

NEWSLETTER

Fernando León

PLAYING FOR THE LONG TERM CHAMPIONSHIP



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In these uncertain times, our clients often ask us how we position our portfolios to deal with momentous and unpredictable events such as the pandemic and the US election. So, I thought it would be a good idea to explain how we think about portfolio construction.

At Seilern, a portfolio manager's main role is to manage risk rather than to generate alpha. Alpha should largely come from the Seilern Universe, a pre-approved list of investments that have undergone rigorous internal research.

We also consider risk in a different way to our peers. Although many investors see volatility as a reliable measure of risk, it merely shows how a stock's price has behaved in the past. It doesn't tell us much about the company's future performance. For example, it does not consider any fundamental changes that the business model of a company might be undergoing. In a world which moves increasingly faster, this is certainly something to bear in mind as a business's financial performance and stock price might behave in a very different way than they did in the past.

We view risk as the probability of a company deviating from an expected stream of future cash flows. Thanks to the intensity of our research and the limited amount of the companies we cover, we have a deep understanding of those companies' operations and their business models. This allows us to form our own detailed projections. We can then categorise each company by its predictability on the one hand, and its growth potential on the other. We see a company as carrying more risk if its future cash flows are less predictable, not because its shares have been more volatile in the past. Some of the companies in our universe are simpler to 'forecast' than others. At one end, you have a company like Lindt, which has highly predictable returns but doesn't grow fast. At the other, you have the likes of Ansys, which is fast-growing, but fairly hard to predict.

We put a portfolio together like a football coach builds a team. The coach (portfolio manager) considers the strengths and flaws of each and every player (the companies), then tries to construct the most balanced team possible from his squad (the Seilern Universe). This should never be a collection of individual players but a carefully selected team where each player has a defined role – making the team more than the sum of its parts. When Spain was on its way to winning the 2010 World Cup, the coach, Vicente del Bosque, frequently left both Fernando Torres and Cesc Fabregas on the bench, even though they were two of his strongest attacking players. A coach can't select an entire team of strikers. The team needs a solid defence and play-making midfielders to create the scenario in which the strikers can take more risks.

Similarly, we try to construct portfolios that can withstand any kind of environment. With the help of the analysts who cover each company, our portfolio managers aim to build the most balanced portfolios from a risk standpoint – and only from the companies that feature in the Seilern universe.

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To continue with the football analogy, the defence should consist of more mature businesses like Lindt, which generally grow more slowly but are also more predictable. This defensive group often contains consumer-goods companies, medical-technology companies, pharmaceutical firms and asset-light industrial companies with high recurring revenues.

As in football, the midfield is versatile, with a well-balanced mix of defensive and attacking players. Companies in this group normally enjoy fast growth, but still have a high level of predictability. This could be because of their strong market positions or because of some specific characteristic in the business model that creates predictability. Here we typically find mature software businesses with high recurring revenues, consumer-discretionary companies with an element of defensiveness, and some technology platforms.

Finally, we have the strikers and centre-forwards. In a portfolio, these are the high-fliers: rapid-growth tech, software and consumer-discretionary companies that are expanding at pace but whose future cash flows are far less predictable. Even with a solid defence, a well-balanced portfolio can only afford to have a few of these high-fliers. It goes without saying that they must always comply with Seilern's Ten Golden Rules.

Besides managing our exposure to these different companies, we also consider our overall exposure to certain themes and growth drivers. So, we carefully monitor the geographical exposure of the underlying sales to avoid overreliance on one country or region. And while certain factors drive the growth of our companies, including ageing populations, digitisation and the Chinese consumer, we need to make sure that the funds are not overly exposed to any of them – just as a football coach would limit his exposure to right-footed free-kick specialists or tall players who can head in goals from corners.

Transfer decisions are another key consideration. A good football manager knows when to sell his players and which new signings can bring fresh qualities to the team. For the portfolio manager, there are a few things that can lead to a company being 'subbed onto the bench' (when the holding is reduced or sold) or even 'kicked out of the club' (when the company leaves the Seilern Universe). In many cases, a business whose growth is slowing will no longer be a suitable company for our funds or the Seilern universe. And in certain cases, a company's valuation may become so stretched that the risk-reward ratio no longer makes sense.

As for scouting and signing new players, we do this through our 'Search for Growth.' In the hunt for new investment opportunities, managers have to decide whether they need a defender, a midfielder or a striker. This means passing over many good opportunities. Although they might be excellent companies and great performers, they don't fulfil the portfolio's current needs.

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Throughout our history, we've used this system to manage risk. As quality growth investors, we create a portfolio of carefully researched stocks with the aim of holding them ad infinitum. This portfolio needs to be able to weather every kind of condition because, over the long term, the unexpected tends to happen quite often. Like the best football managers, our goal has never been to win one match. Instead, we're building a team to win the long-term championship.

F. León, 06 November 2020

IMPORTANT INFORMATION

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