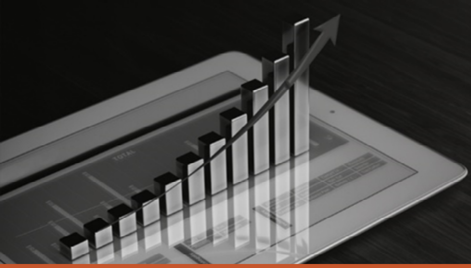


BERENBERG
Funds and Solutions

INSIGHTS – EQUITIES

February 2021

The Berenberg Equity Funds Investing Handbook: Our investment philosophy and what our portfolios look like

The aim of this handbook is to give you a better understanding of our investment philosophy and thinking. We want you to understand the nuts and bolts of our approach and decide for yourself whether you would like to join us on our journey of investing in world-class businesses, with strong moats and structural growth drivers. Together, our lead portfolio managers have decades of experience in successfully applying these principles. They are joined by a younger generation of investment professionals who share the same passion for long-term investing and analysing business models in depth. In this manual we outline the investment principles that guide each and every one of us.

Frequently asked questions about our approach:

Why long-term investing?
What is a quality company?
What kind of growth do we target?
Why is a low debt burden important?
How do we look at management teams?
How do we engage with management?
How are ESG factors integrated?
What is important when looking at valuation?
How do we construct our portfolios?
How do we think about risk?
Why do we invest across the entire market cap range?
How do we work?

We provide answers to these questions below.

Why long-term investing?

We are long-term investors and ideally like to own stocks in perpetuity. We believe this is the right strategy to deliver superior long-term performance. While it is simply impossible to reliably predict how stocks will perform next week, month or quarter, it is indeed possible to correctly identify those companies that will succeed over the long term. A myriad of unpredictable factors drive short-term stock returns. Over longer periods, significantly fewer and much more tangible factors become the dominant drivers. In our process, we aim to discard all the noise and instead focus on understanding those factors.

"In the short run, the market is a voting machine, but in the long run, it is a weighing machine." (Benjamin Graham)

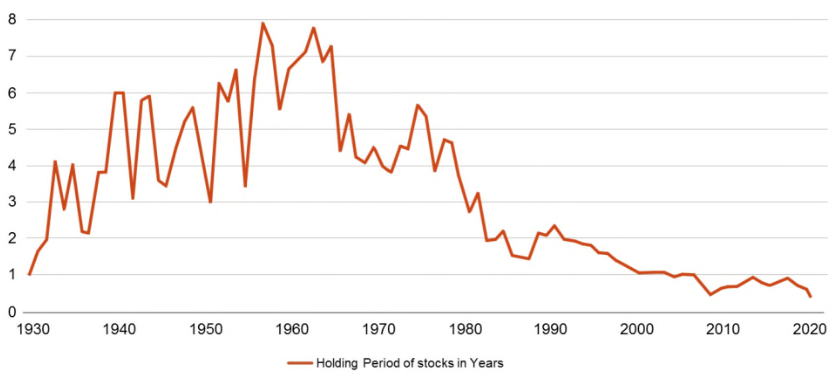
Our approach is particularly rewarding because most investors are doing exactly the opposite. Average holding periods have come down markedly over the years and today are less than six months.

The following publications are part of the Berenberg Funds and Solutions series:

- Spotlight
- ► Insights
  - Equities
  - Fixed Income
  - Multi Asset
  - Systematic Solutions
  - Overlay
  - ESG

*Within **Insights** we aim to give you a better understanding of our investment philosophy and thinking.*

Fig. 1: Holding period of stocks in years

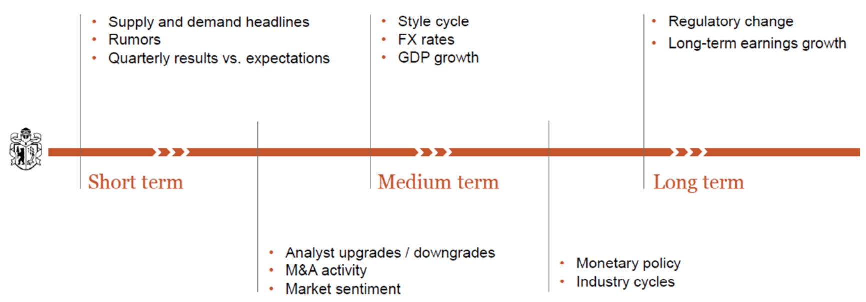


Note: Holding periods measured by value of stocks divided by turnover
Source: NYSE, Refinitiv

This increased ambition to predict tomorrow's market moves often results in a lack of appreciation of longer-term developments. This ultimately creates an opportunity for investors like us, who spend all their time thinking about the long term. For the great majority of companies in our investible universe, we observe a rapid decline in the number of available analyst forecasts as we look more than two years into the future. What is more, in outer years, growth rates quickly revert to the mean. This applies to both the best and worst companies. Generally, we have found that the market overestimates the recovery in growth for struggling companies and underestimates the sustainability of growth for quality companies. This is a market inefficiency we seek to exploit.

Most market participants have an investment horizon of up to 12 months. Our focus on the long term can thus add a lot of value.

Fig. 2: Drivers for stock returns from short to long term



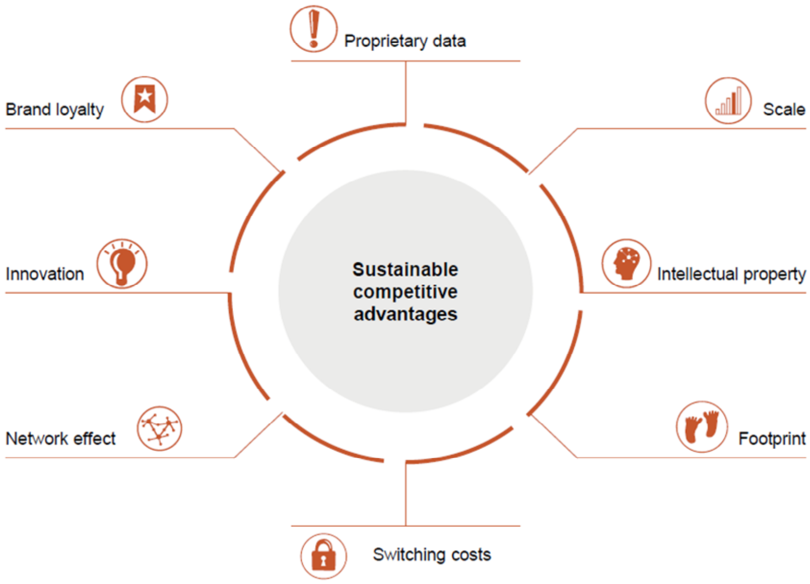
Source: Berenberg

Most important drivers for long-term earnings growth are the reinvestment opportunities a company has at sustainable high returns, which are defined by the attractiveness of the business model and the people and culture in the firm.
Finally, a steady hand and little turnover reduce the trading costs for our clients. Now, none of this is to say that we never sell out of our holdings. When something fundamental turns for the worse and we observe a lasting deterioration in the quality of the business or its growth outlook, we do act very quickly.

What is a quality company?

High entry barriers are key for having a long period of competitive advantage to safeguard the high growth rates for longer time frames and justify valuation multiples.

Across our equity platform, we invest in quality businesses. To us, the most important hallmarks of a quality business are sustainably high returns on capital. Ultimately, it is this single metric that signifies if a company is uniquely positioned within its competitive landscape and benefits from barriers to entry. We invest in companies that are protected by brands, network effects, technological advantage and scale. Scale is interesting because it can manifest itself in different ways such as a cost advantage, a distribution advantage, or the ability to spread selling and marketing spend to protect a brand over a larger number of customers. Brands, network effects, technological advantage or scale all protect the company through high barriers to entry and high switching costs.



To identify such a business, we thus always start with the numbers. At least in most instances the numbers do not lie. However, our analysis does not stop there. We do not just aim to identify past winners, but companies that stay great for years to come. Sometimes it is even possible to identify great companies that become better still. To accomplish that feat, we focus on the extent to which a company's competitive position is not only defensible, but also improving over time. It is hard to define the exact length of the competitive advantage period – the period a company can generate excess returns on its incremental investments. It is not a stationary analysis and has to be done with a dynamic long-term mindset. It is easier to evaluate whether the competitive advantages of the company on a rolling long-term (5 year) basis continues to be intact, weaken or strengthen. The longevity of the competitive advantage is our margin of safety.

Future value creation depends on the company in question being able to find projects that generate a positive spread between the Return on Invested Capital (ROIC) and the Weighted Average Cost Of Capital (WACC). That is how free cash flow for shareholders is generated. Growth creates value only when the spread is positive; it has no effect when the spread is zero and destroys value when the spread is negative. Too many company managements and investors focus on growth without recognizing the need for a positive spread in order to create value.

High dividend payments are in our view not a characteristic of a quality company. We believe that cash generated by the business should be reinvested at high returns. Above average dividend yields are most often a sign of lacking growth opportunities or a structurally low valuation due to disruption risk for the company.

What kind of growth do we target?

High growth potential should be profitable, cash-generative and based on real business expansion.

We are growth investors and only invest in companies that benefit from strong access to growth. To be sure, a high headline growth number alone does not qualify a company to join the ranks of our holdings. We are looking for companies that can grow for long periods and do so profitably. We emphasize sustainability of growth over magnitude of growth. It is also essential that companies can convert those increased profits into real cash flows, which can then be reinvested into the business at high returns on capital.

We always seek to invest in companies that benefit from a strong structural tailwind. Healthily growing end-markets are the bedrock for sustainable growth rates. But we must make sure to identify companies that achieve a lot more than growing with that market. We look for those leaders within their respective fields that are gaining considerable market share. In some instances, they are even single-handedly creating entirely new markets. We put a lot of work into the analysis to understand what the total addressable market (TAM) could be in 5 years or more.

This is not to say that we do not invest in companies with more cyclical business models. But in those cases, it is essential to differentiate between trends that are purely cyclical and those that have a strong structural undercurrent. Generally, in periods of high economic growth, especially those that follow a recession, investors often mistake a cyclical recovery for structural growth.

We have a clear preference for companies that achieve all of this organically. At least in most instances, organic growth is much more likely to deliver attractive returns on capital. It also tends to come with far fewer risks attached. That being said, there are some examples where acquisition-led growth can be very attractive. Where companies have built a strong track record of integrating acquired businesses, and where presented with an attractive opportunity set of future targets, this is also something we would invest in.

We are wary of growth that is driven purely by price increases, even if it indicates strong pricing power. Solely relying on price increases is not a winning formula. Instead, we prefer growth driven by real business expansion. We avoid companies that grow aggressively at low returns, no profitability or no cash flows. On the other hand, we also avoid non-growers or companies that grow earnings by means of share buybacks or restructuring efforts. The range of sustainable growth we target is usually between 10% and 25% p.a..

Why is a low debt burden important?

The companies we invest in do not require a lot of debt to finance growth. That is a side-effect of the quality of the businesses and their cash-generative nature. That is not to say that we will never invest in a company that does use debt to achieve a particular goal. Where that fits into the strategy and ultimately makes the company better - for example through a game changing acquisition – then this is something we would absolutely consider. However, overall the companies we invest in tend to use very little or no debt.

How do we look at management teams?

Part and parcel of a company's outlook is also the quality of its management. To assess management quality, we again spend a lot of time on the historical track record. We also spend a lot of time with the teams themselves. The purpose is to get to know the team, understand how they allocate capital and ultimately find out what their strategy is to enable a great business to thrive and prosper. Some key characteristics that we look for when evaluating management teams are significant stock ownership, and whether the management team has a clear strategic direction and is allocating capital in a way that will drive long-term value creation. The incentive structure of the top-level management should also be aligned with the strategic direction and long-term value creation. We also compare what management teams said they would do with what they actually ended up doing.

How do we engage with management?

Our meetings with management are not the most decisive part of our research process, but they do help us to better understand the business model and long-term growth drivers. We usually meet the management as the second step in the research process. By that time, we have done extensive research on the companies, leaving sufficient time to dig into the details. The meetings rarely change our view entirely. Instead, they tend to deepen our understanding and give us an opportunity to develop further conviction in our view. In those meetings we focus on the company's culture and how it has evolved or taken shape over time. We want to hear from the managers about their long-term view of the business and their strategy. We want to make sure that the CEO and his or her team are putting the long-term health of the business ahead of short-term results. It is a red flag for us if we ask a long-term question and get a short-term answer. Transparency in the communication process of a firm is a key ingredient. We meet invested companies on a more regular basis to make sure we are well informed about business trends and delivery on promises.

Meetings with management teams are essential for understanding the business model but also the company culture and strategic qualities of the corporate leaders.

Engagement is also a key tool in understanding company behaviour when it comes to ESG issues. Having an open dialogue with companies encourages transparency and also allows us to gain better company insights. We regularly engage with companies and consistently monitor our engagement results. Please refer to our Engagement Policy for further details. We believe that it is important that companies are able to showcase their commitment and progress towards their sustainability strategies. For example, this could include us encouraging companies to report measurable and quantifiable sustainability metrics, implementing policies and strategies and even improving executive remuneration structures. Nevertheless, we understand that at times, smaller companies are constrained in resources to disclosure their sustainability footprint. Thus, we expect this to be a journey that we go through together with the companies as we engage with them on material environmental, social and governance issues.

Read more:
ESG – Our Investment Approach in Equity Fund Management

Or visit our website:
www.berenberg.de/ESG

How are ESG Factors integrated?

Along with the rise of ESG, the pressure on asset managers to demonstrate the integration of environmental, social and governance considerations into their investment processes has skyrocketed. We welcome this shift and believe it plays to our strengths. As quality investors who seek to buy companies that can deliver durable long-term growth, we have always regarded the sustainability of their business models as critical. Only where businesses are managed with integrity, well governed, and set up in a way that is both environmentally and socially responsible, is long-term growth possible. Today this is more true than ever. That is not so say that all is perfect with the companies we invest in. In the real world, that is rarely the case. For us, the direction of travel is also critical. We engage proactively with management about the issues they face and monitor closely how they are dealt with over time.

The jury is still out on how best to integrate ESG and assess the sustainability of a business model. We for one believe the standardised frameworks of rating providers – while significantly improved – continue to struggle to account for the complexities and nuances of a real-world business. With regards to smaller companies, overreliance on such frameworks can easily result in significant risks being overlooked or attractive opportunities being missed. Understanding these complexities requires expertise, time and resources. Therefore, we believe ESG analysis must be done in-house and by the portfolio managers who make the final investment decision.

What is important when looking at valuation?

Paying up for growth is rewarding longer-term if the company is a true compounder and the competitive advantage period is long enough.

As quality growth investors we invest in companies that tend to sell for valuations that are in excess of the market average. This is because their quality, i.e., their competitive positions and management teams as well as their future growth outlooks, is far superior to that of the average company. This is another way of saying that we focus on those opportunities where future growth and the degree of certainty of that growth represent a large proportion of the calculation of value. That is not to say, however, that we do not focus on value. Quality growth companies are only attractive when their long-term growth potential is underappreciated by the market. While valuing a business comes only at the end of our investment process, it is nevertheless a critical part. But we are not valuation-driven investors. Our margin of safety does not come from buying stocks on the cheap: instead, it comes from our conviction in the longevity of growth rates and the extent of the competitive advantages. Shortcomings on growth or the competitive position can never be remedied by a low price.

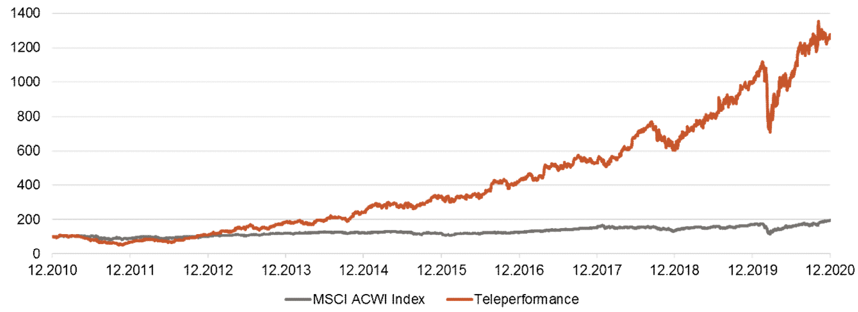
How then do we value potential investment targets? First, how we are not doing it: we do not use discounted cash flow models. More than any other valuation methods, they are susceptible to behavioural biases, inaccurate assumptions and false precision. Instead, we look predominantly at price-to-earnings and price-to-free cash flow ratios. These ratios keep us focused on the key metrics and allow for relatively easy comparisons. We compare a company's expected annualised returns with all the other opportunities available to us in the market. We typically will not invest in a business unless we expect double-digit annualised returns over the next five years.

Value is best thought of as a range and it is better to be approximately right than precisely wrong.

What do we typically pay for a business? Ultimately, we subscribe to Warren Buffett's advice that *"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."*

The following example illustrates why it is so much more important to get the quality and the growth of a company right, than it is to strike a bargain.

In the Spring of 2011, Teleperformance had just reported 2010 results. Earnings per share came in at EUR 1.27. At the time, the stock was trading on c. 16x 2010 earnings. Was that a fair multiple at the time? In retrospect it was an absolute bargain. Over the subsequent decade, Teleperformance would deliver a staggering compound earnings growth of 16% p.a.. The total return delivered to shareholders over that period was an even more impressive 24% p.a.. If one had known at the time about the great growth trajectory ahead, one could have paid 84x and still have performed in line with the market. (The MSCI ACWI delivered 6% pa over that period).



Source: Bloomberg, 31.12.2010 – 31.12.2020. This is only a retrospective example and does not constitute a recommendation. Past performance is not a reliable indicator of future returns.

How do we construct our portfolios?

We run concentrated and benchmark agnostic portfolios and focus on the very best investment ideas. Our investment approach, with its strong emphasis on a fundamental, bottom-up understanding of each holding's business model, industry position and runway of growth, is time-consuming and resource-intensive. We go to great lengths to find the most attractive investment opportunities across our universes. Once identified, we watch them closely. We monitor them as well as the competitive landscape, are in close contact with our management teams and engage on important issues around the sustainability of their business models. We do not want to dilute the insights of that hard labour by mixing our very best ideas with those that are less good. Diversification is achieved by owning companies with different structural growth drivers and end-market exposures. We typically invest in 30-50 companies in our all cap strategies and roughly 70-120 stocks in our small cap strategies. We are almost always fully invested.

Being a disciplined seller is also key for protecting the growth and earnings profile of the portfolio.

The most common reason for selling out of a business is that we found a better one. When we have identified a business that is better than the one we have the least conviction in, the latter becomes a source of capital and we make the switch. The hurdle for this is high and it does not happen often. A more important although less common reason for selling is when we become concerned that a company's competitive advantage is deteriorating or when management is misallocating capital. We do not waste any time in such cases and act quickly in order to protect the compound earnings growth of the portfolio. And finally, we sometimes sell for valuation reasons. When the price is so high that the rate of earnings growth will not be able to overcome the valuation headwind and still provide double-digit annualised returns, it is time to part with a company, no matter how great.

How do we think about risk?

We do not subscribe to the view that volatility equals risk. And unlike many of our peers, we do not spend our time focusing on tracking errors and the statistical gap of portfolio versus benchmarks returns. They are interesting metrics and they may provide valuable insights into the style of a fund manager but, especially in the context of managing an active portfolio, these metrics are unhelpful. The risks we do care about a great deal are company specific. They are factors that can affect profitability and company valuations. Among the many risks we think about, weakening or maturing market growth and deteriorating returns on capital caused by intensifying competition or wrong capital allocation feature most prominently. Preventing those risks from materialising in our portfolios can only be achieved with deep knowledge of all the companies we are invested in.

Why do we invest across the entire market cap range?

We find attractive opportunities in all market cap ranges and have the great advantage that we start investing in companies when they are too small for most investors.

With our equity platform we invest across the entire market cap range. We run both Global and European All Cap strategies that only exclude micro caps and we also manage dedicated Small and Micro Cap strategies. This wide market cap spectrum does not just increase our opportunity set to identify great businesses to invest in. We also see an attractiveness in each of these different buckets. Large caps, for instance, can sometimes offer particularly entrenched competitive positions. On the flip side, they are often thought to be mature behemoths that lack awe-inspiring value creation. While that may be true at times, for the bucket, there are always enough individual opportunities with potential to deliver extraordinary performances. Just think of the US tech giants and their performance. In Europe, too, there are several mega-caps that continue to expand at a rapid clip. It is merely a matter of being absolutely disciplined in focusing on the few gems and discarding the rest.

The Small and Micro Cap buckets show equally attractive opportunities. While they are often thought to be higher risk, we believe that here too it is possible to find unique businesses that are nearly impossible to replace. And they often tend to have a very long growth trajectory ahead of them. While our All Cap funds do not invest in micro caps, i.e., companies with a market cap of less than EUR 500m, we believe our dedicated strategy still gives us a competitive advantage. By the time these companies become investible for most, we will have already followed them for a very long time and have therefore better knowledge and higher conviction.

How do we work?

Focus is key, therefore we think that it is not needed to cover the market completely, as only a small fraction of stocks have delivered steady above average returns longer term and we believe we are able to identify them through our process and experience. We are a team of 12 equity portfolio managers. While we do not hold many formal meetings, we do speak on a constant basis. We exchange views, challenge each other and research new investment ideas together. Nobody works in a silo. This is possible, because we are generalists who are all comfortable exploring new business models. None of us are constrained by sector boundaries or rather a "sector mindset". We are deliberately set up this way. We do not just want to identify the best companies within their sectors, but the best ideas within a pond of quality businesses. While we never venture out of that pond, within it we are free to pursue any investment opportunity. Keeping a broad perspective and being able to weigh very different companies against each other is thus essential. That said, over the years we have built up strong knowledge for the industries we have always been investing in, mainly Technology, Consumer, Industrials and Healthcare. Valuation and portfolio construction only become relevant when we truly want to own a business. This is also why we consider ourselves to be business analysts rather than financial analysts. We think and act as if we were going to buy an entire business and hold it for years to come. We believe this mindset sets us apart from most.

Staying disciplined!

Staying disciplined and sticking to what we know best is the single most important factor within our control determining our funds' future performance. It is of course true that different investment styles – according to the vagaries of fashion – undergo some cyclicality. In times of nervousness and fear, investors cling to what is perceived to be quality. When the market turns more buoyant, the appetite for cyclical and riskier assets returns. While these ebbs and flows of capital may have a short-term impact, they are not sustainable drivers of long-term performance. Thinking first and foremost of our clients makes it very easy to stay within our guardrails rather than being tempted to venture out. Our template has proved that it can provide safety and growth, that it can protect the downside and compound to the upside over time. Equity portfolio managers need perspective, discipline and patience.

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Berenberg equity competence

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