is a very powerful driver of share prices.** Using the same sample, Michael Mauboussin and Dan Callahan[7] found the stocks with the largest improvement in returns over the ten-year period (i.e., moved from Q5 to Q1) delivered the highest returns, whereas stocks that migrated from the top quintile to the bottom quintile delivered the weakest returns. This suggests the change in investment matters most.

7 Michael J. Mauboussin and Dan Callahan, Economic returns, Reversion to the Mean and Total Shareholder Returns – Anticipating Change is Hard but Profitable, Credit Suisse Global Financial Strategies 2013 pp. 2-7

Importantly, the persistence in high returns together with improvements in return, which is integral to a firm's competitive advantage period, is a bigger driver of future shareholder return. Looking at the same data, those stocks that showed persistence in high returns over the period had higher returns and a significantly higher Sharpe ratio. Stocks that started in Q1 and remained in Q1 for the ten-year period delivered a total shareholder return of 19.2% with a standard deviation of just 22.8%. These companies essentially 'beat the fade' or had a longer competitive advantage period than the market forecast.

Figure 5

Total shareholder returns (2003-2012) for all 2002 to 2012 quintile combinations

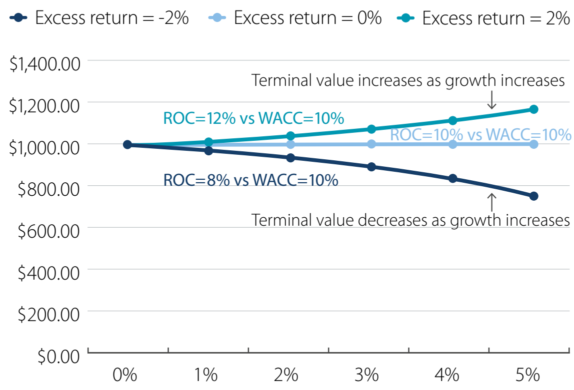
	Q1		Q2		Q3		Q4		Q5	
2002 Quintile	TSR	St Dev	TSR	St Dev	TSR	St Dev	TSR	St Dev	TSR	St Dev
Q1	19.2%	22.8%	12.9%	27.4%	11.7%	41.8%	7.4%	23.9%	6.3%	27.2%
Q2	17.9%	29.9%	17.2%	26.9%	11.1%	21.1%	6.6%	26.0%	3.9%	28.1%
Q3	24.4%	27.7%	15.3%	26.0%	20.4%	31.4%	13.9%	28.3%	9.3%	32.2%
Q4	29.0%	33.4%	23.0%	34.4%	15.1%	31.6%	18.9%	39.3%	10.9%	27.7%
Q5	27.2%	54.3%	25.4%	43.7%	20.6%	59.6%	16.7%	38.3%	10.2%	44.5%

Source: Credit Suisse HOLT and FactSet

If an investor can anticipate a meaningful positive change in excess return (cash return on invested capital – cost of capital), identify firms that have a longer competitive advantage period than the market anticipates and can reinvest those excess returns into the business (growth), they will generate shareholders returns above the market. These are the characteristics of a Future Quality company.

Figure 6

Change in terminal value based on changes in growth and excess returns



Source: Aswath Damodaran, Stern School of Business

The importance of growth

This concept was explored further in two McKinsey research papers that investigated the relationship between total returns to shareholders and the change in return on invested capital (ROIC). Published in 2006 and 2007 respectively, '*Balancing ROIC and growth to build value*'[8] and '*How to choose between growth and ROIC*'[9] both also incorporated the impact of growth (as defined by change in revenues). They identified high correlations between value creation, growth and returns and showed that if companies grew faster and increased returns more than the market, they subsequently outperformed the market.

These two studies highlight the importance of focusing on changing profitability as a driver of share price returns. However, neither study incorporated a cost of capital or discount rate due to the inherent challenges of assigning an appropriate cost of capital to individual companies in an empirical exercise. True wealth creation does not come from the absolute level of ROIC, but from the spread between returns and the cost of capital. Wenner and LeBer[10] in 1989 spoke of the importance of management's focus on shareholder value analysis (SVA) – the process of analysing how business decisions affect a company's economic value (net present value of the expected cash flows discounted at the cost of capital). They emphasised that long-term cash generation is rewarded by the market, not growth for growth's sake or earnings per share.

It is also important to understand the relationship between growth and excess returns. When a company is generating excess returns, growth will be rewarded. When a company is generating returns below the cost of capital (in other words, destroying value), growth will be penalised. In the example shown in Figure 6, Aswath Damodaran[11], Professor of Finance at New York University Stern School of Business, highlights the change in terminal value based on changes in growth and excess returns. If a company is generating returns in line with its cost of capital, growth will not be rewarded or penalised, meaning the terminal value will remain unchanged.

Cash-based measures of value creation

We believe cash flow is a better measure of profitability than reported or operating earnings and has a higher predictive power than the other two measures in terms of shareholder return. We therefore focus on CROIC, rather than the return on equity metric used in Arzac's[12] Value Creation Model and Fruhan's[13] study.

8 Bing Cao, Bin Jiang, and Timothy Koller, "Balancing ROIC and growth to build value" - McKinsey on Finance Spring 2006

9 Bin Jiang and Timothy Koller, "How to choose between growth and ROIC" - McKinsey on Finance Number 25 Autumn 2007 pp. 19-22

10 David Wenner and Richard Leber, Managing for Shareholder Value – From Top to Bottom (Harvard Business Review, November – December 1989)

11 Aswath Damodaran, "Return on Capital (ROC), Return on Invested Capital (ROIC), and Return on Equity (ROE): Measurement & Implications" – Stern School of Business July 2007 pp. 62-64

12 Enrique R. Arzac, *"Do Your Business Units Create Shareholder Value?"* - Harvard Business Review January – February 1986 pp. 123

13 William E. Fruhan, Jr., Financial Strategy: Studies in the Creation, Transfer, and Destruction of Shareholder Value - Homewood 1979

Kenneth Hackel, Joshua Livnat and Atul Rai[14] have written extensively on the subject and demonstrated that investment strategies based on free cash flows have merit.

Models linking cash returns and cost of capital (also known as value-based measures), started evolving meaningfully about 30 years ago, and this forms the basis of our analysis. The best-known value-based measures are economic value added (EVA), cash flow returns on investment (CFROI), shareholder value added (SVA), economic margin (EM) and cash value added (CVA). For more detail on each of these, Daniela Venanzi[15] in *'Financial Performance Measures and Value Creation: the State of the Art'* is a good reference.

The other benefit of these value-based measures is that they allow investors to compare corporate performance and profitability globally. Accounting differences between regions are reconciled and given the cost of capital is embedded in some of these calculations, a clear comparison can be made between firms around the world.

We have identified that improving and sustainably high cash returns are correlated with positive relative share price returns, and that this is enhanced when combined with growth.

It also requires a robust valuation framework to identify the most attractive opportunities. In *'Measuring and Managing the Value of Companies'*[16] Tim Koller, Marc Goedhart and David Wessels discuss the value-based concepts in detail and define the fundamental principles of value creation.

Figure 7

ROIC and growth drive multiples

$$\text{Value} = \frac{\text{Invested Capital} \times \text{ROIC} \times \left(1 - \frac{g}{\text{ROIC}}\right)}{\text{WACC} - g}$$

Source: Tim Koller, Marc Goedhart and David Wessels

The above calculation sets a framework, but assumes growth and ROIC remain constant in perpetuity. It doesn't integrate an appropriate competitive advantage period, after which returns would fade towards the cost of capital. This can be addressed in part by incorporating a two-stage discounted cash flow model with appropriate terminal assumptions. Many value-based valuation models, including CFROI and economic margin (EM), incorporate a specific competitive advantage period over which a company can generate excess return, after which returns will fade towards the cost of capital or weighted-average cost of capital. This is appropriate as most high return businesses and industries will attract competition and will see their returns erode over time. Similarly, low return businesses and industries will see competitors exit the industry and can see their returns rise over time. Aswath Damodaran[17] outlined these concepts in his paper *'Return on Capital (ROC), Return on Invested Capital (ROIC), and Return on Equity (ROE): Measurement & Implications'*.

This is the theory behind HOLT's Competitive Life-Cycle Framework as outlined below and analysed by Bart Madden[18] in *'Maximising Shareholder Value and The Greater Good'*. A typical firm will move through four phases of profitability and growth through its life.

14 Kenneth Hackel, Joshua Livnat and Atul Rai, "A Free Cash Flow Anomoly" Journal of Accounting, Auditing & Finance Volume 15 Winter 2000

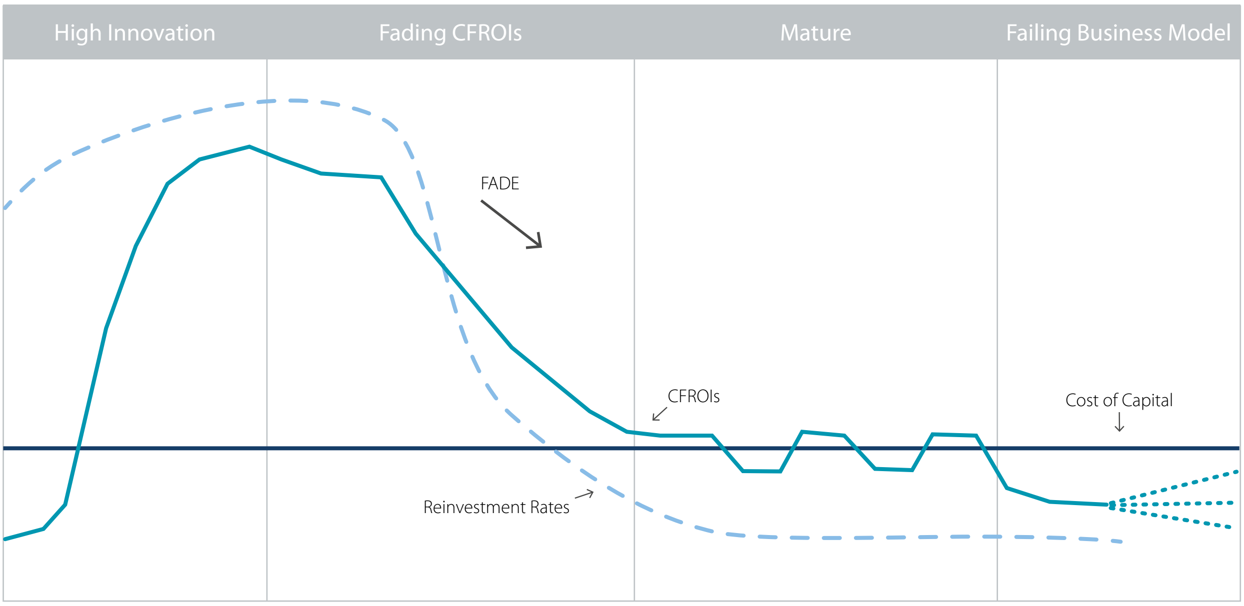
15 Daniela Venanzi, "Financial Performance Measures and Value Creation: the State of the Art" Springer Milan Heidelberg Dordrecht London New York 2012 pp. 13-30

16 Tim Koller, Marc Goedhart and David Wessels, *"Valuation – Measuring and Managing the Value of Companies"* - McKinsey & Co Fourth Edition pp. 66

17 Aswath Damodaran, "Return on Capital (ROC), Return on Invested Capital (ROIC), and Return on Equity (ROE): Measurement & Implications" – Stern School of Business July 2007 pp. 53-60

18 Bart Madden, "Maximising Shareholder Value and the Greater Good" – LearningWhatWorks 2000 pp. 7-10

Figure 8
HOLT's Competitive Life-Cycle Framework



Source: Credit Suisse HOLT

To value the company appropriately, an investor must therefore forecast economic cash returns, growth, required operating assets and the competitive advantage period.

Madden's work highlighted that in most cases, positive shareholder returns are associated with 'surprising' positive patterns of actual fade in relation to earlier expected patterns for that period and vice versa. In other words, the company was able to grow and generate excess returns for longer than expected, so the competitive advantage period was longer than the market forecast.

Earll Murman et al.[19] in the book *'Lean Enterprise Value'* stated: "Understanding value creation is not difficult, but determining the specific actions to create value can be more complex and a challenge, especially in a changing world".

19 Earll Murman, et al., *"Lean Enterprise Value"* – Palgrave Macmillan / The Lean Enterprise Foundation 2002 pp. 177

In summary, value-based profitability measures are better at identifying corporate performance. The change in these profitability measures, growth and the competitive advantage period are key drivers of future share price performance, and the capital allocation decisions of management will impact both.

Future Quality companies will have long competitive advantage periods through which they can sustain high and/or improving cash returns. The challenge for investors is that only a fraction of companies within the global universe will display such characteristics.

How Nikko AM's Global Equity team identifies Future Quality

Recognising Future Quality requires long-term fundamental research. To evaluate whether an individual investment may meet our Future Quality criteria, we focus on several factors that help us to accurately forecast the competitive advantage period.

Understanding the ***quality of the franchise*** helps us make informed assumptions on growth rate, profitability and the competitive advantage period of the company. As Michael Porter[20] explains in his "value chain approach", the profitability of a company is influenced by its industry structure (quality of the franchise) and the strategic decisions (quality of management) it makes. The company's profitability is influenced by industry attractiveness (Porter's[21] five competitive forces) and its position within that industry will dictate whether it can generate above-industry or below-industry returns (competitive advantage period).

In assessing the ***quality of management***, we look for a strong and consistent strategy, good corporate governance, identifiable and aligned incentive programmes, an excellent track record, and disciplined capital allocation. Ideally all stakeholders should benefit from management actions as this will ensure a more sustainable business. The quality of management is integral to understanding the sustainability of a firm's competitive advantage period. Management's capital allocation decisions will have a meaningful impact on the competitive advantage period and the ability to generate excess returns. This is clearly a crucial factor in the financial outcome for shareholders.

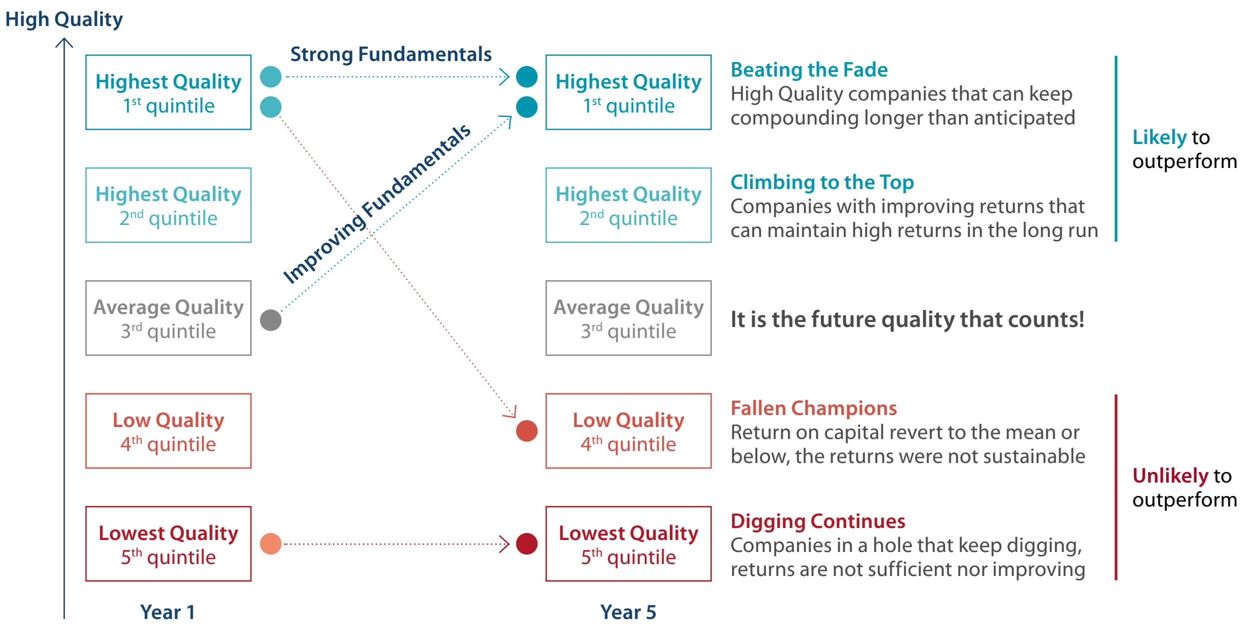
The ***quality of balance sheet*** underpins the company's growth aspirations. A strong balance sheet will be able to finance profitable growth and make the management team's capital allocations decisions far easier. Investors must focus on funding sources and the cost of that funding, the leverage within the business and working capital requirements and changes.

20 Michael Porter, *"Competitive Advantage"* – The Free Press. New York 1985 pp. 11-15

21 Michael Porter, *"How Competitive Forces Shape Strategy"* – Harvard Business Review, March/April 1979 pp. 137-145

Figure 9

Future Quality – the change in return on invested capital impacts performance



Source: Nikko AM

Valuation through analysis of the balance sheet, management and franchise, allows us to forecast growth, margins and asset turns of the business, the capital expenditure and funding requirements, the competitive advantage period and cost of capital. These are the key components to calculate future CROIC and the value of the company, and helps us to make an informed decision as to whether a potential investment is Future Quality and valued attractively.

Future Quality companies should outperform the market over the long term

Future Quality investing aims to identify companies that can generate superior or improving cash returns above the cost of capital and have competitive advantage periods longer than the market anticipates. Simply buying the top quintile highest quality companies alone does not lead to outperformance, rather it is the future quality of the companies that impacts performance. Figure 9 illustrates that Future Quality businesses with 'Strong Fundamentals' generate high returns on invested capital today which we forecast to be sustainable due to their extended competitive advantage position. These are companies that can "beat the fade" in returns. Companies with 'Improving Fundamentals' are generating lower returns on invested capital today, but we expect them to generate substantially higher returns in the future. These are companies that we forecast to surprise positively as they generate incrementally better returns over time.

Part 2 Summary

Regardless of the starting point, Future Quality investing is about identifying companies that can attain and sustain high returns on investment in the future. We believe a portfolio of Future Quality companies should outperform the market over the long term.

In Part 3, we look in greater depth at how Sustainability and Environmental, Social and Governance (ESG) issues are an integral component within our definition of Future Quality investments, and within the Global Equity Team's investment process.

Part 3

ESG in the investment process

ESG in the investment process

Building on our first two sections, Part 3 frames how the Global Equity team integrates ESG factors into our investment process. We considered the growing body of academic research as well as our own investment experience to determine that ESG has become an integral part of being a fundamental investor.

There are four pillars to Future Quality investing, each contributing to the investment case. Some, such as the strength of a company's balance sheet, give a picture of financial health at a specified date. However, the Global Equity team believes a company's value is a reflection of its future earnings – hence our focus on Future Quality – and that these future earnings are determined by strength of both the company franchise and its management. We spend a great deal of our time on the analysis of these critical variables.

Like with balance sheet data, ESG ratings add value by providing a snapshot of a company's status. However, ESG factors are contingent liabilities or assets that aren't standardised and are often difficult to measure. If such factors are significant, they will impact future returns and consequently corporate value. Therefore, understanding how ESG factors might influence future returns makes integrating ESG an essential part of being a fundamental investor. Our detailed conclusions are:

- Correlation: There is increasing evidence of a strong correlation between companies with high ESG scores and financial performance. However, there are limitations to ESG data and the data itself doesn't explain *why* ESG matters.
- Corporate value: ESG factors influence value in many ways. The sustainability of a company's future returns can be influenced by Environmental and Social factors, while Governance acts as the mechanism for establishing how a management team is likely to allocate capital in the future.
- Decision-making: Engagement, in the form of investigative discussion with management through to voting, provides long-term investors with a unique position to determine which ESG factors may be material and are therefore better placed to add value.

The rise of ESG

It is becoming increasingly recognised that companies cannot achieve high, long-term returns with unsustainable business practises. ESG factors can help identify

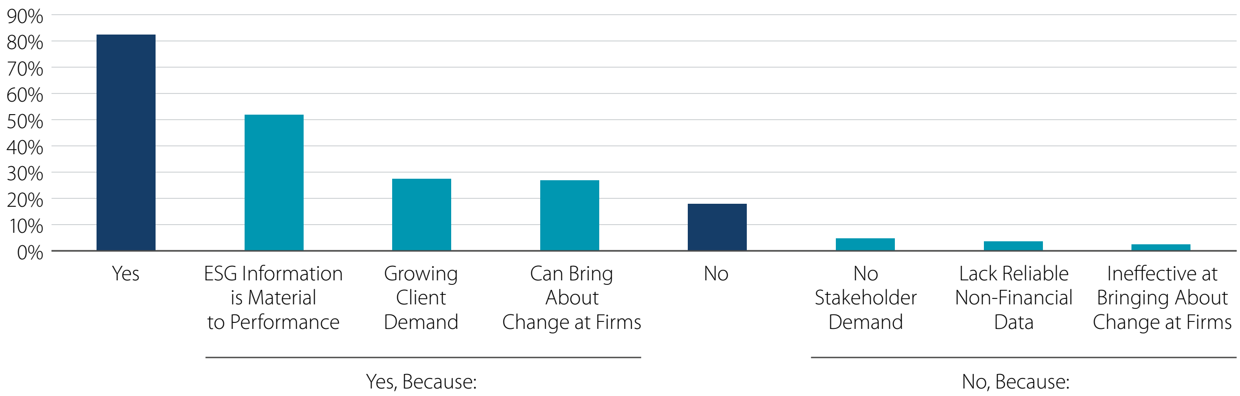
Figure 10

The four pillars of Future Quality: Subjective Nature of Franchise and Management Quality

Source: Nikko AM

Figure 11

2017 ESG survey of 'mainstream' investor responses to: 'do you consider ESG information when making investment decisions?'



Source: Amel-Zadeh, A., and George Serafeim, *"Why and How Investors Use ESG Information: Evidence from a Global Survey."* Working Paper, SSRN[23] (2017)

change and the potential for accelerating returns (see Figure 11). Certainly, the growing interest is reflected in strong asset flows across the globe[22] but none of this explains the changing attitude of asset owners.

The age of the millennials

Demographic trends suggest a huge transfer of wealth is underway. Millennials are inheriting billions of dollars from their parents and this new group of investors have different expectations as to how their money is managed. These investors are increasingly asking *how* their return is generated.

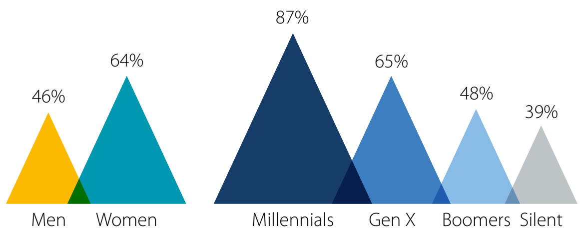
Consider the following survey data:

- 66% of all US consumers think it is important for brands to take a stand on issues like harassment, discrimination, and diversity.
- 44% of full-time millennial employees would feel more loyal towards their organisation if their CEO took a stand on a hotly-debated issue.
- 76% of millennials believe their investment decisions are a way to express their social, political and environmental values, while 87% said that a company's impact in these areas is a key consideration when they make investment decisions.

Wealthy individuals across generations are interested in investing for environmental or social impact, but millennials are by far the most active in evaluating and indeed, demanding these strategies. We believe this shift is secular and this paper explains how we add value for our clients by integrating ESG into all aspects of our

Figure 12

Where will millennials invest?



The majority of Millennials, Gen X and women believe that a company's track record in environmental, social and governance is an important consideration for investing. In fact, 37% of all high-net-worth investors are reviewing their portfolio's for impact investments.

Source: Bank of America's US Trust 2018 Wealth & Worth Report

22 Global Sustainable Investment Alliance, 2020 Industry Report

23 Amel-Zadeh, A., and George Serafeim, 2017. *"Why and How Investors Use ESG Information: Evidence from a Global Survey."* Working Paper, SSRN

investment process. First, we start with a brief summary of the research.

Value of ESG data

The reporting of ESG data is a relatively new field. MSCI only started rating companies in 2006. Given the increasing interest in the area, there is a growing body of research testing the link between ESG factors and investment performance. With more than 1,000 studies on the subject, featuring a broad range of negative, neutral and positive conclusions, consensus has been difficult to find.[24] However, in our search for Future Quality companies, we have found some areas of ESG that we believe add value.

For example, Kim et al. (2012) examined the relationship between sustainability scores and earnings quality.[25] Their conclusions suggest a link between the quality of reported earnings and companies deemed to follow socially responsible practices. They found that firms exhibiting strong ESG characteristics are less likely (1) to manage earnings through discretionary accruals, (2) to manipulate real operating activities, and (3) to be the subject of SEC investigations. These characteristics are all disqualifying from a Future Quality perspective.

Other academic studies (Gompers et al., 2003), using a variety of indicators of effective corporate governance, have provided evidence that companies with stronger shareholder rights and management accountability have delivered stronger fundamental performance over time.[26]

More recently, MSCI published research (Cass Business School; Giese et al., 2017), found data supporting the assertion that high rated ESG companies were higher quality companies compared to bottom quintile companies,[27] as measured by profitability.

In other words, well managed, quality companies should be effective at managing their ESG risks. The economic rationale for this transmission is explained in Godfrey et al. (2009),[28] Jo and Na (2012)[29] and Oikonomou et al. (2012)[30]. This body of work shows that companies with above-average ESG scores typically have above-average compliance standards and risk control, and suffer less from severe incidents that result in significant share price loss. Moreover, Giese et al., Gregory et al., (2014)[31] and Nagy et al. (2015)[32] also found significantly predictive power from changes in ESG factors.

The limitations of ESG data

Although a selective review of the research suggests ESG ratings add value, we are wary of the inherent limitations of relying too heavily on ESG data in our process.

The **first** limitation is the lack of standardisation and legal authority given to the quantification and disclosure of data by management teams. Unlike the accounting profession – which benefits from decades of standardisation backed by case law – ESG remains in its infancy. One of the main pillars of the accounting profession is the understanding of materiality. Every day, evidence of material ESG factors is wide ranging: extreme weather; man-made disasters such as the Deepwater Horizon oil spill; child labour, to name but three. However, all of these are easily identified *after* the event. Identifying a material ESG factor *ahead of time*, understanding how that might alter value and whether it should be disclosed is significantly more problematic. One of the common features between the ESG pillars is their contingent nature. And contingent events are inherently difficult to estimate and enforce disclosure. This issue is evidenced by the existence of the Sustainable Accounting Standard Board (SASB), which has a focused framework for targeting disclosure of ESG factors based on the SEC's interpretation of materiality.

24 For examples see Carpenter et al. (2009) and Fulton et al. (2012)

25 Kim et al. (2012)

26 P. Gompers, J. Ishil, A. Metrick, Quarterly Journal of Economics, Vol. 118, No. 1, February 2003

27 Giese, Lee, Melas, Nagy & Nishikawa, Foundations of ESG Investing, November 2017

28 Godfrey, Merrill & Hansen, 2009, The relationship between corporate Social responsibility & shareholder Value, Strategic Management Journal, Vol 30, pp. 425-445

29 Jo & Na, 2012, Does CSR Reduce firm risk, Journal of Business Ethics, Vol 110, pp. 441-456

30 Oikonomou, Brooks & Pavelin, 2012, The Impact of Corporate Social Performance on Financial Risk & utility, Financial Management, Vol 41, pp. 483-515

31 Gregory, Tharyan & Whittaker, 2014, Corporate Social responsibility and Firm Value; Strategic Management Journal, Vol 30, pp. 633-657

32 Nagy, Kassam & Lee, 2016, Can ESG add Alpha? An analysis of ESG Tilt and Momentum Strategies, Journal of Investing, Vol 25, No.2 , pp. 113-124

The **second** and more often raised issue with ESG research to date is the inability to split correlation from causality. Academic research has identified the statistical issue of correlation mining (Harvey et al., 2016)[33] and a lack of differentiation between correlation and causality (Kruger et al., 2015).[34] Even where some research has attempted to test the transmission mechanism behind why high ESG scores might lead to improved financial performance, researchers have suffered from a lack of data.[35] That the ESG data industry is still in its infancy presents an issue for those needing statistical proof that ESG adds value.

The **third** and final issue with ESG data is that most of it is backward looking. In a similar way that companies with high returns today may not generate high returns in five years' time, companies with high ESG scores today may not be tomorrow's quality companies. Finding a company in an industry with high returns or a high ESG score is not enough. Finding a good business capable of sustaining high performance requires a thorough understanding of the conditions the company operates in as well as an assessment of both its management and its governance structure.

We believe ESG has greater value in understanding the transmission mechanisms behind why the link between high ESG scores and quality may be high. Giese, Lee et al., try to address this issue by reviewing three different transmission mechanisms: cash-flow generation, tail risk management and systematic risk such as increased regulation. However, with just over a decade of MSCI ratings data, they have concluded that data sets are too small and that it is difficult to differentiate between causality and correlation.

The transmission mechanism and context is important as without that we are unable to determine whether a high ESG score has led to better returns or lower risk, or if the high returns have simply afforded a management team the resources to address these risks. Without understanding the transmission channel, we are unable to understand how ESG might improve returns or how management might allocate capital to sustain high returns into the future.

33 Harvey, Liu and Zhu, 2016, Review of Financial Studies, Vol 29, No.1, pp. 5-68

34 Krueger,P 2015, Corporate Goodness and shareholder Wealth, Journal of Financial economics, Vol 115, No. 2, pp. 304-329

35 Giese et al. (2017), as above, pp. 26

Figure 13
The four pillars of Future Quality: Franchise Quality

Balance sheet
Growth is appropriately financed, not reliant on issuing significant debt or new shares

Valuation
Disciplined approach, paying too much for a high quality company can turn it into a low quality investment

Franchise
Lasting sustainable competitive advantage, protecting the high return on investment over the long term

Management
Sound strategic and capital allocation decisions, supporting high return growth opportunities

Objective → **Subjective**

ESG is firmly embedded in our process
High, long-term returns cannot be sustained with unsustainable business practises.

Source: Nikko AM

Figure 14
Michael Porter's five forces that shape industry structure

Source: Michael E. Porter, Competitive Strategy, New York: The Free Press (1980)

A company's fair value (and ultimately its share price) should equate to the present-day value of those future returns. Therefore, ESG is an integral part of the subjective analysis required in understanding likely future returns.

This is important because it is the assessment of a company's competitive advantage period ('Franchise Quality') and how they invest their capital ('Management Quality') that will determine the likely cash flow returns the company will achieve in the future. We discuss how ESG impacts a company's Franchise Quality first.

Franchise Quality: ESG and the sustainability of returns

We believe the link between ESG and a company's future returns is intuitive and that ESG must form a core part of understanding a company's future return profile – what we call 'Franchise Quality'. The Franchise Quality of a business is one of the four pillars of our Future Quality investment philosophy.

Porter's Five Forces: the competitive advantage period

Michael Porter's Five Forces framework[36] is the 'gold standard' for analysing competitive advantage periods and understanding how external forces within an industry might alter a company's future return profile. Importantly this framework demonstrates that a firm does not operate in a closed loop. External forces will undoubtedly have an impact such as how suppliers or consumers behave.

Traditional theory (based on Graham & Dodd's 'Security Analysis'), provides a logical approach for making investment decisions and requires a qualitative assessment of financial performance and value. Analysis by experienced investors of a wide variety of public information, supplemented with management interviews combine to create a 'mosaic approach' to long-term investing.

The historical foundation of this approach assumes that value is aligned with book cost. However, this link has dissipated in recent decades as capital intensity has decreased and the hold of technology on society has taken root. Intangible assets such as brand value, reputation, trust, research and development (R&D) pipelines, employee turnover and equality have all exerted a greater influence on management action and returns.

According to Mauboussin et al. (2013),[37] there are three broad sources of added value: production advantages, consumer advantages, and external factors. Production advantages are easier to contextualise and may include resource or production economies of scale. Consumer advantages are more prevalent in today's technologically advanced society, with natural network effects for companies such as Google. The final 'external' factor impacting value includes subsidies, tariffs, quotas, and both competitive and environmental regulation. Changes in government policy can have a meaningful impact on corporate value. Consider the impact of deregulation on the airline and trucking industries, Basel III on financial services, or subsidies on the solar energy industry.

Porter's Five Forces and ESG

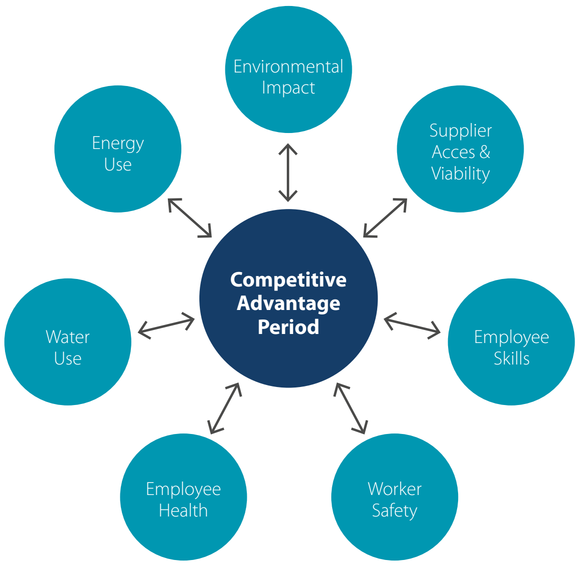
An obvious area of focus in the ESG field has been on the external forces created by environmental legislation and its impact on a firm and industry returns, most relating to carbon pollution. Although many investors

36 Porter's Five Forces, Michael E. Porter, Competitive Strategy, New York: The Free Press, (1980)

37 Mauboussin, Callahan & Majd, Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance, October 2016

Figure 15

The competitive advantage period and a company ecosystem



Source: Nikko AM, Harvard Business Review, Creating Shared Value – Michael Porter and Mark Kramer

simply address this issue with exclusion policies, this approach may be too simplistic.

On the subject of exclusions, Porter's work on the competitive advantage period and the impact of environmental legislation is controversial. Porter's research suggests that strict environmental regulation does not hinder competitive advantage periods, but can often lead to further advances.

This has been tested many times as summarised by Ambec et al.,[38] and concludes that there is a positive link, although varied in strength, between regulation and innovation. This work confirms our view that integrating ESG isn't confined to merely minimising risk but also offers up significant investment opportunities too.

Of course using the word 'external' is a misnomer. Regulation, the environment, waste, diversity, employee safety, etc. are all part of the company's ecosystem.

38 Ambec, Cohen, Elgie & Lanoie, *'The Porter Hypothesis at 20: Can environmental regulation enhance innovation and competitiveness?'* (2010)

Figure 16

The four pillars of Future Quality: Management Quality

Balance sheet

Growth is appropriately financed, not reliant on issuing significant debt or new shares

Valuation

Disciplined approach, paying too much for a high quality company can turn it into a low quality investment

Franchise

Lasting sustainable competitive advantage, protecting the high return on investment over the long term

Management

Sound strategic and capital allocation decisions, supporting high return growth opportunities

Objective → **Subjective**

ESG is firmly embedded in our process

High, long-term returns cannot be sustained with unsustainable business practises.

Source: Nikko AM

Companies do not operate in a bubble and with the increase in penetration of social media, management teams are increasingly aware of how ESG factors can influence future returns. How and why management chooses to invest capital will also have a significant bearing on returns.

Management Quality: Governance and the allocation of capital

Governance is the mechanism for how a company achieves its objectives. Our understanding of governance, and role of management, is key to determining whether the company's capital will be deployed effectively.

Since the world of business is dynamic, companies must constantly assess trade-offs and make difficult decisions. A clear strategy and objective will provide all stakeholders with the starting point for assessing a company's prospects and evaluating performance.

Corporate behaviour is also impacted by local law, customs and culture. As a general rule, companies that operate under common law have the strongest protection for shareholders, whereas those operating under civil law have weaker protection for shareholders and stronger protection for other stakeholders, such as creditors.

These different starting points perhaps explain why countries with a bias towards shareholder value also generate higher returns than those with a more balanced stakeholder approach. However, as is so often the case, the statistics don't tell the whole story. To conclude that one specific country or approach is preferable would be wrong.

Despite these differences, the framework for analysing governance and management has not changed significantly over the years. Graham & Dodd,[39] in the original edition of their *'Security Analysis'*, raised the question of governance by emphasising potential conflicts of interests between stockholders and corporate management. The lack of information or control faced by 'outside' investors – known as the agency problem – is well known and the nature of the issues during the start of the 20th century remains the same today.

Agency theory explains why management action may not be aligned with shareholder interests. There are three areas in capital allocation where these conflicts may arise:

- **'Size isn't everything':** Company size is a crude proxy often used for remuneration and may lead management teams to 'empire build'.
- **'Long shots':** Management teams may have a different risk tolerance and may undertake high risk strategies to achieve remuneration goals.
- **'Short-termism':** Different time horizons can also lead to unwanted behaviours. The most common being the focus on short-term returns or targets.

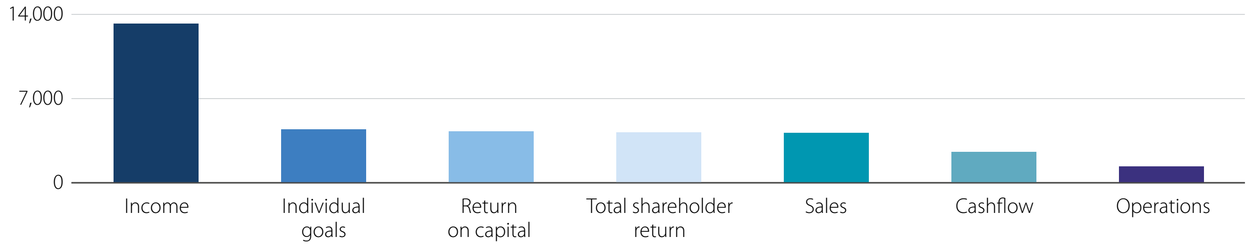
Determining the right incentive scheme for a company is difficult. We can certainly point to the dominance of earnings-based measures within incentive schemes – and in particular, 'adjusted earnings' – as a concern for long-term investors. This is illustrated below:

39 Graham & Dodd, Security Analysis (1934)

Figure 17

Use of incentive metrics among 1,721 US companies

Count of US firms between 1998 and 2013



Source: CSFB Holt Governance Database, ISS

The focus (and failure) of short-term incentives is of particular concern given the debate over timeline is ultimately meaningless. There should only be one aim: to generate value. This applies to activities that management expect to deliver value, both in the short term and longer term.[40]

Ultimately, good ESG disclosure, appropriate long-term incentive schemes and a governance structure that protects shareholders' interests are all positive signals, but are not in themselves substitutes for the value created from engaging with management.

Engagement: why engagement creates value
To have a greater understanding of how ESG may impact future returns, engagement with management should be a key goal for any fundamental investor. Discussions with management regularly help us contextualise the likely success of future capital allocation decisions and how ESG factors may impact future returns.

Research to date – though limited – has shown a link between engagement and long-term value. (Blackrock & Ceres[41] and Dimson, Karakas & Li[42]). The full value gained from appropriate engagement is best illustrated by the following table developed for the Principles for Responsible Investment (PRI) by O'Sullivan & Gond from Cass Business School[43].

Although the Global Equity team are active investors, we are not activists. Our engagement with management teams is intended to help us understand how they can achieve high returns and to assess whether they are good stewards of our clients' capital. We prefer to work constructively with management teams rather than agitating for change, although we will seek change where we feel the sustainability of returns is at risk. Voting is another key area of engagement. We vote on all matters put to shareholders, following our voting guidelines, investment philosophy and our clients' wishes. In normal circumstance we support company

40 Alfred Rappaport , 2011 *'Saving capitalism from short termism: how to build long term value and take back our financial future'* (NY: McGraw Hill, 2011, pp. 140-142)

41 Blackrock & Ceres, *'21st Century Engagement, Investor Strategies for Incorporating ESG Considerations into Corporate Interactions'* (2015)

42 Dimson, Karakas & Li, Active Ownership. *Review of Financial Studies* (2015)

43 Cass Business School and PRI, *'How ESG engagement creates value for investors and companies'* (2018)

44 O'Sullivan & Gond (2018)

Figure 18
How engagement creates value

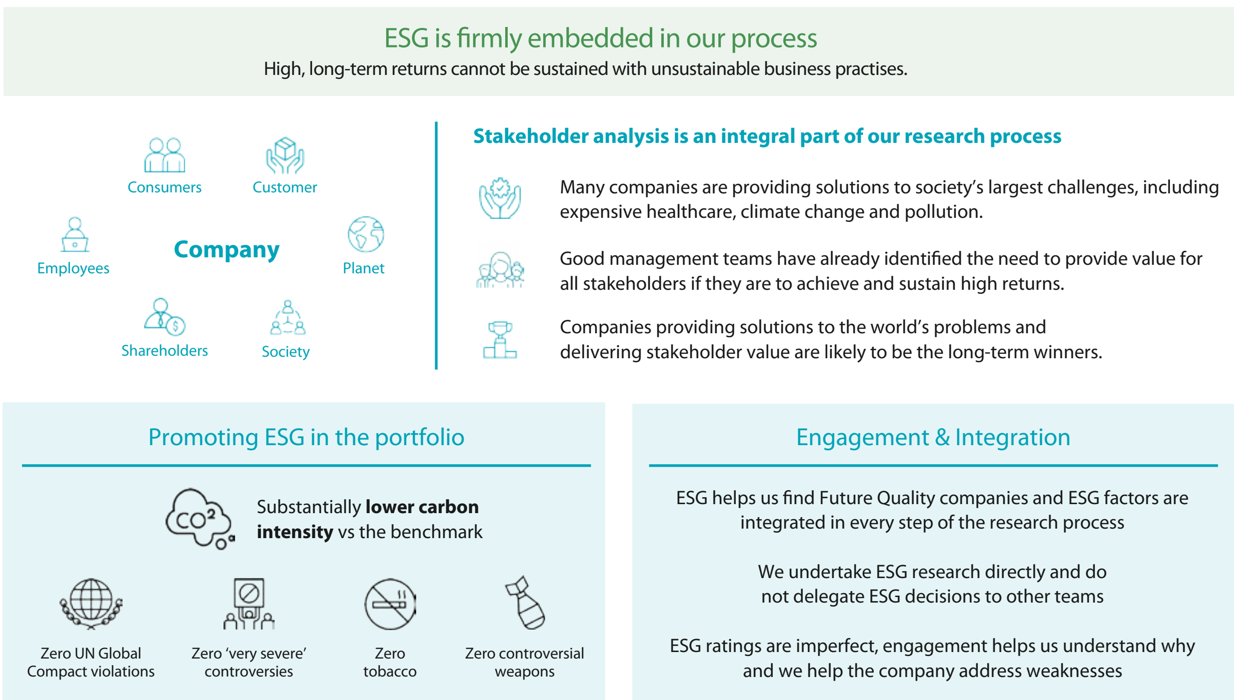
Value Creation Dynamics	Corporations	Investors
Communicative	Clarifying expectations and enhancing accountability	Signalling and defining ESG expectations
Exchanging Information	Managing impressions and rebalancing misrepresentations	Seeking detailed and accurate corporate information
	Specifying the business context	Enhancing investors ESG communication and accountability
Learning	Anticipating and detecting new trends related to ESG	Building new ESG knowledge
Producing and diffusing knowledge	Gathering feedback, benchmarking and gap spotting	Contextualising investment decisions
	Developing knowledge of ESG issues	Identifying and diffusing industry best practice
Political	Enrolling internal experts	Advancing internal collaboration and ESG integration
Deriving political benefits	Elevating sustainability and securing resources	Meeting client expectations
	Enhancing the loyalty of long-term investors	Building long-term relationships

Source: PRI, O'Sullivan & Gond,[44] Cass Business School (2018) management, however, we will withhold support or oppose management where we believe it is in the best interests of our clients.

Stakeholder analysis is an integral part of what we do. As Future Quality investors, we want to know whether the company has a sustainable competitive advantage, whether it has an organisational and governance structure that will help management maintain and enhance that competitive advantage, and if its structure provides management with both accountability and strong incentives to add value. We are also looking for evidence that management is thinking about the company's future; about what the organisation will look like in 10-15 years from now.

Part 3 Summary
ESG research helps us find Future Quality companies and ESG factors are integrated in every step of the research process. While ESG ratings are imperfect, engagement helps us understand where issues exist, and we use the information to help companies address areas of weaknesses. We believe long-term, active investors have the opportunity to add value by integrating ESG factors into their analysis. We consider ESG to be an essential lens through which to implement our Future Quality philosophy.

Figure 19
Our Future Quality ESG Approach



Source: Nikko AM

Investment guide conclusion

Our belief is that we have moved into a new regime where inflation will be structurally higher, despite the longer-term structural anchors of higher debt burdens, ageing societies and ongoing technological disruption. Energy markets remain constrained, labour in short supply and fiscal policies remain vulnerable to the demands from voters to alleviate the pressure on real wages, particularly for lower income groups.

As focused stockpickers, the future profitability of companies is always a priority for us. The advantage of being active stock pickers is that we are not beholden to the market weighting of past winners, burdened with potentially bloated levels of profitability. Instead, we can focus on companies more likely to experience positive surprises in revenue and profitability in the coming years.

In summary, the search for Future Quality stocks with enduring drivers of growth will continue to define our portfolios. We believe that over the next 18-24 months, the focus on companies capable of creating meaningful value will only intensify. Future Quality companies will therefore find themselves in a strong position. Our consistent focus on enduring high-return franchises with strong management teams, robust balance sheets and credible starting valuations, will help us navigate a path through these challenges.

Appendix: How to choose between growth and ROIC

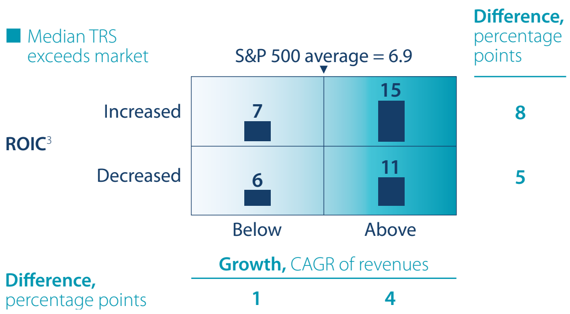
Appendix: How to choose between growth and ROIC

Figure 20

High ROIC

For companies that already have high ROIC, growth generates higher TRS than further improvements to ROIC.

Total returns to shareholders (TRS)[1] for companies with high returns on invested capital (ROIC),[2] 1996-2005, %



1 *Median of compound average annual TRS from 1996 to 2005 for each group of companies, adjusted for compound 1996-2005 average TRS of S&P 500 index companies (6.9%).*

2 *78 companies with 10-year average ROIC ≥20% and market capitalization >$2 billion in 1995.*

3 *Excluding goodwill.*

Source: Bin Jiang and Timothy Koller

Bin Jiang and Timothy Koller[45] explored the relationship between total returns to shareholders and the change in ROIC. However, they took this a stage further and also incorporated the impact of growth (as defined by change in revenues). They identified high correlations between value creation, growth and returns. They looked at High ROIC, Median ROIC and Low ROIC companies and analysed the dynamics of these companies over a ten-year period (1995-2005) when growth and returns improved more or less than the market.

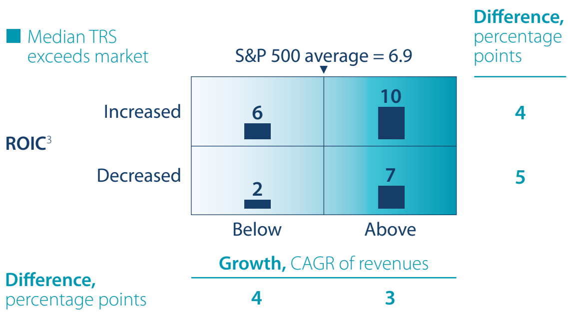
45 Bin Jiang and Timothy Koller, *"How to choose between growth and ROIC"* - McKinsey on Finance Number 25 Autumn 2007 pp. 19-22

Figure 21

Medium ROIC

Companies with medium ROIC must maintain their growth *and* improve their ROIC.

Total returns to shareholders (TRS)[1] for companies with high returns on invested capital (ROIC),[2] 1996-2005, %



1 *Median of compound average annual TRS from 1996 to 2005 for each group of companies, adjusted for compound 1996-2005 average TRS of S&P 500 index companies (6.9%).*

2 *129 companies with 10-year average ROIC ≥9% but <20% and market capitalization >$2 billion in 1995.*

3 *Excluding goodwill.*

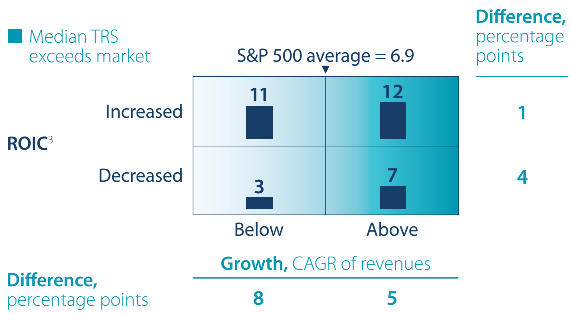
Source: Bin Jiang and Timothy Koller

Figure 22

Low ROIC

For companies with a low ROIC, improvement in ROIC is clearly more important than growth.

Total returns to shareholders (TRS)[1] for companies with high returns on invested capital (ROIC),[2] 1996-2005, %



1 *Median of compound average annual TRS from 1996 to 2005 for each group of companies, adjusted for compound 1996-2005 average TRS of S&P 500 index companies (6.9%).*

2 *64 companies with 10-year average ROIC ≥6% but <9% and market capitalization >$2 billion in 1995.*

3 *Excluding goodwill.*

Source: Bin Jiang and Timothy Koller

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Headquartered in Tokyo since 1959, Nikko Asset Management and its subsidiaries employ personnel representing 25 nationalities, including 233 investment professionals. The firm has a presence through subsidiaries or affiliates in a total of 11 countries and regions. More than 400 banks, brokers, financial advisors and life insurance companies around the world distribute the firm's products.

The investment teams benefit from a unique global perspective complemented by the firm's historic Asian DNA, striving to deliver consistent excellence in performance. The firm also prides itself on its progressive, solution-driven approach, which has led to many innovative funds launched for its clients.

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