Insights
Fundamental Growth and Core Equity

April 2021

Selecting Quality Stocks in Cyclical Sectors

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The three pillars of the Fundamental Growth and Core Equity team's philosophy are quality, sustainable growth, and reasonable valuation. Within this framework, we have consistently identified high-performing stocks in high-growth industries supported by secular growth trends — such as e-commerce and software.

Although our equity portfolios are concentrated, we still seek diversification across industries; this raises the question of how and when do we invest in companies whose growth is more dependent on cyclical economic factors. This question is particularly topical at present, given the potential for economically-sensitive stocks to relatively outperform against the backdrop of the global recovery from the pandemic.

Unearthing Quality

Each element of our philosophy plays a role in our approach to investing during periods of economic recovery, but we will begin with quality. We define and measure quality through our Confidence Quotient (CQ) framework. Our analysts combine quantitative data with their domain expertise and judgment to make a forward-looking assessment of companies' ability to "sustain" growth over a three-to-five year horizon (at a minimum). Management, industry structure, pricing power, capital intensity, balance sheet strength, regulatory influence, ESG, and an extensive list of other factors complete the scorecard used to assess our confidence in the sustainability of growth. In essence, it is an assessment of our confidence in a company's future earnings potential, and thus helps us determine what we are willing to pay for that income stream.

Evaluating Quality — Confidence Quotient

CQ is our proprietary indicator of a company's quality and consists of our analysts' assessment on a 1 to 10 scale of the following characteristics:

Market Position — Sustainable Competitive Advantage

Management — Conviction in Leadership

Financial Condition — Strength of the Financial Model

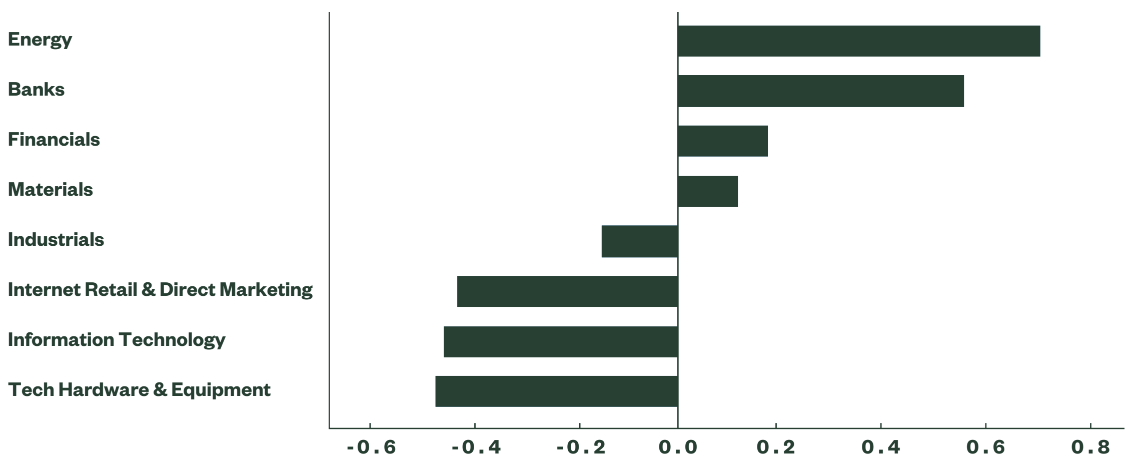
Transparency — Visibility of Business

Fundamental Momentum — Business Is Trending Positively

The assessment for each of these five areas is supported by a detailed scorecard of sub-measures, which are also ranked on the 1–10 scale. Included in the sub-measures are Environmental, Social and Governance (ESG) criteria, which are an important part of the CQ analysis.

With that background in mind, the sectors with the highest degree of cyclicality are financials, energy, industrials and certain materials companies (gold companies are the exception). These sectors are positively correlated to rising interest rates (Figure 1), which generally rise as economic growth accelerates. The business models of companies in these sectors are often more volatile, illustrated in part by higher sector betas. As such, they generally have lower CQ scores because we have less confidence in our ability to predict their growth rates and their return potential. Over the years, we have selectively identified opportunities in these sectors, however, and the following examples illustrate our process at work.

Figure 1
MSCI World Select Sector Correlation with Nominal 10-year US Treasury Yield



Source: Bloomberg Finance L.P., MSCI, as of March 3, 2021, based on daily data points. Banks are a sub-index of Financials; Internet Retail & Direct Marketing is a sub-index of Consumer Discretionary (not shown); and Technology Hardware & Equipment is a sub-index of Information Technology. Past performance is not a guarantee of future results.

Key Considerations in Energy and Materials

Commodity prices are set by the market, leaving companies operating in these sectors as price-takers. The industries are fragmented, with new projects generating sizeable increases in supply. Quite often, the companies are partially state-owned, prioritizing job creation, and thus supply, over profit. Capital intensity is high given that resources are a depleting asset, requiring ongoing investment to maintain production. Returns on capital, for energy in particular, have been poor over the last decade, as have total returns to shareholders.

ESG (economic, social, governance) factors, which are integrated into the CQ analysis, present an additional risk — there are numerous examples of environmental and community disasters, labor disruptions and injuries throughout history, as well as government and regulatory unpredictability. Predicting such events is naturally very difficult, yet we know they happen. As a result, most companies in the sectors score poorly on our CQ metric and are unappealing to us at any price. But there are always exceptions.

Iron Ore and the China Factor

In the early part of the last decade, we recognized that China was experiencing explosive growth in infrastructure and urbanization. This was well before it became a consensus call and was partly driven by our collaborative culture and the input of our China and emerging markets teams. Further research helped us identify the iron ore industry as having the attributes we look for when scoring companies.

- Three companies dominated the industry
  - — Effectively controlling supply, providing visibility.
  - — Setting prices annually.
- Superior assets, meaning:
  - — High concentration of ore per ton mined which lowers mining costs.
  - — High reserve lives brings certainty of production and lower exploration costs.
  - — Relatively fewer impurities — attractive to China to blend with domestic ore to make quality steel and reduce emissions.

These attributes gave us high confidence in the long-term earnings power of these companies, something the broader market underappreciated relative to other miners at the time, thus completing the mosaic along with attractive valuations. After a long period of time and extraordinary returns, valuations became less attractive, China's demand growth slowed, and new supply caught up with demand. Our analysts lowered CQ scores to reflect these changes and we eliminated positions.

The Opportunity in Building Materials

More recently, Martin Marietta Materials (MLM) has been a preferred holding in the materials sector, a company we highlighted in a previous newsletter. MLM's primary business is in aggregates, which are used in highways, infrastructure, commercial and residential construction. It will certainly benefit from an economic recovery, which typically underpins the housing market, while the potential passage of an infrastructure spending bill offers further support. But why would we own this company ahead of other names in the sector?

- MLM's broad network of quarries in geographies experiencing strong growth due to demographic shifts is driving demand for its products.
- High transport costs for heavy materials enables pricing power for locally-based producers as switching options are limited.
- Natural stone has unique properties that make substitutes difficult; as the cost of stone in an overall project is generally small, customers tend to be relatively insensitive to price.
- Barriers to competition are high — opening new quarries is difficult, given a shortage of stone resources and high regulatory and environmental hurdles.
- MLM management has proven skilled at identifying strategic assets for acquisition, executing on integration and extracting synergies.

These metrics, captured in our CQ analysis, manifested in strong historical performance and particularly recently in anticipation of the economic recovery.

Financials Sector — Focusing on More than Rates

Financials share many of the attributes of the mining and energy sectors — fragmented industry structure, potential disintermediation from new entrants, significant government/regulatory intervention, and dependence on exogenous cyclical factors like interest rates. We are not interested in the many low CQ stocks in the financial sector, but we have identified relatively attractive investment opportunities with sustainable growth.

Two financials that drew our attention are First Republic Bank and SVB Financial Group (Silicon Valley Bank). These companies:

- Serve niche markets that benefit from secular growth trends in the innovation economy and high net worth segments.
- Have unique service offerings, which help drive sustainable growth.
- Have strong management teams that consistently delivered on capital allocation and strategic initiatives.
- May be less dependent than other banks on rising interest rates, but the benefit of steady growth drives the longer-term compounding of shareholder returns that we seek.

Other areas in the financials sector that exhibit these consistent growth characteristics include data providers like the London Stock Exchange, S&P Global, and CME. They have platforms that clients depend on and are difficult to replicate. Significant revenue is driven from subscriptions, which are recurring and frequently increase annually, with clauses that provide a natural hedge against inflation. Data needs and, increasingly, analytics will likely continue to drive growth for these companies well into the future. Regulatory risks are present, but are lower than for the wider sector. As long as these dynamics are in place, which sustain the high CQ scores, and valuation is not excessive, we expect to realize the benefits of compounding growth with these investments.

Industrials Sector — Opportunities in Any Cycle

Within industrials, many companies have business models with relatively long-term attributes and excellent management teams. Solutions orientation, recurring service revenue contracts, oligopolies, etc., which all translate into pricing power, are some of the shared characteristics. An illustrative example is United Rentals (URI), a US company with high cyclical exposure, but one where we had a differentiated view relative to consensus.

Our research identified a long-term trend toward outsourcing of industrial equipment that the market viewed as cyclical, and thus undervalued the business model's evolution. Key attractions for us included:

- Renting, instead of owning, utilizes less capital for companies and avoids maintenance and obsolescence — United Rentals could drive higher utilization rates of the equipment through centralization.
- Industry consolidation has been led by URI and a similar UK-based company, Ashtead, who enjoy the benefits of being the dominant two players:
  - Equipment purchasing power increased as their businesses grew.
  - Diversification of regional and end-market exposure helped them to move products through their network to where they were needed most.

While high leverage was a concern reflected in our CQ framework, we had confidence in two countercyclical defenses. During downturns, less investment is required in the rental fleet, thus increasing cash flow, while weaker players would be shaken out of the market, ultimately leading to greater consolidation and scale. This, combined with the potential to increase rental penetration rates instead of owning, underpinned our confidence that the business was less cyclical than the market perceived, a view that was proven correct over subsequent years.

Conclusion — Disciplined Investment for Superior Returns

By scoring business models through our CQ Framework, we can compare business models across the globe in any sector. If sustainable growth trends can be identified in cyclical companies, such that their CQ scores, combined with attractive valuation, compare favorably to other sectors, we will allocate funds accordingly. By identifying the best combination of quality, sustainable growth and reasonable valuation, we believe we can deliver superior, consistent investment returns in various market environments. Even this one!

Company	**First Republic Bank**	**SVB Financial Group**	**Ashtead and United Rentals**	**Martin Marietta**
Sector	Financials	Financials	Industrials	Materials
Description	A US bank and wealth management company, catering primarily to high net worth segments in large cities on the west coast and northeast. Rare opportunity for secular growth in bank sector.	A commercial bank that serves emerging growth companies and the venture capital industry. Unique bank leveraged to the secular growth in the innovation economy.	Equipment rental companies, which operate networks of locations primarily in North America as well as the UK. Dominant top-two players in fragmented US equipment rental market.	Produces aggregates (crushed stone) for the construction industry. High quality business model with the ability to price above inflation.
CQ Score Highlights	Market Position: 8.0 Management: 8.0 Overall CQ: 7.4	Market Position: 8.0 Management: 8.0 Overall CQ: 6.8	Market Position: 7.4 (Ashtead), 7.2 (URI) Management: 7.7 Overall CQ: 7.2	Market Position: 7.8 Management: 8.0 Overall CQ: 7.3

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ID436900-3507281.1.1.GBL.RTL 0321
Exp. Date: 04/30/2022