Understanding investing: equity selection

A guide for charities

Rathbones
Look forward

The value of investments and the income from them may go down as well as up and you may not get back your original investment. Past performance should not be seen as an indication of future performance.

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An overview of how Rathbones analyses and selects potential equity investments for its charity clients and strives to avoid the permanent loss of capital.

Selecting equities is a vital component of the overall investment process. Selected carefully, equities can be the growth engine of a charity's portfolio over the long-term – potentially delivering returns above the rate of inflation and offering growing dividends where appropriate.

However, as equities are one of the more risky and volatile asset classes, trustees need to ensure their investment managers use a robust and structured framework to help analyse and select the right companies for their charity's investment strategy.

At Rathbones, our investment analysts and managers research the overarching trends and themes that influence company and market performance and use a combination of fundamental, valuation, quantitative and qualitative analysis techniques to select and review equity investments.

As part of this process, a charity's investment management team needs to consider whether a company is a 'great' company, whether it offers value as an investment, and whether it displays any of the key risk factors that could lead to permanent loss of capital.

Determining the quality of a company

Good investment returns often come most consistently from purchasing shares in great (good or high quality) companies. A great company is generally one that can generate, sustain and ideally grow high returns on capital over the long term.

Determining the quality of any potential equity investment involves understanding a company's fundamentals and possible business risks, as well as its financial health.

Analysing the quality of the company and potential business risks

Companies that have a strong brand, significant market share, pricing power, technological edge, ability to innovate, good environmental, social and governance (ESG) credentials, a management team with a good track record, and a high or growing return on capital tend to represent good business quality and lower business risk.

Performing an in-depth analysis of a company's marketplace and competitive position is an essential component of establishing how strong and sustainable its business model is - now and for the future. This involves assessing the attractiveness of the company's products or services, understanding the business's bargaining power relative to its customers and suppliers, and analysing its vulnerability to potential new entrants and substitute products along with the level of competitive intensity it faces.

Analysing a company's financial health and financial risk

Before investing in a company, our investment analysts use a number of measures to assess what financial leverage the business is carrying and whether this is appropriate for the type of business. This includes reviewing various obligations that the company might have over and above financial debt, such as lease, rental and pension payments. It's essential to check that a company is able to cover its debt through earnings and assets.

A range of metrics also help our teams to evaluate the quality of a company's earnings power and to analyse and review its cash flows, return on assets and capital and the growth in invested capital.

These analyses provide insight into how efficient a company's operations are, how successful the management's capital allocation decisions are, and its potential for future growth.

Determining the value of an investment opportunity

Today's market offers numerous excellent examples of great companies – many of which have demonstrated incredible resilience and the ability to innovate and respond to consumer and market trends and challenges. However, it's crucial to remember that a great company doesn't always translate into a great investment.

Various factors surrounding the valuation of a company and investor sentiment help to establish if it is a good investment at any given time. But determining if an equity is valued appropriately is arguably the trickiest part of investment analysis.

As such, it's important to consider a company's current valuation relative to its future projected earnings, future cash flow, growth prospects, history and peers. The growth trajectory that a company can enjoy is a crucial determinant of its future profitability and, therefore, its current value.

These analyses help determine whether an equity represents good value and is potentially a good investment opportunity. They can also help identify if an equity is expensive and reflective of high investor expectations. Expensive equities can lead to higher risk over time if the underlying business doesn't meet investor expectations, regardless of the quality of the company.

Thematic growth drivers also play an important role in establishing which equities might benefit from growth in their sectors. Our investment teams conduct analysis to identify promising investment themes that may generate good market performance. For example, technological evolution and climate change are currently emerging as areas with significant growth opportunities, while understanding how the capitalist system is evolving has highlighted useful insights around the development of taxation, deglobalisation and the role of the state within the economy. This research can also identify anti-themes and those sectors and companies more likely to face risks and headwinds, such as oil, office real estate, high street retailers, tobacco and traditional media.

Understanding risk and avoiding permanent loss of capital

As part of developing a charity's investment strategy, the investment managers will discuss investment risk, which focuses primarily on the volatility of various asset classes and their correlation with each other. However, when it comes to equity selection, volatility is less relevant – the real risk is the threat of permanent loss of capital.

As mentioned above, the three main sources of risk when selecting equities include the quality and sustainability of a company (business/ESG risk), its financial health (financial risk), and the risk of overpaying for shares in that company (valuation risk). Our investment teams use this triangle of risk to look for companies that score well on all three.

However, within these sources of risk, certain factors are more likely to derail the investment case and lead to the permanent loss of capital. These include a sensitive operating leverage, accounting fraud, ESG concerns and disruption of the 'economic moat'.

Operating leverage is the relationship between a company's revenue and its costs. It indicates how sensitive a company's profits are relative to changes in revenue. In the correct environment of anticipated growth, a high operating leverage can drive strong returns. But in a downturn, the tide can go out very quickly. Companies with high fixed costs, high levels of debt and shrinking revenue can represent a greater risk.

Accounting fraud has the ability to create a very quick permanent loss of capital and potential zero value outcome for investors. Red flags include poor earnings quality, shifting future expenses, boosting income with one-time gains, a frequent minimal difference between profit and cash or a poorly composed board.

A company's ESG credentials are becoming increasingly important to investors. Assessing how a company scores on an ESG matrix is now crucial to understanding its outlook and possible risks in relation to its response and management of environmental, social and governance issues.

We are experiencing one of the greatest periods of technological change in living memory, which is disrupting the economic moats of all companies across all industries. To this we can now add the pressing climate change agenda and the many changes accelerated by the coronavirus pandemic. Understanding the distinct advantages that a company has over its competitors that allows it to protect its market share and profitability is imperative to being able to notice the warning signs that might lead to permanent loss of capital.

Recognising when to sell

Most investment managers agree that one of the most difficult things to do is to know if, and when to sell an equity. Sometimes a sell decision is obvious, as with accounting fraud or when there are signs that an economic moat is about to be undermined, but more often this happens gradually and it's not always clear if a share price fairly reflects a company's value.

To bring some discipline to the sell decision, Rathbones uses a defined process, called 'the suspect screen'. This helps to review underperforming securities and ensure that the investment thesis has not changed. All equity holdings are screened monthly and those that underperform their index and have seen downgrades are flagged. Any holding that is flagged for three consecutive months is designated a 'suspect' and must be reviewed, and an investment case must be submitted to the Rathbones Equities Committee.
We also review holdings when a significant event occurs, such as a major acquisition, to ensure that the equity is held for genuine conviction rather than inertia.

The fundamentals of investing

This guide accompanies one of our charity investment training webinar series: Equity selection. You can watch the full webinar by following this link.

Our training webinar series is designed to provide trustees and senior finance staff with an understanding of the fundamentals of charity investment as well as highlighting their responsibilities.

Please visit:
rathbones.com/charities to find out more about the training series or to read our other guides.

To find out more about Rathbones' approach to portfolio construction and investing for charities, please contact:

Natalie Yapp
natalie.yapp@rathbones.com

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rathbones.com

@Rathbones1742

Rathbone Brothers Plc

@Rathbonesplc