REPRINTED FROM DECEMBER 14, 2023

THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

AI Revolution Will Ultimately Benefit Data-Heavy Companies

KISHORE RAO is a Principal, Analyst and Portfolio Manager on Sustainable Growth Advisers' Investment Committee. He has been with the firm since 2004 and sits on SGA's Executive Committee. Mr. Rao has been co-manager of SGA's Emerging Markets Growth Portfolio since its inception in 2014, and of SGA's Global Mid-Cap Growth Portfolio since its inception in 2018. In 2020, he joined the portfolio management team of SGA's flagship U.S. Large Cap Growth Portfolio as co-manager, and in 2022 he joined the portfolio management teams for SGA's Global Growth and International Growth Portfolios. Prior to joining SGA, Mr. Rao was a member of the investment team at Trident Capital. Previously, he was a Founder and General Manager of the Street Events division of CCBN before it was sold to Thomson Reuters, an Investment Analyst at Tiger Management following health care services and software companies, and an Analyst at Wellington Management following semiconductor equipment. He has a B.S. in Industrial Management from Carnegie Mellon University and an MBA from Harvard Business School.

SECTOR — GENERAL INVESTING

TWST: A good place to start is with an introduction to the company, so tell us a bit about Sustainable Growth Advisers.

Mr. Rao: SGA was started in 2003, so we just recently celebrated our 20th anniversary. We're quite pleased and proud of that. We're grateful to our clients who have made that happen. We started with one client in 2003. Today, we have just over 100 various institutional clients. We work directly with investment firms on a subadvisory basis, in some cases with pension plans, endowments, and various sophisticated intermediaries.

At the end of the quarter, we had about $23 billion in assets under management, split with about $13 billion in U.S. equities, about $9 billion in global equities, and about $0.5 billion in EM and international equities.

All of those strategies, I should point out, are managed by the same team with the same philosophy, the same process, so what we do doesn't really change very much between these different strategies. Rather, our clients over time have come to us and said, well, we really like what you do but we don't want just a U.S. version, we want a global version, or we would like an EM version, or an international ex-U.S. version.

If those variations are simply based on geography but don't require us to change our discipline or our process or philosophy, we're happy to accommodate those kinds of requests.

To conclude, we have 34 people on the team, and 17 are equity owners in the firm.

TWST: Could you talk a bit about the concept of "sustainable growth"? My sense is that's the singular focus of SGA's style of investing. What does that mean to the firm?

Mr. Rao: Yes, it is the singular focus, and what we mean by sustainable is important. I think that word has taken on different connotations subsequent to the founding and naming of the firm. What we mean are companies that can sustain their growth — they have very durable market positions, they have very predictable and consistent business models that deliver strong results year in, year out. We are really looking for linear growth compounders.

Said differently, we try to avoid cyclical companies that have growth now and then don't have growth next year and then have growth the following year, and it varies greatly.

We're looking for low variability, and we're looking for long durability in addition to high magnitude. So those are some of the aspects that we are focused on when we talk about sustainable growth.

TWST: Tell us more about your research and stock selection process. How do you evaluate the growth, quality and valuation characteristics that you look for in investments?

Mr. Rao: At the highest level, we really sit at the intersection of those three things that you just talked about — quality, growth and valuation. That's the hallmark of what we do. Quality, however, is a word that has been almost commoditized in the last decade or so, and so I think it's important to take a minute to define that. We have five attributes that we're looking for.

The first is pricing power. We're looking for those companies that have really unique value propositions and competitive positions, so they can be price setters rather than price takers. Quite often these companies operate in oligopolies or emerging oligopolies. Our companies

have higher gross margins than most, and that's a key metric for us to validate that these companies really do have pricing power.

The second attribute is repeat revenues. We're looking for companies that are very predictable and consistent in their growth, and so you'll see a couple of business models quite often in our portfolios that embody this idea.

For example, companies that sell products on a consumable basis. A company like **Ecolab** (NYSE:ECL), which makes industrial sanitation and hygiene supplies, so literally the product goes down the drain every day and it has to be replenished and replaced.

It can be that kind of industrial consumable, or it could be a more traditional consumer consumable.

A second model that embodies repeat revenues would be subscription or maintenance-oriented companies, and those are best characterized today with the enterprise software companies that we have in the portfolio, many of which are using the software-as-a-service model.

They provide those software services to businesses on a predictable, monthly, recurring revenue basis. They have very high retention rates, typically in the 90% or better range, and so those companies have very high visibility and consistency and low variability in revenues, earnings and cash flows.

decade we saw a lot of companies grow by taking on cheap debt and cutting costs and levering up their balance sheet and repurchasing shares. That model may have worked in the prior decade with quantitative easing, but in our view that is not going to be sustainable going forward in a market with higher rates.

So again, the durability and the nature and the composition of that growth is important to us, both on the top line and the bottom line.

So, that's how we define quality and that's how we define growth, and then lastly on valuation, we're very focused on the cash flow-based valuation.

We have a metric we call the enterprise yield. It's a more conservative metric than free cash flow yield even, and we consider all kinds of other calls on capital a company might have to pay, including unfunded pension obligations or an acquisition program that requires the company's cash to be diverted away from shareholders.

We're really trying to calculate each year how much of the cash flow that the company generates could be returned to our shareholders' pockets, so we're almost taking a private equity-like approach to the public markets, finding companies that have really good cash flows, figuring out how much of that could be returned to shareholders, and that's how we come up with this metric.

"Unlike prior technological disruptions, this Generative AI revolution may benefit data-rich incumbents most. Take, for example, Intuit (NASDAQ:INTU), which provides QuickBooks accounting software for millions of small businesses, or its TurboTax division which helps millions of individuals prepare their taxes. Both will become stronger with those massive data troves."

The third model would be companies taking tolls on proprietary networks. That could be a company like **Visa** (NYSE:V), for example. It's operating a credit card network that's heavily trafficked and used frequently, often many times a day, by the end consumer, and it takes a small toll every time.

All of these speak to a business model, a very predictable, reliable, consistent set of financial results, year in, year out.

Now, no company is perfect and delivers what we would target, let's call it 18% growth. That would be our dream, to find a company that could grow 18% earnings and cash flows every year. That doesn't exist. But these kinds of business models have lower variability in those underlying earnings and cash flow streams.

We're also very focused on the financial aspects of the company, meaning the cash flow conversion. Do they turn the earnings into free cash flows at a high rate? Typically you'll see our companies are generally capital light and have very good cash flow characteristics.

Also, we look at the financial leverage on the balance sheet. So that's the third aspect: financial strength.

The fourth would be management strength, and we're looking for companies led by people who are good stewards of capital, good citizens in the world at large, and have stability and strong continuity and succession.

And then the fifth aspect would be growth, and we're looking for both top-line growth as well as bottom-line growth. I think in the last

1-Year Daily Chart of Intuit Inc.

Chart provided by www.BigCharts.com

I think the idea of cash flow being important is something that the public markets value from time to time. You'll hear the mantra "cash is king" episodically, typically in environments like this where market liquidity is getting tighter and people remember the importance of that lesson.

We try to stay true to that all the time, through all phases of the market cycle. We don't try to play the trend du jour of the markets, but rather stay true to our discipline in all these criteria I just spoke to.

TWST: Let's dive more specifically into the large-cap growth portfolio, starting with a brief snapshot of the strategy.

Mr. Rao: I spoke to how selectivity is really important to us. Another manifestation of that selectivity is managing concentrated portfolios, 25 to 30 holdings in our U.S. strategy. We cap that on purpose because, again, we want to stay true to the discipline of being highly selective and making very conscious choices about what we own.

We all know about the benefits of diversification. I think most academic studies show that the benefits of that diversification in an equity portfolio peak out at some point, often in 15 to 35 names.

And then beyond that there's the risk of what Warren Buffett would call di-worsification: that those holdings in the long tail of a broader portfolio are really just names that are lower in quality, lower in valuation return potential, or have been placed there by the portfolio management team to neutralize benchmark risk, and effectively they're closet indexing.

We guard against all of those risks by having the hard ceiling of 30 names in the U.S. portfolio, and so we have a constant competition amongst all of the names on what we call our qualified company list. That's about 100-odd names, and those are names that meet the criteria that I spoke to earlier, that have been vetted by our team.

We have two analysts following each company, a primary analyst and a backup analyst, and each maintains a financial model of the company. We want to have a diversity of informed opinions to guard against behavioral finance risk.

That's another issue that's undeniable in the active management industry, and we guard against that by having two analysts following each name, and each portfolio managed by a three-person portfolio management team.

We know the philosophy works. It's worked for multiple decades. We just want to make sure the people involved stay true to the philosophy and adhere to the philosophy, and that's why we have these multiple layers of human redundancy to make sure we're staying true.

TWST: You mentioned the idea of constant competition with your qualified company list. Tell us about a few examples of recent changes to the portfolio, both in terms of adding or adding to a position, and trimming or exiting a position.

Mr. Rao: We have been investors for a pretty long time in a company called **Intuitive Surgical** (NASDAQ:ISRG), which makes robotic-assisted surgery equipment. Very importantly, what's attractive to us is there's a consumable element which is the vast majority of the revenue stream: for every procedure, that consumable piece has to be replenished and replaced.

So it's a very attractive, high-growth business model, and again, a very recurring and predictable one as well.

They're the leader in this robotic-assisted surgery category, an incredibly innovative company with tremendous margins and cash flows. But more recently, the stock has done really well, and on our math, the valuation became more challenged.

As part of our discipline, we exited the position a couple of months ago at prices similar to where the stock is priced today. So this is an example of the valuation discipline in action. We still maintain our research coverage of the company, it's still on our qualified company list, but because of that internal competition and discipline we sold it off.

Among names that we added earlier in the year is a company called **ServiceNow** (NYSE:NOW). It's a leading provider of service management software for large corporations around the world, and large government organizations as well. It's a company we followed for many years.

Very unique in what it does, very high margin structure, very high 98% renewal rates, growing in the 20% range, with free cash flow margins in the 30% range. So, a very attractive business.

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1-Year Daily Chart of Intuitive Surgical, Inc.

Chart provided by www.BigCharts.com

We had watched it from the sidelines because we didn't think the price was right, and then over the course of 2022, when the entire market sold off — particularly higher growth companies — that gave us a nice entry point to come into the name earlier in 2023.

We enjoyed the appreciation, and then more recently the stock has recovered back to its prior highs, and we have trimmed a little bit as a result.

TWST: Obviously you're not a theme investor, but are there certain areas that you see presenting better opportunities right now?

Mr. Rao: We are very much bottom-up investors and not top-down thematic investors. We want to make sure we know these companies intimately, and that their fundamentals stand on their own merits.

But one area that's of course been in the news quite a bit is the whole generative AI movement. I think the market has, over the course

of the year, been focused on some of the most immediate and obvious beneficiaries, and we are investors in some of those companies, including **Nvidia** (NASDAQ:NVDA), **Microsoft** (NASDAQ:MSFT), **Amazon** (NASDAQ:AMZN) and **Alphabet** (NASDAQ:GOOGL).

But over time I think there's another set of winners that until recently have not been fully appreciated, and those go back to these enterprise software companies that I alluded to before.

In our view, GenAI will certainly require the incredible accelerated computing capabilities of a company like **Nvidia**. It will certainly require the cloud computing infrastructure of those other companies I mentioned — **Amazon**, **Alphabet** and **Microsoft**.

But in all those cases, whether we're talking about consumer application or business application, the heart of GenAI is really about the data, and therefore, in our view, the companies with the most data will be best able to train their GenAI model to produce insights.

And so, unlike many prior technological disruptions that favored the disruptive insurgent upstart, we actually think this revolution will benefit the scaled incumbents the most. Take, for example, a company like **Intuit** (NASDAQ:INTU), the software company that provides QuickBooks small business accounting software for many millions of small businesses, or its TurboTax division which helps individuals prepare their taxes.

But on the cautious side of the ledger, we have some challenges, including the latent impact of all the interest rate hikes that have taken place over the last year or two, and those are still perhaps percolating through the system.

We have the resumption of student loan payments that could be an impediment. We have two tragic, major global conflicts in the Middle East and Ukraine, and either of those could evolve in unpredictable ways quite suddenly.

Like I said, there are reasons to be optimistic, but reasons to be careful and cautious. In our view, that's in large part why we're so confident and optimistic about what we do, because we're investing in companies that have these more dominant, competitive positions but also this very reliable, predictable business model as well as attractive growth.

So, if there's difficulty in the economy, these companies should perform better on a fundamental basis than the average company, and if the environment is strong, then these companies should continue to grow at very high rates and perform well.

We think with this kind of volatility and uncertainty, the kinds of companies we're invested in provide a smoother ride, if you will, through the ups and downs of the markets and the economy and the whims of investors.

"So, if there's difficulty in the economy, these companies should perform better on a fundamental basis than the average company, and if the environment is strong, then these companies should continue to grow at very high rates and perform well."

By virtue of that market leadership in each of those categories and the massive amounts of data it has, it will be able to generate insights that help other customers benefit from the aggregation of that data.

The company has been a very good steward of data, preserving confidentiality and anonymity, but is able to extract insights from that meta-scale data.

That's one example. Another company called **Workday** (NASDAQ:WDAY), which is the leader in providing human capital management software to large enterprises, or a company like **Salesforce.com** (NYSE:CRM), which helps businesses maintain and manage their customer relationships — these would all be examples, in our view, of some of the less obvious and maybe less immediate beneficiaries of the GenAI movement that will really prosper in the years to come.

TWST: That's clearly a promising area. Is there anything in particular that you are cautious or concerned about in the current market?

Mr. Rao: Well, it's certainly a very uncertain world. I think that's an understatement. There are reasons to be optimistic and there are reasons to be concerned.

I think on the optimistic side, there's some evidence that inflation is cooling and the economy is holding up, so far, reasonably well. There's also a lot of investor cash on the sidelines.

1-Year Daily Chart of ServiceNow Inc.

Chart provided by www.BigCharts.com

TWST: What are your thoughts on valuations right now? How do you feel valuations look overall, and specifically for large-cap growth stocks?

Mr. Rao: We haven't touched on this idea of the Magnificent Seven, and that has obviously been a disproportionate driver of market returns, those seven companies. As I alluded to, we do own some of them, but we own them at what we consider to be reasonable weightings, anywhere

between a 3% and 6% position in the portfolio. We do not own them at a benchmark weight just because they're a large weight in the benchmark.

Following the benchmark blindly, I think, poses a lot of risk, absolute wealth risk, and that's what we're most focused on, protecting wealth in an absolute sense — first and foremost preserving it, and then secondly compounding it.

So, we don't build the portfolios around benchmark weights, but those names have grown to very large sizes in these benchmarks, and some of those in particular carry large multiples.

The rest of the market, I think the multiples are not cheap. I would not call it a cheap market. I think the S&P multiple is about 19x right now, so it's probably on the higher end of the range relative to where interest rates are.

That would be another factor to put in the cautious category, especially if those companies in the index are highly cyclical and are going to be exposed in a market downturn.

That's another reason we feel quite confident about how our philosophy and our process positions us in a market environment that might be more expensive on traditional measures like earnings, because we're much more cash flow focused, and we think our cash flow discipline and valuation is actually reasonably attractive at this point. We utilize the metric referenced earlier, enterprise yield.

One way to think of what we're doing is we build what we call growth bonds. I don't mean that in the sense that we're fixed income investors, because we're not. But we think about how much cash flow the company produces a year, and it's about 3% in aggregate for the portfolio, about 3% yield. Some of it's returned to shareholders, some of it's reinvested.

But this 3% enterprise yield is compounding at a 15%-plus rate, and so, over time, maybe even the entirety of a market cycle, we think this formula of a roughly 3% cash flow yield compounding at 15% should drive double-digit absolute returns. And that's exactly what our strategy has done over the last 20 years.

That's a long answer to your question about valuation, but that's how we think about it and how it's a bit different than the market and the Magnificent Seven.

TWST: That's been a common subject, so I'm glad you addressed it. I'm wondering, to the extent that you incorporate a top-down view into your process, what are the main macro factors top of mind for you and your colleagues these days?

Mr. Rao: We are very much bottom-up investors, but of course we're not oblivious to what's going on in the world. And we're very mindful of unintended concentrations, for example, so we do employ industry limits, sector limits, those kinds of disciplines, to make sure that even though we're excited about a set of companies — for example, some of these software companies — we would limit the industry exposure to 25%.

One top-down risk would be, with the higher rates, highly leveraged sectors like commercial real estate, or companies that are dependent on the massive private equity/private credit complex, where maybe the transparency of how those companies are doing is not so obvious and evident.

We don't have any direct exposures to commercial real estate or the PE complex but we're very mindful of the risks that those sectors have, and we're always scrutinizing our companies to see if they have any customer concentration or customer dependency on those kinds of sectors.

TWST: What is your outlook for the new year rapidly approaching, and is there anything in particular you're keeping a close eye on or doing to position SGA's portfolio?

Mr. Rao: It goes back to those balanced sets of risks and rewards.

We're keeping a close eye on inflation and if it will continue to moderate. We're keeping a close eye on unemployment and the labor situation. We are keeping a close eye, of course, on what's happening around the world in terms of the conflicts. Student loan payment resumption and higher rates and those impacts, and what that's going to do to consumer spending as well as business spending. Those are all things that we're very focused on.

But we sleep well at night in the sense that we know our companies are less exposed to the volatility of the macroeconomic cycle because of those repeat revenues that I spoke to earlier, and those three business models that we own quite frequently — companies that sell consumables, subscriptions, or take tolls on highly trafficked networks — have less economic sensitivity than the average company.

So, mindful of the risks, but we think we're well positioned despite those risks.

TWST: Any final thoughts to wrap up?

Mr. Rao: One final point I'd make is, in our view the next decade ahead — and that's often how we think, in that kind of time frame — the equity markets and the large-cap growth space will be different than the last decade.

The last decade, returns were helped in large part by easy money, quantitative easing and central bank accommodations, a rising China, peace. A lot of those variables are changed now for the next decade ahead.

Rates will probably be higher. We can argue about the floor, but the floor is probably higher. There's going to be more geopolitical uncertainty with these various conflicts around the world, and of course, tensions between the United States and China are on and off again. It's going to probably be a more multipolar world than we saw in the last decade.

And with those kinds of changes, valuation discipline will be more important than it was in the last decade, and finding companies that can grow predictably and reliably and consistently despite all the volatility that's out there, we think, will also be better rewarded and more important than in the prior decade.

The good news for our clients is that's the same thing we've been doing all along: finding high quality, reliable, consistent growers that are attractively valued. We haven't changed what we do, we just think the world and the market is coming towards us.

TWST: Thank you. (MN)

KISHORE RAO
Principal, Analyst & Portfolio Manager
Sustainable Growth Advisers
(203) 348-4742
www.sgadvisers.com
email: info@sgadvisers.com

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