Business quality MATTERS

Magellan's investment edge comes from finding quality businesses that stand the test of time.

Vihari Ross, Head of Research at Magellan

In the future, when you wake up your hot coffee will be ready, the fridge will have reordered your groceries and a drone will already have delivered them that morning. A digital assistant will inform you it's a little chilly outside and summon your autonomous vehicle to take you to the office. While there, you will collaborate in virtual reality with colleagues around the world, as high-speed internet makes the link-up as clear as real time. Later you will go to your friend's 150th birthday party.

This might seem like science fiction, but it is a reality well underway to being created by some of the world's highest-quality businesses such as Alphabet, Amazon and Microsoft.

Those of you who know Magellan will know that our focus has always been on quality businesses. For us this approach makes a lot of sense—by looking only at those companies that we consider have the best economics, we are setting our investors up for better outcomes as well as reducing the risk of material capital losses.

There are thousands of companies listed on world exchanges yet at Magellan we regard our eligible universe of potential investments to be only about 150 companies. These are the businesses that we have deemed to be of sufficient quality to consider for investment, a hurdle that requires a rigorous dive into the economics of the business and the industry in which it operates.

> **"For us, the largest determinant of quality is the presence of an 'economic moat'..."**

But what does quality mean? For us, the largest determinant of quality is the presence of an 'economic moat'; that is, a sustainable competitive advantage that protects the economics of the business and enables it to accrete value for its shareholders over time.

However, it's not just about identifying the existence of such an advantage, but also identifying what are the key factors driving that advantage and how dependent the business is on good management for generating these robust outcomes. Sometimes the truly strong businesses are revealed when even poor management teams are unable to undo their favourable economics!

If, however, businesses can be identified that have strong moats, have sensible management as agents of shareholder capital, possess the ability to invest capital at high rates of return and have predictable outcomes or discernible tailwinds that can be used to build conviction, then we are positioning our lens towards those businesses that are most likely to succeed. This is at the core of what our investment committee process seeks to achieve.

Of course, the subsequent step is to determine which of these stocks is then trading at a reasonable price, and then (subject to portfolio construction considerations, including risk controls) which high-conviction investments will be made at a point in time.

SUSTAINABILITY IN MOATS

The factors that drive an economic moat can be varied and evolving. The business might have a structural or size advantage that enables it to be the lowest-cost producer and beat its competitors on price such as Google can via the return on investment achieved by advertisers on its platform and can Lowe's, the US retailer of home-improvement goods. The business might own a unique brand or franchise that resonates with its customers, conferring it with true pricing power as has French luxury-goods conglomerate Louis Vuitton-Moët Hennessy.

A network effect or two-sided market is another source of moat that is incredibly difficult to unwind. This is evident in the platforms operated by payment networks such as Visa. In this case, the two sides—card users and card-accepting merchants—support the utility of the platform. That is, the more Visa card holders there are, the more vendors want to accept them, and the more places that accept cards, the more people want to use them. This network is self-reinforcing over time: since the first cards were issued in 1958 Visa's network has grown into a business that intermediates more than US$11 trillion in global payments spent via 3.3 billion cards issued by 16,000 financial institutions connected to 50 million merchants worldwide.

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Equally important to this discussion, however, is the question: Are the advantages we have identified sustainable? This is a critical piece of our analysis as our assessment of quality must be forward-looking. It might be tempting to look at history alone and see which businesses have had the best returns on capital over time, but this might prove to be a poor guide as to the business's future.

Identifying quality goes hand in hand with identifying risk. Disruption, though an emotive word, whether driven by changing technology or changing consumer preferences, in reality simply reflects the way people are now and will in future live their lives.

The earliest two-sided markets were newspapers, where greater readership encouraged greater advertising sales upon the limited real estate of the printed page. Only one side of such a market needs to be disrupted for the network to collapse; in this case, as we all know, it was the movement of readership onto online platforms and away from print.

Advantages related to the low-cost labour in certain countries are being disrupted as the cost of capital goods declines rapidly. A robotic palletiser used to move product from distribution centres through to supermarket shelves now costs only US$25,000 compared to US$1 million five years ago. This means that for many multinationals seeking to cut costs, it now makes sense to replace low-cost labour in emerging economies with low-cost capital—a remarkable shift in relative advantages. Unilever, for example, added 1,000 robots to its cohort in the last year and intends to grow this to a fleet of 10,000 in coming years. Nike is investing in localised manufacturing, intending to autonomously produce customised footwear on demand.

And, of course, Amazon has changed the playing field for retailers and goods producers alike in its ongoing drive to lower prices and usurp commoditised brands with its own.

Further, there is indeed a plethora of other disruptive factors at play, including cloud computing, the dominance of social media, growth in on-demand video content, the trend towards health and wellness, and automated manufacturing and advancement in artificial intelligence technology among many others that require careful analysis of the implications for businesses.

It is important to identify whether or not a company will be a winner from these changes, be immune or be threatened and, if the latter, will it suffer a mere speed hump or face an existential threat to the moat around its business? Some of these identified risks might take 10 or 20 years to play out.

At Magellan, this focus on quality businesses such as Alphabet, Amazon, Microsoft and others represents the core of our investment philosophy and goes directly to achieving our investment objectives of absolute returns coupled with capital protection for investors. ▲

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