

# Seeing Further in Changing Times

The Future Quality Approach  
to Global Equities



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## Key Themes

## Chapter 1

# Seeing further: achieving Global Equity success through quality ingredients



# Seeing further: achieving Global Equity success through quality ingredients

Any top chef will tell you that the secret to culinary success is to use the best ingredients. Higher-quality produce often have more natural and intense flavours, making the final dish taste better. So, two cooks following the same recipe could result in differently tasting dishes simply because they didn't use the same ingredients.

## High-quality investment ingredients

This analogy also applies to investment. A simple recipe for active managers in the global equity space has three central ingredients: **Trust, philosophy and discipline**. However, variations in the quality of those ingredients can result in vastly different outcomes over time.

Firstly, when choosing an actively managed strategy you're choosing to trust people rather than machines or algorithms to make the investment decisions. Great investment teams do not come together by accident. They are facilitated by a supportive business culture that enables people to work efficiently and well together, and that can also attract new talent. Quite simply, to stand out from the crowd, you need a trusted, high-quality team and a supportive culture.

As much as fund managers look to the past to inform their views of the future, it is important to acknowledge that each cycle is slightly different to previous cycles – history doesn't tend to repeat itself but it often rhymes. When presented with unexpected market, economic or even geopolitical scenarios, a good fund manager needs a bedrock of strong principles for investing they can go back to irrespective of what is happening in the world. That's why our second key ingredient is a clear, robust **philosophy**.

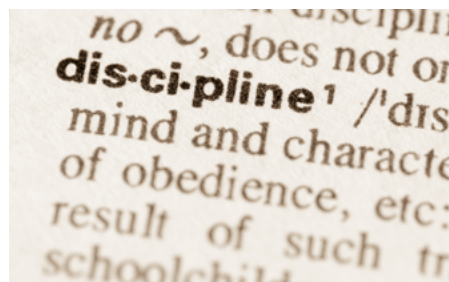
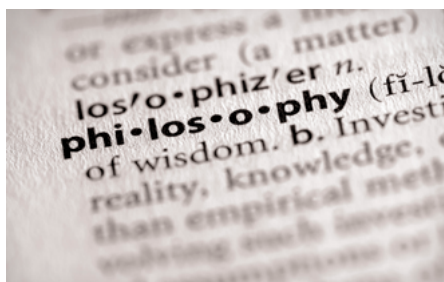
The final ingredient reflects how those first two elements work together, the need for a **disciplined**, repeatable process designed to make the team work better, reinforce the culture and to ensure the philosophy is delivered consistently.

## Eyes on the future as well as the present

Now it could be argued that in times of plenty it's easy to obtain high-quality ingredients, whereas in times of want, quality produce is much harder to find. Again, the same is true for investments.

In the period following 2008's financial crisis, global markets largely flourished in a benign environment that benefited from central banks experimenting with ultra-loose monetary policy. However, the 2020s have so far been a tougher environment for investors. Having endured the pandemic, a steep rise in inflation and the associated rise in interest rates, we now face an investment landscape where international and domestic politics are also influencing market activity.

Amid so much macroeconomic and geopolitical noise, it is easy for investors to get caught up in the here and now. That's why we would add a final ingredient to our



Global Equity recipe – incorporating the additional element of **forward thinking to see further**.

## Seeing further across global equity

As well-established Global Equity managers, we feel we have all the ingredients needed to meet or even surpass our clients' long-term expectations.

We have fostered a strong team dynamic, and believe our collective knowledge and experience are powerful tools for delivering investment performance. Since inception we've established an open and flat structure to enable truly transparent decision making for stock selection. With no 'star manager' egos bringing individual influences on stock selection, our people are collaboratively at their best. This enables us to think differently, transforming intelligent insights into innovative, relevant investment opportunities and makes us a trustworthy choice for our clients.

An ever-changing investment landscape makes having a robust, forward-thinking philosophy even more essential. Our focus on **Future Quality** means we are very particular about the type of company we invest in – businesses that can attain and sustain high returns on invested capital will deliver better performance for shareholders over the long term.

Finally, we have a strong, long-term track record that attests to the discipline and consistency of how our investment philosophy has been implemented over time. However, being disciplined doesn't equate to being dogmatic. As the world's markets, macroeconomic environment and geopolitical backdrops shift, it is essential that our process sees further and can adapt to new and relevant information that may alter the pathway ahead.

In essence, while the criteria of what we look for at a company level may not change, we must be humble and accept that we may make mistakes along the way; we need to be patient when our expectations aren't met within an expected timeframe; and we have to be aware that new factors may elicit an unanticipated change that prompts us to reassess our initial thesis.

## Pragmatism in times of change

And it is this willingness to be disciplined regarding process and philosophy, but pragmatic concerning the evolving investment environment that will be essential going forward. In a world where norms can be rapidly

altered by the shifting of geopolitical alliances or the development of disruptive new technology, the need to base investment decisions on fundamentals becomes even greater.

Quality management teams can create opportunities to improve their business's prospects through idiosyncratic means – such as undertaking a prudent acquisition, divesting an underperforming business or investing in a significant R&D innovation – and our top priority is always to find such companies that are on a unique path to sustaining and ideally improving returns on capital. However, there are also broader long-term trends that can help companies grow faster or sustain higher returns and enhance companies along the Future Quality path.

While geographies or sectors may not influence our allocation choices, we do look at broad market themes – such as changing demographics and the need to decarbonise and improve sustainability – which drive social and economic change and boost capital spending but are also driven by structural requirements and are less dependent on macro cycles. These themes can be leveraged from a bottom-up perspective by identifying the companies most likely to benefit from such tailwinds but that also meet our standard of attaining and sustaining high returns on invested capital.

## Harnessing long-term thematic opportunities

We have identified four common drivers of Future Quality for the coming decade:



### AI adoption

The emergence of artificial intelligence (AI) is an emerging, but dominant market force and has become impossible to ignore. Our research shows that while AI contains an element of hype, it has the potential to transform technology for the next generation. It is too

early to define the long-term winners from the new business models and use cases being inspired by AI, but there are market leaders already benefiting from the rapid adoption of this new technology that fit our Future Quality criteria.



### Enablers of the energy transition

The need to reduce humankind's reliance on fossil fuels and create cleaner alternatives through renewable energy sources is irrefutable, but the transition is not proving to be straightforward. Existing energy supplies have to be maintained and supported while cleaner and more sustainable energy sources are introduced. Although there is a fruitful pool of investment opportunities on both sides of this equation, the transition is heavily reliant on fiscal spending and political support can be fickle. Meanwhile, higher borrowing costs are providing a headwind, so the investment pathway is proving to be a little bumpy.

### Normalisation and structural growth in global travel

The travel industry is still in the process of recovering from pandemic-imposed restrictions, with countries at

differing stages of normalisation. Yet, when you look at the core consumers of travel, demand remains robust. This is particularly true for younger generations, who place greater value on “experiences”. Furthermore, a new travel cohort is emerging from developing countries where rising gross domestic product per capita means more people will be able to afford to travel in the future.

### Providers and enablers of healthcare efficiency

With an ageing population, providing sufficient and efficient healthcare, as well as reducing the cost of such services, will be one of the world's most important challenges going forward. In our view, this demographic test has been – and will continue to be – a great hunting ground for investment ideas as healthcare companies innovate to deliver much-needed solutions. That said, some subindustries within the healthcare sector have been challenged by an inventory overhang as post-pandemic demand is unwound although this re-rating has left valuations at an attractive level.



## Safeguarding investors for today and tomorrow

Another key attribute that enables the best chefs to stand out from the crowd is their attention to detail. At Amova Asset Management, our Global Equity team not only represents the best, high-quality ingredients in that they are trusted, experienced investors, who apply a proven philosophy with discipline, but they are also meticulous in their examination and re-evaluation of the investment landscape now and in the months and years to come. Their forward-thinking, pragmatic approach not only helps to safeguard investors against potential risk but also identifies the Future Quality leaders of tomorrow. A dependable recipe for long-term investment success.

### Part 1 Summary

We are Global Equity investors with a difference. We find Future Quality. Those companies beating the fade or on a path to leadership. Companies that are efficient with capital not only today but more importantly for tomorrow, who will attain and sustain rewarding returns.

In Part 2, we take a deeper look at the Future Quality concept, outlining the three fundamental principles that underpin our definition of Future Quality investments (value creation, long-term outperformance, and competitive advantages).

## Chapter 2

# 'Future Quality' companies



# 'Future Quality' companies

We believe investing in 'Future Quality' companies will lead to outperformance over the long term. Part 2 draws on academic evidence to outline the three fundamental concepts underpinning the definition of 'Future Quality' investments.

First, we look at business value creation models. We assess the level of excess cash return on invested capital earned by firms – and the future sustainability of those returns – by assessing the firm's competitive advantage period.

Second, we analyse past stock market returns to highlight that it is not merely the level of excess cash return on invested capital earned by a company that drives shareholder returns. Rather, the market rewards companies that can allocate capital to improve cash returns on investment and maintain their competitive advantage.

And third, we assess the role of growth and its impact on shareholder returns for businesses with high, medium and low cash return on invested capital structures.

Drawing on this academic research, we explain in detail what we mean by 'Future Quality' and why we believe it leads to long-term outperformance. If an investor can anticipate a meaningful positive change in excess return (cash return on invested capital minus cost of capital), identify firms that have a longer competitive advantage period than the market anticipates, and can reinvest those excess returns into the business (growth), they should generate shareholder returns above the market. These are the characteristics of a Future Quality company.

**Future Quality companies are those that will attain and sustain high returns on investment.**

Figure 1 Four pillars of Future Quality



**ESG is firmly embedded in our process**

High, long-term returns cannot be sustained with unsustainable business practises.

Source: Amova AM

## Defining Future Quality to see further

We define 'Future Quality' as a business that can generate sustained growth in cash flow and high and improving returns on invested capital at attractive valuations. Our portfolios only comprise companies that exhibit these characteristics and our research is devoted to unearthing companies that meet our criteria.

This concept underpins the Future Quality investment approach, and our analysis of a stock's 'Future Quality' characteristics determines whether a new investment opportunity merits inclusion in the portfolio or if an existing holding should be sold. When identifying 'Future Quality' companies, we analyse several variables including management quality, franchise quality and balance sheet quality. We then combine this analysis with a disciplined valuation approach.

## Excess return and the competitive advantage period

A company creates value by generating a spread between its cash return on invested capital (CROIC) and the cost of capital. The length of time this spread or excess return can be earned by a company is known as its 'competitive advantage period'.

Forecasting the sustainability of this spread (competitive advantage period), the magnitude (excess return) and the ability to reinvest the excess return into the business (growth) are key to determining Future Quality attributes.

Focusing on the sustainability of excess returns and improvements in CROIC is vital. The market rewards companies that can improve returns and maintain their competitive advantage. In his paper titled '**Do Your Business Units Create Shareholder Value?**', Professor Enrique Arzac of the Columbia Business School described this concept as the Simple Value Creation Model.<sup>1</sup>

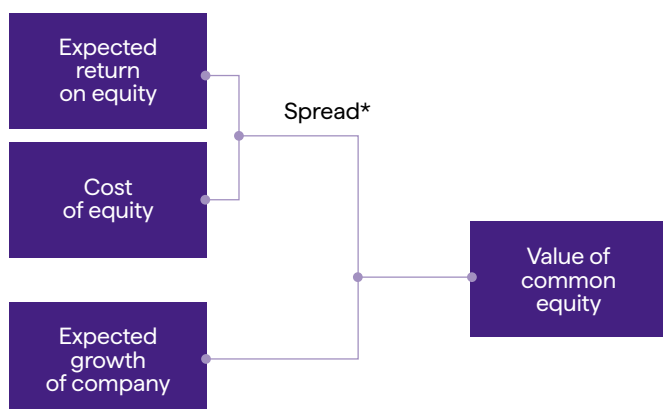
Arzac identified the importance of the sustainability of that excess return in valuation. Management's decision-making should focus on allocating capital to business units that can generate excess returns over the long term.

Similar studies have explored the concept of value creation over the years. Professor William Fruhan (Harvard Business School) in his book '**Financial Strategy: Studies in the Creation, Transfer, and Destruction of Shareholder Value**'<sup>2</sup> concludes that the only way to increase the value of an asset is to influence either the cash flow derived from that asset or the discount rate (weighted-average cost of capital). He further explains that the profitability of a firm is based on the capital intensity, profit margins and leverage and that the value of the firm is determined by the excess return, growth and the competitive advantage period. Hogan et al. (1999)<sup>3</sup> pointed out that shareholder value is created when a company invests in projects earning a return in excess of the cost of capital.

## Value creation and share prices – are high returns on invested capital all that matter?

Buying the best or worst quality company based on historical returns is a poor investment strategy. Empirical evidence suggests high or low return businesses exhibit very little correlation to future shareholder returns. Michael Mauboussin and Dan Callahan<sup>4</sup> from Credit Suisse HOLT conducted a ten-year study of historical returns and forward share price returns. The universe (1,355 US companies excluding financials and utilities) was divided into quintiles based on HOLT's cash flow

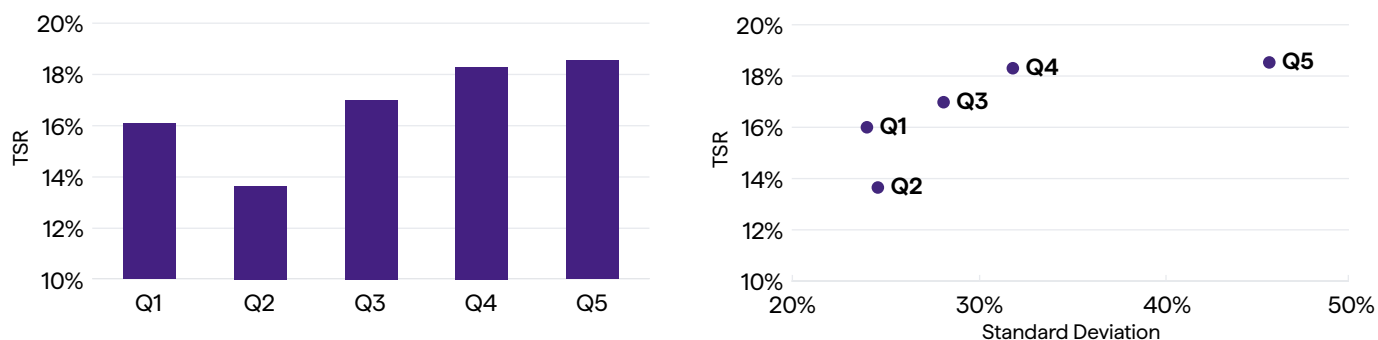
Figure 2 The Value Creation Model



Source: Professor Enrique Arzac, Harvard Business Review  
\*Spread = Excess return on equity above cost of equity

- 1 Enrique R. Arzac, "Do Your Business Units Create Shareholder Value?" Harvard Business Review January/February 1986 pp. 123
- 2 William E. Fruhan, Jr., Financial Strategy: Studies in the Creation, Transfer, and Destruction of Shareholder Value - Homewood 1979 pp. 7-15
- 3 James Hogan, Robert Neyland and Mark Greslee, "Creating Shareholder Value" – Electric Perspectives, September/October 1999 pp. 44-54
- 4 Michael J. Mauboussin and Dan Callahan, Economic returns, Reversion to the Mean and Total Shareholder Returns – Anticipating Change is Hard but Profitable, Credit Suisse Global Financial Strategies 2013 pp. 2-7

**Figure 3** Total shareholder returns (2003-2012) by quintile based on 2002 CFROI ranking



Source: Credit Suisse HOLT and FactSet

return on investments (CFROI) in 2002, with quintile 1 (Q1) being the best return businesses and quintile 5 (Q5) being the worst. Figure 3 shows the performance of each quintile over the subsequent ten-year period. This suggests that low quality companies (as defined by historical returns) perform well and even better than their high-quality counterparts; however, when risk is adjusted, there is no discernible pattern. The Sharpe ratios for Q1, Q2, Q3, Q4 and Q5 were 0.45, 0.34, 0.42, 0.41 and 0.29, respectively.

**However, improving future returns is a very powerful driver of share prices.** Using the same sample, Michael Mauboussin and Dan Callahan<sup>5</sup> found the stocks with the largest improvement in returns over the ten-year period (i.e., moved from Q5 to Q1) delivered the highest returns, whereas stocks that migrated from the top quintile to the bottom quintile delivered the weakest returns. This suggests the change in investment matters most.

Importantly, the persistence in high returns together with improvements in return, which is integral to a firm’s competitive advantage period, is a bigger driver of future shareholder return. Looking at the same data, those stocks that showed persistence in high returns over the period had higher returns and a significantly higher Sharpe ratio. Stocks that started in Q1 and remained in Q1 for the ten-year period delivered a total shareholder return of 19.2% with a standard deviation of just 22.8%. These companies essentially ‘beat the fade’ or had a longer competitive advantage period than the market forecast.

<sup>5</sup> Michael J. Mauboussin and Dan Callahan, Economic returns, Reversion to the Mean and Total Shareholder Returns – Anticipating Change is Hard but Profitable, Credit Suisse Global Financial Strategies 2013 pp. 2-7

**Figure 4** Total shareholder returns (2003-2012) for all 2002 to 2012 quintile combinations

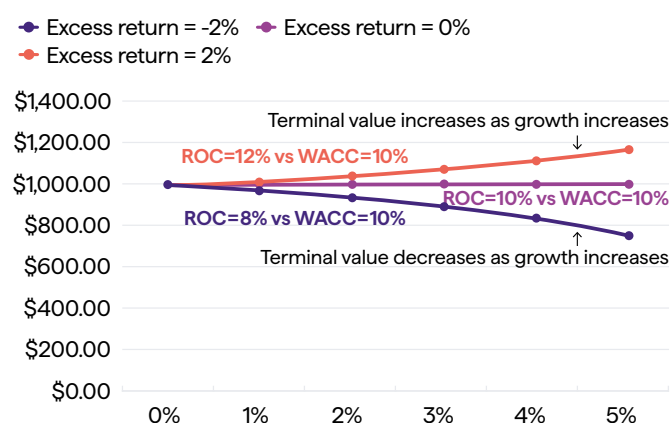
		Q1		Q2		Q3		Q4		Q5	
		TSR	St Dev	TSR	St Dev	TSR	St Dev	TSR	St Dev	TSR	St Dev
2002 Quintile	Q1	19.2%	22.8%	12.9%	27.4%	11.7%	41.8%	7.4%	23.9%	6.3%	27.2%
	Q2	17.9%	29.9%	17.2%	26.9%	11.1%	21.1%	6.6%	26.0%	3.9%	28.1%
	Q3	24.4%	27.7%	15.3%	26.0%	20.4%	31.4%	13.9%	28.3%	9.3%	32.2%
	Q4	29.0%	33.4%	23.0%	34.4%	15.1%	31.6%	18.9%	39.3%	10.9%	27.7%
	Q5	27.2%	54.3%	25.4%	43.7%	20.6%	59.6%	16.7%	38.3%	10.2%	44.5%

If an investor can anticipate a meaningful positive change in excess return (cash return on invested capital – cost of capital), identify firms that have a longer competitive advantage period than the market anticipates and can reinvest those excess returns into the business (growth), they will generate shareholders returns above the market. These are the characteristics of a Future Quality company.

## The importance of growth

This concept was explored further in two McKinsey research papers that investigated the relationship between total returns to shareholders and the change in return on invested capital (ROIC). Published in 2006 and 2007 respectively, **‘Balancing ROIC and growth to build value’**<sup>6</sup> and **‘How to choose between growth and ROIC’**<sup>7</sup> both also incorporated the impact of growth (as defined by change in revenues). They identified high correlations between value creation, growth and returns and showed that if companies grew faster and increased returns more than the market, they subsequently outperformed the market.

**Figure 5** Change in terminal value based on changes in growth and excess returns



Source: Aswath Damodaran, Stern School of Business

These two studies highlight the importance of focusing on changing profitability as a driver of share price returns. However, neither study incorporated a cost of capital or discount rate due to the inherent challenges

of assigning an appropriate cost of capital to individual companies in an empirical exercise. True wealth creation does not come from the absolute level of ROIC, but from the spread between returns and the cost of capital. Wenner and LeBer<sup>8</sup> in 1989 spoke of the importance of management’s focus on shareholder value analysis (SVA) – the process of analysing how business decisions affect a company’s economic value (net present value of the expected cash flows discounted at the cost of capital). They emphasised that long-term cash generation is rewarded by the market, not growth for growth’s sake or earnings per share.

It is also important to understand the relationship between growth and excess returns. When a company is generating excess returns, growth will be rewarded. When a company is generating returns below the cost of capital (in other words, destroying value), growth will be penalised. In the example shown in Figure 5, Aswath Damodaran<sup>9</sup>, Professor of Finance at New York University Stern School of Business, highlights the change in terminal value based on changes in growth and excess returns. If a company is generating returns in line with its cost of capital, growth will not be rewarded or penalised, meaning the terminal value will remain unchanged.

## Cash-based measures of value creation

We believe cash flow is a better measure of profitability than reported or operating earnings and has a higher predictive power than the other two measures in terms of shareholder return. We therefore focus on CROIC, rather than the return on equity metric used in Arzac’s<sup>10</sup>

6 Bing Cao, Bin Jiang, and Timothy Koller, **‘Balancing ROIC and growth to build value’** - McKinsey on Finance Spring 2006

7 Bin Jiang and Timothy Koller, **‘How to choose between growth and ROIC’** - McKinsey on Finance Number 25 Autumn 2007 pp. 19-22

8 David Wenner and Richard LeBer, **Managing for Shareholder Value – From Top to Bottom** (Harvard Business Review, November – December 1989)

9 Aswath Damodaran, **‘Return on Capital (ROC), Return on Invested Capital (ROIC), and Return on Equity (ROE): Measurement & Implications’** – Stern School of Business July 2007 pp. 62-64

10 Enrique R. Arzac, **‘Do Your Business Units Create Shareholder Value?’** - Harvard Business Review January – February 1986 pp. 123

Value Creation Model and Fruhan's<sup>11</sup> study. Kenneth Hackel, Joshua Livnat and Atul Rai<sup>12</sup> have written extensively on the subject and demonstrated that investment strategies based on free cash flows have merit.

Models linking cash returns and cost of capital (also known as value-based measures), started evolving meaningfully about 30 years ago, and this forms the basis of our analysis. The best-known value-based measures are economic value added (EVA), cash flow returns on investment (CFROI), shareholder value added (SVA), economic margin (EM) and cash value added (CVA). For more detail on each of these, Daniela Venanzi<sup>13</sup> in 'Financial Performance Measures and Value Creation: the State of the Art' is a good reference.

The other benefit of these value-based measures is that they allow investors to compare corporate performance and profitability globally. Accounting differences between regions are reconciled and given the cost of capital is embedded in some of these calculations, a clear comparison can be made between firms around the world.

11 William E. Fruhan, Jr., *Financial Strategy: Studies in the Creation, Transfer, and Destruction of Shareholder Value* - Homewood 1979  
 12 Kenneth Hackel, Joshua Livnat and Atul Rai, "A Free Cash Flow Anomaly" *Journal of Accounting, Auditing & Finance* Volume 15 Winter 2000  
 13 Daniela Venanzi, "Financial Performance Measures and Value Creation: the State of the Art" Springer Milan Heidelberg Dordrecht London New York 2012 pp. 13-30

We have identified that improving and sustainably high cash returns are correlated with positive relative share price returns, and that this is enhanced when combined with growth.

It also requires a robust valuation framework to identify the most attractive opportunities. In 'Measuring and Managing the Value of Companies',<sup>14</sup> Tim Koller, Marc Goedhart and David Wessels discuss the value-based concepts in detail and define the fundamental principles of value creation.

Figure 6 ROIC and growth drive multiples

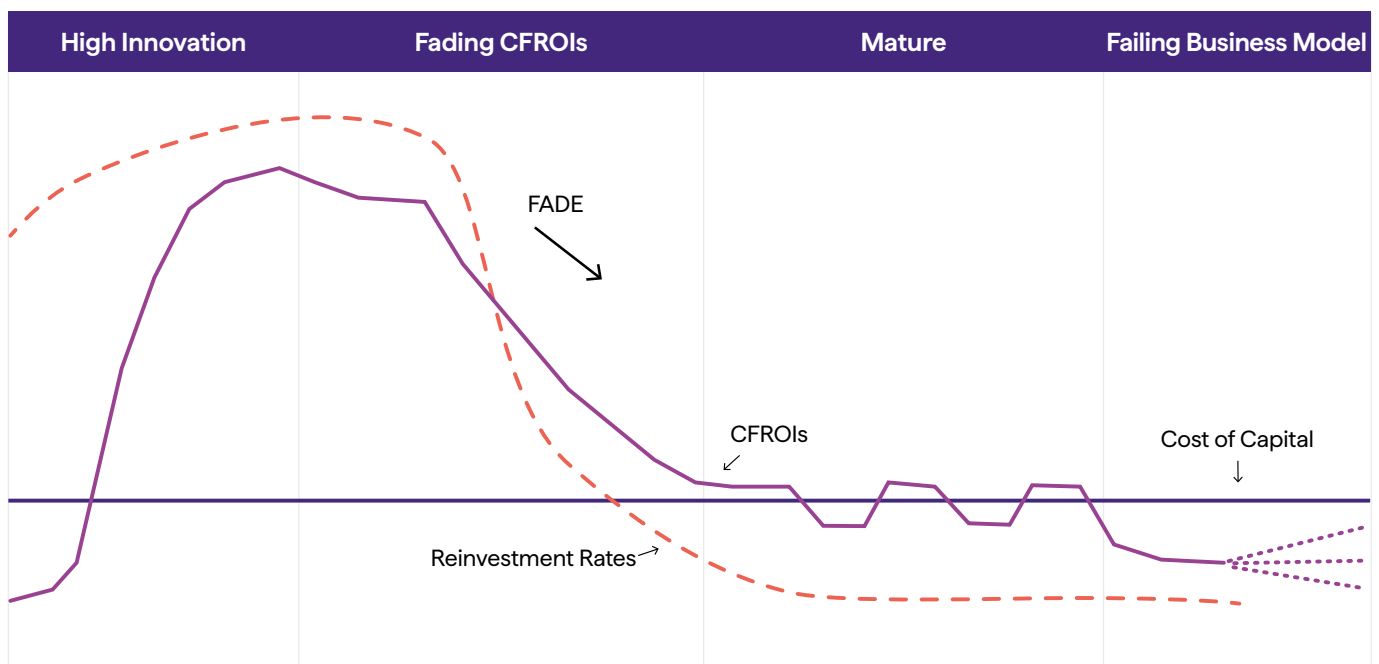
$$\text{Value} = \frac{\text{Invested Capital} \times \text{ROIC} \times \left(1 - \frac{g}{\text{ROIC}}\right)}{\text{WACC} - g}$$

Source: Tim Koller, Marc Goedhart and David Wessels

The above calculation sets a framework, but assumes growth and ROIC remain constant in perpetuity. It doesn't integrate an appropriate competitive advantage period, after which returns would fade towards the cost of

14 Tim Koller, Marc Goedhart and David Wessels, "Valuation - Measuring and Managing the Value of Companies" - McKinsey & Co Fourth Edition pp. 66

Figure 7 HOLT's Competitive Life-Cycle Framework



Source: Credit Suisse HOLT

capital. This can be addressed in part by incorporating a two-stage discounted cash flow model with appropriate terminal assumptions. Many value-based valuation models, including CFROI and economic margin (EM), incorporate a specific competitive advantage period over which a company can generate excess return, after which returns will fade towards the cost of capital or weighted-average cost of capital. This is appropriate as most high-return businesses and industries will attract competition and will see their returns erode over time. Similarly, low return businesses and industries will see competitors exit the industry and can see their returns rise over time. Aswath Damodaran<sup>15</sup> outlined these concepts in his paper **‘Return on Capital (ROC), Return on Invested Capital (ROIC), and Return on Equity (ROE): Measurement & Implications’**.

This is the theory behind HOLT’s Competitive Life-Cycle Framework as outlined below and analysed by Bart Madden<sup>16</sup> in **‘Maximising Shareholder Value and The Greater Good’**. A typical firm will move through four phases of profitability and growth through its life.

To value the company appropriately, an investor must therefore forecast economic cash returns, growth, required operating assets and the competitive advantage period.

Madden’s work highlighted that in most cases, positive shareholder returns are associated with ‘surprising’ positive patterns of actual fade in relation to earlier expected patterns for that period and vice versa. In other words, the company was able to grow and generate excess returns for longer than expected, so the competitive advantage period was longer than the market forecast.

Earl Murman et al.<sup>17</sup> in the book **‘Lean Enterprise Value’** stated: “Understanding value creation is not difficult, but determining the specific actions to create value can be more complex and a challenge, especially in a changing world”.

In summary, value-based profitability measures are better at identifying corporate performance. The change in these profitability measures, growth and the competitive advantage period are key drivers of future share price

performance, and the capital allocation decisions of management will impact both.

**Future Quality companies will have long competitive advantage periods through which they can sustain high and/or improving cash returns. Those companies beating the fade or on a path to leadership. The challenge for investors is that only a fraction of companies within the global universe will display such characteristics.**

## How Amova AM’s Global Equity team identifies Future Quality

Recognising Future Quality requires long-term fundamental research. To evaluate whether an individual investment may meet our Future Quality criteria, we focus on several factors that help us to accurately forecast the competitive advantage period.

Understanding the **quality of the franchise** helps us make informed assumptions on growth rate, profitability and the competitive advantage period of the company. As Michael Porter<sup>18</sup> explains in his “value chain approach”, the profitability of a company is influenced by its industry structure (quality of the franchise) and the strategic decisions (quality of management) it makes. The company’s profitability is influenced by industry attractiveness (Porter’s<sup>19</sup> five competitive forces) and its position within that industry will dictate whether it can generate above-industry or below-industry returns (competitive advantage period).

In assessing the **quality of management**, we look for a strong and consistent strategy, good corporate governance, identifiable and aligned incentive programmes, an excellent track record, and disciplined capital allocation. Ideally all stakeholders should benefit from management actions as this will ensure a more sustainable business. The quality of management is integral to understanding the sustainability of a firm’s competitive advantage period. Management’s capital allocation decisions will have a meaningful impact on the competitive advantage period and the ability to generate excess returns. This is clearly a crucial factor in the financial outcome for shareholders.

The **quality of balance sheet** underpins the company’s growth aspirations. A strong balance sheet will be able

15 Aswath Damodaran, “Return on Capital (ROC), Return on Invested Capital (ROIC), and Return on Equity (ROE): Measurement & Implications” – Stern School of Business July 2007 pp. 53-60

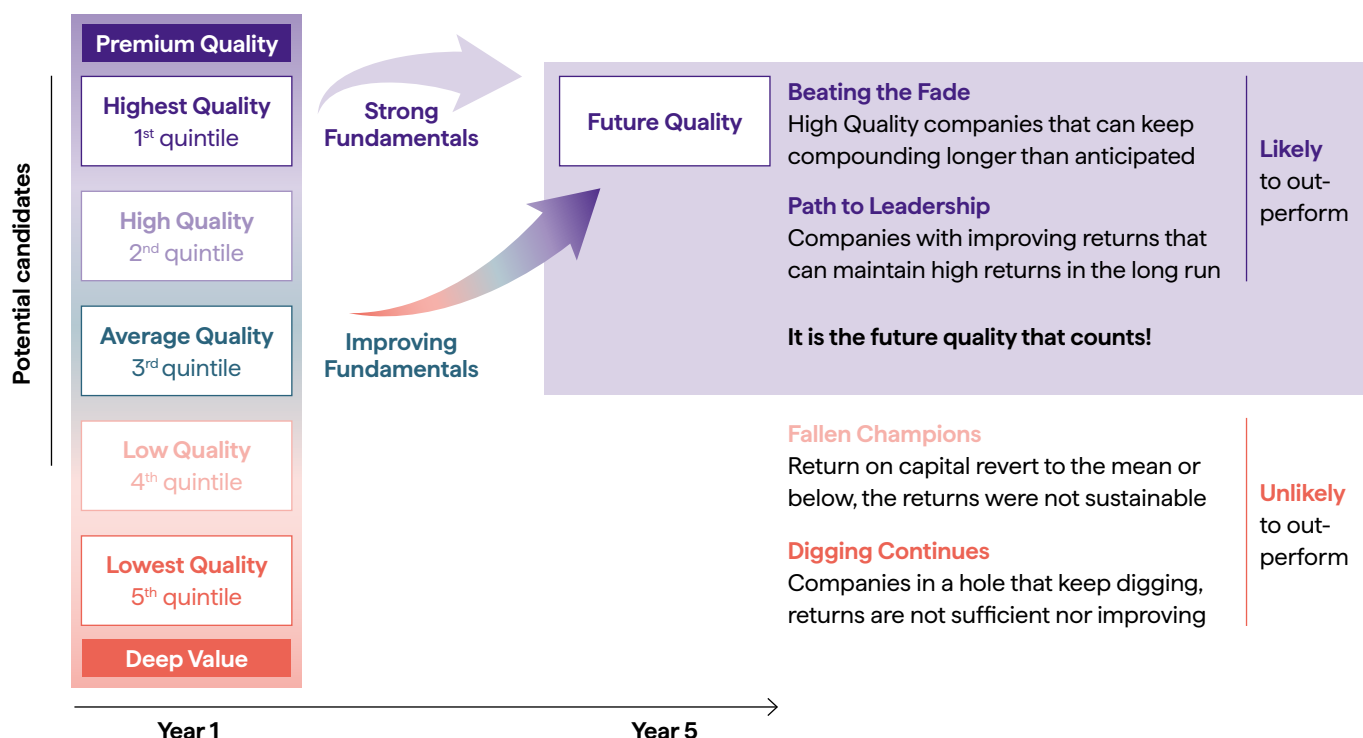
16 Bart Madden, “Maximising Shareholder Value and the Greater Good” – LearningWhatWorks 2000 pp. 7-10

17 Earl Murman, et al., “Lean Enterprise Value” – Palgrave Macmillan / The Lean Enterprise Foundation 2002 pp. 177

18 Michael Porter, “Competitive Advantage” – The Free Press. New York 1985 pp. 11-15

19 Michael Porter, “How Competitive Forces Shape Strategy” – Harvard Business Review, March/April 1979 pp. 137-145

**Figure 8** Future Quality – the change in return on invested capital impacts performance



Source: Amova AM

to finance profitable growth and make the management team’s capital allocations decisions far easier. Investors must focus on funding sources and the cost of that funding, the leverage within the business and working capital requirements and changes.

**Valuation** through analysis of the balance sheet, management and franchise, allows us to forecast growth, margins and asset turns of the business, the capital expenditure and funding requirements, the competitive advantage period and cost of capital. These are the key components to calculate future CROIC and the value of the company, and helps us to make an informed decision as to whether a potential investment is Future Quality and valued attractively.

## Future Quality companies should outperform the market over the long term

Future Quality investing aims to identify companies that can generate superior or improving cash returns above the cost of capital and have competitive advantage periods longer than the market anticipates. Simply buying the top quintile highest quality companies alone does not lead to outperformance, rather it is the future quality of the companies that impacts performance. Figure 8

illustrates that Future Quality businesses with ‘Strong Fundamentals’ generate high returns on invested capital today which we forecast to be sustainable due to their extended competitive advantage position. These are companies that can ‘beat the fade’ in returns. Companies with ‘Improving Fundamentals’ are generating lower returns on invested capital today, but we expect them to generate substantially higher returns in the future. These are companies that we forecast to surprise positively as they generate incrementally better returns over time.

## Part 2 Summary

Regardless of the starting point, Future Quality investing is about identifying companies that can attain and sustain high returns on investment in the future. We believe a portfolio of Future Quality companies should outperform the market over the long term.

In Part 3, we look in greater depth at how Sustainability and Environmental, Social and Governance (ESG) issues are an integral component within our definition of Future Quality investments, and within the Global Equity Team’s investment process.

## Chapter 3

# ESG in the investment process



# ESG in the investment process

Building on our first two sections, Part 3 frames how we integrate ESG factors into the investment process. Considering the growing body of academic research as well as our experience to determine that ESG has become an integral part of being a fundamental investor.

There are four pillars to Future Quality investing, each contributing to the investment case. Some, such as the strength of a company's balance sheet, give a picture of financial health at a specified date. However, our Global Equity team believes a company's value is a reflection of its future earnings – hence our focus on Future Quality – and that these future earnings are determined by the strength of both the company franchise and its management. We spend a great deal of our time on the analysis of these critical variables.

Like with balance sheet data, ESG ratings add value by providing a snapshot of a company's status. However, ESG factors are contingent liabilities or assets that aren't standardised and are often difficult to measure. If such factors are significant, they will impact future returns and consequently corporate value. Therefore, understanding how ESG factors might influence future

returns makes integrating ESG an essential part of being a fundamental investor. Our detailed conclusions are:

**Correlation:** There is increasing evidence of a strong correlation between companies with high ESG scores and financial performance. However, there are limitations to ESG data and the data itself doesn't explain why ESG matters.

**Corporate value:** ESG factors influence value in many ways. The sustainability of a company's future returns can be influenced by Environmental and Social factors, while Governance acts as the mechanism for establishing how a management team is likely to allocate capital in the future.

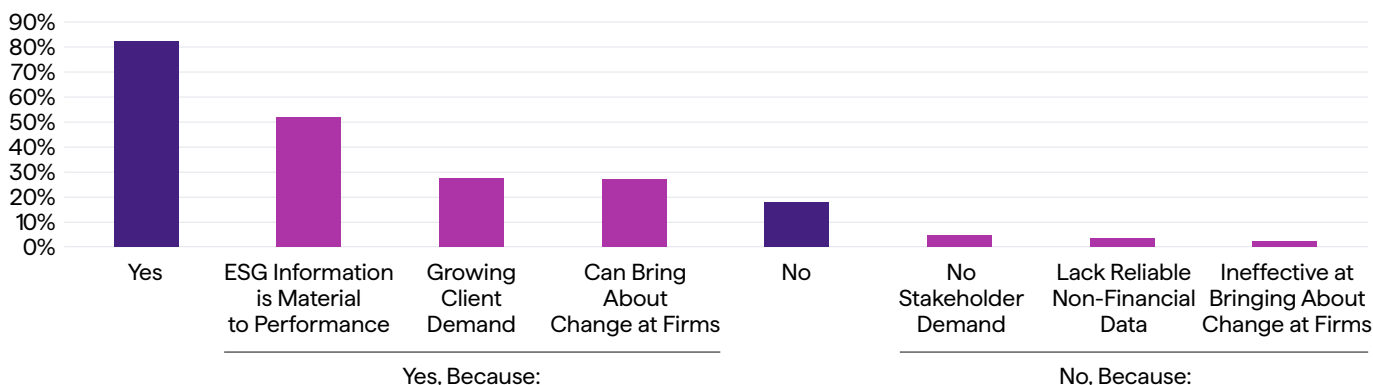
**Decision-making:** Engagement, in the form of investigative discussion with management through to

**Figure 9** The four pillars of Future Quality: Subjective Nature of Franchise and Management Quality



Source: Amova AM

**Figure 10** 2017 ESG survey of 'mainstream' investor responses to: 'do you consider ESG information when making investment decisions?'



Source: Amel-Zadeh, A., and George Serafeim, "Why and How Investors Use ESG Information: Evidence from a Global Survey," Working Paper, SSRN23 (2017)

voting, provides long-term investors with a unique position to determine which ESG factors may be material and are therefore better placed to add value.

## The rise of ESG

It is becoming increasingly recognised that companies cannot achieve high, long-term returns with unsustainable business practises. ESG factors can help identify change and the potential for accelerating returns (see Figure 10). Certainly, the growing interest is reflected in strong asset flows across the globe<sup>20</sup> but none of this explains the changing attitude of asset owners.

## The age of the millennials

Demographic trends suggest a huge transfer of wealth is underway. Millennials are inheriting billions of dollars from their parents and this new group of investors have different expectations as to how their money is managed. These investors are increasingly asking how their return is generated.<sup>21</sup>

Consider the following survey data:

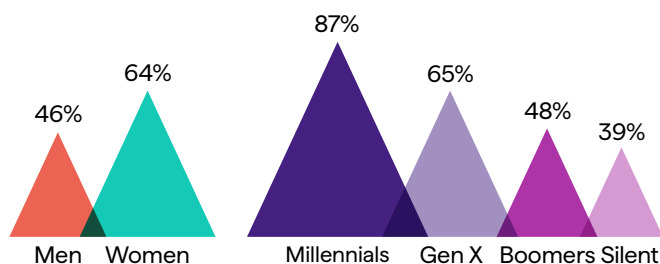
- 66% of all US consumers think it is important for brands to take a stand on issues like harassment, discrimination, and diversity.
- 44% of full-time millennial employees would feel more loyal towards their organisation if their CEO

took a stand on a hotly-debated issue.

- 76% of millennials believe their investment decisions are a way to express their social, political and environmental values, while 87% say that a company's impact in these areas is a key consideration when they make investment decisions.

Wealthy individuals across generations are interested in investing for environmental or social impact, but millennials are by far the most active in evaluating and indeed, demanding these strategies. We believe this shift is secular and this paper explains how we add value for our clients by integrating ESG into all aspects of our investment process. First, we start with a brief summary of the research.

**Figure 11** Where will millennials invest?



The majority of Millennials, Gen X and women believe that a company's track record in environmental, social and governance is an important consideration for investing. In fact, 37% of all high-net-worth investors are reviewing their portfolios for impact investments.

20 Global Sustainable Investment Alliance, 2020 Industry Report

21 Amel-Zadeh, A., and George Serafeim, 2017, "Why and How Investors Use ESG Information: Evidence from a Global Survey", Working Paper, SSRN

Source: Bank of America's US Trust 2018 Wealth & Worth Report

## Value of ESG data

The reporting of ESG data is a relatively new field. MSCI only started rating companies in 2006. Given the increasing interest in the area, there is a growing body of research testing the link between ESG factors and investment performance. With more than 1,000 studies on the subject, featuring a broad range of negative, neutral and positive conclusions, consensus has been difficult to find.<sup>22</sup> However, in our search for Future Quality companies, we have found some areas of ESG that we believe add value.

For example, Kim et al. (2012) examined the relationship between sustainability scores and earnings quality.<sup>23</sup> Their conclusions suggest a link between the quality of reported earnings and companies deemed to follow socially responsible practices. They found that firms exhibiting strong ESG characteristics are less likely (1) to manage earnings through discretionary accruals, (2) to manipulate real operating activities, and (3) to be the subject of SEC investigations. These characteristics are all disqualifying from a Future Quality perspective.

Other academic studies (Gompers et al., 2003), using a variety of indicators of effective corporate governance, have provided evidence that companies with stronger shareholder rights and management accountability have delivered stronger fundamental performance over time.<sup>24</sup> More recently, MSCI published research (Cass Business School; Giese et al., 2017), found data supporting the assertion that high rated ESG companies were higher quality companies compared to bottom quintile companies,<sup>25</sup> as measured by profitability.

In other words, well managed, quality companies should be effective at managing their ESG risks. The economic rationale for this transmission is explained in Godfrey et al. (2009),<sup>26</sup> Jo and Na (2012)<sup>27</sup> and Oikonomou et al. (2012)<sup>28</sup>. This body of work shows that companies with above-average ESG scores typically have above-average compliance standards and risk control, and suffer less from severe incidents that result in significant share

price loss. Moreover, Giese et al., Gregory et al., (2014)<sup>29</sup> and Nagy et al. (2015)<sup>30</sup> also found significantly predictive power from changes in ESG factors.

## The limitations of ESG data

Although a selective review of the research suggests ESG ratings add value, we are wary of the inherent limitations of relying too heavily on ESG data in our process.

The **first** limitation is the lack of standardisation and legal authority given to the quantification and disclosure of data by management teams. Unlike the accounting profession – which benefits from decades of standardisation backed by case law – ESG remains in its infancy. One of the main pillars of the accounting profession is the understanding of materiality. Every day, evidence of material ESG factors is wide-ranging: extreme weather; man-made disasters such as the Deepwater Horizon oil spill; child labour, to name but three. However, all of these are easily identified after the event. Identifying a material ESG factor ahead of time, understanding how that might alter value and whether it should be disclosed is significantly more problematic. One of the common features between the ESG pillars is their contingent nature. And contingent events are inherently difficult to estimate and enforce disclosure. This issue is evidenced by the existence of the Sustainability Accounting Standards Board (SASB), which has a focused framework for targeting disclosure of ESG factors based on the SEC's interpretation of materiality.

The **second** and more often raised issue with ESG research to date is the inability to split correlation from causality. Academic research has identified the statistical issue of correlation mining (Harvey et al., 2016)<sup>31</sup> and a lack of differentiation between correlation and causality (Kruger et al., 2015).<sup>32</sup> Even where some research has attempted to test the transmission mechanism behind why high ESG scores might lead to improved financial performance, researchers have suffered from a lack of data.<sup>33</sup> That the ESG data industry is still in its infancy presents an issue for those needing statistical proof that ESG adds value.

22 For examples see Carpenter et al. (2009) and Fulton et al. (2012)

23 Kim et al. (2012)

24 P. Gompers, J. Ishil, A. Metrick, Quarterly Journal of Economics, Vol. 118, No. 1, February 2003

25 Giese, Lee, Melas, Nagy & Nishikawa, Foundations of ESG Investing, November 2017

26 Godfrey, Merrill & Hansen, 2009, The relationship between corporate Social responsibility & shareholder Value, Strategic Management Journal, Vol 30, pp. 425-445

27 Jo & Na, 2012, Does CSR Reduce firm risk, Journal of Business Ethics, Vol 110, pp. 441-456

28 Oikonomou, Brooks & Pavelin, 2012, The Impact of Corporate Social Performance on Financial Risk & utility, Financial Management, Vol 41, pp. 483-515

29 Gregory, Tharyan & Whittaker, 2014, Corporate Social responsibility and Firm Value; Strategic Management Journal, Vol 30, pp. 633-657

30 Nagy, Kassam & Lee, 2016, Can ESG add Alpha? An analysis of ESG Tilt and Momentum Strategies, Journal of Investing, Vol 25, No.2, pp. 113-124

31 Harvey, Liu and Zhu, 2016, Review of Financial Studies, Vol 29, No.1, pp. 5-68

32 Krueger, P 2015, Corporate Goodness and shareholder Wealth, Journal of Financial economics, Vol 115, No. 2, pp. 304-329

33 Giese et al. (2017), as above, pp. 26

**Figure 12** The four pillars of Future Quality: Franchise Quality



Source: Amova AM

The **third** and final issue with ESG data is that most of it is backward looking. In a similar way that companies with high returns today may not generate high returns in five years' time, companies with high ESG scores today may not be tomorrow's quality companies. Finding a company in an industry with high returns or a high ESG score is not enough. Finding a good business capable of sustaining high performance requires a thorough understanding of the conditions the company operates in as well as an assessment of both its management and its governance structure.

We believe ESG has greater value in understanding the

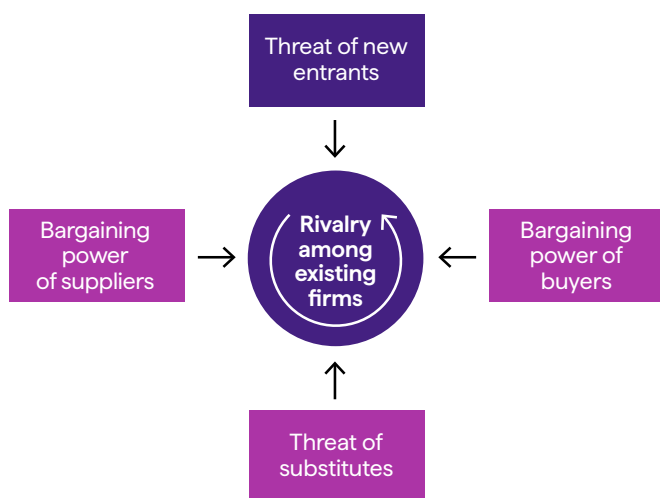
transmission mechanisms behind why the link between high ESG scores and quality may be high. Giese, Lee et al., try to address this issue by reviewing three different transmission mechanisms: cash-flow generation, tail risk management and systematic risk such as increased regulation. However, with just over a decade of MSCI ratings data, they have concluded that data sets are too small and that it is difficult to differentiate between causality and correlation.

The transmission mechanism and context is important as without that we are unable to determine whether a high ESG score has led to better returns or lower risk, or if the high returns have simply afforded a management team the resources to address these risks. Without understanding the transmission channel, we are unable to understand how ESG might improve returns or how management might allocate capital to sustain high returns into the future.

A company's fair value (and ultimately its share price) should equate to the present-day value of those future returns. Therefore, ESG is an integral part of the subjective analysis required in understanding likely future returns.

This is important because it is the assessment of a company's competitive advantage period ('Franchise Quality') and how they invest their capital ('Management Quality') that will determine the likely cash flow returns the company will achieve in the future. We discuss how ESG impacts a company's Franchise Quality first.

**Figure 13** Michael Porter's five forces that shape industry structure



Source: Michael E. Porter, Competitive Strategy, New York: The Free Press (1980)

## Franchise Quality: ESG and the sustainability of returns

We believe the link between ESG and a company's future returns is intuitive and that ESG must form a core part of understanding a company's future return profile – what we call 'Franchise Quality'. The Franchise Quality of a business is one of the four pillars of our Future Quality investment philosophy (Figure 12).

## Porter's Five Forces: the competitive advantage period

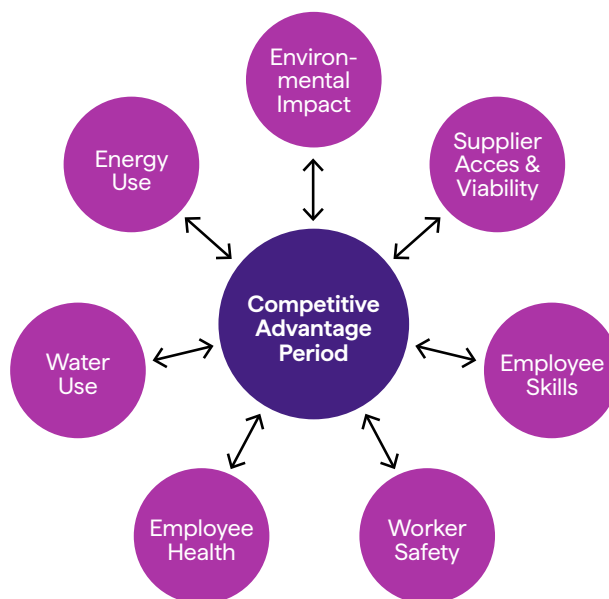
Michael Porter's Five Forces framework<sup>34</sup> is the 'gold standard' for analysing competitive advantage periods and understanding how external forces within an industry might alter a company's future return profile. Importantly this framework demonstrates that a firm does not operate in a closed loop. External forces will undoubtedly have an impact such as how suppliers or consumers behave.

Traditional theory (based on Graham & Dodd's 'Security Analysis'), provides a logical approach for making investment decisions and requires a qualitative assessment of financial performance and value. Analysis by experienced investors of a wide variety of public information, supplemented with management interviews combine to create a 'mosaic approach' to long-term investing.

The historical foundation of this approach assumes that value is aligned with book cost. However, this link has dissipated in recent decades as capital intensity has decreased and the hold of technology on society has taken root. Intangible assets such as brand value, reputation, trust, research and development (R&D) pipelines, employee turnover and equality have all exerted a greater influence on management action and returns.

According to Mauboussin et al. (2013),<sup>35</sup> there are three broad sources of added value: production advantages, consumer advantages, and external factors. Production advantages are easier to contextualise and may include resource or production economies of scale. Consumer advantages are more prevalent in today's technologically advanced society, with natural network effects for companies such as Google. The final 'external' factor

Figure 14 The competitive advantage period and a company ecosystem



Source: Amova AM, Harvard Business Review, Creating Shared Value – Michael Porter and Mark Kramer

impacting value includes subsidies, tariffs, quotas, and both competitive and environmental regulation. Changes in government policy can have a meaningful impact on corporate value. Consider the impact of deregulation on the airline and trucking industries, Basel III on financial services, or subsidies on the solar energy industry.

## Porter's Five Forces and ESG

An obvious area of focus in the ESG field has been on the external forces created by environmental legislation and its impact on a firm and industry returns, most relating to carbon pollution. Although many investors simply address this issue with exclusion policies, this approach may be too simplistic.

On the subject of exclusions, Porter's work on the competitive advantage period and the impact of environmental legislation is controversial. Porter's research suggests that strict environmental regulation does not hinder competitive advantage periods, but can often lead to further advances.

This has been tested many times as summarised by Ambec et al.,<sup>36</sup> and concludes that there is a positive

34 Porter's Five Forces, Michael E. Porter, Competitive Strategy, New York: The Free Press, (1980)

35 Mauboussin, Callahan & Majd, Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance, October 2016

36 Ambec, Cohen, Elgie & Lanoie, 'The Porter Hypothesis at 20: Can environmental regulation enhance innovation and competitiveness?' (2010)

link, although varied in strength, between regulation and innovation. This work confirms our view that integrating ESG isn't confined to merely minimising risk but also offers up significant investment opportunities too.

Of course using the word 'external' is a misnomer. Regulation, the environment, waste, diversity, employee safety, etc. are all part of the company's ecosystem. Companies do not operate in a bubble and with the increase in penetration of social media, management teams are increasingly aware of how ESG factors can influence future returns. How and why management chooses to invest capital will also have a significant bearing on returns.

## Management Quality: Governance and the allocation of capital

Governance is the mechanism for how a company achieves its objectives. Our understanding of governance, and role of management, is key to determining whether the company's capital will be deployed effectively.

Since the world of business is dynamic, companies must constantly assess trade-offs and make difficult decisions. A clear strategy and objective will provide all stakeholders with the starting point for assessing a company's prospects and evaluating performance.

Corporate behaviour is also impacted by local law, customs and culture. As a general rule, companies that

operate under common law have the strongest protection for shareholders, whereas those operating under civil law have weaker protection for shareholders and stronger protection for other stakeholders, such as creditors.

These different starting points perhaps explain why countries with a bias towards shareholder value also generate higher returns than those with a more balanced stakeholder approach. However, as is so often the case, the statistics don't tell the whole story. To conclude that one specific country or approach is preferable would be wrong.

Despite these differences, the framework for analysing governance and management has not changed significantly over the years. Graham & Dodd,<sup>37</sup> in the original edition of their 'Security Analysis', raised the question of governance by emphasising potential conflicts of interests between stockholders and corporate management. The lack of information or control faced by 'outside' investors – known as the agency problem – is well known and the nature of the issues during the start of the 20th century remains the same today.

Agency theory explains why management action may not be aligned with shareholder interests. There are three areas in capital allocation where these conflicts may arise:

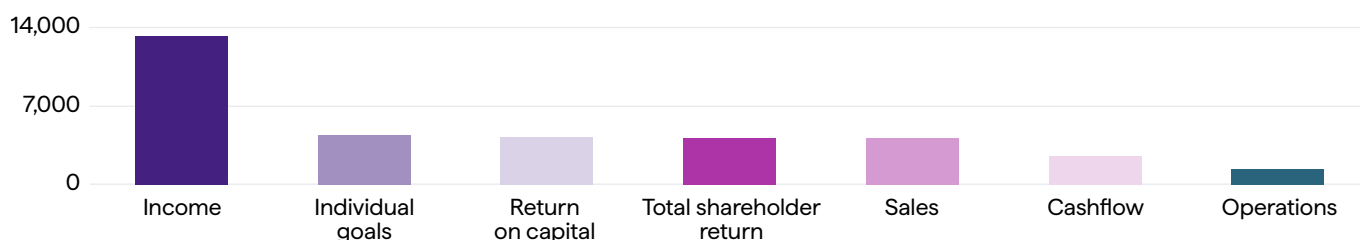
37 Graham & Dodd, Security Analysis (1934)

Figure 15 The four pillars of Future Quality: Management Quality



Source: Amova AM

**Figure 16** Use of incentive metrics among 1,721 US companies Count of US firms between 1998 and 2013



Source: Amova AM

- **‘Size isn’t everything’:** Company size is a crude proxy often used for remuneration and may lead management teams to ‘empire build’.
- **‘Long shots’:** Management teams may have a different risk tolerance and may undertake high risk strategies to achieve remuneration goals.
- **‘Short-termism’:** Different time horizons can also lead to unwanted behaviours. The most common being the focus on short-term returns or targets.

Determining the right incentive scheme for a company is difficult. We can certainly point to the dominance of earnings-based measures within incentive schemes – and in particular, ‘adjusted earnings’ – as a concern for long-term investors. This is illustrated in Figure 16.

The focus (and failure) of short-term incentives is of particular concern given the debate over timeline is ultimately meaningless. There should only be one aim: to generate value. This applies to activities that management expect to deliver value, both in the short term and longer term.<sup>38</sup>

Ultimately, good ESG disclosure, appropriate long-term incentive schemes and a governance structure that protects shareholders’ interests are all positive signals, but are not in themselves substitutes for the value created from engaging with management.

## Engagement: why engagement creates value

To have a greater understanding of how ESG may impact future returns, engagement with management should be a key goal for any fundamental investor. Discussions with management regularly help us contextualise the likely success of future capital allocation decisions and how ESG factors may impact future returns.

Research to date – though limited – has shown a link between engagement and long-term value. (Blackrock & Ceres<sup>39</sup> and Dimson, Karakas & Li<sup>40</sup>). The full value gained from appropriate engagement is best illustrated

38 Alfred Rappaport, 2011 ‘Saving capitalism from short termism: how to build long term value and take back our financial future’ (NY: McGraw Hill, 2011, pp. 140-142)

39 Blackrock & Ceres, ‘21st Century Engagement, Investor Strategies for Incorporating ESG Considerations into Corporate Interactions’ (2015)

40 Dimson, Karakas & Li, Active Ownership. *Review of Financial Studies* (2015)

**Figure 17** How engagement creates value

Value Creation Dynamics	Corporations	Investors
<b>Communicative Exchanging Information</b>	Clarifying expectations and enhancing accountability	Signalling and defining ESG expectations
	Managing impressions and rebalancing misrepresentations	Seeking detailed and accurate corporate information
	Specifying the business context	Enhancing investors ESG communication and accountability
<b>Learning Producing and diffusing knowledge</b>	Anticipating and detecting new trends related to ESG	Building new ESG knowledge
	Gathering feedback, benchmarking and gap spotting	Contextualising investment decisions
	Developing knowledge of ESG issues	Identifying and diffusing industry best practice
<b>Political Deriving political benefits</b>	Enrolling internal experts	Advancing internal collaboration and ESG integration
	Elevating sustainability and securing resources	Meeting client expectations
	Enhancing the loyalty of long-term investors	Building long-term relationships

Source: PRI, O’Sullivan & Gond, 44 Cass Business School (2018)

by the following table developed for the Principles for Responsible Investment (PRI) by O'Sullivan & Gond from Cass Business School<sup>41, 42</sup>

Although we are active investors, we are not activists. Our engagement with management teams is intended to help us understand how they can achieve high returns and to assess whether they are good stewards of our clients' capital. We prefer to work constructively with management teams rather than agitating for change, although we will seek change where we feel the sustainability of returns is at risk.

Voting is another key area of engagement. We vote on all matters put to shareholders, following our voting guidelines, investment philosophy and our clients' wishes. In normal circumstance we support company management, however, we will withhold support or oppose management where we believe it is in the best interests of our clients.

Stakeholder analysis is an integral part of what we do. As Future Quality investors, we want to know whether

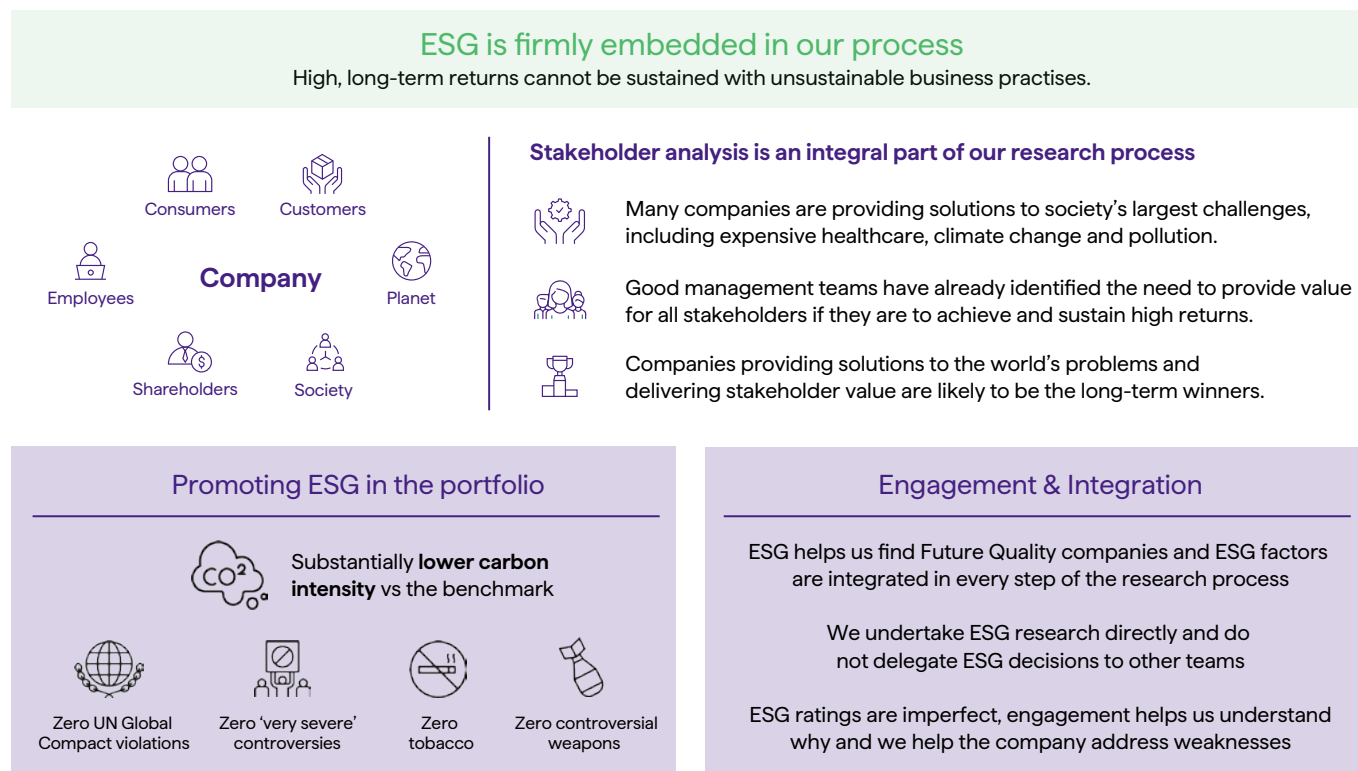
the company has a sustainable competitive advantage, whether it has an organisational and governance structure that will help management maintain and enhance that competitive advantage, and if its structure provides management with both accountability and strong incentives to add value. We are also looking for evidence that management is thinking about the company's future; about what the organisation will look like in 10-15 years from now.

### Part 3 Summary

ESG research helps us find Future Quality companies and ESG factors are integrated in every step of the research process. While ESG ratings are imperfect, engagement helps us understand where issues exist, and we use the information to help companies address areas of weaknesses. We believe long-term, active investors have the opportunity to add value by integrating ESG factors into their analysis. We consider ESG to be an essential lens through which to implement our Future Quality philosophy.

41 Cass Business School and PRI, 'How ESG engagement creates value for investors and companies' (2018)  
 42 O'Sullivan & Gond (2018)

Figure 18 Our Future Quality ESG Approach



Source: Amova AM

# Investment guide conclusion

Our belief is that we have moved into a new regime where inflation will be structurally higher, despite the longer-term structural anchors of higher debt burdens, ageing societies and ongoing technological disruption. Energy markets remain constrained, labour in short supply and fiscal policies remain vulnerable to the demands from voters to alleviate the pressure on real wages, particularly for lower income groups.

As focused stockpickers, the future profitability of companies is always a priority for us. The advantage of being active stock pickers is that we are not beholden to the market weighting of past winners, burdened with potentially bloated levels of profitability. Instead, we can focus on companies more likely to experience positive surprises in revenue and profitability in the coming years.

In summary, the search for Future Quality stocks with enduring drivers of growth will continue to define our portfolios. We believe that over the next 18-24 months, the focus on companies capable of creating meaningful value will only intensify. Future Quality companies will therefore find themselves in a strong position. Our consistent focus on enduring high-return franchises with strong management teams, robust balance sheets and credible starting valuations, will help us navigate a path through these challenges.

## Appendix

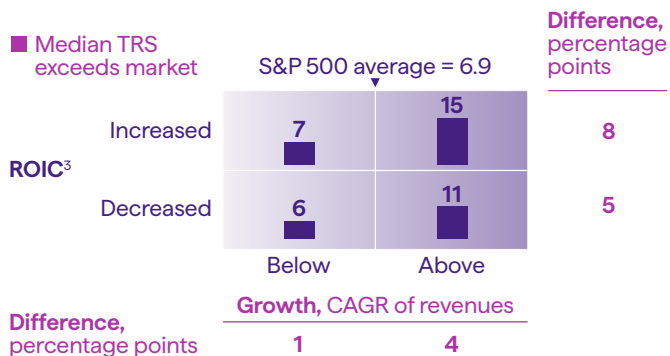
# How to choose between growth and ROIC



**Figure 19** High ROIC

For companies that already have high ROIC, growth generates higher TRS than further improvements to ROIC.

**Total returns to shareholders (TRS)<sup>1</sup> for companies with high returns on invested capital (ROIC),<sup>2</sup> 1996-2005, %**



1. Median of compound average annual TRS from 1996 to 2005 for each group of companies, adjusted for compound 1996-2005 average TRS of S&P 500 index companies (6.9%).
2. 78 companies with 10-year average ROIC  $\geq 20\%$  and market capitalization  $> \$2$  billion in 1995.
3. Excluding goodwill.

Source: Bin Jiang and Timothy Koller

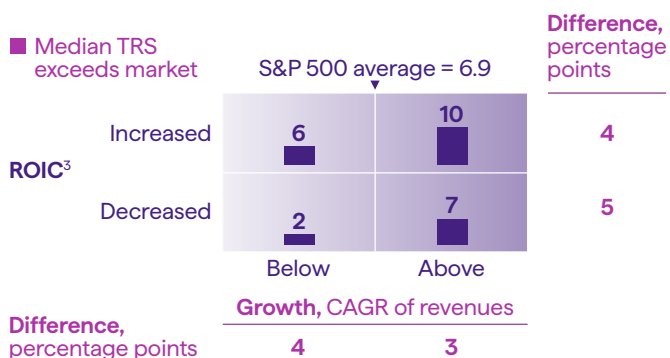
Bin Jiang and Timothy Koller<sup>43</sup> explored the relationship between total returns to shareholders and the change in ROIC. However, they took this a stage further and also incorporated the impact of growth (as defined by change in revenues). They identified high correlations between value creation, growth and returns. They looked at High ROIC, Median ROIC and Low ROIC companies and analysed the dynamics of these companies over a ten-year period (1995-2005) when growth and returns improved more or less than the market.

43 Bin Jiang and Timothy Koller, "How to choose between growth and ROIC" - McKinsey on Finance Number 25 Autumn 2007 pp. 19-22

**Figure 20** Medium ROIC

Companies with medium ROIC must maintain their growth and improve their ROIC.

**Total returns to shareholders (TRS)<sup>1</sup> for companies with high returns on invested capital (ROIC),<sup>2</sup> 1996-2005, %**



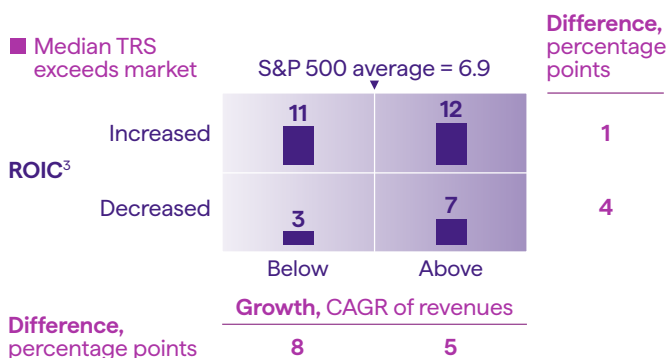
1. Median of compound average annual TRS from 1996 to 2005 for each group of companies, adjusted for compound 1996-2005 average TRS of S&P 500 index companies (6.9%).
2. 129 companies with 10-year average ROIC  $\geq 9\%$  but  $< 20\%$  and market capitalization  $> \$2$  billion in 1995.
3. Excluding goodwill.

Source: Bin Jiang and Timothy Koller

**Figure 21** Low ROIC

For companies with a low ROIC, improvement in ROIC is clearly more important than growth.

**Total returns to shareholders (TRS)<sup>1</sup> for companies with high returns on invested capital (ROIC),<sup>2</sup> 1996-2005, %**



1. Median of compound average annual TRS from 1996 to 2005 for each group of companies, adjusted for compound 1996-2005 average TRS of S&P 500 index companies (6.9%).
2. 64 companies with 10-year average ROIC  $\geq 6\%$  but  $< 9\%$  and market capitalization  $> \$2$  billion in 1995.
3. Excluding goodwill.

Source: Bin Jiang and Timothy Koller

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# Important Information

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\* Including employees of Amova Asset Management and its subsidiaries.

\*\* Consolidated assets under management and sub-advisory of Amova Asset Management and its subsidiaries.

Except where otherwise noted, the information is as of 31 March 2025.