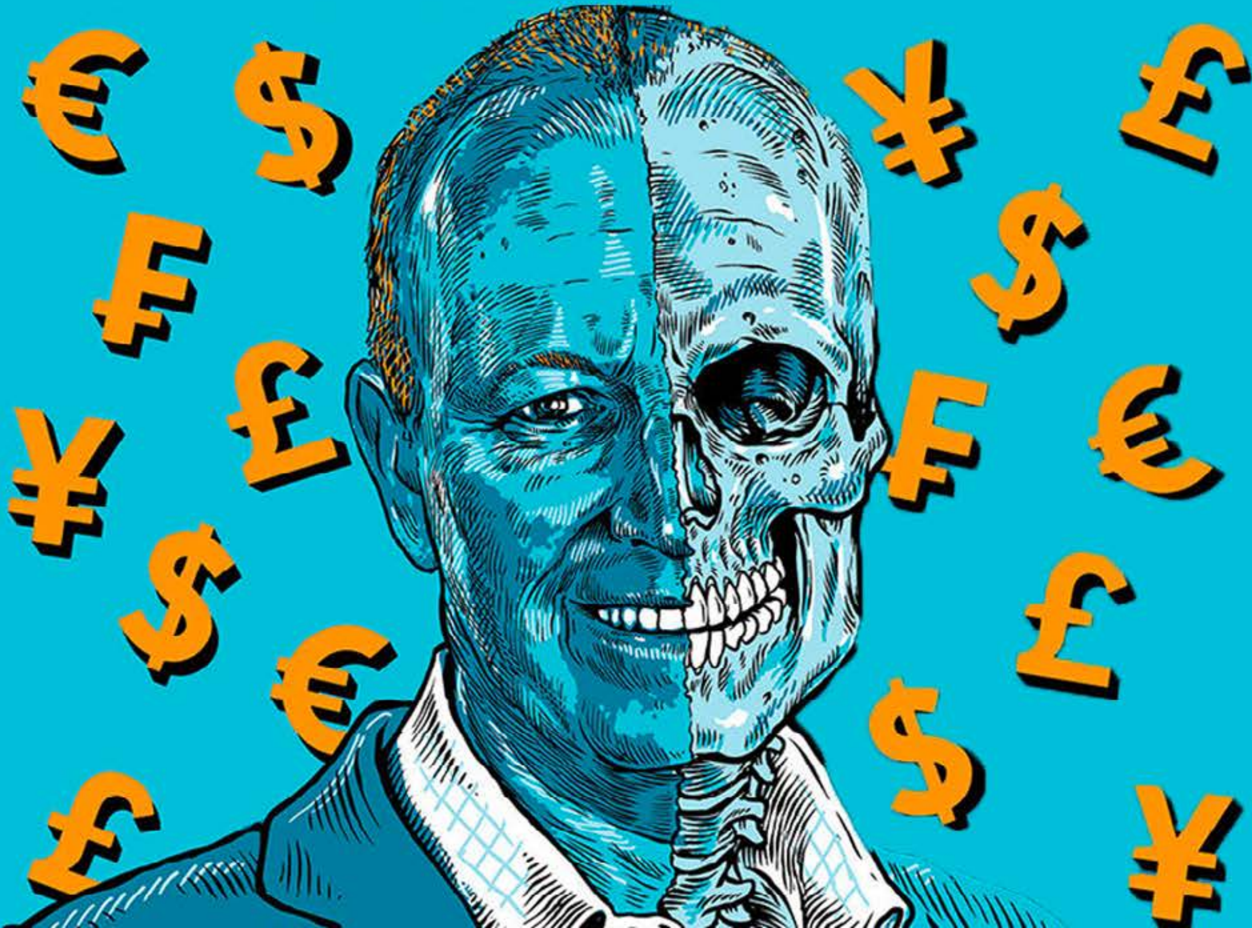
AORIS INVESTMENT MANAGEMENT

Stephen Arnold's international stock picks

Sean Aylmer speaks to Stephen Arnold, founder and Chief Investment Officer at Aoris Investment Management, about the Aoris International Fund. They profile a number of the stocks held by the fund including Costco, Nike, LVMH and Tractor Supply.

READ TRANSCRIPT



Fear and Greed Daily Interview: Stephen Arnold's international stock picks

Welcome to the Fear and Greed Daily Interview. I'm Sean Aylmer.

It's always interesting talking to fund managers about where they're choosing to invest their money. Today, we're going to look at some of the big international stocks that sit within the Aoris International Fund. Stephen Arnold is the founder and chief investment officer at Aoris Investment Management. Stephen, welcome to Fear and Greed.

Hi, Sean. It's a pleasure to be here.

Now, actually, in that introduction, I did say where you're investing your money, but it's not actually your money. It's your client's money of course.

It is. But I should note that all of my personal money is invested in these portfolios as well. So I sit alongside our clients and get exactly the same investment outcome as do our clients.

I think they call that alignment somehow, Stephen. I think that's the word we use nowadays. Alignment.

Yes.

Something like that. Now, look, tell me, when you're going and you're picking international stocks. What's the process? There are literally tens of thousands or more stocks to choose from around the world. What's the process you go through?

Well, Sean, our portfolio is different in many ways, and one of which is that we are very concentrated, which is another way of saying that we're very selective. We own a maximum of 15 companies. So as you said, there's just a vast opportunity for us to choose from but by being so concentrated and so selective, it allows us to set our criteria very, very high. So we describe ourselves as quality first value investing. So through those two simple lenses, you can imagine that we are very demanding when it comes to both quality and value. So to dig a little bit deeper, the sort of businesses we are in, you can think of satisfying three interesting criteria. The first of which is that they are durable, in other words, that have been around a long time, and we expect them to stay be successful for a very long time to come so they are durable. The other thing is that they are highly profitable. Wealth comes from businesses that generate high returns on capital. And the third thing is that they grow. So we are looking to create wealth for our clients through the success, the growth and wealth creation of some of the world's most fantastic, wonderful businesses. And those businesses are durable, they're profitable and they grow.

That's really interesting. Those three ways of thinking about it. But how did how do you narrow it down? You said you've just got 15 stocks and we'll get to some of those in a moment. How do you narrow it down? How do you find those 15 that have got those three attributes?

Sean, it's a combination of knowing that there's certain types of businesses and certain types of industries that, by their nature, just simply don't grow. They are not that durable and they're not that profitable. So our starting point is that we don't own banks or insurance companies. We won't own mining and resource companies. You can imagine the vicissitudes of macroeconomic variables make those businesses a bit fragile, less durable and less profitable. And we don't own businesses that are second rate businesses. We believe that the disproportionate returns will go to the best companies. We believe in owning leadership, winning businesses. And so that really narrows our lens.

Yeah, yeah. The banks and financials why don't you own those?

Well if you think about the economics of banks, they generate, certainly on an international context, returns on equity, either side of 10 per cent, most likely a single digit number, and that's with the benefit of a lot of leverage. So for every dollar of assets on the balance sheet, the returns are pretty poor. But they're only generating those outcomes by taking a lot of risk. There's a lot of competitive risk. There's a lot of macroeconomic risk, interest rate risk and leverage risk. So that feels like just not a great equation to us. Very poor economics and a lot of risk in those businesses. And for that reason, they just don't grow. We want, when we think about growth for us, we want businesses to grow comfortably in excess of the broader economy. And banks just don't do that. And of course, banks are, by their nature, very opaque. As an outsider, as it's been shown time and time again, we often don't know what's going on, the things going on inside a bank that we would really like to know as owners and so for us by being so selective, it's easy to say, well, there's just better opportunities for us elsewhere. And rather than trying to pick through and find a bank that we feel comfortable with, either steer ourselves off. I'm sure we'll talk about some of the businesses we do own.

Yeah. So let's jump into that and mean some household names, even though none of them are listed here. Costco, L'Oreal, LVMH, Nike, you know, let's say Nike, certainly durable. I'd imagine we'll have that one. It has been profitable. It's not too mature to grow, though.

Absolutely not. And that's a business I describe as embodying the athlete's mindset. They are very, very competitive. And I don't think I think too much about market share. They just want to grow. It's not that we've got to take a dollar of market share from Adidas or somebody else. We just want to sell more of what we make. And in order to do that, it's a business. It's very good at a lot of things. It's very good at a supply chain and logistics, which matters a lot in the current environment. But they're very good at keeping their brand relevant through investing in athletic sponsorship and brand innovation so their products just don't get stale, and they've got a long record of being successful in appealing to a very broad swathe of society, from kids and adults to professional athletes and everybody else, men and women, and geographically they do well everywhere. It's amazingly broad business and it's been an amazingly successful business. And it really is a good example of us owning winning businesses. And as I said before, we believe in the best returns going disproportionately to the best businesses. And Nike increasingly pulls away from the crowd and strengthens and deepens its leadership position.

And you talk about a broad based one of the most amazing companies in the world, I think, which you own is LVMH, Louis Vuitton Moet Hennessy, the luxury brands good, which seems to be everywhere one way or another. Why do you like LVMH? And I mean, that's a very, very different concept to Nike.

Oh, absolutely. And part of what makes it durable is it's got real heritage brands from Tiffany to Louis Vuitton, Christian Dior and many, many others that have been around for decades. But part of what the company does very well is to retain a contemporary feel so that these heritage brands never feel stale. The business is remarkably broad. It operates across many categories of luxury goods, fashion, leather wines and spirits and perfume and cosmetics. And it does so in every country in the world. And that breadth and diversification across categories, brands and geographies is a real powerful ballast for the business. And like Nike, investing heavily into their best assets with their brands, they've been able to grow well in excess of the broader economy for a very long period of time at a high level of profitability. So it really embodies those characteristics of durable, profitable and growing.

Moving well away from that retail space, Accenture, the I.T. Consulting and Outsourcing Group. Why do you like that one?

Oh look, part of what makes it durable is its remarkable ability to stay relevant to their clients. Now, their clients should think about the world's two thousand largest organisations. And Accenture's business is helping those super large organisations deal with change. And there's change going on today, yesterday, tomorrow and next year. The world is constantly changing and Accenture stays relevant to those super large organisations by solving today and tomorrow's needs and retrains people, hires people with contemporary skill sets and makes lots and lots of small acquisitions to bring in those skill sets. Surface cybersecurity for the world's largest banks that need Accenture's help with e-commerce solution, taking IT infrastructure to the cloud, Accenture is able to solve those problems. So it's big, broad and got global scale. It stays relevant to their client's current needs. And for those reasons, it's really grown well in excess of its peer group, proved remarkably durable and very profitable.

Stay with me, Stephen. We'll be back in a minute.

My guest this morning is Stephen Arnold, chief investment officer at Aoris Investment Management. OK, so we've talked about Nike, LVMH, Accenture, Costco is in there, L'Oreal's in there, as I mentioned before. They're all big multinationals. Now, one company I had never heard of, and I'm guessing it is exactly what it says it is Tractor Supply Co. That's very local, that one sounds anyway.

Yeah, well, Sean, it's a funny misnomer here. I'm not sure of the historical reason behind it, but they don't actually sell tractors.

Oh, really? It's like rare earths. There are lots of rare earths in the world, but they're called rare earths.

It's not that rare after all. Tractor Supply is a retailer serving the rural communities of America. And for those rural communities, they are often have families on the land. And what do they need? They need animal supplies, pet supplies, fencing, workwear, tools and some household basics, the whole variety of general merchandise that the household might otherwise have to drive a long way to go. So a Home Depot might be forty five minutes drive away. My Walmart might be an hour's drive away, but my Tractor Supply is down the road so location is a big plus point. And culture is another big plus point. It's a business across their two thousand stores hires their customers, which means that we want people working on a store who are like our customers. They have land, they understand our customers needs, and they do it remarkably well. They keep their employees in, as you know in retail the turnover can be at a phenomenal rate. So your customers never know who they're dealing with. Tractor Supply keeps their employees a very long time, which means in turn, they keep the customers a very long time. When we think about durable, one good way to test this competitively, and that's a business that over time, both Walmart and Home Depot have had a crack at competing directly with them. In both cases, Home Depot and Walmart have packed up and gone home, which is a good proof point to just how formidable a retailer the Tractor Supply is.

Yeah. Now, tell me, how active are you? How often do you change the 15 companies in your portfolio?

Well, Sean we try and balance between being patient but responsive. So to the extent that circumstances change, prices change. Sometimes the strength of a business is not what we thought it was. Sometimes that changes. So the way it nets out, as we would expect across our 15 stocks to make three or four changes each year. And that's pretty much what we've done over the last three years.

Is it harder to sell out when things are good or sell out when things are bad?

Well, I think it's hard. It can be hard to sell full stop, which is why we structure ourselves to have a maximum of 15 companies because we know that we're always finding interesting new ones. And if we don't have that hard selling at 15, we'll find ourselves buying three more selling none. Two more selling one. And then the 50th best stock is probably not as good as our 15th. So that creates a lot of discipline for us and keeps that quality and value criteria very high. So it's one way that we create some discipline into our process by keeping our stock numbers tight.

And it makes sense. The sixty four dollar question, though, of course, how has the fund performed in recent years?

Well, we like to deliver. We target returns over a cycle of eight to 12 per cent after fees. Now, over the last three years, we've delivered ahead of that 15.3 per cent in the three year period to the end of April. And that's a few percentage points ahead of what the broader international equity markets has done. So we're pleased to have exceeded our benchmark and also exceeded the top end of our eight to 12 per cent target.

OK, and just finally, ESG, how do you the world is thinking more about the environment, social and governance issues. How do you bring those sorts of things into your fund?

Look, I think, Sean, it's become more important. When you think about the consumers, where a product is sourced, how it behaves clearly matters more and more today, more than it did a decade or two ago. So when we think about the ability of a business to remain durable, those ESG considerations are more important. Now for us, the sorts of businesses that we actively exclude tobacco, and gaming, and banks, mining all put us in a pretty good zone. When it comes to the types of behaviour that we look for, for our businesses in the portfolio, then we set our criteria pretty high and our across our portfolio, including all of the businesses we've spoken of, we think that they exhibit very high standards when it comes to all of those ESG principles.

So, Stephen, what do you think the outlook for the market is, and particularly with the spectre of inflation hanging around?

Look, I think inflation is a very relevant consideration. Now, the central banks have taken what seems to be a pretty benign approach, that it'll come, it'll cycle through and it'll go away quickly. But, of course, there's a real risk that that's not the case. I think for investors and certainly, for us, we should be thinking for a few characteristics when it comes to the sorts of businesses you want to own in an environment where the risk of inflation is clearly going up. You want businesses have got pricing power to have the ability to put through the inflation into their price, particularly when it's supported by value. It's easier to charge a bit more when you're delivering a bit more value. Secondarily, you want businesses that have got a good history of being operationally efficient rather than those companies that are a bit lax nine years out of 10 and then have a big once a decade restructuring program so that institutionalised good operational excellence is a good defence mechanism. And when you think about the companies like Costco and L'Oreal, the purchasing muscle that they've got puts them in a great place to manage cost inflation should we see it. And then, of course, there's inflation may well have important implications for how equities are valued. And then I think the real risk areas are those businesses in that sort of hyper growth businesses that might be losing money today, valued on the promise of profits somewhere down the future. I think if we see higher rates, the valuation of those businesses is very vulnerable.

Stephen, thanks for talking to Fear and Greed.

Thank you for having us.

Stephen Arnold, chief investment officer at Aoris Investment Management. This is the Fear and Greed Daily Interview. Join me every morning for the full Fear and Greed podcast with all the business news you need to know. I'm Sean Aylmer. Enjoy your day.