James Hambro & Partners

Quarterly Comment

October 2021

Survival of the (financially) fittest

At James Hambro & Partners, our investment philosophy is built on the desire to deliver consistent returns to our clients. By taking a longer-term view and delivering consistent performance through all phases of the economic and market cycle, portfolio returns will naturally benefit from the power of compounding, Albert Einstein's eighth wonder of the world.

Crucial to this is the ability to navigate and avoid permanent losses in the tough times. There are very few assets or businesses that can avoid the impact of a recession or the visceral chaos of a stock market crash. But it is in those difficult moments that the resilience of a company, a management team, an investment or a portfolio will create the foundation not just for weathering the storm but also building back in a stronger position than before to benefit from the eventual upturn.

The pandemic has created the conditions to see this in action. Seeing how companies have endured through this most extraordinary period provides some instructive examples of the resilience we look for when we choose to invest.

When the going gets tough

'It is not the strongest of the species that survive, nor the most intelligent, but the ones most responsive to change.'
Charles Darwin

Natural selection is well understood as it relates to the biological world. Members of a species with certain traits favoured by their environment will survive and thrive by out-competing other species for limited resources.

Evolution is typically viewed as a gradual and incremental process. But extreme events that quickly and dramatically alter the prevailing environment – droughts, floods, asteroid impacts – can cause a rapid acceleration in the pace of change. During periods of gradualism, attributes such as strength, speed or intelligence may be in high demand, but ultimately it is a species' resilience and adaptability to change that counts.

Businesses are tested by change in a similar way.

In good times, a high growth rate and great sales pitch can make up for an uncertain path to profitability, a weak balance sheet or a toxic business culture. But this fragility is soon exposed during the inevitable setbacks, be it recessions, wars or even pandemics. As Warren Buffet said, ***"Only when the tide goes out do you discover who's been swimming naked."***

COVID-19 unquestionably qualifies as an 'extreme evolutionary event' for financial markets and businesses. The deepest recession since the Second

World War, record high unemployment and mass lockdowns lead to an overnight change in consumer habits. The prevailing strong business environment was not just disrupted, it was demolished.

And just as in the natural world, when the going gets tough, resilience and adaptability matter more for businesses than anything else.

'What you should learn (when) you did not anticipate something is that the world is difficult to anticipate. That's the correct lesson to learn from surprises – that the world is surprising.'
Dr Daniel Kahneman

Taking the best route to market

What a company sells is important, but we pay as much attention to how the company sells it.

Companies with a substantial recurring or predictable sales are better-placed to weather a variety of market environments. We are attracted to subscription revenue models or businesses benefiting from inexpensive but habitual purchases that are essential to their customers' operations or daily lives.

Microsoft provides an instructive example. Under the leadership of Satya Nadella, Microsoft has shifted sales of its suite of productivity tools to a subscription model delivered over the internet. This move to 'software as a service' has made Microsoft's business more predictable. It also benefits the customer by allowing more regular updates of its products and more flexibility to scale usage as their business grows.

Greater recurring revenue combined with offerings that are now more critical to its customers have made Microsoft's business significantly more resilient than in the past. As a result, the group sailed through the COVID disruptions with barely a blip.

When combined with high profit margins, limited capital intensity and suitable levels of debt, resilient businesses typically generate higher and more consistent levels of free cash flow. This allows them the freedom to reward shareholders with excess returns in good times but, vitally, continue investing through hard times to bolster their advantages and strengthen their competitive position.

The value of a trusted position

The nature of the pandemic has meant that many companies have been able to operate with limited impact on their business, but we have been particularly interested in how those businesses exposed to more challenged end-markets have negotiated the past 18 months.

One such is Compass Group, the world's largest catering company. Serving offices, schools, universities, sports stadiums and conference centres, there weren't many industries more upended by events of the last eighteen months. Compass's experience has been illuminating.

As the largest and most diverse caterer, its greater exposure to more defensive end-markets such as healthcare and defence provided invaluable cash flow whilst more focused competitors struggled to keep the lights on. Compass also benefitted from a "flight to trust" as clients sought quality partners with health and safety expertise, supply chain resilience, and financial stability. This resilience allowed the business to enhance their customer offer and take advantage of trends accelerated by COVID, like digital ordering and food delivery.

As COVID restrictions have gradually lifted, Compass has enjoyed an acceleration in the pace of new business wins. New sources of growth have been unlocked, given an increased focus on costs and the increased complexities related to food safety and service in response to COVID. This is happening at a time when many of Compass's competitors (particularly smaller, local players) are still fighting for survival.

While the pandemic was certainly not plan A, Compass's resilience should ensure they exit it with greater market share, faster growth, and a larger potential market today than pre-pandemic.

In a crisis, a company's business model and competitive strengths provide the ultimate margin of safety.

Pricing power

Business resilience is not just about coping in a crisis but adapting to an ever-evolving world. Top of the current list of corporate concerns is the recent acceleration in inflation, as supply constraints meet re-opening demand and stimulus support. Rising materials, shipping and labour costs leave companies with a difficult choice – pass the increases onto customers via higher prices and risk choking off demand or try to stay competitive on the shop floor but at the cost of lower profits?

One of the first questions we ask ourselves when looking at any potential business is whether it has pricing power? Can they increase prices at (or even above) inflation without reducing demand for their products or services?

Like most simple questions, the answer is usually complicated.

We try to understand the value a company provides to its customers. This can be lots of things: convenience, cost savings, deeper insights, faster product development, or even higher social standing. We want customers that feel they are getting value from the transaction. Happy customers are more likely to be loyal customers, and loyal customers are more likely to accept price rises over time.

We are particularly interested in companies that provide low cost but 'mission critical' products for their customers, where the consequences of failure or poor performance are disproportionate to the cost of the product.

While a small percentage of the overall system cost, TSMC's semiconductors and Amphenol's connectors are vital to powering the electronics in everything from computers and smartphones, to brake sensors in cars and flight controls in fighter jets; systems that depend on their quality and reliability. This puts them in a powerful position to pass on increased costs with little pushback from customers.

Alongside great or critical products, a lack of realistic competitors or comparable substitutes can be a sure sign of the ability to pass on higher input costs.

High switching costs and network effects are both variations on the theme that it becomes harder to change as a product or service becomes more valuable to you over time. Classic examples are software systems; once embedded in an organisation it becomes time-consuming and costly to change providers and re-train staff. Microsoft has benefited from this effect given the ubiquity of its Teams application which has become essential through remote working and the hybrid working environment many companies plan to adopt.

Adaptability and the importance of culture

'Not everything that counts can be counted.'
Albert Einstein

Culture is one of the most important, yet least understood, drivers of long-term value. It can attract the best people, provide direction in a crisis and help avoid disruption; it is difficult to create and harder to sustain but that also makes it near impossible to copy. Those able to maintain an effective culture invariably see their competitive advantages grow over time. Culture is extremely difficult to measure, especially in the short-term. Over the long-term though, it is arguably more important than anything else.

It is 20 years since Simon Wolfson became chief executive of Next Plc. At 33 years old, he was the youngest ever chief executive of a FTSE 100 company. Since taking charge, Next shares have returned over 1,500% (including dividends) compared to the FTSE All-Share return of 200%. This has been achieved in a fashion retail sector that is fast-changing and highly competitive, and where the growth of ecommerce has driven many of Next's most obvious peers to the brink of extinction.

Next's success has been testament to the culture and principles instilled across the business:

- A culture of adaptability that embraces disruption, rather than fighting it. Next has been committed to investing in promising new ventures even when such investments pose a threat to its existing business. By 'following the money', over the past decade, the business has shifted from stores to online, from a single brand to multi-brand aggregator and from UK to overseas.

- A recognition that long-term success depends on treating all stakeholders fairly. The company has twice lowered commission rates for third-party brands that sell through Next's platform in the last three years. At the height of the pandemic in March 2020 Next wrote to their suppliers committing to honour and pay in-full for orders due to leave their factories over the month ahead. In the words of Wolfson, ***"We want our partners to view Next as an invaluable ally, not a necessary evil."***

- A culture of ownership, autonomy and the freedom to make mistakes. The company strongly believes that ownership drives empowerment among their employees. More than a quarter of Next's 40,000 staff hold share options or awards over a combined 6.4m shares. Valued at over £500m, Next employees own 5% of the company and are the group's fourth largest shareholder. In an industry with staff turnover as high as retail, this degree of alignment is a massive advantage.

Next's long history of thoughtful investment has built a business with considerable flexibility and resilience. Despite ongoing COVID-related challenges, full year sales and profits in 2021 are expected to be ahead of comparable numbers in 2019 before the pandemic. This would be some achievement.

It is in periods of crisis where its deep-rooted cultural advantages have become even more apparent.

The right culture alone can't guarantee long-term success, but the wrong culture guarantees the opposite.

Winning by not losing

You don't need to win the most stages to win the Tour de France. In fact, in eight of the 108 Tours completed to date, the overall winner didn't win even a single day's racing.

Like most long-term pursuits the Tour rewards consistency and endurance over flat-track speed and short-term glory; not being dropped from the peloton on a tough ascent is a surer route to the yellow jersey than winning even a stage. Investment is just such a long-term pursuit, with success a result of having the resilience to remain in the race during the most gruelling of stages.

Morgan Housel, author of The Psychology of Money, puts it simply: ***"average returns for an above-average period of time = extreme outperformance."***

Our focus on diversified portfolios and resilient businesses is designed to protect us from costly mistakes. Recent events have been a reminder that long-term success is often about 'staying in the game' - we view the ability to manage adversity while retaining the capacity to reinvest as the hallmark of any quality business and purpose of any diversified portfolio. ■

Contact Details

James Hambro & Partners LLP
45 Pall Mall, London, SW1Y 5JG
United Kingdom

+44 (0)20 3817 3500
www.jameshambro.com

Opinions and views expressed are personal and subject to change. No representation or warranty, express or implied, is made or given by or on behalf of the Firm or its partners or any other person as to the accuracy, completeness or fairness of the information or opinions contained in this document, and no responsibility or liability is accepted for any such information or opinions (but so that nothing in this paragraph shall exclude liability for any representation or warranty made fraudulently).

The value of an investment and the income from it can go down as well as up and investors may not get back the amount invested. This may be partly the result of exchange rate fluctuations in investments which have an exposure to foreign currencies. You should be aware that past performance is not a reliable indicator of future results. Tax benefits may vary as a result of statutory changes and their value will depend on individual circumstances.

creative

Designed by www.jcreative.co.uk