Hassan Elmasry

Marathon man

Macquarie Professional Series

No.1

FORWARD thinking

MACQUARIE

High cashflow companies with low risk, generating solid long-term returns:this simple mantra guides the portfolio management team behind Macquarie's inaugural fund in the Macquarie Professional Series, led by Hassan Elmasry of Morgan Stanley Investment Management.

Marathon Man

By Bruce Madden

As the leader of an investment team which manages a long term buy-and-hold portfolio, it seems appropriate that Hassan Elmasry runs marathons in his spare time.

Where marathon runners often test the limits of personal endurance, Elmasry and his London-based team test global companies for their enduring qualities. They seek intangible assets and business activities that generate high returns on capital, high free cashflow and have staying power – thus compounding shareholder wealth – through almost all market and economic conditions.

That's the theory, and the theory, tested over the past nine years, really works.

Welcome to the refined world of franchise analysis where a company's intangible assets – its brand, patents, licenses or distribution agreements – are sought for their ability to generate long-term, sustainable return on capital.

Developed by Morgan Stanley Investment Management in 1996, the Global Franchise investment strategy ("Strategy") has delivered average annual rates of return of some 18.9% since inception*. Its focus may be intangibles, but its returns have been nothing less than rock solid: the MSCI World Index delivered an average annual rate of return only 6.7% over the same period (to 31 July, 2005). (Past performance is not a reliable indicator of future performance)+++

Leading the Global Franchise team is University of Chicago educated MBA and economics graduate Hassan Elmasry, whose name would currently mean little or nothing to Australian financial advisers.

*Source: Morgan Stanley Investment Management Limited

That is about to change. Macquarie Investment Management Limited, through its Macquarie Professional Series of funds, has secured access to Elmasry's five-person team and their Global Franchise Strategy.

This is something of a coup for Macquarie and Australian advisers, although Australian investors have been limited to a $500 million mandate. Elmasry says the whole Global Franchise program has "limited capacity".

"It's not an infinitely scaleable investment approach. You have to remember that we're looking at a small universe of potential investments…and a good number of them are smaller and mid cap stocks. That creates some constraint on the amount of money we can invest.

"We made a commitment to our clients that we would not grow the whole program beyond a certain size. Limiting the Australian vehicle's capacity is part of that broader commitment to all of our existing clients worldwide", he says.

But back to the process: what is it that represents a worthwhile investment for Hassan when applying the Strategy? Bottom-up, value investors, Hassan and his team first and foremost wear out a lot of shoe leather visiting a large number of companies each year.

The team will always interview a company's management, as well as the company's suppliers, customers and competitors, before making a decision to invest in its stock. The team will test the quality of the business, right down to checking for potential cracks or symptoms of what it terms: "franchise abuse".

The Global Franchise portfolio is made up of very few stocks (up to a maximum of 40) – and included just 29 companies at 31 August 2005.

To refine a portfolio to such a small universe of stocks highlights the rigorous approach to testing each company. In short, there are three fundamental filters through which each company is assessed before it can pass as Global Franchise investment grade:

- how capital intensive is the business (the less the better)
- does the business depend on intangible assets like patents, licences, distribution agreements and brands (the more the better)
- does the company possess the potential to deliver superior long-term returns on its capital? (the more the better)

Says Hassan: "Well, it's a really small universe of companies that we think fit the criteria that we're looking for.

"By definition, a lot of companies are average businesses. The truth is that there's a really big part of the universe of listed companies that struggle to earn their cost of capital with any consistency. We don't think that such businesses merit a 'buy-and-hold' method.

"So the universe of companies that fit our criteria is pretty small, and when you overlay a strong value perspective to stock selection on that high quality group, the portfolio becomes very concentrated."

Hassan is an unabashed buy-and-hold investor, looking for companies that stack up for the long-term, rather than those stocks that occupy the more 'speculative' end of the investment spectrum.

For the company to be a solid, long-term prospect it needs, in his words: "to be a good organic compounder of capital".

"And that means it generates a high return on its invested capital and can do so for a sustained period".

The teams's research also backs the notion that certain companies are better than others at sustaining high returns on capital over a long period of time.

Those companies include businesses which can create a higher barrier to entry through the use of hard-to-replicate intangible assets, like brands, licensing agreements, patents or trade marks, for example.

The Fund has easily recognisable brands in its portfolio, including tobacco and liquor company stocks. Names like British American Tobacco and Imperial Tobacco, as well as Diageo (with household brand names like Gordons, Johnny Walker and Smirnoff) are just a few examples.

Other brands include food companies Nestle, Danone and Cadbury Schweppes, while drug companies Novartis, Merck, Bristol Myers Squibb and GlaxoSmithKline also make the grade.

In fact, as the chart below shows, the Global Franchise portfolio's top 10 stocks account for a significant proportion – some 47% – of the total portfolio. These are the high return, repeat businesses that the Global Franchise team invests in.

On the flip side, the businesses that are least attractive to Elmasry's team are those that disproportionately rely on their physical assets, or at least the competitive advantage of those physical assets, in order to earn a return.

Take commodities or manufacturing, such as steel or petrochemical companies, for example. According to Elmasry's analysis, such firms typically attempt to be the lowest cost producer of their commodity and also rely on very high capital intensity for their competitive advantage.

"This almost invites an incursion from a rival who replicates the business model and then absorbs that excess return," Hassan says.

"The two of them end up sharing the market and competing on price – and you witness reversion to the mean in action."

So, quality and value, coupled with that extra intangible asset are what drives the research on companies within the Fund.

Elevator companies are a good example. Companies with brand names like Zardoya Otis or Kone, which are held by the Fund.

"Well," Hassan says, "boring old elevator companies are one industrial equivalent of a razor and razor blade business model. "You get the new equipment installation, which is an okay business, but that pretty typically leads to longer-term service contracts which provide a nice recurring revenue stream. But those service contracts are also a chance to sell more replacement parts and often require very little capital to operate, but generate persistent free cash flow.

Top ten equity holdings[1]

Macquarie Morgan Stanley Global Franchise Fund

Security name	Brands	Country	%
British American Tobacco Plc	Lucky Strike, Rothmans, Dunhill, Kent	United Kingdom	8.0
Cadbury Schweppes	Dr Pepper, 7-Up, Cadbury's, Snapple, Motts, Orangina	United Kingdom	6.0
Reckitt Benckiser Plc	Lysol, Dettol, Finish, Calgonit, Electrasol, Woolite, Lempsip	United Kingdom	4.7
Swedish Match AB	Redman, Southern Pride, Bryant & May, Boxer, La Paz	Sweden	4.6
Altria Group Inc	Marlboro, Kraft, Nabsico, Post, Suchard	United States	4.6
Nestle SA	Nescafe, Perrier, KitKat, Maggi, Haagan-Dazs, Dog Chow	Switzerland	4.4
Kone OY	Kone Elevators	Finland	4.0
GlaxcoSmithKline Plc	Flovent, Paxil, Augmentin, Trizivir, Avendia	United Kingdom	4.0
Diageo Plc	Gordons, Johnny Walker, Smirnoff	United Kingdom	3.8
Groupe Danone SA	Danone, Danon, Evian, Lu, Volvic	France	3.5
Total:			**47.6**

[1] Source: Morgan Stanley Investment Management. Data as of 31 August, 2005. Top ten equity holdings are provided for informational purposes only and should not be deemed as a recommendation to purchase or sell the securities mentioned. This portfolio is actively managed, therefore holdings may not be current. Morgan Stanley and others affiliated with it, may hold positions in or may seek to perform investment banking services for the companies listed. Each portfolio may differ due to specific investment restrictions and guidelines.

"The nice thing about elevator maintenance is that it can't be deferred. It's pretty typically mandated at regular intervals and only by a select group of providers."

So, what is the main differentiator of the Strategy when compared with investment strategies used by other value stockpickers? Elmasry says his team has a very specific approach to measuring quality that is "pretty unique".

He argues that many value fund managers will simply look to a broad universe that includes lower quality companies that happen to be selling for less than what they believe the intrinsic value is.

"And they will look for a catalyst event to help realise that value. For example, real estate could sell below its net tangible assets or airline companies that sell for less than the value of their aeroplanes, or a utility that sells for less than the present value of its discounted cash flows.

"Although those businesses may not be fundamentally attractive in and of themselves… they're hoping for the catalyst to come along and help realise the value.

"We won't look at businesses like that – we're less focussed on trying to second guess a catalyst."

Risk minimisation

In a world where absolute return is quickly becoming the expectation of large and small investors alike (as opposed to relative return against a fixed benchmark) Morgan Stanley's Global Franchise Strategy holds its own.

The notion of high return/reduced risk is one of the fundamental tenets of the Strategy when conceived in 1996 in answer to the challenge set by a large pension fund.

The pension fund realised its liabilities for pension obligations were real and not pegged to the performance of the stockmarket.

"They wanted to measure risk in more absolute terms rather than in relative terms," Hassan says.

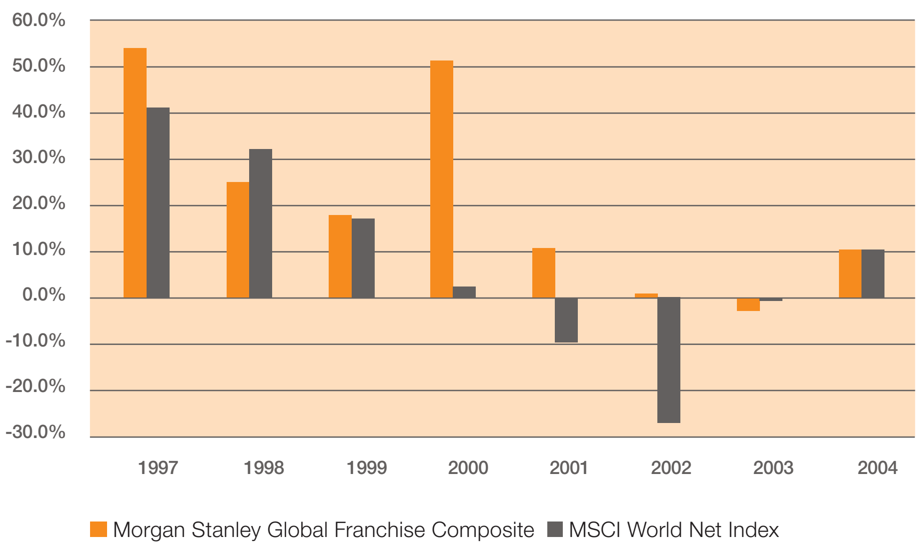
"So we approach every investment we make with an eye towards 'what is the absolute risk?' What is the possibility that we lose significant principal when we make this investment? Rather than: 'how will this make us different to the benchmark or similar to the benchmark."

As Hassan points out, the Strategy has enjoyed years where the returns are very different from the benchmark, "in both good and bad ways" but the absolute returns have been good.

As the chart shows, the Strategy's absolute return performance supports its strong capital preservation bias in stock selection. And it certainly highlights the value that can be added by stock selection that focuses on quality and value in absolute terms.

As you can see, in Australian dollar terms, the Strategy has delivered lower volatility of returns and positive annual returns in all but one year since its inception in March 1996, despite the most prolonged bear market in recent history. Not a bad track record for risk minimisation and growth. (Past performance is not a reliable indicator of future performance.)

Calendar year returns since inception (A$)++



The major potential downside for Australian advisers and their clients is the capacity constraint and as a consequence limited access.

Macquarie and Morgan Stanley have set a maximum limit of A$500 million on the value of the portfolio that Morgan Stanley will manage for Macquarie in accordance with the Strategy – due to capacity constraints for the programme as a whole.

As European and US investors already know, the performance from the Strategy makes it worth a second look.

Since its inception on March 31, 1996, the Strategy has returned cumulative gains of a resounding 404% (to July 31, 2005). Compare that with the MSCI World Index of 83% for the same period.[++]

(Past performance is not a reliable indicator of future performance.)

While all financial advisers appreciate that past performance is not a reliable indicator of future performance, the Strategy boasts an impressive history of performance gains in both rising and falling market conditions.

Stephen van Eyk of the Australian research firm that bears his name, said his group's analysis of the Strategy "gives us confidence that the new fund is likely to add value at certain stages of the cycle, and we expect that it will be in demand from advisers seeking a long only global equity fund with absolute return characteristics." By focusing on absolute risks and returns, the Strategy does not seek to measure itself against a particular benchmark, as is the case with relative return or index funds.

During the three year bear market period in global equities, between 2000 and 2002, the Strategy not only managed to deliver positive results, but returned over 30% per annum more than the MSCI World Net Index (net dividends reinvested).

Such results may come as welcome news for Australian financial planners looking to bolster the international equity component of client portfolios.

As an asset class, global equity has been problematic – in performance terms – for financial planners and their clients in recent years. And while the simple message that Australia represents just two per cent of available sharemarket opportunities has been well-heeded in this country, the benchmark figures have been less than encouraging news for those willing to diversify their equity holdings into offshore markets.

Macquarie, through the Macquarie Morgan Stanley Global Franchise Fund, is the first fund manager in Australia to offer retail investors access to the Strategy.

Macquarie Adviser Services' Division Director Peter Shepherd said the arrangement helped ensure Macquarie's longstanding adviser client base had access to an exciting collection of specialist investment funds previously unavailable to the traditional retail market.

Mr Shepherd said talks were underway to bring similar agreements together with Australian and other offshore asset managers.

"Roll on the best of breed."

* Source: Morgan Stanley Investment Management Annualised return 18.95% – source: Global Franchise Composite, Gross, in AUD before fees.
[++] Source: Morgan Stanley Investment Management. Past performance should not be construed as a guarantee of future performance. Performance returns reflect the average annual rates of return. Periods less than 1 year are not annualized. The composite results shown are GROSS of investment advisory fees, are quoted in AUD and include the reinvestment of dividends and income. The comparison index is the MSCI World Index with Net dividends reinvested. The inception date of the Global Franchise Composite is March 31, 1996.

MACQUARIE PROFESSIONAL SERIES

THE INTANGIBLE WORLD OF HASSAN ELMASRY

Hassan Elmasry heads the Morgan Stanley Global Franchise team based in London. On the face of it, the team's work seems pretty straightforward: find companies that can sustain high returns on capital, buy into them and hold on to them.

If only life could be that simple. In reality, the team spends every waking hour searching the world for the few companies that meet their stringent selection criteria.

So what are they looking for? Companies they favour have one thing in common: they own or control intangible assets, such as brands, patents or licences, which put them in a dominant position and are difficult to replicate. The team believes it is these companies that tend to deliver high returns over time, regardless of market cycles.

The team ignores benchmark indices when constructing portfolios. They are only interested in absolute returns and absolute risk, with particular emphasis on preserving capital – in fact, during the three year bear market in global equities between 2000 and 2002, the Global Franchise Strategy outperformed the MSCI World Index by over 30% per annum.[1]

We believe the team is quite unique, which is just the thing we're after for the Macquarie Professional Series, an exclusive collection of highly individual funds. So, if you want to make intangible assets work for you, the Global Franchise Strategy is now available to the Australian retail market via the Macquarie Morgan Stanley Global Franchise Fund.

Call 1800 005 056
to order an information kit now or visit
www.macquarie.com.au/professionalseries

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[1] Source: Morgan Stanley Investment Management Limited. The performance of the Global Franchise Strategy is represented by the performance of Morgan Stanley's Global Franchise Composite, which is an aggregation of all fee-paying fully discretionary portfolios managed according to a similar investment strategy (individual portfolios may have differing investment guidelines). The performance of Global Franchise Composite is not the performance of the Fund, which is relatively new and has no significant performance history. The performance of the Global Franchise Composite does not take into account fees and expenses. Past performance is not a reliable indicator of future performance. The inception date of the Global Franchise Composite is 31 March 1996.

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