AORIS INVESTMENT MANAGEMENT

The Constant Investor

It's about the stocks you don't buy

Alan Kohler, July 18, 2018 Fund Manager Interviews

This week's fund manager is **Stephen Arnold**, who just recently, six months or so ago, started a new investment business called **Aoris Investment Management**. Stephen came from Evans & Partners, started his career in BT and he's a very unusual creature is Stephen. He talks more about what he doesn't do and the stocks he doesn't buy than the ones he does. He filters out an incredible number of global stocks. I should add that the fund is global, not domestic, and it's really well-worth listening to the things that Stephen Arnold doesn't invest in.

Here's **Stephen Arnold**, the **Founder and CEO of Aoris Investment Management**.

Stephen, I note that Aoris means something from grammar denoting a past tense which does not contain any reference to duration or completion of the action. So I imagine that that's your reason for choosing the name, Aoris. Explain to us what about the meaning of Aoris made you choose it?

Well, actually the background that I came across was that it's derived from a Greek word which means unconstrained and without boundaries, so I like that association. We certainly have some pretty clearly defined parameters but within those parameters then we're certainly very fundamental, bottom-up, index agnostic. We end up as investors holding a portfolio that looks really nothing like the index, nothing like many of the peers that your followers would be familiar with. That's the association and origin that we drew from.

Tell us a bit about your own background. You came from Evans & Partners, how long were you there for?

I was at Evans & Partners for six and a half years and created from scratch the international capability there. I ended up managing $1.1 billion dollars of client assets across a spectrum of high net worth individuals, single and multi-family offices, self-managed superannuation and retail funds for Australian investors. Over the six-and-a-half-year period in a peer group of 100-plus managers the performance of the portfolio I was responsible for would be in the upper half of the top 10% over that period of time.

Stephen Arnold
Founder & CIO

Alan Kohler
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Can you tell us what your performance was over the six and a half years?

Yeah, I can. The since inception annualised return at Evans & Partners was 18.3% pre-fees and outperformed the benchmark by 4.9% p.a. I started my career at Bankers Trust in 1991 and that was just coming in the days when BT was Australia's pre-emanant domestic and international equity fund manager. Then I joined Platinum Asset Management, I was employee number seven there and benefitted from several years under the tutelage of Kerr Neilson and got an appreciation for a very robust and disciplined investment approach that he and the team at Platinum applied.

Then before joining Evans & Partners I spend 10 years in London. I think that really benefits an international investor having spent some time out of Australia and London's probably no better place. It's a very worldly city as you'd be aware. Most of my time there was at Goldman Sachs where I was effectively the second most senior person in a small team managing about $6 billion dollars for the ultra-high net worth clients of Goldman Sachs Asset Management.

What did you have in mind in starting Aoris? Is it a similar fund to the one at Evans & Partners, for high net worth individuals, for sophisticated investors, that sort of thing? For example, what's the minimum investment?

Yeah, look, let me tackle that in a couple of different ways, both in terms of what sort of business we want to be and what sort of clients we want to appeal to. As a business, we really want to do one thing well, so we're passionate and dedicated investors and rather than following the conventional approach of product proliferation where you start out with one product and then you have your long short fund and your small cap fund and your Asian fund and your healthcare fund and so on and so on. We've been very clear and very public in our communication that we're going to have a single portfolio.

That's very unconventional but we want to do one thing well and build a simple business around a single strategy. We don't need a lot of people to do that but I'm very keenly aware of the organisational complexity that creeps in as you add people and products. In terms of the investment process, as it was at Evans & Partners, it's a long-only fund holding between 10-15 businesses internationally, so unusually concentrated. But that comes from a very conservative approach where we have very demanding criteria in terms of the quality of businesses we want to own and very demanding business criteria in terms of the price of valuation that we're willing to pay.

When you think about the intersection of those two criteria there is simply not many businesses that sit in that intersection. Rather than have less demanding criteria and own more and more stocks, which is a more conventional approach, we want to keep our criteria very demanding and we're comfortable owning the small number of businesses that satisfy those criteria. Thirdly, in terms of the type of clients that we want to satisfy, I think it's less defined by the organisation or the size of the client and more defined by their mentality. The type of client that we will suit are those that are independent minded fundamental investors willing to do things that are different to not follow conventional investment dogma, if you like. We've resonated well with pockets across the spectrum from wealthy individuals, single family offices, multi-family offices, right through to small pension funds. It's the investment mentality rather than the organisational size that better defines the type of client that we'll resonate with.

I often find that the way to kind of express the way you invest is by telling us what you have invested in, can you tell us what your portfolio looks like now?

Yeah, absolutely. As an organisational principle, we're very transparent. In our monthly investor communications we show every stock that we own, which again is somewhat unconventional. I am happy to pick out one or two businesses that people would be familiar with and probably across the 14 stocks we own today there will be more businesses that people will not be familiar with than those that they are. Let's pick out a couple that we'll recognise. One would be Accenture.

Accenture is the world's largest IT outsourcing and consulting business. It's a business that through its scale and size and breadth does particularly well with that Fortune 500/Fortune 1000 group of businesses. 97 of the top 100 clients have been customers for more than 10 years. The client retention by itself gives you some insights into the strength of the business, that they keep their clients on average for 30 years. They have 175 clients that spend more than $150 million dollars a year with Accenture. In fact, in the last quarter alone they signed 13 deals with a value of more than $100 million dollars. It's a business that over a long period of time has grown at about twice the rate of the IT market. IT spending is not quite the growth market that people naturally think it is. While we get excited by the Amazons and Facebooks and so on, according to Gartner, the IT market globally grew by 3.8% last year which is about in line with nominal GDP, so it's not really an excess growth market in total. Accenture in the last 3 months grew organically at 9% and over the last 5 or 10 years they would have grown on average about twice through aid of the total IT market.

It's a business with good growth, very attractive profitability and one of the keys has been that they've been able to evolve their offering in order to stay relevant to their clients. They've done a better job of that than some of their historic peers like IBM which have somewhat stagnated because they haven't been able to remain relevant to their clients, Accenture has reinvested in skillsets and capabilities organically and through small acquisitions, so that's remained an important partner with the world's largest companies.

I don't know if you'll do this – I wouldn't mind hearing about a company that I hadn't heard of that you've invested in?

Sure, okay. Let's pick out Amphenol, Amphenol is one of the world's largest makers of IT connectors. They're seemingly quite simple devices that join electric cables or circuits and they have their traditional sort of male/female physical properties. You'll find these connected pretty much wherever you'll find electric circuits. Amphenol is particularly strong in connectors that are needed in demanding physical environments, whether they're high or low pressures and temperatures. If you think about where commercial and military planes fly, offshore energy environments and mobile phone networks have got to go over mountains, these connectors often have got to perform well in harsh environments.

When we think about the breadth of the business, which is important to us, we like what we call multi-legged stools, meaning a business operating across many parts of the economy and many end-markets is an important characteristic. About 20% of Amphenol's revenue goes into automotive electronics, so this is not just about electric cars since every part of the car has got more and more electrics. I know because I just bought a new car a couple of weeks ago and there's more and more things that are electrified. That's a very interesting growth market for them, as are mobile phone devices, mobile phone networks, aerospace and corporate data centres.

If you think about the data centres that the likes of Amazon and Microsoft are building, then Amphenol does a good job supplying connectors into that. It's a market that's pretty fragmented, but like Accenture, Amphenol has grown organically at about twice the rate of the overall market over many, many years and done so with a surprisingly high and consistent profitability. In fact, their EBIT margin or their pre-interest, pre-tax profit margin is very consistently about 20%. It's a combination of high profitability, high organic growth and then management doing sensible things with the surplus cash the business generates, it's grown its EPS more than twice the rate of the average US company.

That's a good illustration that to get an exciting growth story it doesn't have to be in exciting parts of technology that people are more naturally familiar with. It can be in these wonderful businesses that we might interact with without knowing it.

How do you find these businesses? Because I note that one of the things you don't do is to take any sell side research, which is broker research. I mean, that is an unusual thing to do. Therefore, you don't get any ideas from brokers at all, so how do you find these stocks?

Well, the process is unconventional in some respects, but we want to be independent, we want to make up our own mind and not have our views shaped by the interpretation or views of others. You could describe it as being a "first principle" approach or a DIY approach rather than drawing on the research from the sell-side. When it comes to building our own financial models, we'll get out the annual reports and do it the traditional way rather than taking other people's work.

Part of it comes from having a very clear sense of what we don't do. Because we don't like financial leverage, we won't own banks, period, or insurance companies, period. So we've already excluded more than 20% of the market. We don't like the vagaries of commodity prices. We're not political scientists nor are we economists and we don't know where oil prices are going or interest rates or currencies. So, we won't own oil companies or mining companies and that takes out another 15% of the market.

We don't like regulated businesses because regulation is really just an extension of government policy and we know that government policy can change and we don't like moving goal posts, so we won't own telcos or utilities or most of healthcare because healthcare's a very regulated industry. We're also wary of fickle consumers and people might choose different shampoos and breakfast cereals one week to another and the supermarkets that those goods are sold through have got a lot of structural pressures, so we won't own the consumer packaged goods companies like a Coke or a Pepsi or a Proctor & Gamble. Part of the answer to your question, Alan, is having a pretty large "too hard basket".

That's amazing! It'd be about two-thirds of the market that you won't invest in, that's amazing!

That's right, in fact it's even more than that. Then from what's left we have these very clearly defined and quite demanding hurdles. We don't like businesses that are what we call fragile, that if we go back to 2009 they lost money or had to cut their dividends. In fact, if we think about the top 20 largest Australian companies in 2009 about half of them cut their dividends and about half of them had to issue equity to repair their balance sheets. Well, we like to have all-weather businesses, not fair-weather businesses, such that if we think about all the things that can go wrong in the world, and there's plenty, we want to know that the businesses we're owning were durable and profitable during the GFC. If the answer to that's yes then we don't have to worry too much about all of these macro externalities that we can and do worry about.

But if you owned banks or if you owned energy companies then you do have to spend time thinking about that and we just don't think we're going to have any edge there. We've excluded probably 85% of the market and from what's left we use screens and filters to help us identify stocks that might embody the profitability characteristics that we're looking for, have the conservative balance sheets that we're looking for and have shown a tendency to grow their balance sheets at moderate rates because we don't like acquisition machines, management that are out there doing big acquisitions all the time because we know that those things often end in tears. Those screens are very effective in helping unearth good businesses like an Accenture or an Amphenol or many of the other businesses that we own or would like to own.

Fascinating. One of the things you don't do – and we're talking more about stuff you don't do and companies you don't invest in – but you don't use your cash balance to reflect your view of the market which is to say you don't use cash to reflect market timing, explain to us why not?

Well, it's a very selective approach. We would put up our hands and say that I think that equity markets are expensive and I would have told you the same thing at pretty much any point in time over the last five years. But expensive markets doesn't mean that every stock in the market is expensive and I think that's a critical distinction. We're not owning markets, we're owning businesses and we're owning businesses with a patient long term time horizon. We own businesses that we know can comfortably navigate and remain profitable during tough periods.

What we think a lot about is the repeatability of our process and we want to think that if we're applying certain principles or approaches to our investment decisions, that they're going to help us make good decisions well more than half of the time. Reflecting back over the last five or ten years, when I think about expressing views on market levels and how helpful that is to generating good client investment outcomes, if I'd been allowed to take cash up to much higher levels and express views on overall markets it would have generated a very significant opportunity cost because it would have denied clients the opportunity of owning good wealth creating businesses like Accenture and Amphenol that have performed very well.

It's not conventional but our view is that the repeatability of holding high cash levels or shorting the market, expressing a view on the overall market is something that people are just not going to get right enough of the time. If you think about it, you've got to be right twice. If the market in the next 6-12 months falls 20% and someone that's held high cash levels today, well that's great. But they've then got to have the fortitude to reinvest once the market's fallen. When the market falls then all you're reading about is all the disasters going on in the world because that reflects the prevailing sentiment and someone's then got to take their cash and reinvest in the face of those very negative headlines and that's not easy to do. Expressing views on the market requires you to get it right twice and do it repeatedly through the cycle and I put up my hand and say it's not something that I can do well.

I presume if a stock that you own and like falls in price because of market sentiment, you'd like to be in a position to buy more of it?

In a market decline you've certainly got more degrees of freedom. It means that there are more stocks that you'd like to own because they embody the quality characteristics that we're looking for that are now cheap enough to buy and that's great. Or we can reallocate capital within the portfolio to businesses that are relatively cheaper than others or businesses that are relatively better than others. We like the degrees of freedom to come with cheaper markets but we'd rather own wealth creating businesses and be largely fully invested through the cycle because I think that will generate the best through the cycle long term client outcomes, that's what we're focused on.

Is one of your filters debt, do you just simply exclude companies that are highly leveraged or not?

It's a great point and it's so relevant today because I think directionally interest rates feel like they're going higher and if debt was a problem for the world 10 years ago then it's a much bigger problem today because the debt to GDP is higher pretty much everywhere than it was five or ten years ago and it's certainly true at the corporate level. We're looking for businesses that have comfortable net debt to EBITDA levels, but we go further than that because the capital structure risk isn't expressed solely by what's on the balance sheet, we've got to then look at what's off the balance sheet and there we're thinking about operating lease obligations. If you're a retailer you're probably renting real estate and that's a substitute for owning real estate and so we want to capitalise that and recognise it as if it was debt. Likewise, most countries other than Australia have defined benefit pension obligations often which are not fully funded. We want to look at both the net pension obligation and we also want to look at the gross pension obligation when we're thinking about how conservative or sound a company's couple structure is and we want to own businesses at the very conservative end on a holistic on and off-balance sheet context.

When you exclude all these things that you exclude, how big is your universe of stocks to choose from?

Liquidity matters as well. We want to feel like that even if we were investing a substantially greater quantum of client funds than we're responsible for today, then we can comfortably buy and sell the stocks so we won't own the very, very small or illiquid companies. The universe is probably a few hundred and the good thing is there's always more out there than we've discovered. It's not the case that we've exhausted it. There's businesses that don't come through our screens because there's always adjustment and judgement required to the reported accounting which is why we don't think that you can factor or robo-invest, you can't take a set of principles, express them as mathematical formulae and think that the quantitative approach will do all the work.

So, the screens are helpful but they're not the whole answer and as we go around the world visiting businesses and reading widely and getting to know them, then there's always more out there than we're aware of today. That keeps the exercise very intellectually stimulating.

One of the things you also focus on is environmental social and governance (ESG), which I think your approach looks quite interesting. Tell us about that.

I think there's a couple of points to note in that very relevant and important sphere, Alan. Number one is there's no universal set of principles across those three spheres of environmental, social and governance that satisfies everybody. Number two is that no set of principles can be adequately expressed quantitatively, so while it might feel satisfying to think that we can tick boxes or score to include or exclude businesses based on these principles, and it might be from a board diversity point of view or it might be through some other quantitative metrics. Our view is that these things all require judgements, that's the second point.

The third point is that for good ESG a satisfactory hurdle rate doesn't mean zero infractions - we don't hold perfection as a standard. The fourth point is that it requires a judgement about the context of the business and all of the constituents that it touches - has it been a good steward of the environment and has governance been well above average. It requires a holistic assessment. A company might produce products that allows its customers to reduce waste, reduce workplace accidents, reduce energy, but it's not reflected in the energy or health and safety of company A, it's reflected in the energy, raw material efficiency and labour health and safety of its customers, so we have to think about holistically across its supply chain, its customers and the other organisations it interacts with. Is it, if you like, doing a good job from an ESG perspective. That might be captured in the resource usage of its customers rather than the resource usage of the business itself.

You have what's called a trifecta of things, business franchise, management and capital structure – and we've talked a bit about capital structure and the business franchise. I just want to focus for a minute on management. Most investment managers, and I'm sure you're part of that, generally kind of visit the company and look at them in the eye, interview them and so on and get a sense of the quality of the management that way. But most of my listeners can't do that because they're small investors whether they're investing directly or whatever, they can't go and visit companies. Are there ways that you kind of assess management without visiting?

Absolutely. We're looking at a combination of what they say and what they do. I think that if you were to think about any individual that you were having a conversation with, the things that they talk about will give you clues into what they think is important. If a company spends all their time talking about EPS growth or a recent acquisition, that gives you a clue as to what management think is important. If they were talking about how much they've added value to their customers or they were talking candidly about something that hasn't gone wrong, that will give you other clues into how management thinks and acts, the candour and transparency with which the organisation operates internally.

So just simply by reading the annual report and the Chairman's letter is going to give you some important clues simply from the public domain about what management thinks is important, how they communicate, how transparent and candid they are. Then we want to look at that over a period of time, so looking at the annual report not over a single year but over several, will give you a clue as to the consistency of management and do they flip and flop and talk about different things every year or is there a consistency, a sense of purpose, a sense that the ship is sailing in a purposeful direction.

Not everything goes right every year for a business and that will give you a clue as to how management respond when things don't go well, what do they do about it and how do they communicate that? It'll also give you clues as to how management think about allocating capital. Management's job's not just running the business. We think about it as being, they're the stewards of the business, they're also stewards of the company's culture and values and how they define that's important. They're also stewards of the capital the business is generating and how they allocate that is very important.

Are they expansionist, do they get excited about making big overseas acquisitions or are they more moderate, disciplined and controlled? You can get some genuine insights into all those things simply by reading the annual reports.

Perhaps we could just finish, Stephen, by talking about your fees. You've got a simple fee structure of 1.5% per year, but also with an option of 1.1% and a performance fee of 15% over the benchmark. What is the benchmark?

Our benchmark, Alan, is the MSCI-all countries world index, ex Australia.

Accumulation or not?

Yes, it's the world including emerging markets, excluding Australia.

And what do you find your customers mostly go for, the flat 1.5% or the performance fee?

I think people will probably gravitate towards the performance fee and it's probably more comparable to many of our peers that have that lower base fee with a performance fee option. We want to present simple transparent choices. One thing to note, Alan, is that our fees are inclusive of equity transaction costs. We know of no other manager anywhere in the world where the equity brokerage costs are absorbed by the manager and that's what we do.

Well, I don't know of anyone either, that's very positive, good for you.

Equity brokerage really traditionally bundles up sell-side research which we don't pay for and also sell-side execution and we don't employ a trader, but where we use an external broker to help us execute, then we pay for that so we get an invoice every month for execution. Also worth noting, Alan, is that we'll very shortly have a currency hedged version. In the long list of things that we don't do is active currency management. Again, we don't think that we're going to get that right on a repeatable basis, so we'll present clients with two very clear options, fully un-hedged or fully hedged, and people know exactly what they're getting and we're not going to co-mingle stock selection with currency selection.

That was Stephen Arnold, the Founder and CEO of Aoris Investment Management.