# GLOBAL Insight

Wealth Management

## Monthly focus

February 2021

# Adding value

Looking beyond financial statements to uncover added investment value.

An interview with Habib Subjally

For important and required non-U.S. analyst disclosures, see page 8
All values in U.S. dollars and priced as of market close, Jan. 31, 2021, unless otherwise stated
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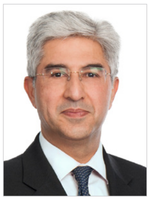
# Focus



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Habib Subjally leads a team of 11 global equity specialists (sector, portfolio and risk management) and has over 20 years of industry experience. Prior to joining RBC Global Asset Management in 2014, Habib and his team spent eight years together at First State Investments, managing global equities. Previously, he held positions at various asset management firms as Head of Small- & Mid-Cap Research, Head of Global Equities and Head of North American & Global Equities Research.

Habib is a Certified Chartered Accountant and holds the ASIP designation with the CFA Society of the UK. He has a BSc (Hons) from the London School of Economics.

# Adding value

In a conversation with Habib Subjally, head of RBC Global Asset Management's global equity investment team based in London, we look at why going beyond financial statements to develop an understanding of how a company's unreported, "contingent" assets and liabilities can be the most important source of added investment value. Many of these "intangibles" fall under the heading of ESG (environmental, social, governance) factors.

**Jim Allworth – There's a widely-held view that because all financial information about every public company as well as most economic and market data have become available instantaneously and simultaneously to all investors, active portfolio management is no longer capable of earning returns better than those delivered by the benchmark indexes. This belief has driven a multi-decade flow into passive investment vehicles that mimic some index or defined component of the market.**

**Yet standing against this view your team has consistently added appreciable value versus market returns. Can you tell us why or how your team is able to accomplish this?**

**Habib Subjally** – The short answer is that we focus a great deal of our effort on understanding the many factors that make a company a sustainably successful business and aren't captured in the financial statements. These are usually difficult to access, and, hence, aren't necessarily understood or even recognized by anyone who hasn't looked at them.

We pay great attention to the reported financial data too. I think our ability to do the most sophisticated, revealing financial analysis is second to none. But there is a limit to what such analysis can tell us about a company's future prospects. And, in a world filled with tens of thousands of CFAs (chartered financial analysts) and MBAs and CPAs it is unlikely we can uncover something through financial analysis alone that would allow us to consistently add investment value.

In fact, short-term financial results can be misleading. For example, a business that eliminates all research and development (R&D) spending will undoubtedly increase its short-term profits, margins, and cash flows. This increase in profitability might be sustained for several years, and during this period any profit-based valuation method will indicate it has become a more valuable business. However, at some point in the future this business will cease to have any new products for its customers. This, in turn, will likely lead customers to defect to competitors and result in lower profits and declining cash flows and, ultimately, a less valuable business. In the long run, financial returns eventually reflect the real value of the business

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but the time lags are considerable and can result in misleading investment conclusions.

Let's be clear, we are only interested in financially strong companies and that can best be determined by close examination of financial statements and results. But we want financially strong companies that bring more than just that to the table. Specifically we look for factors we recognize through experience are likely to give the company a sustainable competitive advantage that will deliver above-average returns to shareholders for years into the future.

The discounted, present value of future cash flows is our primary tool for determining what a business is worth today. That requires us to forecast what those future cash flows will be, an exercise which, in our experience, entails much more than simply extrapolating past performance off into the future.

### JA – How do you go beyond the financial statements?

**HS** – Analysis done by our RBC colleagues reveals that to the extent the percentage price move of an individual stock is different from that of the market index, only about 25% of that difference is explained by changes in the factors financial analysts and most investors pay attention to such as financial metrics, size, country, currency exposure, value, growth, etc. That leaves 75% not explained by these factors that are well reported and closely watched. This provides a significant opportunity for us to add value through security selection.

It would be ridiculous to expect every internet, biotech, or utility company to generate identical performance to all the others in its respective industry. Intuitively we know that each business is different because it has a unique history, management team, strategy, corporate culture, employees, reputation, and brand, among countless other variables. This is what leads similar businesses to have different financial outcomes and different share price returns.

Analyzing these "extra-financial" factors is not as simple as measuring how much a business spends on R&D, employee training and development, environmental safety, and customer care, to name a few examples. It also requires an assessment of how wisely this expenditure is undertaken, and its financial impact. For example, corporate history is full of examples of businesses that spent huge amounts on R&D but did not have much to show for it.

### JA – How do you organize your thinking about these extra-financial factors?

**HS** – We adhere to a straightforward over-arching principle: businesses with strong competitive dynamics generate considerable economic value over the long term—poor businesses destroy it. When you look at the forces that drive competitive dynamics (see table below) you realise that all are largely determined by intangible factors that can only be uncovered and assessed by a deeper understanding of a business that goes well beyond what can be revealed in financial statements and short-term results.

### Competitive dynamics

| | |
|---|---|
| **Business model** | The unique element that gives the business a sustainable edge over competitors |
| **Market share opportunity** | How effectively a winning business model will take market share |
| **End-market growth** | A winning business model should be exposed to growing end markets |
| **Management & ESG** | Management that makes the right strategic decisions and operates in a responsible and sustainable manner |

Source - RBC Global Asset Management

Forecasting how a company is likely to fare in the future requires having a well-supported view about to what degree it possesses and can manage these intangible elements.

**JA – I notice you regard ESG (environmental, social, governance) factors as a competitive force. These are factors that weren't talked about a decade ago and, even now, they are generally regarded as hurdles a company has to clear rather than a positive element of competitive advantage.**

**HS** – When "social" factors first came on the investment scene it was in response to a growing number of investors saying, "I don't want to own the shares of a company that produces or is the source of something that runs counter to my personal values."–e.g., alcohol, tobacco, pollution, etc. In its much enlarged ESG form, it is still viewed by many as a way to determine what not to own—that is, as a way to keep a portfolio out of trouble, if you like. And that is certainly one role for it.

But we think these factors offer a great way to uncover investment opportunity. Over decades of conversing with owners/managers of highly successful businesses, we know that these factors are frequently cited as the prime driver of business decisions and direction.

For example, many of these highly successful businesses see employee engagement as their key to success, and they have developed ways of measuring, monitoring, promoting, and sustaining it. For others it may be customer satisfaction driving the bus or research-driven innovation. For almost no successful business is inertia the prime driver of success, which is what would be implied by simply extrapolating past results into the future.

We have considered ESG factors from the outset because in our experience they are a key driver of excess investment returns. Companies that intentionally promote high levels of employee engagement, care about customer satisfaction and can track it, have constructive relationships with their suppliers, and can understand and manage the environmental impact of their business, products, and suppliers are very often more effectively managed on all fronts.

ESG also drives important risk mitigation with respect to regulators, reputation, the stability of supply chains, etc. For example, a company that has developed an understanding of the potential impact of climate change on its end markets, suppliers, employees, and facilities—and has a plan for dealing with it—is, in our view, a less risky investment than one that hasn't.

If management has correctly identified employee engagement as one of its key success drivers, and intentionally works to build that engagement and maximise its value in the operation of the business, then, in our view, it is accumulating an important "contingent asset"—one that could quite conceivably be the most important asset it has but one that is not recorded anywhere in the financial statements. Conversely, a business that devalues its employees, suffers from high turnover, and is unable to attract needed talent, becomes more likely to suffer operational failure. Over time this builds a "contingent liability" that also may be hidden from general view.

### Extra-financial factors determine long-term shareholder value creation

| **Weak** ESG/business practices | |
|---|---|
| Colleagues | Lack of training, unsafe working conditions, high turnover |
| Customers | No returns policy, poor product labelling, systematically over-charging |
| Suppliers | High reputational risk, lack of audit, weak quality-control procedures |
| Environment | Pollution, high-cost carbon reserves, excessive water usage |

Contingent liability

Contingent asset

| **Strong** ESG/business practices | |
|---|---|
| Colleagues | High level of engagement, strong corporate culture, innovation encouraged, R&D investment |
| Customers | Responsive to needs, convenient opening times, effective dispute resolution |
| Suppliers | Timely bill payment, efficient production planning, good traceability |
| Environment | Effective emissions control, sustainable sourcing practices, renewable energy usage |

Source - RBC Global Asset Management

Assets can be drawn on and are a source of return and corporate staying power. Liabilities come due and payable, often at inopportune times and can even capsize a business. Identifying both is an important source of adding value for the investor.

**JA – In addition to the ability to analyse a company's future prospects in the way you've described, this approach sounds like it also requires some degree of investor patience.**

**HS** – Yes, for sure. The scale and time horizon over which these extra-financial factors impact corporate and financial factors is not clear. It's hard to estimate to what extent poor culture will impact future corporate profits and when this will become apparent. As active investors we have to accept this temporal uncertainty.

**JA – So, I take it you would be a strong advocate of active investment management over passive?**

**HS** – Well yes. I guess that's obvious. But look, any well-considered investment strategy has its place. However, passive investing almost by

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definition means accepting the bad with the good. Passive investment vehicles are designed to mimic a broad index or a sector or some sub-set of stocks that meet a pre-determined set of standards derived from financial statements and maybe market prices—all factors that are well known.

Active management, at least so far as I can speak for how we do it, implicitly is forward looking and requires that one do the work to identify those companies likely to add value over the long term as distinct from those likely to destroy it.

And, of course, even then there is the question of value. A topic we haven't really touched on. It's possible to pay too much for a great business.

**JA – Sounds like another conversation Habib. Thanks for this one.**

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As of December 31, 2020

| | | | Investment Banking Services Provided During Past 12 Months | |
|---|---|---|---|---|
| Rating | Count | Percent | Count | Percent |
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| Hold [Sector Perform] | 615 | 40.73 | 166 | 26.99 |
| Sell [Underperform] | 67 | 4.44 | 12 | 17.91 |

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