

SWISS EQUITIES

# THE ART OF COMPOUNDING

**DANIELE SCILINGO**

Head of Swiss Equities

Q4 2023

Enabling the compounding effect to materialise requires discipline and patience and is what we believe sets us apart from many other investors.

**Regardless of style or philosophy, successful investing entails acquiring assets at a price lower than their intrinsic value. Unfortunately, many investors disregard the critical element of time in their investment decision, succumbing to short-term thinking and momentum-based strategies. We believe sustained investment success hinges on the time-driven power of “compounding”.**

Compounding refers to the rate at which we augment our clients' wealth over extended periods. We firmly believe that portfolios centred around compounding companies at discounted valuations offer a reliable and robust path to long-term capital appreciation. Our primary focus is identifying and acquiring these companies within the Swiss small and mid-cap universe, at precisely the right price and time.

We devote significant attention to determining the optimal price we pay for businesses to maximise the compounding effect for our clients. This means that we only acquire stakes in businesses when the market price significantly undercuts the net present value of the projected stream

of cash flows. While identifying a great business isn't rocket science, comprehending its intrinsic value and acquiring it at the right price sometimes presents challenges.

Nevertheless, buying at the right price holds little value if one doesn't maintain the position for an extended period, enabling the compounding effect to materialise. This requires discipline and patience and is what we believe sets us apart from many other investors.

The generation of free cash flow at a high and sustainable rate, relative to invested capital, is a key element of a successful company and often translates into a fruitful investment over the long-term. Companies, regardless

Companies achieve “compounder” status when they can sustain their competitive advantage, often referred to as their “moat,” against competition, market saturation, disruptive business models, and other challenges that may arise.

of size, require maintenance capital expenditure and investments for growth to preserve and enhance their productive asset base. Consequently, we meticulously scrutinise a company’s lifecycle.

### BEYOND QUALITY

Compounders – those consistently surpassing their cost of capital year after year, even in volatile markets – exhibit distinct characteristics. While they are typically associated with quality companies demonstrating sustainable returns on equity and clean balance sheets featuring low debt-to-equity ratios, our definition of compounders extends beyond quality. Our investment process targets companies capable of generating high returns on capital and strives to ensure the sustainability of those returns over an extended timeframe. In our assessment, companies achieve “compounder” status when they can sustain their competitive advantage, often referred to as their “moat,” against competition, market saturation,

disruptive business models, and other challenges that may arise.

The prevalence of a robust competitive edge combined with durability is crucial, as a company’s ability to fend off competition ultimately impacts its long-term value. We’ve observed that the market often underestimates the durability of competitive advantage, consequently undervaluing the long-term compounding opportunity.

Compounders possess a sustainable competitive advantage thanks to their intangible assets, such as strong brand recognition. Competitors typically find these challenging to replicate. In our view, the secret to compounders’ success largely lies in their resilience during economic downturns. Thanks to their durable competitive advantages, their profit margins typically endure better during recessions. Their ability to generate superior risk-adjusted returns across the economic cycle is paramount.

### COMPOUNDERS IN DIFFERENT ECONOMIC CONDITIONS

#### DEFLATIONARY

In low inflation environments, compounders typically remain appealing. Our experience suggests that these companies can continue to grow earnings and deliver a relatively high return on capital in challenging environments, as their pricing power, and consequently earnings, remain robust.

#### INFLATIONARY

For investors concerned about rising inflation, we believe compounders possess exceptional pricing power, providing an effective hedge against inflationary conditions, and at the very least matching inflation.

Regardless of how enticing the growth narrative may appear, great companies for long-term investment must generate a positive spread, in our view.

## CREATING VALUE

Future value creation hinges on a company's ability to identify projects generating a positive spread between return on invested capital and the cost of capital. This is how free cash flow is generated. While this may seem obvious, the market at times subscribes to the motto of "growth at all costs." Ultimately, regardless of how enticing the growth narrative may appear, great companies for long-term investment must generate a positive spread, in our view.

Growth only creates value when the spread is positive. Often, company managements and investors fixate on growth without acknowledging the need for a positive spread to create value. While it is vital that the companies we own grow their free cash flow over time, driven by top- and bottom-line results, we also prioritise sustainability over the magnitude of growth. Our sweet spot encompasses sustainable earnings + growing free cash flow + an emphasis on high potential for cash conversion.

## STOCK SELECTION

Our stock selection hinges on one key criteria: operating leverage. Companies with high operating leverage can enhance operating income by increasing revenue. High operating leverage can lead to increased profitability when a company operates at full capacity, as fixed costs are distributed over a larger number of units, resulting in lower per-unit costs and higher margins.

High operating leverage can provide a competitive advantage by enabling a company to offer lower prices compared to competitors with higher variable costs. Additionally, it can lead to higher returns on investment for shareholders, as the company can generate more profit with the same level of investment.

## INTELLIGENT MANAGEMENT

We believe it is crucial to invest in companies where the management has a history of disciplined, intelligent, and efficient utilisation of free cash flow. We seek evidence of disciplined capital allocation and distribution practices – it's vital that management remains committed to building and enhancing the company's intrinsic value for the long term, without succumbing to the lure of short-term targets. Therefore, we favour companies whose remuneration and incentive policies encourage compounding that aligns with shareholders' long-term interests.

Well-managed companies capable of generating substantial excess returns possess the opportunity to consistently create future competitive advantages by investing proactively, ahead of their competition, thereby initiating a virtuous cycle of strengthening. This offers substantial return potential for patient long-term investors.

Through their innovative prowess, compounders continuously reinvent themselves, creating new applications and markets. When it comes to innovation, profitability

As a small country facing a robust currency and fierce international competition, Swiss companies are perpetually compelled to innovate.

regains relevance. Healthy and high-margin companies can afford substantial research and development expenditures. For companies offering interchangeable products and services differentiated primarily by price, their competitive moats are relatively easy to overcome, as competitors can readily emulate them. We regard cost leadership as an unstable strategy over time. Eventually, new competitors may emerge to

challenge cost leaders. In contrast, innovation leadership guarantees a company's future success. Fortunately, Switzerland boasts a high number of innovation leaders and a dense population of compounders. As a small country facing a robust currency and fierce international competition, Swiss companies are perpetually compelled to innovate.

#### THE MIRABAUD SWISS EQUITY TEAM



**DANIELE SCILINGO**  
Head of Swiss Equities



**THOMAS JÄGER**  
Senior Portfolio Manager



**JAN WIDMER**  
Senior Portfolio Manager

#### WHY INVEST WITH US

We believe that investing is an active pursuit. It entails rigorous fundamental research that delves deep beyond "stock stories" to identify not only a company's competitive advantage, but also its capacity to sustain it. It demands hands-on examination of companies and industries and relies on experienced analysis that is attuned to competitive dynamics. This analysis does not simply project the past; it anticipates how the current environment may evolve.

Albert Einstein famously described compounding interest as the most potent force in the universe. We steadfastly believe that the long-term trajectory of company earnings with robust cash conversion capabilities determines the generation of returns, and finding compounders represents the pinnacle.

Compounding wealth is a journey that necessitates patience, discipline, and stamina. The mindset of perpetually seeking out compounders proves more rewarding than expending intellectual capital and time on frequent trading in a quest for short-term gains.

At Mirabaud Asset Management, we have embraced the compounding mindset for decades, and it remains our ethos for tomorrow. Connect with us and embark on a wealth compounding journey.

---

## IMPORTANT INFORMATION

This marketing material is for your exclusive use only and it is not intended for any person who is a citizen or resident of any jurisdiction where the publication, distribution or use of the information contained herein would be subject to any restrictions. It may not be copied or transferred.

This material is provided for information purposes only and shall not be construed as an offer or a recommendation to subscribe, retain or dispose of fund units or shares, investment products or strategies. Potential investors are recommended to seek prior professional financial, legal and tax advice. The sources of the information contained within are deemed reliable. However, the accuracy or completeness of the information cannot be guaranteed and some figures may only be estimates. In addition, any opinions expressed are subject to change without notice.

All investment involves risks, returns may decrease or increase because of currency fluctuations and investors may lose the amount of their original investment. Past performance is not indicative or a guarantee of future returns.

This communication may only be circulated to Eligible Counterparties and Professional Investors and should not be circulated to Retail Investors for which it is not suitable.

Issued by: in the UK: Mirabaud Asset Management Limited which is authorised and regulated by the Financial Conduct Authority. D14 In Switzerland: Mirabaud Asset Management (Suisse) SA, 29, boulevard Georges-Favon, 1204 Geneva. In France: Mirabaud Asset Management (France) SAS., 13, avenue Hoche, 75008 Paris. In Luxembourg, Italy and Spain: Mirabaud Asset Management (Europe) SA, 6B, rue du Fort Niedergruenewald, 2226 Luxembourg.

**FOR PROFESSIONAL INVESTORS ONLY**