Global Equity Investing in a "Higher for Longer" Regime

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With surging interest rates and an inverted yield curve over the past year, many investors have braced for a rate-driven recession. However, the US economy has proven resilient in 2023. Factors such as expansionary fiscal policy, the prevalence of low-cost fixed rate mortgages, and strong corporate balance sheets yielding significant interest income all contributed to positive economic growth. With inflation still at an elevated 3-4%, bond yields have climbed rapidly into positive real territory. To us, all of this suggests an economy with higher nominal growth and higher inflation may persist for some time, without a "landing" in the immediate future. This paper explores strategies for global equity investing in this new economic climate, and what may lie ahead.

New Regime has Big Implications for Global Equity Investing

Following a decade in which low interest rates provided a rising tide for Global equities, we believe the new economic backdrop will present challenges for certain equity styles.

GROWTH - We believe "aggressive growth" equities, characterized by high multiples and top-line growth, face headwinds from higher discount rates and, in many instances, increased competitive intensity due to enormous amounts of capital deployed into their market in the venture capital bubble of 2020-2021. In our view, industries such as SaaS, electric vehicles, specialized ecommerce marketplaces, and pockets of biotech such as mRNA and gene therapies are facing varying degrees of this issue. Many have been forced into sizeable cost reductions to reduce capital consumption, but are still dealing with elevated compensation costs, and in cases such as electric vehicle manufacturers, punishing input cost inflation. Eventually, we expect these markets will rationalize and create some interesting opportunities. However, many will likely face permanently impaired prospects.

VALUE - Meanwhile, we think lower growth, low multiple, value-oriented equities may be more insulated from discount rate headwinds (except for bond proxy sectors like utilities) but could see margin compression due to inflation in costs without commensurate pricing power. We believe that falling too far down the quality spectrum risks value destruction. Equities are perpetual reinvestment machines, and value creation requires reinvestment at a return exceeding a company's cost of capital. A decade of low inflation and real rates has made this look easy. Rising labor, component, and financing costs have eroded the incremental margins of many large companies – particularly among banks, telecoms, and heavy industry. With ample competitive alternatives, inflation's burden is more likely to fall on equity holders rather than customers.

We believe the path to outperformance over the next decade will require a narrower set of key fundamental characteristics –specifically, businesses with both healthy balance sheets and stable profit streams protected from inflation.

Quality Growth Investing for the Decade Ahead

We believe the most successful approach to global equity investing will be anchored in the long-term growth and compounding of shareholder value, rather than relying on growth in a particular financial metric like top-line revenue or mean reversion on valuation multiples. We find this sustained growth only occurs at companies with at least one of a few enduring competitive advantages.

Durability of Competitive Advantage

DURABLE

Network effects
Low cost producer
IP / Regulation
Brand

FLEETING

Culture
Great management
Better technology
Great capital allocators
Customer-centric

These advantages help drive market share gains over time, and result in consistently high returns on capital. They can also eliminate the need for external financing, often resulting in cash heavy balance sheets. The best brands and lowest cost producers enjoy pricing power in excess of inflation, while inferior brands and higher cost producers can only attempt to pass through cost inflation. Network effect and marketplace models can see faster growth as higher nominal dollars flow through a 'take rate' model. This preserves the companies' value creation engine and allows them to continue investing at exceptional marginal rates of return despite elevated costs.

Equity returns in 2023 have demonstrated the power of these attributes, with growth indices outperforming value indices as rates rose to 15-year highs. The ACWI Growth index has outperformed the ACWI Value index by over 1,500 basis points. And within the US the Russell 1000 Growth has outperformed the equivalent Value index by 1,000 basis points year to date. While the media has attributed this to a few 'top heavy' idiosyncratic equities, it is no coincidence these are deeply advantaged businesses with pricing power, strong control over their cost structure, and reasonable starting valuations that happen to be some of the largest index weights.

Key Drivers of Prospective Returns

In this new regime, we are focusing our diligence on three key areas:

1. **Duration:** With heightened interest rate volatility, we are closely monitoring risk models to prevent any unintended duration bets. We don't want modest incremental changes in rates to be a large driver of relative performance. Moreover, most companies with consistently high incremental returns are insulated by cash heavy balance sheets and we expect will outperform their leveraged counterparts.

2. **Revenue growth and margin structures in an inflationary context:** Wage growth, particularly in 'blue collar' wages, continues to outpace productivity growth. Even if this wage growth is mostly nominal, not real, it tends to be the stickiest source of inflation. We believe select business models can benefit from an inflation-based tailwind to revenue growth against a fixed cost structure. Visa and Mastercard are prime examples as higher wages are spent on goods and services, but most marketplace or 'take rate' businesses should benefit to some degree. Below the top line, there are also clear winners and losers. Counterintuitively, large technology companies that pay workers well have fared the best with this backdrop. Their workers face the least pressure from elevated costs, have strong personal balance sheets, and have enjoyed years of strong wage growth. Contrast this with large automakers embroiled in labor disputes, whose workers took large pay cuts following the 2008-2009 financial crisis, have seen anemic compensation growth since, and are significantly more impacted by higher housing, gas, and food prices. While some attractive companies have large manufacturing labor forces, in particular Airbus and Safran, they benefit from a duopolistic industry structure that has allowed them to pass along these increases to a largely commoditized airline customer base. Western automakers again fail this test as a long tail of foreign competition limits pricing power.

3. **Customer demographics and economic health:** Businesses catering to consumers with strong balance sheets (ex-China so far) should fare better than those with customers getting squeezed by the higher cost of basic needs. Companies like L'Oreal, Lululemon, and best-in-class luxury goods have counterintuitively proven more resilient than dollar stores. This logic also extends to B2B enterprises. Companies serving the biotech industry, where capital markets-driven financing has been highly impacted by elevated interest rates, are firmly in a downcycle while traditionally "cyclical" sectors like travel and energy remain strong.

What Changes in a Slowdown

Eventually, the headwinds from higher interest rates will pressure consumers. Home purchases can only be delayed for so long, vehicles depreciate and must be replaced, student loan payments have resumed, and credit card balances are back to pre-COVID trends. Likewise, years of large fiscal deficits limit the government's ability to mount a typical Keynesian response. The Fed will cut rates, though how quickly is critical and unknowable. We believe this would finally create the backdrop more defensive bond proxy sectors need to outperform, and result in another blow to aggressive growth, as slowing growth drives significant multiple compression. Quality growth will fare somewhere between the two, with consumer and industrial companies underperforming while healthcare would likely be in vogue again. Counterintuitively, we believe many of the largest growth technology stocks can outperform, as they have already gone through a slowdown and emerged with leaner cost structures and lower valuations. In fact, big tech gave a preview of their recession playbook a year ago: immediate headcount reductions, freezing non-compensation costs, and diverting resources into their highest priority areas of growth. Time and time again, large companies with strong balance sheets and deep competitive advantages take market share through recessions and emerger stronger on the other side.

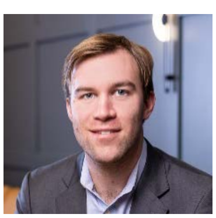
Applying a Quality Growth Framework to Rising Megatrends – AI & GLP-1's

Though we analyze companies 'bottom-up', it is only possible to do so with a perspective on their growth prospects. Large inflections in end market growth can take time to see clearly, but are priced in quickly once the market spots them. We believe that two are emerging currently: generative AI and highly effective obesity drugs.

Read our Assessment of the Opportunities Created by these Megatrends on Page 4

Outlook

Looking ahead, we remain excited about the long-term prospects for our unique set of quality growth businesses and the value creation they can contribute to an investment portfolio. While economic turbulence and technological disruption may drive continued volatility, we believe it will bring opportunities to invest in excellent companies below their intrinsic value. The rapidly evolving economic backdrops and monetary policy regimes of the past few years, despite being dizzying at times, provide a fertile landscape for uncovering investment opportunities.



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Assessing Opportunities Created by AI Adoption

AI has dominated the conversation since ChatGPT's "iPhone moment" in March, followed by Nvidia's massive inflection in growth in May. Every company we have spoken to believes there will be some adoption of generative AI by their employee base over the next few years. Such a unanimous endorsement is extremely rare and a strong indicator, even beyond the near-term trajectory of GPU sales. We would contrast this with the reaction to blockchain technology a few years ago, which was often cautiously optimistic publicly, but appeared highly skeptical or even outright dismissive privately. That said, we believe dramatic claims of impending large-scale unemployment or enormous productivity gains are far-fetched. It will take a long time to improve and implement AI into an enormous number of specialized use cases. This naturally gives companies and workers time to adapt. Much like personal computers made workers capable of far more individual output, AI will augment human capabilities as opposed to replacing the vast majority of jobs. In instances where AI significantly decreases the time and cost of output – such as graphic art or advertising copy – volumes will rise in response to lower prices. The companies and economies most at risk are the ones which resist technology instead of embracing it, with early evidence of counterproductive "bans" enacted by the EU. Which ad agencies will shed more workers in a globally competitive market: American firms embracing the latest AI productivity tools, or European firms prohibited from adopting them? Ultimately, we think the laws of economics will win out and drive adoption. While this won't necessarily lead to an inflection in economic growth, we believe it represents a large opportunity for the technology sector and will form the basis of a new cycle of growth in the semiconductor and software industries over the next few years.

Assessing Winners and Losers from GLP-1 Adoption

Over the past decade, healthcare costs have risen well ahead of inflation in the developed world and skyrocketed in the United States. Though this dynamic has many underlying drivers, two of the largest are an aging population and increasing rates of obesity. While medicine cannot solve the former, a category of drugs developed for diabetes patients called GLP-1 antagonists is shaping up to a be a potent weapon against the latter. The two primary beneficiaries are Eli Lilly and Novo Nordisk, whose success has made headlines globally. However, the economy-wide ramifications could be much greater. Over the next few years, both companies will significantly ramp supply, marketing spend, and development of more potent drugs. If adoption remains robust, these drugs have the potential to reverse a multi-decade increase in obesity, thereby significantly shaking up the healthcare and consumer industries. Some of the most successful large consumer packaged goods and restaurant companies, such as McDonald's, Dominos, Pepsi, and Mondelez have benefited from a less health-conscious consumer. Early survey data shows that GLP-1 patients not only reduce calorie intake significantly, but also shift consumption away from 'junk' foods in particular. With 42% of the US adult population qualifying as obese and a high degree of interest in GLP-1s even beyond that potential patient pool, there is meaningful earnings power at risk. This also may create opportunities, as some businesses may be less at risk based on geographic exposure and product mix. Likewise, obesity causes many secondary health problems that can require medical services ranging from pharmaceuticals to major surgery. Capital that had followed the demand for these products may shift elsewhere if growth in conditions ranging from fatty liver disease to knee replacement is impacted. This also may lead to significant system wide savings despite the oft-cited cost of these drugs. While it is impossible to know what adoption will be in 2030 and beyond, this may be the beginning of the end of a megatrend.