NOMURA ASSET MANAGEMENT U.K. LTD.

Nomura's Global Equity Team on Capital Reinvestment

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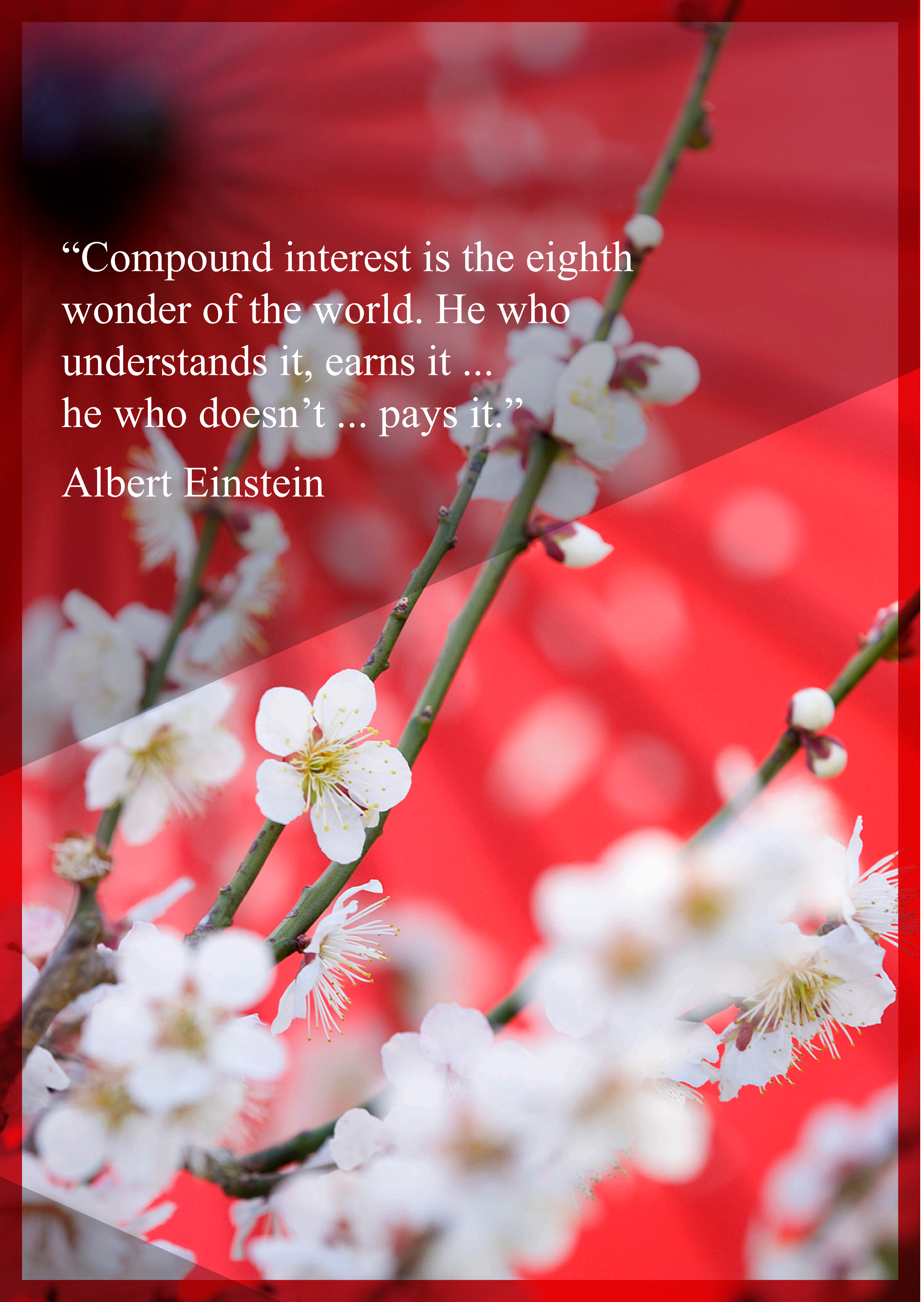

There is a mathematical series, well known to man, but often misunderstood. It is at the heart of the concept of "long term investing", but investors often act counter to its mathematical laws. The mathematical series is geometric, but commonly goes by the name 'compound interest'. The passage of time magnifies its impact on investment results, amplifying profits and making losses hard to recover from. It makes repeatability and the avoidance of substantial declines in investment values key components of a long term investment strategy. Our investment process is designed with this in mind. We look for "Quality at Discount Valuation" and with this philosophy we aim to repeatedly find investments that are priced too cheaply and are unlikely to irreversibly decline in value.

This note is part of a series that looks at our definition of "quality", which may differ from other investors. We aim to invest in 'at least decent' quality companies according to four key quality characteristics. This note looks specifically at the importance of attractive returns on capital and the opportunity a company has to reinvest.

***Quality:* Strong competitive advantages, consistent cash returns to shareholders, skilled management, a history of attractive returns on capital and the opportunity to make attractive reinvestments are characteristics of "quality" companies. These companies can often sustain their returns for longer than the market recognises or are less likely to experience irreversible declines in profitability.**

What is the point of a corporation? Perhaps we should start by inverting the question. What is clearly not the point of a corporation? To excessively damage the environment, treat its employees unfairly, disregard society at large, invest in or develop products people don't want to buy, operate inefficiently, excessively reward senior management or eventually go bust. So reverting back to the original question we suggest that the point of a corporation is to sustainably create value in a way that can be fairly distributed among its many stakeholders. Unfair value distribution now is likely to disrupt the company's ability to create value in the future. Of course your perspective on what is a fair share depends on your 'worldview', but as responsible investors we clearly believe that the value should be shared and that that shareholders (the owners of the corporate) should feature prominently in the sharing process.

Corporates that are able to create significant value are therefore our favoured investment candidates and that value creation capability is encapsulated as "a history of attractive returns on invested capital and the opportunity to make attractive reinvestments". What an attractive return is, however, is a question with no easy answer. Over the past 25 years the S&P500 has produced a total return of roughly 9.7%, the FTSE100 7.3% and the STOXX Europe 600 index 8.2% (all nominal and in USD terms) so perhaps the threshold depends on where you are but also who you are. As long term global investors we would say 13% clearly is attractive and 3% clearly is not, hence the attractiveness threshold for us, is somewhere in between. We think of the attractiveness threshold as a personal opportunity cost of capital, which for the average equity investor is probably in the range of 7-9%, based on historic stock market returns. But it could be very different for an individual depending on the returns available on their alternative investment opportunities. Sticking with 7-9% as a generalised threshold for attractiveness, we might say that the "point" of a corporation is to grow book value per share over the long term at a rate of above 7-9%, if that is possible, because this is an attractive rate of value creation. An attractive rate of value creation means there will be plenty of value to share out to employees, customers, society at large, the environment and, of course, shareholders. Why do we say "if possible"? If a company is not able to make attractive reinvestments, let's say only 3% returns on capital are available, then it should not make them and, instead, return the cash, it would otherwise have invested, to shareholders. If it does not do this then the rate of book value growth will slow to unattractive levels and there will not be any excess cash. If it does the rate of book value growth will still slow but there will be cash available to invest elsewhere, to create value elsewhere. Management need to be wise enough to know the difference between reinvestment and attractive reinvestment.

Let's imagine a pie maker and a pizza maker start separate businesses with the same starting capital of £10,000. The pie maker is lazy and his pies are quite frankly average, but the pizza maker works smarter and harder and makes the best pizzas in town. When counting their profits at the

end of the year the pie maker made £500 (a 5% return on invested capital) and the pizza maker made £1,000 (10% return on his capital). Both companies decided to expand and reinvest all their profits into the businesses, and this continued for many years while still earning the same return on investment as they did in their first year. In 15 years' time the compounding effect of returns means the pizza maker will be making a profit of £3,800 in year 15 versus the pie maker at £990 (3.8x more annual profit!). Furthermore as the profits reinvested have been larger for the pizza maker he will be a larger company with more stores and equipment than the pie maker. In fact on a book value basis (total capital invested in the business over the last 15 years) the pizza maker will be twice as large with a value of £41,800 versus the pie maker at £20,800. While the pie maker probably had some fun making pies, he would have been better off investing his capital in the stock market and taking a job with the pizza maker.

Disentangling "attractive returns and the opportunity to make attractive reinvestments" from our other characteristics of quality companies is difficult, if not impossible, to do. Inherent competitive advantages and management decision making contribute to the creation of attractive investment opportunities which management can then choose to take or not. If management repeatedly make poor decisions then the number of attractive investment opportunities will dwindle, but on the other hand strong competitive advantages as a starting point makes management less likely to choose unattractive investment options (because most opportunities are attractive).

Ross Stores is a US discount retailer, selling designer clothes, accessories, footwear and other goods at prices significantly discounted to normal retailer prices. It does this by purchasing excess inventory from manufacturers at low prices and by operating in low cost locations. Focusing on the financial performance, Ross Stores has produced a return on equity capital of 22-48% over the past 10-15 years, so despite buying back significant amounts of stock from 2008-2018 it has grown its book value at a compounded rate of around 12%, which is definitely attractive, and its share price increased at a compound rate of 26-27%. The stock price has risen faster than book value per share because the price/book multiple has expanded, which reflects reduced interest rates (making stocks look relatively more attractive) and recognition by the investors that the company is making attractive reinvestments and creating value at an increasing rate. The company has increased its number of stores from 890 in 2008 to 1,622 in 2018 and increased its number of employees from around 39,000 to almost 83,000 over the same period, which is good news for employees and the society at large. So with a track record of attractive reinvestment Ross Stores has created a bigger value pie (pizza), to the benefit of many stakeholders.

On the other hand STMicroelectronics is a French-Italian electronics manufacturer of a wide range of microcontrollers, sensors, amplifiers, and other electronic components for a variety of end markets (e.g. automotive). The company has earned a return on equity capital of between -14% and 17%

over the past 10-15 years, but the 17% not the -14% was the anomaly. Such unattractive returns have not stopped the company reinvesting (even though some years there is no profit). Despite the reinvestment the book value per share actually shrank over the past 10 years at a rate of roughly 5.5% per year and until it rallied in 2017 the share price had actually fallen over the preceding 10 years. After 10 years of restructuring STMicroelectronics was finally able to benefit from increased demand for sensors in smart phones and cars and this caused the stock price to rally strongly in 2017, but even so Ross Stores has produced a hugely superior long term investment return. In addition the efforts to resuscitate the business, over many years, has seen STMicroelectronics close sites around the world, to the obvious detriment to employees and their communities. We would contend that customers probably took too great a share of any available value delivered by STMicroelectronics products, which caused the low returns and less than sustainable situation for the company.

So here we have a model of the investment mechanism inherent to the companies we like to invest in and the other notes in this series should help complete the picture with an explanation of the other characteristics of “quality” companies. The issue we have not discussed however is the fair price to pay for a share in such a company. Our philosophy is to look for “Quality at Discount Valuation” so we may know what “quality” is, but what is a “discount valuation”? Here we need to refer to our threshold of attractiveness for returns on capital. If a company earns well above this then it seems fair to pay more and if it earns less it is fair to pay less, but how much more and how much less? And for the particularly curious reader, who is wondering why we don’t focus just on the very best quality companies, but rather “at least decent” quality, well that will be a subject of some future discussion!

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