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On diversification, sustainability and competitiveness...

An interview with portfolio manager Benjamin Moore on investing in Europe, how he goes about looking at companies, and the events of the past 10 months

You have a focus on finding exceptional businesses. What do you mean by that?

We look for three key characteristics: first, growth through the cycle – we need to be confident that the company will be bigger in five years; second, returns on capital – attractive business economics, and a management team that allocates capital effectively; and finally, a sustainable competitive advantage – the company's economic moat, what form competition will take, and how the company can withstand it. This is the most important factor as it will define the durability of a company's long-term growth and returns.

How do you identify a company's competitive edge?

We spend most of our time on this question, and the answer is always nuanced. Several frameworks help us: we look at Professor Michael Porter's Five Forces to understand the competitive dynamics of an industry. We also assess specific sources of competitive advantage such as brand power, switching costs, scale benefits – Morningstar has produced a very interesting structure here that helps our analysis.

We try to get into the mindset of the customer and understand their decision-making process. If you go into a bar and order a Negroni cocktail, the barman will inevitably use Campari[1] to make it. Campari has defined the Negroni since the cocktail was invented more than a century ago; they have a secret recipe, and a brand that has been nurtured for more than 150 years. So it would be incredibly difficult to persuade that barman to use something else in its place. And this in turn gives Campari strong pricing power and attractive economics.

Sustainability is another term that is popular nowadays – but a lot of people understand it to be an environmental, social and governance (ESG) concept. How do you resolve this?

As long-term owners we need be comfortable that the companies we hold are managed well. This means they are not abusing their key stakeholders and are not damaging the environment, neither of which would be a recipe for long-term success. Our quality filter has led us to avoid the more capital-intensive, pollutant industries for decades – because we are not comfortable with long-term environmental implications, but also because the economics are often unattractive.

How do you think about governance?

Culture is intangible but it is one of the most important aspects of a business. There is a temptation to think about "exceptional businesses" in abstract terms, but in reality companies are in a constant state of evolution. There are thousands of decisions being taken every day, and much of a company's long-term success will come down to how these decisions are taken. So, once we are comfortable with the economics of a company and its competitive position, we focus on understanding its culture and the quality of its people. Management incentives must be aligned with our clients', and we want a breadth of talent and insight within the organisation. This is why governance is so important to us.

Some of the most critical decisions are around capital allocation: what to do with the profits generated each year. For example, on top of Campari's attractive economics, the management has invested these profits very effectively. They have acquired new brands which they have nurtured and grown – including a little aperitif business from the north of Italy called Aperol, now double the size of the Campari brand!

How do you manage risk?

I'm constitutionally risk-averse. So while a concentrated fund may appear risky, for me the biggest risk is the companies themselves. The quality of the businesses we own is our first line of defence; knowing them intimately helps us mitigate risk.

Diversification is also key – we invest across a range of different sectors and industries. But there are some sectors where we find few ideas that fit – often capital-intensive industries where products are undifferentiated or regulated, like utilities or banks.

Some argue that it is risky to avoid certain big companies or sectors as this leads you to diverge from the index, but from my perspective the index itself is risky, because it contains so many businesses with economics that are mediocre or worse!

What are your thoughts on growth versus value?

I am not convinced that the distinction is particularly helpful, but I'll frame the answer in two ways: first, the question of cyclical versus defensive companies; and second, how we think about valuation.

Low volatility does not automatically mean high quality for us. Because our focus is so long-term our approach can weather volatility – so we don't rule out cyclical businesses. Take Sika, for example. It is a Swiss company that makes chemicals for the construction industry – its products transform the economics of building projects and also help the environment (as they save time and water usage). Sika is exposed to the construction cycle, but it also has clear growth drivers in any environment as buildings become more sophisticated. Its business model is asset-light and it has a strong brand and an outstanding culture – so it's a good example of an exceptional cyclical business.

Turning to valuation: an exceptional company doesn't necessarily make an exceptional investment. When we buy a business we think about our potential return in terms of the cashflows it generates relative to the price we pay. So while we won't compromise on quality, we are very valuation-sensitive. It's a constant competition for capital in terms of what goes into the fund and how it is weighted.

What has 2020 and Covid-19 taught you?

2020 has taught me an immense amount. If I were to pick one thing it would be the valuable reminder that bad things happen (Forrest Gump expressed this more memorably!). But as Howard Marks says: "You can't predict. You can prepare." We can't predict exactly what will happen or why, but we can be prepared – by focusing on businesses that are strong enough to survive sharp shocks.

So our approach hasn't changed at all – if anything we have more conviction in the importance of finding exceptional businesses that can weather the storms along the way.

[1] Mention of specific companies should not be taken as a recommendation.

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