NATIXIS INVESTMENT MANAGERS

MARKET INSIGHT

The HUB

NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

Consistency trumps cool in the search for alpha

It may not be fashionable, but focusing on downside protection can help beat the index

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Investor behaviour responds to emotions. That is particularly true of retail investors, but also applies to the institutional world. Even sophisticated investors can be swayed by market gyrations and can over-react to positive or negative trends.

If investors can rely on more consistent returns, with lower volatility and fewer shocks, they are more likely to act rationally over both short and long time horizons.

Consistent returns can be achievable by focusing on high-quality companies with growth potential and therefore less likelihood of sudden value loss. If investors also meaningfully engage with those companies and incorporate ESG measures into their assessment of them, downside risk is further reduced.

Honing consistency

IML, an affiliate of Natixis Investment Managers, has spent the last 25 years honing a process which produces this kind of consistency.

IML trains its sights on ASX-listed companies which have a clear competitive advantage and which invest to maintain and extend that advantage. "With these kinds of companies, it is much easier to forecast the value they will create, so the risk of getting things wrong diminishes," says Daniel Moore, portfolio manager at IML.

The companies Moore and his colleagues target typically have a highly-experienced and passionate management team which is aligned with shareholders over the long term.

It looks to buy the companies at a "reasonable price". Moore says: "That doesn't necessarily mean a low PE, but a low price relative to our definition of quality. We are willing to pay an above-average multiple as long as the quality is above average too."

It's a conservative approach, which focuses as much on minimising downside risk as on seeking upside.

How downside capture boosts portfolios

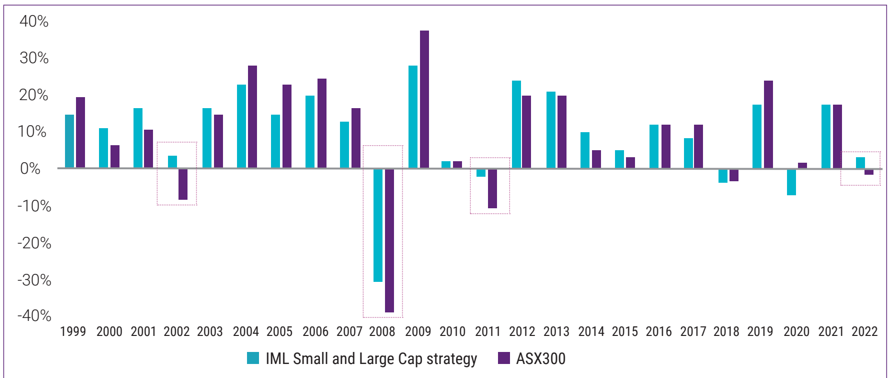
Depuis un quart de siècle, IML est
For a quarter century, IML has been recognised for its market-leading downside capture ratios. "This is IML's hallmark; it has been doing this for 25 years and is a major reason IML's flagship large and small cap strategies have outperformed the index over that time," says Louise Watson, Natixis Investment Managers' head of Australia and New Zealand.

The downside capture ratio for IML's flagship strategy, is 65% (as at 30 June 2023)[1], meaning if the ASX falls 10%, the portfolios of IML investors decline by only 6.5%. The protection is evident (below) during all of the major market declines of the last 20 years.

Key takeaways:

- If investors can rely on more consistent returns, with lower volatility and fewer shocks, they are more likely to act rationally over both short and long time horizons.
- IML focuses on minimising downside risk – investing in companies with a clear competitive advantage and employing active ownership to ensure boards create, not destroy, value.
- ESG is part of its rigorous fundamental analysis: IML invests in companies with lower ESG scores as long as they are on a pathway to improvement and have a fully-capitalised plan to reduce emissions.

1 Source: IML, September 2023. Past performance is not an indicator of future results.



Past performance is not reliable indicator of future performance. As a 31 December 2022; returns net of fees

And downside protection does not come at the expense of capturing market upside. Upside capture in IML's flagship strategy is some 83% and the standard deviation is 11.1, compared to 13.5 for the ASX index overall (at 31 December 2022).

"Downside protection is really important for long-term returns mathematically," notes Watson. "If your portfolio falls 50%, you need it to return 100% just to get back to where you were."

Downside protection is also paramount for investors close to retirement who are still invested heavily in stocks. "In Australia, the Great Financial Crisis pushed out retirements by three to four years on average," she adds.

Active ownership can prevent erosion of value

Performance can be further enhanced, IML believes, through active ownership. "Active ownership is another area we are known for," says Moore. If companies fail to act in the best interests of their shareholders, IML is not afraid to act and steer boards in the right direction.

Over 200 letters to company boards over the last couple of decades are a testament to this.

"We have achieved some great outcomes," adds Moore.

Outcomes include preventing companies from making poor acquisitions, ousting underperforming chairs and CEOs, changing the composition of boards, opposing remuneration structures and proposing demergers and sales of businesses. Boards are challenged on their CSR policies too.

Engagement adds value for many asset owners, including Australian superannuation funds, which are relatively new to realising that they have a seat at the table and can agitate for change.

Moore says: "Asset owners are realising that stocks are more than a line item, they indicate your economic interest in a company and confer the right to vote in the long-term interests of all shareholders."

IML's engagement usually starts with meeting companies and engaging directly, right through to formal letters to the board, where an issue will be minuted and therefore opened up to public scrutiny. "That usually focuses the attention of boards," Moore says.

One of the keys to successful engagement, Moore says, is to ensure communication is evidence-based. To strengthen its case and resources, IML may collaborate with like-minded fund managers and asset owners.

Engagement in action

IML has managed to extract significant additional value over the years through its extensive engagement activities.

These include convincing Ansell, a personal protective equipment maker, that it was trading well below IML's estimate of fundamental value. One way to crystallise that value was by selling Ansell's condom division for a high multiple of its earnings. The whole company had previously traded at a modest multiple. The sale proceeds were used for a year-long buyback program, after which the market substantially rerated Ansell.

Another successful engagement program was focused on Tabcorp, a gaming company which had separate betting and lottery businesses. The lottery business had grown its earnings over a multi-year period and was considered by IML to be the jewel in Tabcorp's crown.

"We assessed that the lottery business was worth more than the whole company," says Moore. The other business was losing market share and because it facilitated betting, ESG-conscious investors were not investing in the company as a whole.

A two-year battle with the chairman ensued, with IML leading a group of fund managers to demand the lottery business was demerged. The day of the demerger, the two demerged companies were immediately valued at a combined 8% more than when they were as a single entity and carried on rising afterwards. As of 28 July, they were worth 20% more.

ESG: focus on real-world impact

ESG analysis forms part of the downside protection armoury and is embedded in the investment process.

Moore says: "Our investment checklist for companies includes a major ESG component." ESG is part of the quality scoring of a company alongside the franchise, management and financials, as can be seen on the next page.

If the ESG score is low, the company will be excluded or the investment case report will require a detailed section arguing why the stock should still be considered.

IML will invest in companies with lower ESG scores as long as they are on a pathway to improvement and can demonstrate that. Moore says: "If we only include perfectly green companies, we are not helping to lower emissions, which is essential to real-world ESG impact."

IML prefers, companies with a concrete, fully-capitalised plan to reduce emissions or their carbon footprint, and this plan should be linked to the remuneration of the management teams.

AIM: To rank stocks based on the analyst's assessment of a company's:

- Franchise/competitive position
- Management
- ESG
- Financial strength

Scoring is based on ten factors with a score range of 4-20

Score range	Quality
>13.5	Very high
12-12.5	High
10-12	Average
8.5-10	Low
<10	Very low

FRANCHISE	MANAGEMENT	ESG	FINANCIAL
Competition & Bargaining Power	Operational Execution	Environmental	Balance Sheet
Capital Intensity	Capital Deployment	Social	Transparency
Exogenus	Alignment	Governance	Earnings predictability
Total Score out of 5	**Total Score out of 5**	**Total Score out of 5***	**Total Score out of 5**

Staying the course

It may not be fashionable in a world where many investors like to identify new and emerging trends, but capital growth allied to downside protection, consistent income, and low volatility is a proven way to grow a portfolio over the long term.

It's unflashy and will underperform the market in some periods. But over the long-term, it's a formula that helps reassures investors in times of volatility and keeps them invested throughout the cycle. It is instructive that, over the last 40 years, the S&P 500 has delivered median returns of 15% the month following the end of a bear market.

Moore says: "Investors tend to sell when volatility is extreme and that's historically the worst time to sell. Our aim is to invest conservatively so that they will stay the course."

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