August 2023

CORPORATE EXCELLENCE INSIGHTS

Hérens Quality AM is a specialized provider of systematic Quality Investment Solutions and one of the few providers of Quality equity investment strategies worldwide. Corporate Excellence Insight is our monthly publication that includes a brief update on markets and our thoughts about major trends that are impacting the investment management industry.

MARKET UPDATE: SMOOTH SLOWDOWN EXPECTED

Market outlook stayed optimistic due to a decrease in inflation within developed markets and strong GDP figures, boosting expectations of a smooth economic slowdown. This optimism fueled a widespread upswing in equity markets among all geographical areas.

9.58mln

JOB OPENINGS FALL 34,000 TO 9.582 MILLION IN JUNE

U.S. job openings fell to the lowest level in more than two years in June, but remained at levels consistent with tight labor market conditions, which could spur the Federal Reserve to keep interest rates elevated for some time.

$10bn

ROMANIA'S HIDROELECTRICA TOPS $10 BILLION VALUATION IN 'HISTORIC' IPO

The listing of Hidroelectrica, a leading electricity producer with a strong renewable portfolio, is the largest-ever IPO in Romania, the third-largest to date in the CEE region, and the largest in Europe so far in 2023.

0.3%

EUROZONE GDP GREW 0.3% IN THE SECOND QUARTER OF 2023

Europe's economy showed signs of recovery in spring, emerging from a stagnant start to the year to expand in the months of April to June, a stronger result than economists predicted. But the recovery, after zero growth in the first quarter, was not consistent across countries.

MONTHLY TOPIC: ASSET MANAGER'S HOMEWORK

Revising the results of the past decision making is a part of the asset manager's routine. Everyone, who read Buffet letters to shareholders noticed how much space is being dedicated to his decisions leading to the unfavorable outcomes.
We strongly support this practice and consider it to be an essential component of our investment process. We also believe that by sharing these analyses with the public we aim to increase the transparency of our operations and introduce certain learning element into the broader investment community.

We systematically avoid investments in state-regulated sectors, in capital intensive businesses and companies undergoing turnaround or in the early stage of the restructuring process. We scrutinize historical margin development to understand its consistency over the cycles and pay even more attention to the quality of corporate governance.

A margin of error can be acceptable if it does not have significant impact on the performance. In our Top portfolios, 80-90% of companies deliver outperformance. By revising track-record of the decision-making, our primary goal is to push share of the outperformers higher, minimize the loss in critical cases and generate more value for our stakeholders.

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Historical Buys & Sells: Our Main Learnings

Improvement through revision

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The results of previous reviews, latest of which were published two years ago (https://hqam.ch/publications/insights/kurzer-blick-auf-vergangene-fehler/), have improved our decision-making, thus making a positive contribution to the performance of our portfolios. As such, we systematically avoid investments in state-regulated sectors, in capital intensive businesses and companies undergoing turnaround or in the early stage of the restructuring process. Now, more than ever, we scrutinize historical margin development to understand its consistency over the cycles and pay even more attention to the quality of corporate governance. However, suboptimal choices might follow as long as we invest; so, our main objective is to limit those to a minimum by figuring out what went wrong and how to prevent it from happening again.

Overoptimistic management as a sign to be extra critical

When we look at an investment case, we carefully consider, among other things, the growth expectations outlined by company's management. Those are then put into the context of market estimates to see if those are significantly misaligned, which could signal that analysts are either overly bullish or, on the opposite, overly bearish when it comes to the future growth of the company. Sometimes, however, both sides can be overly optimistic, which usually results into a very harsh landing when reality proves to be far less rosy than anyone has expected. This is exactly what happened to PayPal and Align Technologies.

We bought these companies when the future looked bright for both. PayPal was seeing massive expansion in user base and transaction volumes driven by spike in e-commerce, while Align was capitalizing on the growing interest in clear aligners that surged during lock-downs. The management's addressed growth plans and the historical development of the companies evidenced about fast development pace. However, the paradigm has changed as the products became more commoditized and their competitive advantage weakened leading to our sell decision. Accelerated growth rates were exceptional rather than a new normal despite management beliefs. Hence, historical context matters, and we learned to appreciate "underpromise and overdeliver" approach.

Time is a tricky animal

We think many would agree that it is psychologically challenging to part with the stock after it has taken a significant dive, as "rebound mentality" is a powerful force. We have gotten better at overpowering it, but there remains plenty of room for improvement. This was the case with Korean manufacturer of air and water purifiers, Coway, whom we sold in 2021 after holding it for almost seven years. Although our initial wait-and-see approach to stagnant operational momentum and problem with major shareholder deprived us of a more successful exit, we were more proactive this time.

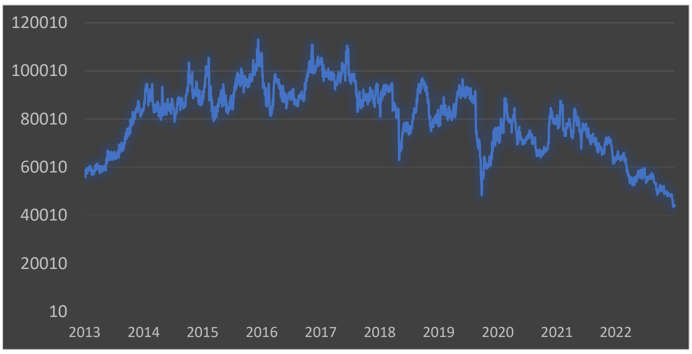

Figure 1: Coway stock price Source: Hérens Quality AM

Since exit, stock price continued its downward movement with no reversal in sight. Our major learning was to be more decisive and to critically evaluate the future potential of the company and to part with it in case of bleak perspective, regardless of the past performance.

Being too slow in the decision-making is costly, but so is being too fast, as many investors experienced in 2011, when Steve Jobs announced he is taking a medical leave. There was a wave of selling of Apple's shares in August when he stepped down as CEO and in October after his passing as Mr. Jobs was perceived, by many, as critical figure for company's success. Apple, however, continued to execute its strategic priorities as usual and share price made a nice recovery.

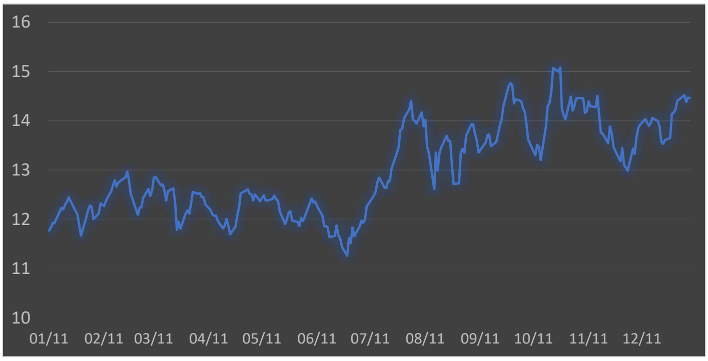

Figure 2: Apple stock during 2011. On October 5, S. Jobs died Source: Hérens Quality AM

We also became a victim of the "running-ahead-of-yourself" phenomenon. Back in early 2022 we sold Moncler, the Italian fashion company, in order to reduce portfolio's exposure to luxury, as it was expected to suffer due to subdued consumer appetite as a result of the war in Ukraine. This risk, however, never materialized. We took note, and applied a different approach when concerns emerged about the business models of Synopsys and Cadence Design Systems – both dominant players in Electronic Design Automation (EDA), potentially being disturbed by the generative AI, we did thorough research first to actually conclude that both will be among major beneficiaries of the AI wave. They remain core holdings of our portfolios by this day.

Better excellent few than many but mediocre

Given lessons from the past, we avoid industries that heavily depend on the commodity prices, either on revenue side or on cost side (if commodity share is relatively large). While this self-imposed restriction is logical and sensible, it does have one negative consequence – in some regions it substantially shrinks investable universe leading to rather concentrated portfolios. In pursuit of diversification we have added LG Household & Health Care, Korean household goods and cosmetics manufacturer, whose stock had a value profile that fit well into the portfolio. However, the overly high reliance on one brand became critical during COVID and raised questions about the overall quality of business model leading to the sell decision.

Margin of Error

A margin of error can be acceptable if it does not have significant impact on the performance. In our Top portfolios, 80-90% of companies deliver outperformance , while in regional 55-60% do. By revising track-record of the decision-making, our primary goal is to push share of the outperformers higher, minimize the loss in critical cases and generate more value for our stakeholders. And while past performance is by no means indication of the future one, past decisions, once analyzed, provide us with a solid reference book to aid in future investment calls.