TD Greystone Asset Management

What Growth Means to TD Greystone Asset Management

What's your Investment Style?

"What's your investment style?" – it's a common question that is asked of institutional investment managers. It's an important question, especially for those institutional investors that hire managers with different styles as an "offset" to each other. The typical response to this question is "growth" or "value" or "income" or "small cap" or a whole host of other terms that essentially group investment managers into different categories. In fact, Morningstar created their Style Box in 1992, which pegs a manager into one of nine squares on a grid to determine where a manager's style fits with regards to size and style (as measured by where they fit along the value-growth continuum).

At TD Greystone Asset Management, our approach to equity investing is biased towards a growth style. We believe that identifying companies with sustainable growth drivers for their businesses translates into higher future earnings, which in turn leads to higher stock prices. How does our growth style manifest into the types of companies we prefer to invest in?

Business Momentum

In our equity research, we focus on a company's business momentum. To us, *business momentum* is more than just looking at earnings growth or revenue growth: it is about understanding what that growth is operationally driven by and how sustainable it is. One method we employ to start thinking about these drivers is to apply Porter's Five Forces model of industry competition, which looks at the threat of new entrants and substitutes, the bargaining power of customers and suppliers, and the type of competition within the industry. Indicators of sustainable growth often times appear at the company level before they impact stock prices. Many investors tend to underestimate the increase in value that occurs when structural improvements in the business occur.

Structural improvements happen all the time, but do not always coincide with earnings per share growth. Over time though, an improved profit profile will result, which leads to an increase in the intrinsic value of the company. Equally important is having a sense of how long that momentum can last – as business momentum matures, a company's ability to generate excess cash flows at a high level of return on invested capital is increasingly important.

Our aim is to assemble a portfolio of such companies whose business momentum comes from a diversity of factors. Some examples would include robust organic growth, increasing market share, execution of a disciplined M&A strategy, clearly identifiable advantages versus peers or a strong presence in a disruptive industry. The more diversified our portfolios' business momentum drivers are, the more resilient the portfolios will be in the face of changes to business and investment environments.

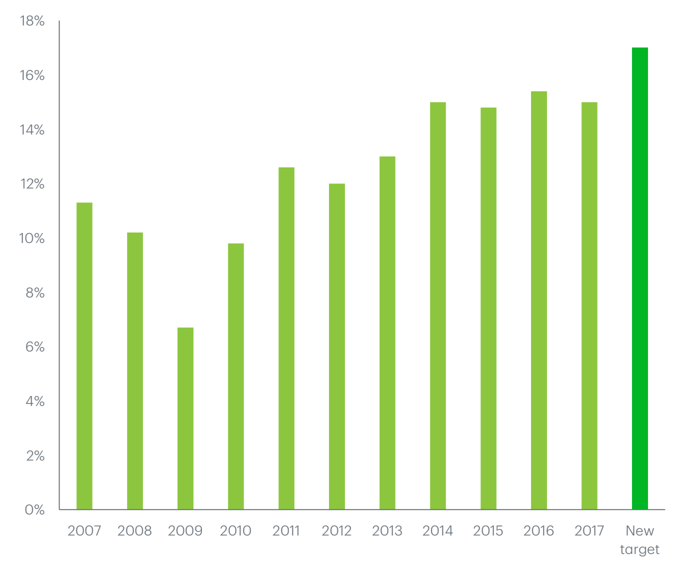
By no means do we have a copyright on the term business momentum! However, it's a term that best describes the type of stocks we own in our clients' portfolio. We define that to mean any improvement in a company's earnings generating capacity and the best way to illustrate that is by looking at a couple of examples that at the time of writing are held in the Greystone equity portfolios.

Smurfit Kappa

Smurfit Kappa (Smurfit) is a world leader in paper based packaging. Operating on a pan-European basis, it is the European leader in containerboard, solidboard, corrugated, and solidboard packaging. The business momentum story is linked to the secular trends of growing demand for bio-degradable packaging (and away from plastic), as well as the increasing complexity of supply chains and the growth of e-commerce, which is a large consumer of corrugated containers. In addition, Smurfit is still relatively small in the scope of the whole market which is fragmented in Europe with a lot of small, family-owned companies. Smurfit's customers are increasingly focused on "value-add" products and logistics which provides it the opportunity to gain market share in both up and down markets.

Smurfit is uniquely positioned to capitalize on these secular growth trends with industry leading business applications and solutions to help its customers to reduce their costs, drive sales growth or reduce their business risk. The company recently announced a medium-term plan to spend € 1.6bn in growth investments between 2018 and 2021. It aims to lift its return on capital from 15% to 17%, assuming a fairly benign pricing environment (see Figure 1), which we believe is possible given a solid track record of meeting targets.

Figure 1: Smurfit Kappa 2007-2017 Return on Capital Employed



Source: Smurfit Kappa company reports.

Nitori Holdings:

Market Insights Driving Greater Market Share

Nitori Holdings (Nitori), listed on the Tokyo Stock Exchange, is a profitable retailer of furniture and home fashion goods mainly in Japan. Business momentum for Nitori has been driven by their continued ability to successfully execute cost reductions while restructuring operations to allow them to gain market share in Japan (see Figure 2). It has an integrated business model of manufacturing and direct purchase relationships, which gives the company cost and market insight advantages that competitors do not have. Benefits of its integrated business model include better management of inventory, more frequent product launches, and lower production costs. These competitive advantages will continue to help the company's business momentum and sustain profitability in the longer term. Its 5-year average return on invested capital of 15.4% is higher than its domestic peers as well as the broader Japanese and world equity markets, which are all in the single-digits.

Figure 2:
Increasing Market Share (Nitori Holdings)

Source: TD Greystone Asset Management, MSCI, FactSet.

Conclusion

From a portfolio management perspective, building a portfolio of companies with different growth drivers is important as we know the market will not reward them all at the same time.

We believe having this diversity in the portfolios helps provides resilience to our longer term results. At TD Greystone Asset Management, our Public Equities team is structured to benefit from strong quantitative identifiers, such as return on invested capital, coupled with a global approach to fundamental analysis where our sector analysts are always asking:

"What is this company's business momentum and how does it compare to its global peers?"

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