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investing ON THE go

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[INTRODUCTION]
**Staci West (SW):** Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. This week we're considering what makes a good economic franchise and how market conditions influence the long-term value of a company. With examples from Kate Spade to medical devices and the National Grid there's something for every investor in today's episode.

**Chris Salih (CS):** I'm Chris Salih, and today we're joined by Bertrand Cliquet, who is a fund manager on the Elite Rated Lazard Global Equity Franchise fund. First of all, thank you for joining us today.

**Bertrand Cliquet (BC):** My pleasure, Chris,

[INTERVIEW]

**CS:** Let's go straight into the fund itself and have a look at some of the holdings. You've obviously got a very eclectic mix of companies within the top 10, the likes of, you know, a luxury fashion holding company, a firm that makes slot machines in Las Vegas, and then a high street Pharmacy, eBay, kidney dialysis company, Japanese security company, Spanish infrastructure firm… Maybe tell us, you know, what's the tenet that runs through them? What do you look for, that all of these various companies display? And maybe go into a bit of detail about one or two of them, if you can?

**BC:** Yes, and it might seem indeed quite eclectic at first sight, to see such a diverse range of companies. But I think what they do have in common is what we call a source of economic franchise. And just to go back to the philosophy of what we're after and we want to deliver for investors, it's really trying to find a way to minimise the risk of error around forecasting the future earnings and cash flows of our companies.

And the benefit of that, in our view, is that it can enable us to be more assertive on valuation. So let me take an example. If you have a company where, you know, the future's really uncertain, it might make 10 million pounds or a hundred million pounds of profits in the next five years, how do you ascribe a valuation to this? And how do you assess how this compares to the current share price and therefore your investment decision? So, what we are looking for is those companies with a source of economic franchise, and they can be a natural monopolies - so, Ferrovial [S.A.] you mentioned, [they're] a Spanish listed business that owns a network of motorways in North America. So, monopolistic situation, you know, really, really robust business.

They can be businesses with scale where the scale gives them an edge. So, CVS Health [Corporation] has a large pharmacy benefit management business. So, they buy in bulk from the big pharma companies on behalf of healthcare plans in the US, and the size and their ability to process this gives them an edge.

You can have network effects. Probably eBay falls into that, where the wider adoption of a product or a service creates some, let's say, virtuous circle, and these virtuous circles in a sense, give significant barriers to entry.

They can have brands, Tapestry [, Inc.] you mentioned. You know, we think the brand will compel the customers to pay a premium price for the product and derive high profitability. Or switching costs. When you have to think about removing or changing a provider of a service, you have to think about it twice because it's costly, it's potentially disruptive to your business and may actually not yield much cost advantage for you.

So, that's what those companies have in common. They have this source of economic franchise, which we think will enable us to forecast their cash flows and profits more accurately. And the second thing they have in common is valuation. As you know, we're convinced that the price investors pay to invest in a company is a crucial success factor or risk. And we think that those companies you know, have been faced with either, let's say disruption from Covid in the case of motorways, where people were not allowed freely to go about their business and therefore [are] still recovering from a traffic standpoint.

Or Tapestry where the company has implemented - or is in the process of implementing - a very, very deep rationalisation of its value chain management in order to deliver its product in the right quantity, at the right time, to the right audience, which means that they won't have to discount and therefore the margins they get on every single product will be significantly improved.

**CS:** Did you want to go into maybe any example of one to sort of talk us through from A-Z perhaps?

**BC:** Yes. I think Tapestry is a very good example. Tapestry is an American-listed company known for a number of its brands. The most prominent of it is Coach; it owned as well, Kate Spade and the Shoemaker, Stuart Whiteman. And the opportunity arose for us to invest in Tapestry when the company's previous management certainly dropped the ball and, you know, missed the rise of Michael Kors. And the new management team set out on a journey to improve the operational performance of the business.

I think the poster child in the industry is probably Inditex [Industria de Diseño Textil, S.A.], the owner of Zara. Very, very nimble value chain, very quick at product turnaround, really good at sensing market trends and reflecting [that] in the product offering.

So, Tapestry was really on the journey and this journey was not only here to re-establish the growth of the business, but here, very much re-established the margin and the premium pricing that they used to enjoy but had to compromise on through heavy discounting because of mismanagement of their value chain.

And so, what we've seen, and there was the lesson from Covid, was some sort of catalyst of history. Covid and the challenges it posed offered [management as well], the ability to implement change at an extremely rapid pace. So, a performance improvement plan that was supposed to take two and a half to three years was put in place within nine months. And so, we are currently starting to really yield and see the benefit of this and that feeds right down to the bottom line, [resulting in] significant improvement in in profits for the group.

**CS:** Obviously the fund is global in nature and what, there is over 41,000, probably more than that now, stocks globally to look at; how do you go about finding these gems that go into your portfolio? How do you cut that universe down firstly? And also, in terms of when you look at these companies, do you look at them individually or do you look at the sector they operate in and try and evaluate who the competitors are? Is there consolidation? How do you go about identifying these types of companies?

**BC:** Yes. it's, it's an excellent question. I think there's a very thorough filtering process. So, the investable universe is composed only of 220 stocks, so it's a very, very select club of companies.

So, what we look for is companies that have a high degree of financial productivity. So, we want companies with high returns or very regulated return, thinking about the National Grid [plc] in the UK - it's a monopoly; it has good returns, but not 25 or 30% returns. So, we want high return on capital or regulated returns.

And then we want companies that have exhibited this consistency in profitability over time, even in the tougher economic environment. And what we think that will provide is a range of companies that will really help us defend capital as well. So, not compromising on the upside capture - and, indeed, our upside capture has been slightly… about a hundred percent since we started - but really protecting capital on the way down as we saw in 2022. So, that's the first filter.

And then we go much deeper in understanding individual securities' characteristics. Where's the lengths of the product cycle? How big are they versus their competitors - which means are they able to generate economies of scales that their competitors might not be able to? Do they have barriers to entry? Is it easy to step into their markets or challenges, in terms of free substitution?

I think it's very important as value investors that we are aware that the world can change, and innovation can introduce [a] risk of substitution. And I think one of the best examples is, you know, you may have owned a lot of very, very cheap newspaper businesses in the 1990s because the trap door was opening under their feet. The transition to online was fundamentally changing and posing a huge challenge to their operations and business. So, that's what we want to identify. And that grinds down to a universe of 220 stocks.

Now, to your question on stocks versus sector, I think we want to understand if an industry is healthy in terms of you know, the barriers, can a company sustain its strong franchise position going forward? But then it all comes down to stock picking. Is a stock individually cheap or expensive?

**CS:** Just turning back then, obviously at the moment in the market, we've got sort of on the one shoulder inflation worrying people, on the other shoulder, the threat of recession worrying people - behaviours and sort of worries about emotion are sort of coming into the market a lot more. You obviously have behavioural filters that are used in the process. How does that help you to manage the fund efficiently?

**BC:** Yes, it's a very good point. I think emotion is a big enemy of investors. I think the last thing you want when you are entrusted with people's money is to have knee-jerk reactions. And having a very strong emphasis on analysis is crucial, and a decision around valuation is important.

So, the way we build the portfolio, after setting up all these filters, we have a set of really interesting companies, those franchise businesses, 220, and the premise is very simple; we would be very happy to invest in any of those businesses, provided valuations were compelling. So, the members of the team, we all do individual stock analysis. We challenge each other on our analysis, on our view of valuation. And the way we approach the forecasting and valuation of our companies, really relies on two principles.

First is being conservative. So, to your point on inflation and risk of recession, what we do is, we're not claiming we are the best and the most accurate economists around, but we want to be on the safe side of conservatism. So, we will always adopt an economic scenario in our forecast that sees that yes, inflation will be a challenge on margins, even for our businesses - and we do think they have much better pricing power than most businesses, so they will protect much better against inflation spikes - but they can't be immune to be very, very honest. So, on the one hand, this set of conservatism in the operating assumptions.

And on the other end in the valuation, a set of discount factors that always assumes normalisation in interest rates. Believe me, about 15 months ago, we felt very, very alone in assuming that, you know, interest rates would, as they did in the past you know, convert to a level that was consistent with long-term GDP growth, long-term inflation, we suggested that investors should discount cash flows at a much higher discount rate than they were used to over the previous 10 years. And I think these two bits you know, creates a high degree of conservatism.

Now, the way we remove the emotion when we build the portfolio is we take this intrinsic value that is built conservatively, we compare it to the share price, and for every single stock we rank the companies in order of valuation appeal. So, the bigger the gap between our view of intrinsic value and the share price, the bigger the position we want to have in the portfolio. And what that means is a lot of these very good companies, they will be expensive. We simply have to be patient.

**CS:** Given you mentioned that, then obviously I think we talked at the start of the year and you mentioned that turnover of the portfolio was higher due to sort of increased opportunities. Could you

maybe just go into why that was such an interesting period for you? You've just mentioned there the discrepancy between what you see as fair value and what the stock actually was. Maybe just talk us through that and is that still the same case today, a few months on?

**BC:** Yes. And you're right. We've seen a heightened level of volatility and a greater dispersion in stock price performance between winners and losers. And that gave us opportunities. And one of the important elements is every time we invest in a stock, we are prepared to give time for the investment case to come to fruition. However, if a stock rerates 25 or 30% within three months, while the investment proposition is genuinely different, not much may have happened from an earnings forecast expectation, but now things are genuinely more expensive.

And we've seen a number of examples, I think Ross Stores [, Inc.] is a good example of that. This is a stock which we bought in the first quarter 2022. So, Ross Stores is one of the heavy discounters in the US, very much like TJX, the owner of TK Maxx. And Ross Stores became inexpensive because the market was very worried about the inventories across the retail chain in the US. And the opportunity arose because the market put Ross Stores in the same bucket as the other retailers, while they misunderstood the business model - Ross Stores thrives when it is able to buy inventory cheaply from those people who have too much inventory on their hands. So, perfect situation here. So, they could buy lots of inventory really cheaply and they thrive as well, I'm afraid when people struggle. A lot of people trade down because of the cost-of-living crisis. So, for this company, you had what was almost perfect storm. They could buy inventory cheaper and sell it to a larger audience because people were trading down. And so, this is a stock that subsequently performed well, and we sold in the fourth quarter. So, hence heightened rotation.

More recently, we've continued to have this, most of the rotation of the portfolio has been in adjusting existing portfolio positions rather than outright buys and sells. So, we only had one sell in the first quarter this year.

**CS:** How does it work in a period like Covid, where perhaps you have a number of companies in the portfolio where you believe in the long-term story, but then over here, you've got this list of 220 and you're like, oh my god, so many of them look so attractive - how do we balance this out?

**BC:** Yes. Well, what's interesting really is through Covid, we never had a picture of a value ranking of stocks that suggested that the market had capitulated.

So, in our view, we were never in [a situation like that of] March 2009 [when the stock market bottomed after the global financial crisis] - you know, a case where, you know, a lot of stocks seem really, really inexpensive. So, what we did is, the challenge of Covid was really forcing us to go back to the fundamentals of our companies. Some of our companies that traditionally are, you know, extremely steady, were disrupted. So, if I take Medtronic [plc] for example, they're the largest manufacturer of medical equipment in the world - half [of] the products they sell are linked to elective surgery. So, you know, somebody was told, I'm sorry, you can't have your new knee or your new hip because, you know,

obviously we have a bigger problem, but that had direct consequence on the business that usually is extremely steady.

So, we had to go back for a number of those businesses, to a deep understanding of the fundamentals, trying to see if those businesses were impaired for the long run, or you know, if we had to weather the storm, assess whether the operating leverage they suffered from on the way down, would benefit us on the way back up, and potentially - with the emergency that they were in - being forced to rationalisation, cost-cutting that would actually make them significantly more profitable once the situation normalised and [became] covid free. And then that's what we saw of those businesses.

**CS:** We've sort of talked a lot about the company specifics and the fundamentals of the companies, how much does top down come into the process in terms of macro? Obviously, we've got inflation, it's looming and continues to loom and be sticky in markets. Does that affect at all the long-term positioning in your portfolios? Do you do anything differently as a result of that sort of hanging [sword of] Damocles in markets?

**BC:** Yes, it's a good question. So, the approach we have is we do build a portfolio on a bottom-up standpoint. We are stock pickers, you know, however, when we value and we forecast the cash flows and earnings of our companies, we have to be very aware of what's happening on the macro side. So, what we do is we have a five-year explicit forecast payout that is trying to be as conservative as possible. So, one of the things and work we've done in the last year, especially second half of the year, is trying to assess whether the different monetary policies put in place during Covid, hadn't created some sort of reservoir of inflation, you know 'quantity theory of money' type approach.

Because even outside the current pressures, we could actually see sustained pressure on inflation because of all this money that was printed. And that's what we have adopted in our forecast. And some companies will be clear beneficiaries from inflation, United Utilities [Group plc] or National Grid are two of those. And some companies will tend to suffer more in a recessionary and inflationary environment. So, Intel [Corporation], for example, is a stock we sold at the backend of last year because we felt it was less equipped to weather this storm. So, but it all goes back to the individual stocks, but we certainly take you know, the context into account with a view of being conservative and on the right side of this conservatism.

**CS:** Okay. And just lastly, I mean, we linked that sort of following on from inflation, I believe there are a few sectors you try to steer clear of, the likes of financials, banks and real estate. Obviously, I mean that might be because the money's not as sticky there, I assume, but could you maybe explain why? And on the back of that, does that change at all when perhaps value investing is more popular? Or what if there is a complete anomaly in one of those sectors? Would you bend those rules to include that anomaly in a portfolio, if you felt the case was that compelling?

**BC:** Yes. It is an excellent question because we certainly describe ourselves as value investors. We want to buy stocks at a discount to their intrinsic value. But we are not value investors in an index sense. When

we look for these franchise companies, let's say, a bank; well banks have low returns, very, very high degree of financial leverage, and, as we've seen recently, I'm afraid, very low switching costs. So, if people want their money back, well, they go elsewhere, and if they can't get their money back, then the bank has a bigger problem, as again, as we've seen. So, for us, you know, we've never invested in banks, for example, because they were structurally unappealing as businesses. Again, if we're looking for those very forecastable, very high return businesses, they don't fit the situation.

**CS:** I was going to say, even if it's something like sentiment where, you know, banks in Europe, in the UK for example, are like quite heavily regulated now, lots of capital… even that wouldn't come into the consideration now if say, an event caused them to depreciate purely based on sentiment?

**BC:** Yes, it's, it's a good point. And if you look at the pattern of performance we've had ,you know, our performance was very strong in the first half of last year, despite the fact that we didn't own any of those big value sectors - no banks, no commodities, no oil and gas. And I think that truly speaks to the fact that this is a strategy that has outperformed value indices very consistently, despite the fact that it doesn't own those classic value sectors.

The advantage of the approach we have, I think, is really not compromising on the upside. So, we've been able to not only outperform value indices, but in the long run, even outperform growth indices. So, we haven't … if you think about the pattern of performance - good upside capture, we'll certainly miss out, if the market you know, becomes overly enthusiastic, you know, this last leg of super sharply rising markets, most likely we will participate, but we will probably expect to lag, but we will have these defensive characteristics. So, it's quite a nice mix actually for long-term value creation for [a] portfolio.

**CS:** Bertrand, once again, thank you very much for joining us today.

**BC:** My pleasure, Chris.

**SW:** Run by a four-strong team located in London, Sydney and New York, Lazard Global Equity Franchise looks for companies that have an edge in their respective business sectors — as explained in this episode. The managers can invest in any business around the world, but because they're looking for industry leaders, there is a natural bias towards larger-sized companies. For more information on the Lazard Global Equity Franchise fund, visit fundcalibre.com – and don't forget to subscribe to the 'Investing on the go' podcast, available wherever you get your podcasts.