# IMAP Conference

# How quality and value factor tilts can help your clients achieve better total portfolio outcomes

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# About Morningstar Investment Management Australia Limited

- Morningstar Investment Management Australia Limited is Morningstar's investment managed business based in Sydney, Australia.
- We offer multi-asset investment management (including multi-manager and direct strategies) and research services to institutions, advisers and individual investors.
- The Sydney office manages and advises on funds just over A$8 billion (as at 30 June 2019).
- Global investment team comprised of 101 professionals

**A$283 bil**

**Assets under management and advisement worldwide**

Data as of March 31, 2019. Includes assets under management and advisement for Morningstar Investment Management LLC, Morningstar Investment Services LLC, Morningstar Investment Management Europe Ltd., Morningstar Investment Management Australia Ltd., Ibbotson Associates Japan KK, and Morningstar Investment Management South Africa (PTY) LTD all of which are subsidiaries of Morningstar, Inc. Advisory services listed are provided by one or more of these entities, which are authorized in the appropriate jurisdiction to provide such services.

# How Morningstar Investment Management Invests

**Our investment approach**

- Objectives-based with a focus on CPI plus portfolios
- Valuation-driven because an asset’s fair value matters
- We manage portfolios to minimise drawdowns
- We manage unconstrained portfolios

# An asset allocator’s perspectives on international equities

- Key considerations when allocating to international equities:
  - View on relative value of asset class – should we own the asset class?
  - Preferred market exposures – countries, regions, sectors, size bias
  - Optimal way to gain the exposure – index, low cost systematic, active management

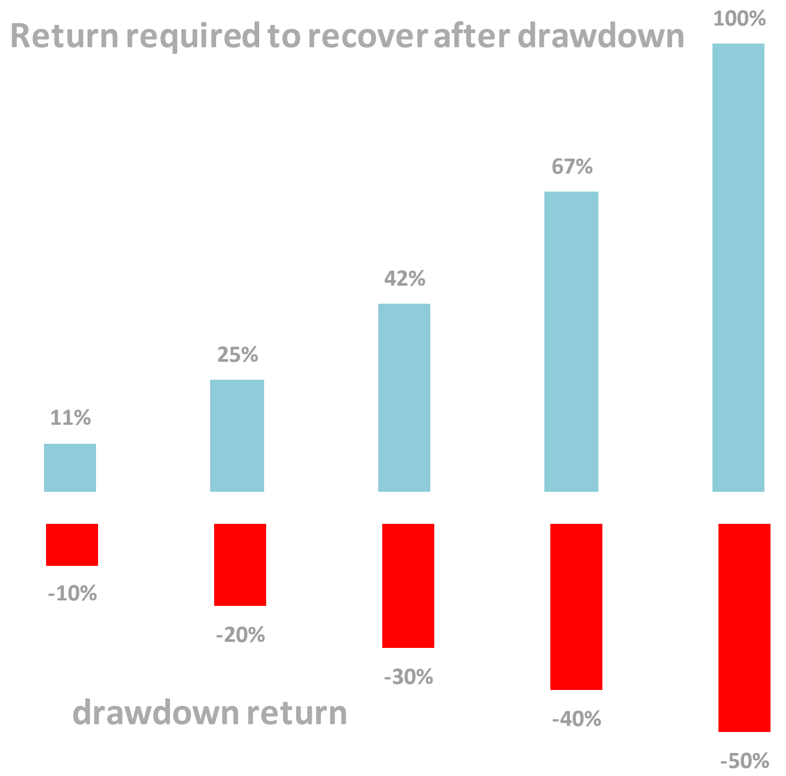
| Bulk beta (index) | Systematic factor exposures | Alpha exposures (active management) |
|---|---|---|
| • Low cost.<br>• Easy access to preferred market exposures (European Equities, Financials etc).<br>• Prone to concentration risk. | • Systematically select portfolio holdings to achieve desired factor exposures.<br>• Low-cost way to improve the overall composition of the asset class exposure.<br>• Potential for better return and/or risk outcomes. | • Select managers with proven ability to add value over the index after fees.<br>• Combined to improve diversification and risk. |

# Why we use systematic tilts – building a complete portfolio

- Equity component of a multi asset portfolio is the largest driver of return and risk.
- Index exposures – great for cheap access to preferred geographies/sectors but will participate in the downside.
- Active managers used to generate outperformance, but typically not focused on draw-down.
- What is missing?

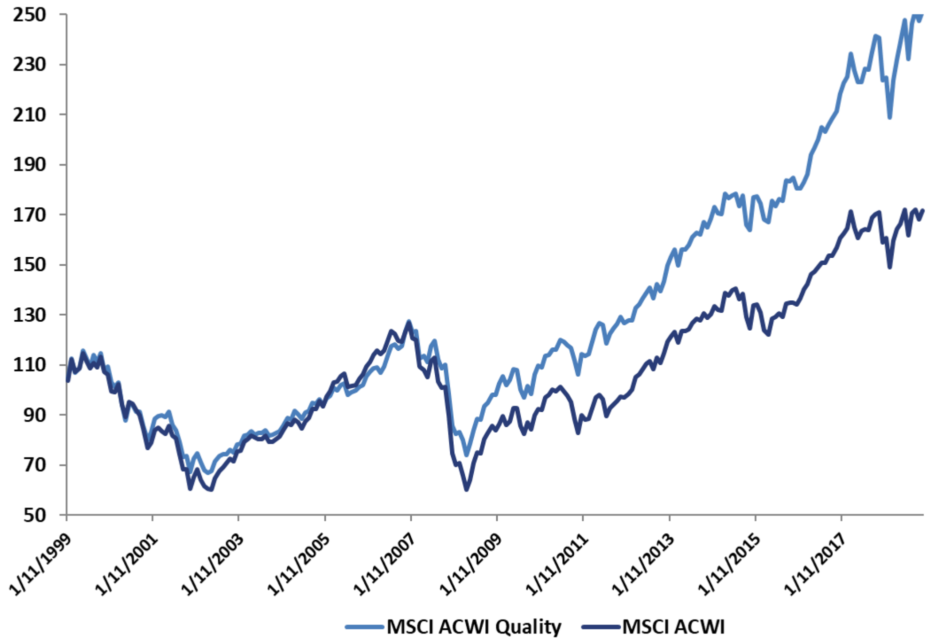
  Something to reduce the drawdown from equities while maintaining long-term return potential.

*"Observations over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favourable business conditions." – Benjamin Graham*



# Why use a quality factor exposure in international shares?

- Quality factor tilt can potentially provide ballast during market turmoil.
- Quality stocks are characterised by;
  - low debt,
  - stable earnings growth, and
  - sustainable competitive advantages which allow the business to remain viable over time
- Tend to exhibit countercyclical outperformance, lower downside capture – good for total portfolio outcomes.
- Aligned with long-term investing.




| | | |
|---|---|---|
| Upside capture ratio | | 0.95 |
| Downside Capture ratio | | 0.85 |
| Capture ratio | | 1.11 |

| | MSCI Quality Index | MSCI Index |
|---|---|---|
| standard deviation | 13.8% p.a | 16.4%p.a |
| # of up months 146 | # of down months 93 | |



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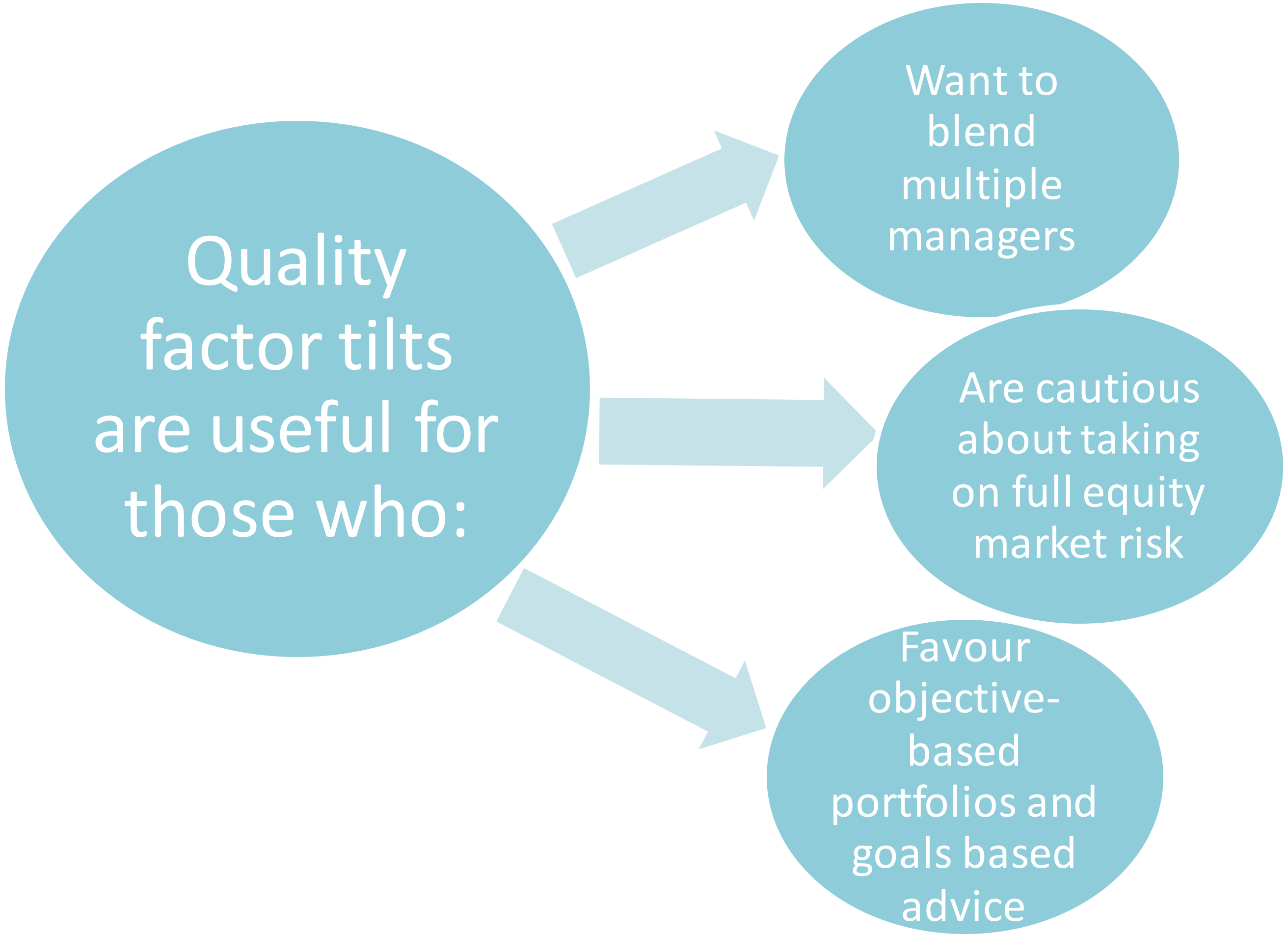
# Could quality factor tilts be suitable for your clients' portfolios?



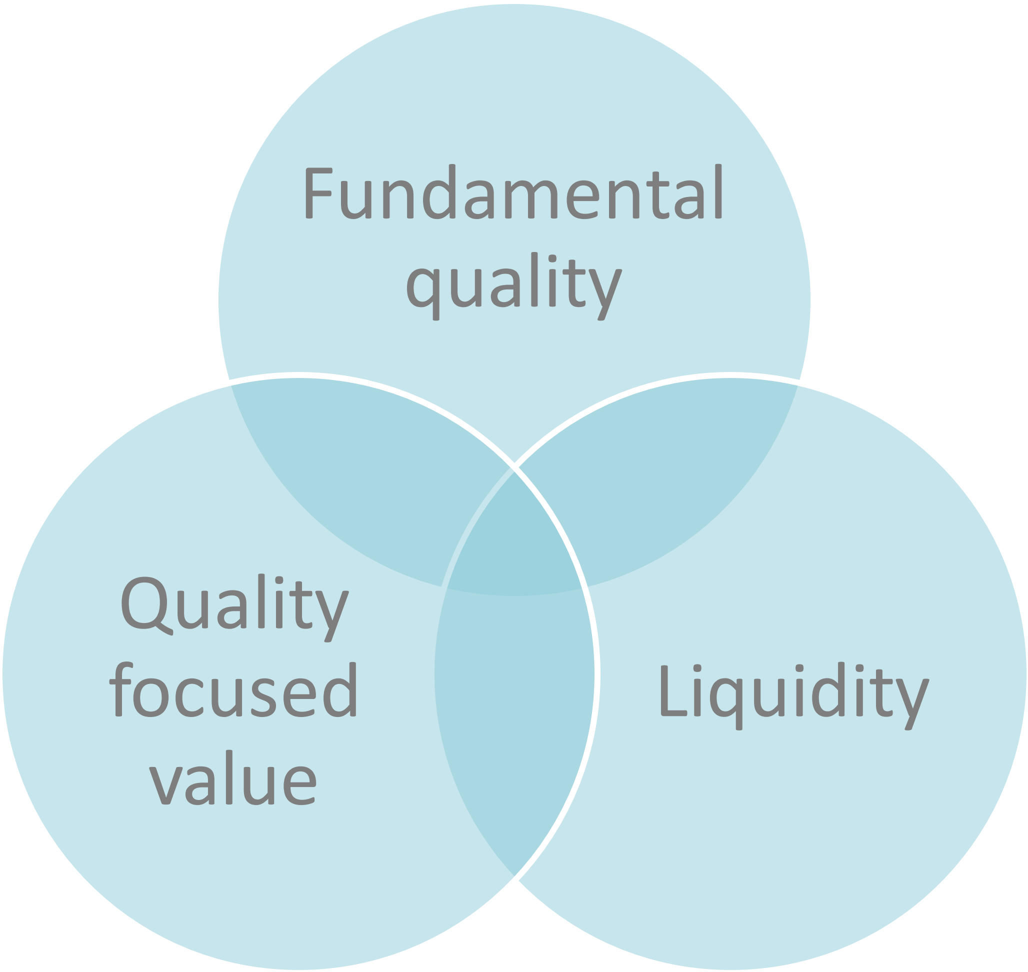

"Fear of loss, or loss aversion, suggests that investors favour countercyclical outperformance. This means limiting the losses experienced in down markets and better preservation of capital."

– Jody Fitzgerald (reducing downside risk capture)

# Quality investing should be combined with a strong valuation framework

- Graham and Dodd formulated the principles of value investing in the 1930s: find high quality stocks and buy them at low prices.

- Implementation and portfolio construction is critical when employing Quality within a portfolio.



# Assessing the fundamental performance of a company

We look at the **fundamental quality** of a company using **profitability (75%)** and **balance sheet (25%)** metrics:

ROE

Operating income stability

Operating profit margin stability

Current interest coverag e

Debt to normalis ed market value

Companies we like will need to meet minimum fundamental performance and risk metric

- Have **minimum profitability** in trailing average ROE, ROA, and profit margin;
- Demonstrate **minimum long-term earnings growth.**
- Demonstrate a **history of positive distributable income**;
- **Not exceed maximum debt** to ‘intrinsic value’ (normalised market value) levels;
- Exceed **minimum interest coverage**;
- **Reject companies** with **too much debt and too low profitability**

# Identifying well priced quality companies

- **Earnings Power Value (EPV):**
  - Stock-level model of normalised distributable earnings.
  - Conservative Cost of capital – different to DCF, doesn't rely on volatile or optimistic growth assumptions.
  - Uses quality-based required returns on capital for final valuation.
  - Consistent valuation metric with broad application.

**Distributable income** ÷ **Cost of capital** = **Earnings power value**

- **Portfolio Construction**

Portfolio construction techniques used to reduce turnover, increase capacity, and maintain momentum neutrality while pursuing systematic quality and value.

# Top Compounders in the Portfolio

Microsoft +653%

Nitori +527%

Raytheon +466%

NetEase +412%

Danaher +399%

NIKE +391%

Chemed +612%

TravelSky +497%

Stryker +454%

ResMed +387%

C.R. +373%

Taiwan +348%

LVMH +343%

General +332%

Recordati +548%

Fiserv +469%

Jack Henry & Assoc +428%

CBOE +373%

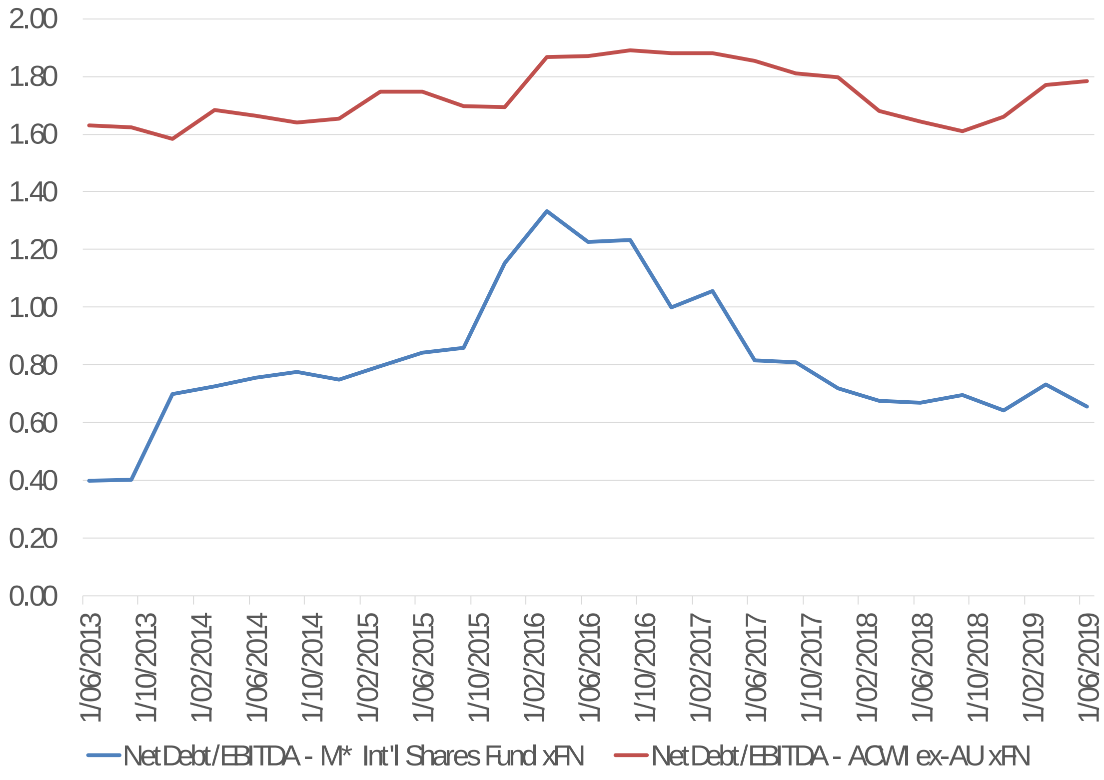
Cisco +342%

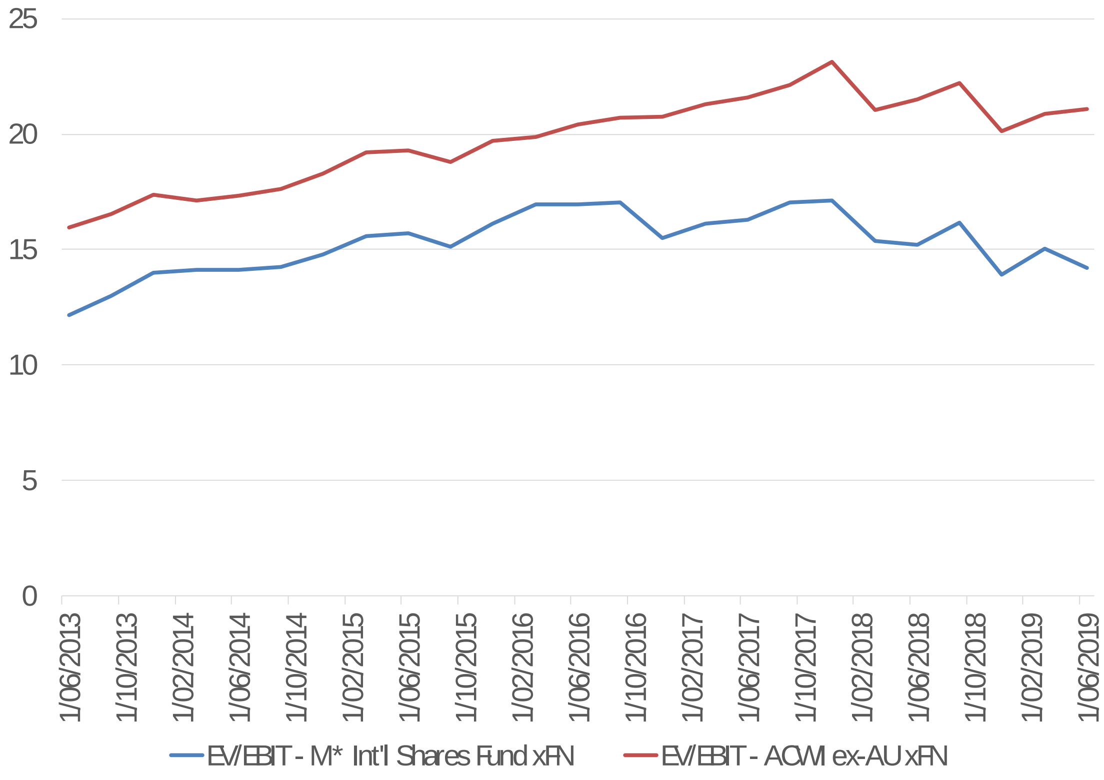
FactSet +330%

As at 30 September 2019

# What happens when you focus on strong balance sheets and profitable companies?

- Portfolio versus index Net Debt/EBITDA and EV/EBIT shows:
  - Portfolio has less than half the debt of the index and is cheaper on reliable earnings
  - Less equity risk in portfolio



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# Smaller upside and downside capture results in smoother returns, capital preservation

- Upside vs downside benchmark capture since inception is in line with expectations, 96% vs 83%.
- Market downside volatility over the last 5-10 years is not comparable to that seen over 10-20 years.
- The strategy is ahead of benchmark since inception and over 5 years, while carrying much less fundamental risk.

Gross Composite Returns as at 31-Aug-2019[1]

| Strategy | Strategy Inception | 3 mth | 1 yr | 3 yr (ann) | 5 yr (ann) | Since Incep (ann) | Sharpe Ratio[2,3] | Sortino Ratio[2,3] | Upside Capture[3] | Downside Capture[3] |
|---|---|---|---|---|---|---|---|---|---|---|
| **Morningstar International Shares (Z class)** | **2013-06-01** | **7.63%** | **5.73%** | **10.91%** | **13.52%** | **14.69%** | **1.26** | **2.64** | **96.3%** | **83.4%** |
| *MSCI All Country World ex-Aus (A$ NR)* | | *7.35%* | *6.98%* | *13.25%* | *12.80%* | *13.92%* | *1.15* | *2.25* | | |
| *Excess to Benchmark Index* | | *+0.28%* | *-1.25%* | *-2.34%* | *+0.72%* | *+0.78%* | *+0.11* | *+0.39* | | |
| **Morningstar International Shares Hedged (Z class)** | **2013-06-01** | **4.29%** | **-1.45%** | **8.17%** | **8.86%** | **10.94%** | **0.91** | **1.18** | **95.0%** | **81.2%** |
| *MSCI All Country World ex-Aus (H A$ NR)* | | *4.35%* | *-0.12%* | *9.92%* | *7.96%* | *9.87%* | *0.74* | *0.97* | | |
| *Excess to Benchmark Index* | | *-0.06%* | *-1.33%* | *-1.75%* | *+0.90%* | *+1.06%* | *+0.17* | *+0.21* | | |

*1. Composite strategy returns are computed by asset-weighting individual monthly portfolio returns using beginning-of-month asset values for each portfolio.*
*2. Annualised.*
*3. Computed from strategy inception.*

Source: Morningstar.

# Why use a factor tilt within a multi asset portfolio?

- Factor investing allows multi-managers and advisors to build client portfolios simply and efficiently due to:
  - The transparent way factor portfolios are systematically constructed – no style drift, predictable performance pattern.
  - The ability to choose the “right” factor to tailor investment outcomes within your portfolio, generating above-market returns, managing risk or enhancing diversification.
  - Lower fees than active management.
- Works particularly well in large and diverse asset classes like international equities.
- Can improve your client’s total portfolio outcomes.

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