Best Ideas Portfolios

What makes a 'quality' company?

In our recent monthly commentaries we have talked about the shift towards quality companies that has been underway in your portfolios. So what exactly is it that makes a 'quality' company, and why are they good investments now?

The way a football team or a tennis player plays, or the way a lawyer creates their trial strategy, will be heavily influenced by their coaches, trainers and professional mentors. In a similar way, professional stock market investors can be grouped together based on the way in which they are trained to select stocks. This is known as their *investment style*.

One of the world's best known investors is Warren Buffet, the 'Sage of Omaha'. He follows the *value style* which entails analysis of company accounts and management to form a view on the intrinsic value of a business today. This style finds safety by trying to judge the downside risks and invest in cheap companies with an expectation they will recover.

Entrepreneurs tend to be thrill seekers and more tolerant of risk. They tend to innovate more, push new boundaries and define new markets for growth.

Stock pickers following the *growth style* of investing try to assess and invest in this upside opportunity.

The concept of 'quality' is the balance between growth and value. Managers who follow this style look for investments with several characteristics. These are companies with less debt, good spending discipline, and which make smart investment decisions themselves. As a result they can create recurring long term sales, stable growth in earnings and a higher return on equity over time.

Evidence beyond financial accounts is also important in assessing quality. Whether a businesses' core products and services tap into global trends (such as climate change or ageing populations) and their behaviour around equality, diversity and socio-environmental responsibility are important considerations. Companies that are more responsible members of society tend to outperform in the long term, mainly since they avoid significant one-off events that prove very costly and take a long time to recover from.

Put simply, quality companies have a good reason to exist, both today and for years to come. Over the long term, these reasons can certainly change. Many of yesteryear's quality companies produced essential 'staples' like toothpaste and toilet paper. Today, long term quality revenues can be found in other sectors as well.

In our view, the prevailing economic environment determines which investment style performs best. When there is low uncertainty and the going seems good, the market is willing to support entrepreneurial activity and growth investing pays off. When the going gets tough, the market prefers to support companies with the safety of fundamental value. When things are uncertain, as we believe they are now, the *quality style* offers the best chance of success.

1 DIVIDEND PAYERS

One of the features of quality companies is their ability to consistently pay dividends. Having a continuously growing market in which to sell products and services certainly helps to achieve this.

The global population aged 60+ is forecast to rise to 1.4 billion by 2030 and 2.1 billion by 2050, which will be about 21% of the global population at that time. As we head toward and enjoy our golden years, our bodies often need a little help along the way. This ever increasing customer base (or market size) is a strong source of recurring revenue for pharmaceutical companies. This means they can invest in research to improve our quality of life as we get older.

CASE STUDY
GlaxoSmithKlein

GlaxoSmithKlein is a pharmaceutical company with a diverse drug portfolio, global revenue base and disciplined spending & investment decisions. It has generated a consistent return on equity over the long term which has allowed it to pay a consistently growing dividend over the last 15+ years.

The company has three main businesses: pharmaceutical medicines, vaccines and consumer healthcare products. The largest is the pharmaceuticals business which has a broad portfolio of innovative and established medicines with a research approach focused on the immune system and use of genetics.

FUND IN FOCUS
Threadneedle UK Equity Income

GlaxoSmithKlein is a holding in the Threadneedle UK Equity Income fund. The fund is a core holding in portfolios, being an actively managed portfolio focused on investing in high quality growth companies in the UK.

2 SUSTAINABLE BRANDS

Brand power is another feature of quality companies. It is the thing that makes products stand out in an otherwise competitive crowd.

Staple products such as food, drink and household items are things we need and want consistently. These are goods that people cannot or will not cut out of their budgets, regardless of their financial situation. Different strata of society may have different levels of demand, but this demand is consistent over time, creating an attractive business opportunity. Some brands are struggling to defend their market share against rivals, especially as consumer tastes evolve. Since people today want products to come from sustainable sources, demonstrating sustainability credentials helps certain brands to stand out.

CASE STUDY
Unilever

Unilever is a consumer staples company leading in the drive towards more sustainable living. Their range of over 400 brands means that around 70% of households around the world contain at least one Unilever product.

Unilever's Sustainable Living plan aims to decouple the company's growth from its environmental footprint by reducing the use of natural resources in its production processes. In 2017 the business sourced 56% of agricultural raw materials from sustainable sources with an ambition to sustainably source 100% by 2020.

FUND IN FOCUS
Troy Trojan

Unilever is a top holding in the Troy Trojan Fund. The fund is a core holding in portfolios and was selected due to its focus on high quality companies with long term sustainable earnings growth.

3 MODERN ERA STALWARTS

A global foothold and a base of established customers is another feature of companies that can deliver quality earnings.

It's been almost 20 years since the dot.com bubble burst and many fantastical internet companies hit the wall. But of those that survived, some have successfully developed the tools and infrastructure that power a huge part of the world's economy today. Digital infrastructure goes well beyond server boxes and network cables. It includes the critical software that allows us to create and communicate ideas, move goods, deliver services and make payments. Sure enough, we still witness some racy, fanciful technology ideas that bubble up from nowhere. But underneath it all, the core digital infrastructure can be thought of as 'corporate staples'. These are services that companies are unable or unwilling to cut out of their budgets if they want to remain relevant, profitable businesses.

CASE STUDY
Microsoft

Having started as a tiny software company that won a huge contract from 'Big Blue' (IBM) in 1980, Microsoft now offers a range of products and services. Its global market presence today places it at the vanguard of the transition to cloud computing.

A recent Forbes article predicts that 83% of enterprise workloads will use cloud computing by 2020. This shift to the cloud significantly reduces IT costs for companies but also increases the stability or quality of revenue for cloud service providers for a very simple reason. Their charging basis becomes a regular subscription instead of "cyclical upgrades".

Around 50% of Microsoft's revenues come from its server products and suite of Microsoft Office products which are increasingly being provided on cloud-based subscription models.

FUND IN FOCUS
Fundsmith Equity

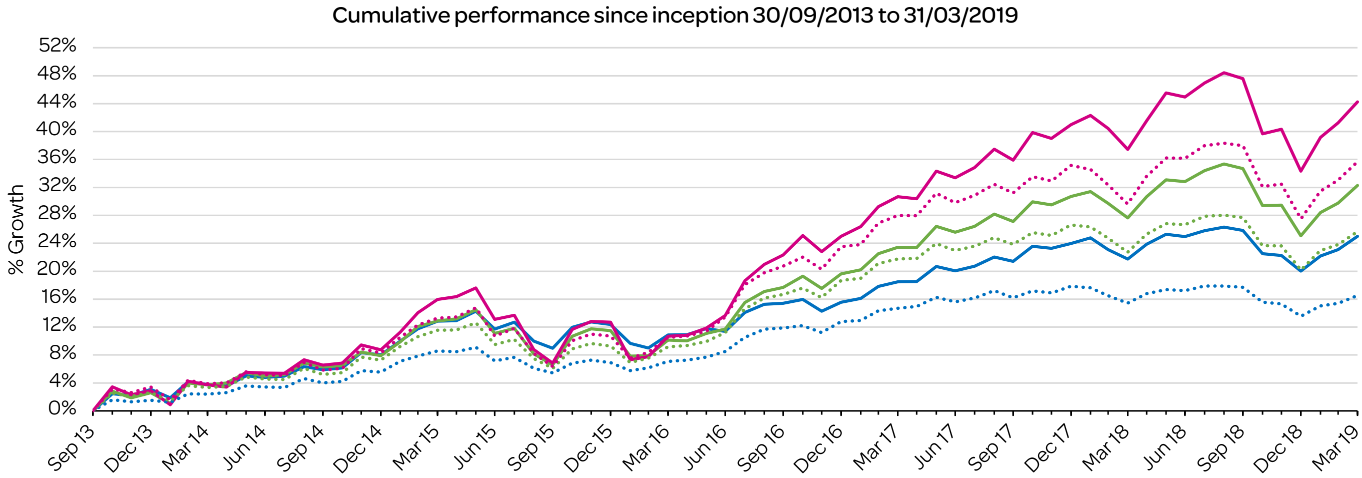
Microsoft is an investment held by the Fundsmith Equity fund. The fund is an actively managed, concentrated portfolio of quality growth companies anywhere in the world.

EQ investors

Next steps

You can view factsheets and invest online via the EQ website. For other questions and enquiries please contact your EQ adviser or visit:

eqinvestors.co.uk
020 7488 7110
enquiries@eqinvestors.co.uk



Annual performance		Apr 18 - Mar 19	Apr 17 - Mar 18	Apr 16 - Mar 17	Apr 15 - Mar 16	Apr 14 - Mar 15
Best Ideas Cautious	——	2.68%	2.74%	6.85%	-1.73%	8.74%
ARC Cautious *	······	0.94%	0.65%	7.11%	-1.38%	6.04%
Best Ideas Balanced	——	3.63%	3.40%	12.08%	-2.44%	8.83%
ARC Balanced *	······	2.41%	0.80%	11.52%	-2.12%	7.93%
Best Ideas Adventurous	——	4.97%	5.19%	18.05%	-4.55%	11.80%
ARC Steady Growth *	······	4.68%	1.31%	15.77%	-2.41%	9.00%

Risk warning

Past performance is not a guide to future performance. The value of investments and the income derived from them may go down as well as up and investors may get back less than they originally invested. The Best Ideas Portfolios are available in **seven** different risk profiles, of which **three** are shown here. Inception dates may vary: please see factsheets for full details.

eqinvestors.co.uk | 020 7488 7110 | enquiries@eqinvestors.co.uk | @eqinvestors | EQ Investors

EQ Investors Limited, Centennium House, 100 Lower Thames Street, London EC3R 6DL

EQ Investors is a trading name of EQ Investors Limited ('EQ') which is authorised and regulated by the Financial Conduct Authority. FCA number 539422. Company number 07223330. Registered address: 6th Floor, 60 Gracechurch Street, London EC3V 0HR.

This document has been drafted solely to keep investors informed and does not constitute a personal recommendation. These model portfolios are not suitable for all investors: investments may only be undertaken based on a recommendation from a financial adviser. Example holdings and funds included in the Best Ideas Portfolios on 31/03/2018. Model performance is shown in sterling, net of underlying fund charges and an EQ management fee of 0.59% (including VAT) per annum, but excludes platform and advice fees. Underlying fund charges may vary depending on platform. All income reinvested; actual returns may vary. * We use Asset Risk Consultants (ARC) to benchmark the performance of our portfolios. ARC benchmark figures are based on participating investment managers' actual performance data, net of fees, following the last quarter end. This document may contain opinions that represent our assessment and interpretation of information with which we have been provided and no representation or warranty, expressed or implied, is given as to its accuracy or completeness. Data sources: EQ, Morningstar.

EQ/0419/316