Intangibles that create the competitive edge

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This paper explores the concept and practice of investing in a portfolio of Australian companies which have a *sustainable competitive edge*. The sustainable competitive edge focussed on in this paper is one that is created by owning or operating intangible assets that are difficult to replicate. The key intangible assets considered include Brands, Licenses, Patents, logistical capability and captive client bases. These key assets enable companies to entrench their products/services in the marketplace, and to deliver superior performance for investors. The paper will describe points to observe in these companies, how to assess what is a reasonable price to pay for them and how these companies can be accessed for effective portfolio construction.

Such a portfolio of Intangible assets can result in strong returns and diversification of returns from other Australian equity managers. As will be discussed in the paper, a focus on Intangible assets that are difficult to replicate, in Australia produces a portfolio of stocks which invests across a broad array of industries and market capitalisation.

Introduction

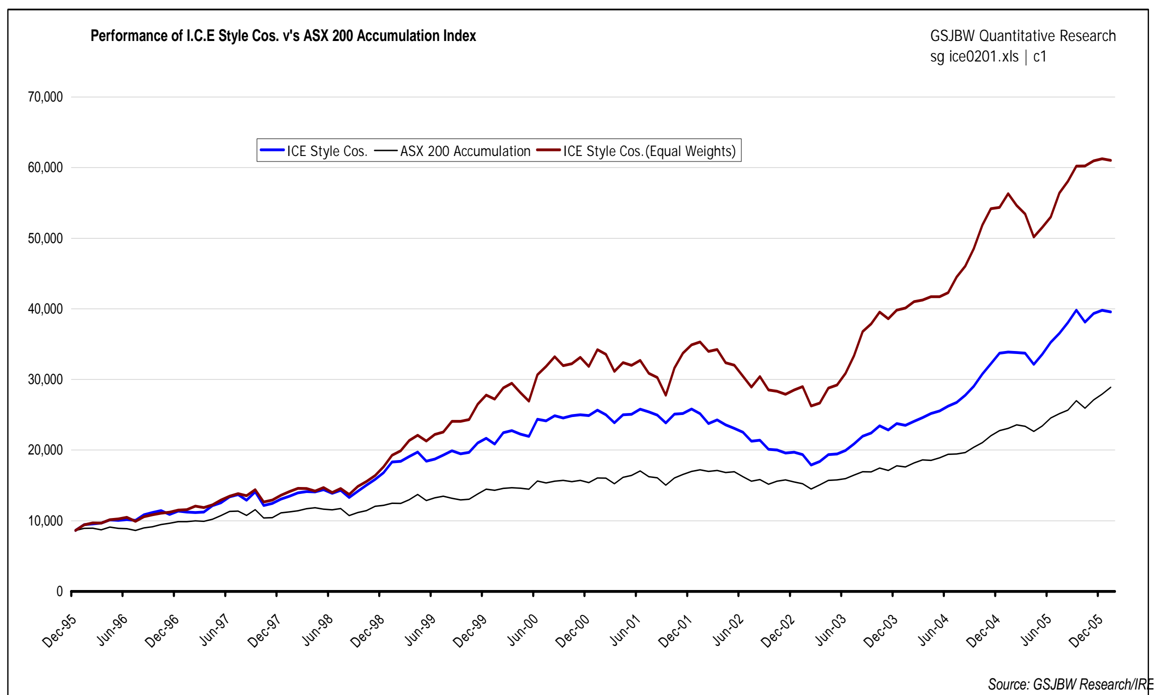
The key features of companies considered to have an established sustainable competitive edge include:

1. Possesses assets that are difficult to replicate
2. Holds an entrenched market position
3. Quality management
4. Strong cash generation

Historical examples of such companies in the Australian market, include Toll, Macquarie Bank, Brambles, Cochlear & Resmed.

Internal research conducted by SG Hiscock & Co in 2005 identified that there are approximately 200 ASX companies that fit within the criteria.

In 2005 SG Hiscock & Co conducted a research project to 1) identify the stocks with the above characteristics and 2) conduct a return simulation to see how a simply constructed portfolio composed off these stocks (under two methodologies – market capitalisation weighted and equally weighted) would have performed. The results were very strong as shown in Chart 1 below.



[**Chart 1**- indicative performance of SGH IC²E style companies over the 10 years to February 2007]
Source: SG Hiscock & Co

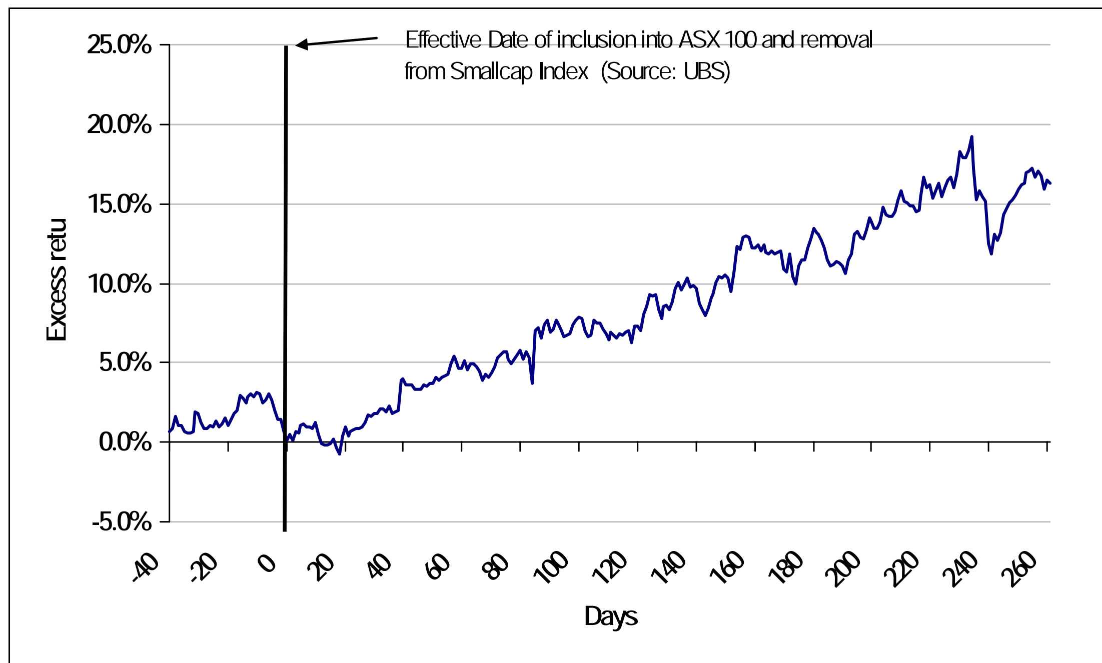
A Fund created with the strategy by SG Hiscock has exhibited similar return characteristics in the period February 06 to June 07 delivering excess returns 16% pa higher than the ASX 300 and a Sharpe ratio of 3.5.

The Narrow Australian Market

A unique feature of the Australian market is that less than one third of the ASX top 100 companies meet the aforementioned criteria. This means that 1) an Australian strategy which aims to invest in companies which possess a sustainable competitive edge (from effective utilisation of quality intangible assets) must access opportunities across the capitalisation spectrum to ensure adequate diversification and 2) the assets to be managed must be capped at a relatively low level given liquidity constraints. Research conducted by SG Hiscock indicates capacity constraints in the vicinity of one third of a billion dollars.

Multi-Cap investing - advantageous

Whilst breadth of opportunity dictates a multi cap approach there are two additional benefits from multi-cap investing. First, it is possible to exploit the inefficiencies which occur when stocks are included and removed from headline indices as Chart 2 illustrates;



[**Chart 2**- Excess Return from Stock as it transitions index]
SOURCE: UBS

As seen in Chart 2 stocks not infrequently experience a fall in share price immediately prior to leaving the Small Caps index and after entering the ASX100 index. This supports the benefit of a multi-cap approach to investing that is prepared to invest through the "barriers" while a stock enters the radars of new research teams and portfolio managers. In addition, continued share price growth after inclusion also suggest that as a stock develops in its maturity stage the greatest opportunities in share price appreciation have not always evaporated. Clearly there is merit in retaining a stock through its cycle. Small Cap fund managers and broking analysts often hand over a successful and growing stock to large Cap teams upon transition into the ASX100. An approach based upon continuity of coverage can assist generation of returns,

Company Life Cycles

Secondly, as a company matures, typically as profitability improves and net cash flow improves[1]. If the management incentives are rational, additional cash flow is returned to investors as a dividend or share buyback as the opportunities for future improvements decline and management avoids over-investments in increasingly less profitable areas. The company gets larger and competition traditionally moves into the mature market segment, making the business more 'mainstream' and reducing the company's specific risk against the market – the systematic market risk therefore increases and the discount factor applied to future earning by analysts declines. The company has evolved from establishing ('*sower*') to emerging ('*grower*'), to being fully developed ('*harvester*').

This lifecycle is of great interest to the investor because there is usually a strong increase in cashflow generation and consequently valuation as a company makes the transition to the next part of the lifecycle (eg grower to harvester). This means a multi-cap investment approach has greater opportunity to benefit from the valuation uplift associated with the transitions. Coupled with the analytical coverage discontinuity that can occur, this suggests a portfolio of stocks that reflect a complete life cycle of companies has additional opportunities to generate outperformance.

It should also be noted that with careful analysis it is possible to determine where a company is currently positioned in its life cycle. Several ways present themselves, one being dividend policy, which is used by companies to signal to their investors information regarding their current strength of balance sheet and future earnings, (see Lintner's theory of dividends [1] and Jensen's cash flow hypothesis[2]) Another is the role of change in the growth of earnings per share.

Measuring Reasonable Price

Over the last 10 years, an additional major challenge in investment analysis has appeared: the increased role intangible assets play in our economic system, which has moved from an industrial economy towards a services and knowledge oriented economy.

Although intangible assets have been around for centuries, increased competition, globalization, deregulation and the advent of information technology (notably the internet), have caused the structures of corporations to progressively change to the point where intangible assets are *increasingly* the major value drivers of many listed companies.

It is logical that intangible assets will be more difficult to value than tangible assets- thus presenting an opportunity.

The unique feature of these companies and the intangible assets that support their activities is that the worth of the assets does not reside in assets, that is , in the independently assessed value of a hard asset such as property which can be valued based on comparable transactions, but in the cashflows that can be produced. Therefore valuations need to look at the specifics of each intangible asset and surety of future cashflows to access the sum total of the valuation.

Two points to note:

1. Surety and predictability of future cashflows occurs when a company's products are entrenched in their market place.
2. Future cash flows when balanced against the current market price of the investment, allow calculation of the return the investor will receive from holding the investment. `

Effective Portfolio Construction

Having explored the *theory and practice* behind investing in individual companies with Intangibles as major assets, and identifying reasonable price, how is such a portfolio constructed?

For investors, a portfolio which attempts to implement a diversified strategy of investing in companies with a sustainable competitive edge (derived from intangible assets which are difficult to replicate which in turn create an entrenched market position) must include a significant component outside the top 100 companies – leading to a capacity in the order of one third of a billion dollars (source SG Hiscock).

It is unlikely that Global fund managers would choose to invest in or operate an Australian domiciled version of this market niche, as the capacity is small relative to their requirements. The minimum set positions in a company for a Global fund manager are usually so large that they would end up owning

many of the smaller “sower” companies, if they invested in them. For this reason such a portfolio is only likely to be managed by an Australian fund manager, and in all likelihood a boutique given the capacity constraints and cross cap investment requirements.

Once a portfolio of companies focusing on Intangibles is established the monitoring of valuation criteria is critical. Measures such as Internal Rates of Return (IRR) and payoff ratios could be used for monitoring purposes. These will ensure that superior company operating performance drives superior share-price performance.

Typically such a portfolio will exhibit a GARP *(Growth at a Reasonable Price)* bias - this being an outcome of the stock selection process rather than a deliberate positioning of the portfolio. Any style bias would be incidental and may migrate over time. The process is fundamentally about selecting a diversified portfolio of companies with the required characteristics.

As previously explored, companies should be invested in across the capitalisation spectrum to retain companies expected to grow earnings per share at a superior rate over the medium to long term.

Nonetheless, while a spread of companies in various stages of the life cycle is desirable, specific investment objectives must always be based on reference to risk, return and time. This will ensure the focus on delivering returns to investors in absolute terms over the short to medium term also. In this way

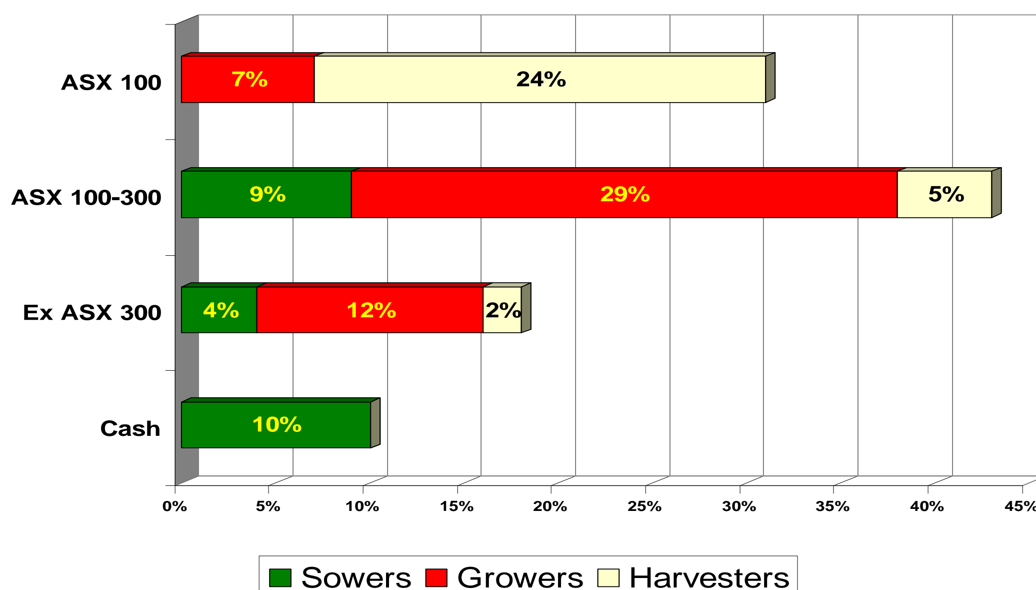
1. The portfolio should be structured to hold cash if attractive opportunities cannot be identified.
2. Stocks should only be included if they exceed medium term absolute return hurdles.
3. An informal Sharpe Ratio of greater than 1 should be targeted to order to provide investors with an appropriate level of return reward per unit of volatility over the long term.

Such a portfolio would not be Index sensitive and would be balanced across the lifecycle spectrum with a significant amount of diversification at the individual stock level. While weightings would vary in response to market conditions the neutral positioning would have;

1. A modest aggregate exposure to a broad spread of Sowers (often small/ micro caps) to deliver capital growth and to facilitate early identification of candidates for the Grower category.
2. A solid aggregate exposure to Harvesters (often large/ mid caps)to provide strong cashflow generation and volatility reduction, and
3. The largest aggregate exposure to Growers (often mid/ small caps) to deliver attractive risk adjusted capital gains plus some income.

Qualitative company assessment identifies approximately 150-200 qualifying Australian shares. One quantitative assessment is undertaken and the valuation criteria are applied the investment universe narrows to around 50 ASX listed stocks.

Chart 3 identifies that a sample portfolio composition resulting from this process would have a mixture of stocks across the market capitalisation spectrum.



[**Chart 3**: Stocks in portfolio by Market Cap and position in the Sower/ Grower/ Harvester cycle]
Source: EQT

Associated Risks

Investing in companies possessing Intangible assets does not come without associated risks. For this reason strong qualitative awareness of the company and its industry must be maintained. The most prevalent downside risks associated include that intangibles can be difficult to manage and to exclusively control, and that they are harder to exploit than a machine is. Further, copying or re-engineering can sometimes occur and there can, on occasion, be limited ability to protect by intellectual property rights. For these reasons the Portfolio manager must be able to draw upon the resources of industry experts to ensure that their qualitative assessment is well grounded.

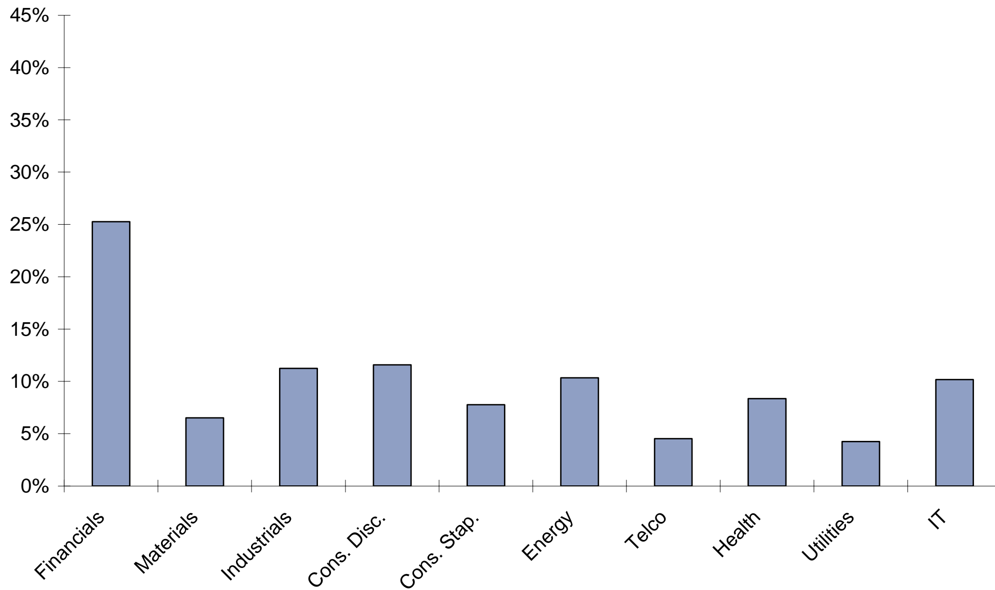
Likewise, the PM must maintain an unemotional relationship to the portfolio. That the market has not yet factored in any intangibles to the share price suggests that they may never factor them in. The PM must be rigid in their quantitative assessment and be prepared to sell a stock. It can always be bought back at a later date if appropriate.

Portfolio Positioning

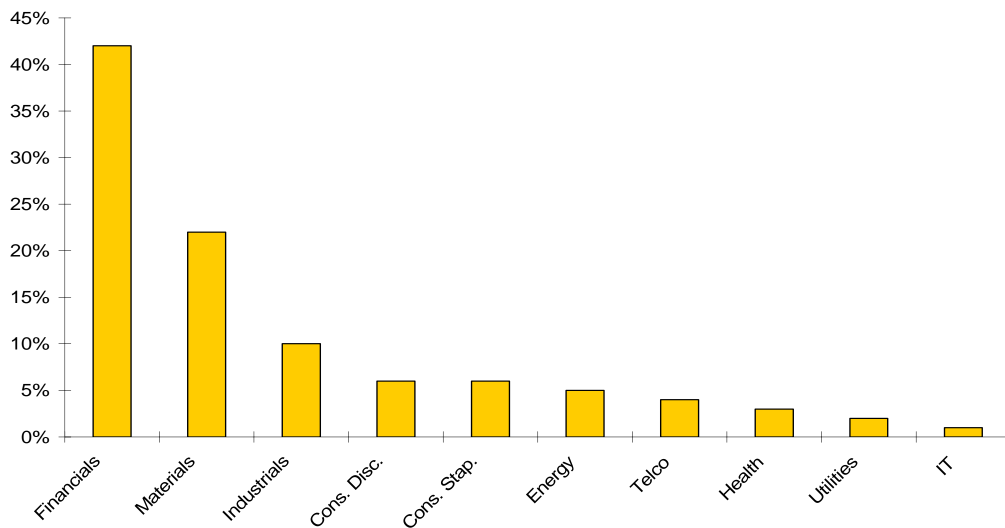
A portfolio that focuses on Intangibles - would find difficulty being placed in a traditional “box’ amongst equity managers. This is because such a fund would be invested across all market capitalisations and be benchmark unaware. It is neither Large Cap, Emerging, Small, Micro-Cap or Sector based. Rather, it is an

aggregation of companies which demonstrate an entrenched market position, many with exposure to global industries.

Adding such a portfolio to a traditional Australian equity portfolio offers significant diversification benefits as the industry exposure will look more like that of the MSCI Global as seen in Chart 4 than the highly skewed Australian market as seen in Chart 5.



[Chart 4: Global Equities are Diversified]
Source: EQT



[Chart 5: Skewed ASX drives 3 outcomes]
Source: EQT

One such portfolio which has utilised this investment strategy is the SGH IC^2E fund managed by SG Hiscock and Co and distributed by EQT Funds Management. This fund, which commenced in February 2006, invests in a portfolio of companies with Intangibles across the company lifecycle and has delivered substantial excess returns since inception. Its targeted fund size is around $300m-400m.

Conclusion

Investing in quality companies with Intangibles assets such as Brands, Licenses, Patents, Logistical capability and captive client bases has proven to be a unique and successful approach to managing an Australian Equity portfolio. These companies have or are in the process of creating an entrenched position for their products/services in the marketplace and hence have the potential to generate ongoing excess returns for investors.

Experience in identifying Global industry trends, as well as bottom up fundamental and qualitative skills are required to identify these companies. A disciplined portfolio structured to own a dynamic "life cycle" of suitable companies is essential, as is the quantitative ability to assess what is a reasonable price to pay for them.

Few managers possess the capability to properly execute this approach, which can be successfully blended with other investment styles to provide an uncorrelated source of outperformance for investors.

Endnotes

[1] (Lintner, J., "Distribution of income of corporations among dividends, retained earnings, and taxes", American Economic Review, May 1956, pp. 97-113)

[2] (Jensen, M.C., "Agency cost of free cash flow, corporate finance and takeovers", American Economic Review, May 1986, pp. 323-329).

Authors
Boyd Peters and Callum Burns

<u>About Boyd Peters</u>

Boyd Peters joined Equity Trustees Ltd in 2002. He is presently National Business Development Manager, spearheading retail initiatives with fund managers who have outsourced their retail distribution to EQT, including Australian boutique manager Intrinsic Value Investments.

Boyd's involvement within Funds Management has been in Business Development. Prior to entering the industry he successfully managed a Mortgage Fund and established a mortgage origination firm which now has offices in 3 states. With a Bachelor in Applied Economics he has over 13 years experience in finance and funds management.

About Callum Burns

Callum is the portfolio manager for the fund SGH IC^2E at SG Hiscock & Co. Prior to joining SGH and setting up SGH IC^2E he was Head of Global Asset Allocation at BT Financial Group where he was responsible for global asset allocation decisions across $8 billion of balanced funds. Callum joined BT via Westpac's acquisition of Rothschild Australia Asset Management where he was also Head of Global Asset Allocation and a member of the firm's Executive Committee. Prior experience includes Head of Balanced Funds at Rothschild and a number of investment roles in the public sector.

Callum has 18 years industry experience and has represented Australia in World Sailing Championships on nine occasions. He holds an Honours Degree in Engineering, a Graduate Diploma in Applied Finance & Investments and is a member of the Financial Services Institute of Australia.

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