Rothschild & Co
Wealth Management

QUARTERLY LETTER | JULY 2023

LongRun Equity

Investment philosophy

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price." — Warren Buffett

We act as long-term business owners investing the wealth you have entrusted us with in a concentrated portfolio of high-quality companies.

LONG-TERM BUSINESS OWNERS

We want to own the highest-quality franchises for the long term. Little do we care about potential moves in short-term stock prices. What's crucial for us is a company's competitive position, a superior and sustainable business model and the ability to compound earnings. We want management teams that allocate capital as if it were their own. We care about valuation, but take the long-term view, avoiding excessively valued businesses but not shying away from high valuations. When you have a great business that continues to prosper, the share price tends to follow. Conversely, a narrow focus on valuation can lead one astray from truly great businesses. We are determined to avoid this mistake.

WEALTH PRESERVATION

The avoidance of permanent capital loss has been in our DNA for centuries. We avoid businesses exposed to external factors outside of their own control, which can crush attractive returns. We think long and hard about whether a business will still have a license to operate in the long term and if there are environmental or social risks.

Only robust companies in control of their own destiny make the cut. To find these, we conduct deep research to understand business models so we can take advantage of noise and temporary swings in stock prices. We would expect our portfolio companies to do the same.

COMPOUNDING

Einstein once dubbed compounding as the "eighth wonder of the world". We couldn't agree more. We look for companies with superior economics and the resulting ability to compound their earnings over the long term. Strong market positions, pricing power, high margins and asset-light business models are the key characteristics that result in high returns on capital and the ability to compound earnings. A sustainable competitive advantage resulting from high barriers to entry is crucial to maintain these high returns in the face of competition, therefore avoiding a permanent destruction of value.

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Values: All data as at 30 June 2023.

Sources of charts and tables: Rothschild & Co and Bloomberg, unless otherwise stated. Past performance is not indicative of future performance and investments and the income from them can fall as well as rise. Strategy performance is shown in EUR, after all fees, in total return, combining income and capital growth. Returns may increase or decrease as a result of currency fluctuations. Please note the strategy's new management started on 01.08.2021

Please ensure you read the Important Information section at the end of this document.

The avoidance of permanent capital loss has been in our DNA for centuries. We avoid businesses exposed to external factors outside of their own control, which can crush attractive returns.

Managing our clients' money is a privilege and a role we take very seriously. It is important to us that our clients know us and understand how we operate.

DEEP RESEARCH

We spend most of our time reading annual reports, conducting and analysing expert calls and speaking with management teams and industry experts. We engage regularly with management, talk to industry insiders and conduct grass-roots research. Books on companies and their leaders, industry newsletters and trade publications as well as podcasts are hugely valuable and are often neglected sources of information.

CAPITAL ALLOCATION

Managing our clients' money is a privilege and a role we take very seriously. It is important to us that our clients know us and understand how we operate. In a similar vein, we want to understand how the management of our businesses thinks, acts and is incentivised. Capital allocation is the most important job of management, and the great returns of a high-quality business can be diluted via poor mergers and acquisitions or empire building. We look for management teams with incentives centered on long-term value creation and that have "skin in the game". These are critical if they are to think and act like owners, rather than managers.

QUALITY OVER QUANTITY

We prefer to analyse and own fewer companies but understand them properly. We see little value in constant screening for 'cheap' companies and it distracts us from our focus on quality. With financial information abundant, no real edge can be gained based on quantitative information in our view. On the other hand, a deep understanding of business models takes time, but this is the only way we believe it is possible to generate superior long-term performance.

FOCUS

Focus is front and center of everything we do. We like focused businesses that are easy to manage and understand. We do not need our companies to diversify; we will take care of this ourselves. Our investment universe and portfolio is equally focused, with limited turnover. This allows us to compound our knowledge of our companies in a way that is similar to how we want them to compound their earnings and cash flows.

BOTTOM LINE

The combination of the above results in a high-quality portfolio of businesses. LongRun's main financial metrics remain strong, with cross-cycle sales growth of 8%, a 26% operating margin, an operating return on invested capital of 53% and a net debt to EBITDA leverage ratio of 0.3x. On a 3.4% free-cash-flow yield, we consider valuation attractive and expect annualised forward returns in the low double digits for LongRun Equity.

Notes from the manager

LongRun returned +4.1% in Q2 2023, slightly behind its benchmark

STRATEGY PERFORMANCE

The strategy returned a solid +4.1% (in EUR, unhedged) in the second quarter, but nevertheless slightly lagged global equities, which rose by 5.7%. The main reason for the underperformance was not being exposed to some of the world's largest companies which performed very strongly, namely Apple, Nvidia and Tesla, as most of our companies actually did well.

Annualised returns since inception of the strategy over seven years ago stand at 10.8% compared to 9.7% for global equities, resulting in an annual outperformance of 1.1 percentage points.

PERFORMANCE DRIVERS

The main positive contributors to the strategy's performance in the second quarter were essentially our technology businesses while healthcare and our Asian names lagged.

Adobe, Alphabet and Microsoft all returned well in excess of 10%. Our heavy weightings in the latter two further boosted their contributions. All three posted strong quarterly results but were in particular buoyed by investor excitement regarding their potential to benefit from artificial intelligence, both in terms of their internal processes as well as the ability to monetise their offering in the field.

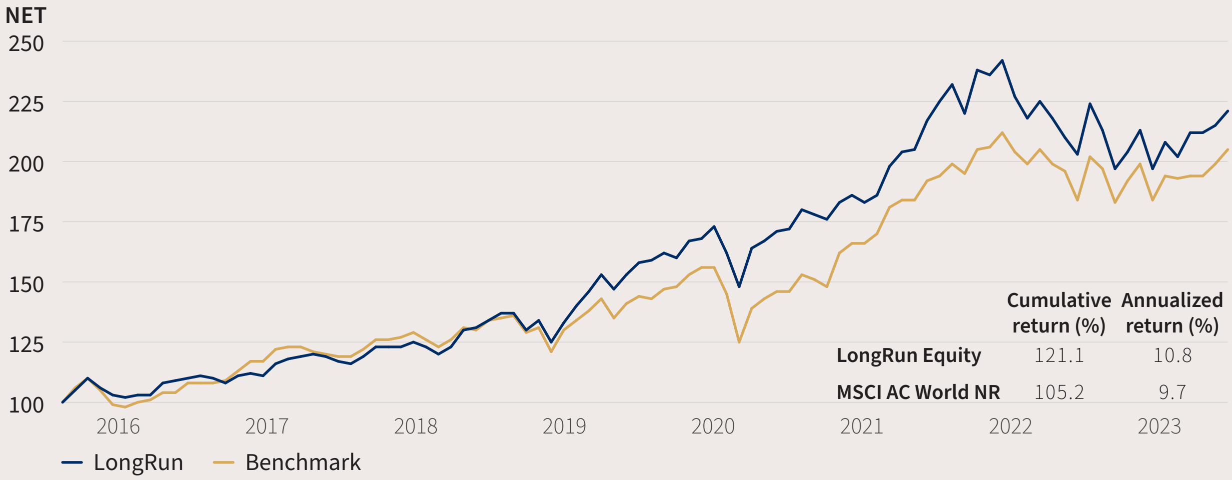
Mastercard and Moody's also handily beat the benchmark with their results once again proving their mission-critical positions providing them with strong pricing power. We physically met with both businesses and remain impressed with the deep moats they have built over the past decades.

Accenture and ASML also did well with their quarterly earnings (once again) blunting investor concerns with regards to softer end market demand.

The biggest detractors for the quarter were Disney, Alibaba, Tencent, Sonova and Thermo Fisher. While their performance was unsatisfactory, at least our decision to keep these positions at lower weights has proven to be correct.

Disney fell by more than 10% on the back of lackluster quarterly earnings and subscriber figures. While we think Bob Iger's return is positive, the task to better position the business in a rapidly changing media landscape will be a challenging and lengthy one. We continue to watch this space.

CUMULATIVE TRACK RECORD (EUR UNHEDGED, %)



Alibaba and Tencent both declined well in the double digits. Earnings were actually solid and Alibaba's decision to simplify and streamline its business portfolio was a clear positive. However sentiment remains a thorn in the side of both companies and we are eager to see this improve.

Our medtech names, and Sonova and Thermo Fisher in particular, continued to struggle. Each fell by 10% or more. Similar to wider sector, the normalisation process in the aftermath of Covid-19 has been a headwind. This has been exacerbated because their operations were boosted far greater than initially anticipated.

ACTIVITY

There was only one transaction in the quarter: the full sale of T Rowe Price. T Rowe is one of the best operators in a however highly fragmented and competitive sector. The more difficult outlook coupled with the company's lack of pricing power have led us to grab the opportunity by the horns (pun intended) and sell our stake following a near 50% rerating of the company's earnings multiple over the past six months.

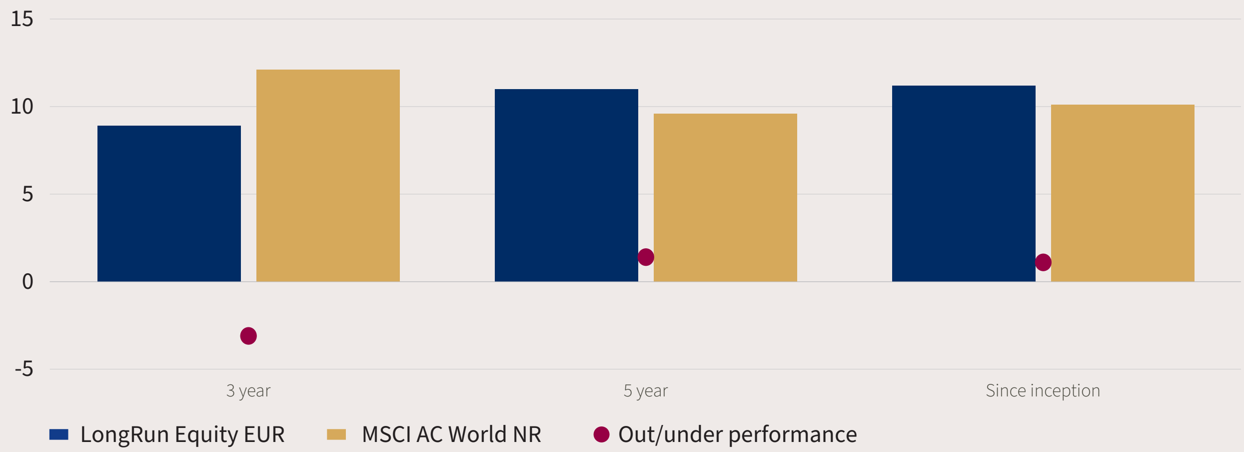
ANNUAL PERFORMANCE

	LONGRUN EQUITY (%)	MSCI AC WORLD (%)
2023	12.0	11.5
2022	-18.5	-13.0
2021	30.4	27.5
2020	10.4	6.7
2019	34.8	28.9
2018	1.1	-4.8
2017	10.0	8.9
2016	5.8	11.1
2015	6.0	4.9

ANNUAL PERFORMANCE

	NET ASSET VALUE	QTD (%)	YTD (%)	INCEPTION TO DATE (%)
LongRun Equity EUR Unhedged	2,075	4.1	12.0	121.1
MSCI AC World NR		5.7	11.5	105.2
Out/under performance		**-1.7**	**0.5**	**15.8**

ANNUALISED PERFORMANCE (%)



Case study: research process

We seek insights consistent with our holding period and concentrated portfolios

Our research process is the foundation upon which our concentrated portfolio of ownership stakes in the world's best businesses is built. As long-term investors, we are looking for insights consistent with our holding period and portfolio concentration, rather than trying to predict short term stock price gyrations.

AVOIDANCE OF PERMANENT CAPITAL LOSS

The avoidance of permanent loss of capital is paramount. This hammer can hit in two ways:

i) significant exposure to external factors outside of a business' control; or

ii) mistakes in assessing a company's fundamentals.

A business subject to significant external factors effectively is not entirely in control of its own destiny. These are typically commoditised industries with the market setting selling prices based on supply and demand. An example is the energy industry where the oil price is by far the most important factor driving earnings, and management has little ability to influence it. We stay clear of these industries.

The second source of permanent capital loss comes from mistakes in assessing a company's business model or competitive moat. This is the reason why we spend so much time on understanding a business's fundamentals and its competitive advantage. Avoiding these blow-ups is crucial to generate long-term investment outperformance.

FOCUS

We are very selective in both the companies we have in our investment universe as well as in our fund. Our hurdles are deliberately set high and turnover is limited. This, we think, is the only way to ensure we know our businesses inside out and can compound our knowledge of them further.

We look for businesses that are themselves focused. We avoid overly complex companies that are the result of empire building and that have disparate and (even worse) ever changing business portfolios

Put simply, if we cannot deconstruct businesses' earnings and cash flows with a meaningful degree of confidence, we'll stay clear of it. Our circle of competence is deliberately narrow, and we stick to it.

DEEP RESEARCH

Our research efforts look to unearth both qualitative and quantitative aspects of our businesses. The focus is on gaining a deep understanding of their business model and competitive advantage.

We very much prefer to do our own, primary research, rather than 'leveraging' third-party information and data. For us, shortcuts just don't work.

The starting point is typically a company's annual report and accounts. We look for information straight out of the horse's mouth, rather than for information regurgitated by intermediaries which often have vested interests (and no skin in the game). In a similar vein, we regularly travel to meet our businesses and their management onsite, rather than at broker conferences or roadshows where they are hollowed out by the humdrum of investor questions.

That said, management teams are, by definition, biased. This is why we put even greater emphasis on speaking to and learning from industry insiders which are naturally more objective. They tend to have dozens of years of industry experience and have worked in various companies, regions and management layers of an industry. They are more likely to tell you the full story and what really makes an industry tick. Managers themselves are often loathe to do so, not least for competitive reasons.

QUALITATIVE ASPECTS

The qualitative, not the quantitative, aspects of a business are the ones which will determine its ability to compound its earnings, not the other way around. Sadly for the average investor, but luckily for us, these are, unlike earnings estimates and valuation multiples, not readily available on financial information systems. The process of identifying and understanding them is time consuming. But it is exactly here where a good research analyst will excel, doing the tedious, unglamorous 'grunt' work.

Qualitative aspects come in many shapes and forms, and vary by industry. But they are often the very gold nuggets that will determine the longer-term trajectory of share prices.

Examples of qualitative aspects that drive earnings are: factors driving the purchase decision, customer loyalty, integration into a customer's processes and value chain, price elasticity, product differentiation, innovation, decentralisation or corporate culture.

The output of all this research will come in a research report in standardised form. We focus on the written word, rather than blowing up our papers with charts and tables. Putting these insights onto paper in a structured way deepens one's understanding of a business. These reports are also the basis for discussions and debates among the decision makers. Finally, they make the investment process more robust – stock prices can go up and down for various reasons, but like this we'll know even in a few year's time what our thesis was, and whether it was correct.

QUANTITATIVE ASPECTS

Quantitative figures are more readily available than the above qualitative ones and are, after all, what us financial (sic) analysts should excel at. And they are also what captures the typical investor's attention most.

For us, there are three types of financial information: i) stock market and share price related information, ii) financial figures from a company's accounts and iii) operational metrics. We focus on all three but think the latter matter most for long-term investors.

Typical examples of such operational metrics would be market share information, volume vs. price data/growth rates, customer satisfaction, utilisation rates, employee productivity, churn rates, or employee engagement/turnover.

All three types of financial information will find their way into a standardised financial model. We have our own definitions for all the key metrics, as consistency is key, so we can compare our businesses and their performance on an apples-to-apples basis. For each of our investments, we look at their financial performance over a full economic cycle, hence at least since 2005. This is a lot of tedious work, but again necessary if one wants to be a long-term investor.

Red flags such as frequent changes in disclosures, in the business portfolio, segment reporting or regular 'one-off' charges are readily spotted. Also, the best businesses often have a financial disclosure to match (and nothing to hide).

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The key output of our models is the intrinsic value of each of our businesses and the implied three year-forward annualised returns. This is based on a discounted cash flow valuation with an explicit forecast period of 15 years and a unique way to define both the cost of capital and terminal value, with particular consideration given to inflation and a businesses pricing power.

OUR RESEARCH IN PRACTICE

One industry which has been fertile ground for the quality investor, is simple and provides good financial disclosure is the global elevator & escalator industry (the three listed players are Kone, Otis and Schindler). We have been invested in the industry for close to ten years.

Elevators and their maintenance are a mission-critical component of buildings but they only account for a small share of customer spend. In elevator maintenance, the decision maker is not even the one paying for the service (the tenant is) meaning they only give limited consideration to price. This is the core of our thesis which is the result of months, if not years of work.

We have conducted a massive amount of research on the industry, speaking to various parts of the whole value chain (suppliers, privately held competitors, building owners, property managers, regulators) as well as to the companies themselves. In addition, we have read books on the industry and it's players, conducted various site visits and gone through statistical data.

On the qualitative side, the industry has a few main attractions. First, it is fairly consolidated on a global and even more so local level. The main competitors are either family owned (which lends itself to long-term value creation) or standalone entities no longer buried in industrial conglomerates. There is plenty of industry information from both government sources and company reporting. This has allowed us to gain a deep understanding of the industry drivers based on analyses such as the elevator density of individual countries or building types or how a market develops over time with as it evolves from new installations to services.

On a company level, the majority of earnings come from the high-margin services business. Services is characterised by long-term contracts and customer loyalty exemplified by high conversion and even higher retention rates in excess of 90% resulting in revenue visibility.

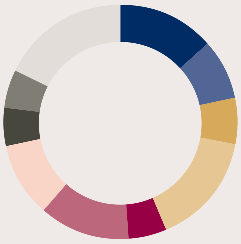
On the more quantitative side, companies mostly are openly disclosing and willing to discuss the operational drivers of their business. This has allowed us to glean valuable insights in terms of the volume and price development for the different parts of the business, the evolution of the installed based of units and the pricing of service contracts as well as differences in margins by geography or business unit.

The main financial ratios are attractive for all the players with consistent mid single digit organic growth, returns on capital well in excess of 50% and >100% free cashflow conversion. There are meaningful differences in execution and corporate culture among the three listed players, however. These have been the main rationale for the specific equity investments we have made in the industry.

Business owner’s portfolio

A deeper look into the strategy and its companies

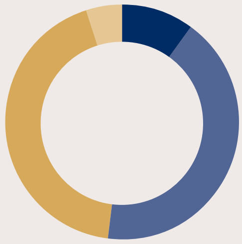
SALES BY BUSINESS (%)



Software	13
Online commerce and advertising	8
Payments	6
Professional services	15
Capital goods	5
Fast moving consumer goods	12
Medtech	10
Other healthcare	5
Luxury	5
Other	17

By weight in portfolio, excluding cash

DEGREE OF PRICING POWER* (%)

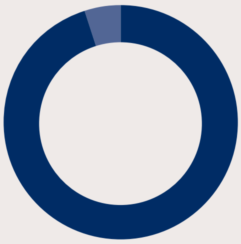


High	10
Medium	42
Low	43
None	5

*In the investable universe, around 5% of companies have medium or high pricing power.

By weight in portfolio, excluding cash

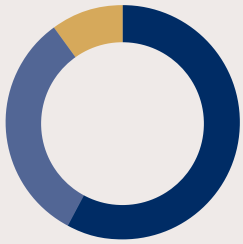
STRENGTH OF COMPETITIVE ADVANTAGE (%)



High	95
Medium	5

By weight in portfolio, excluding cash

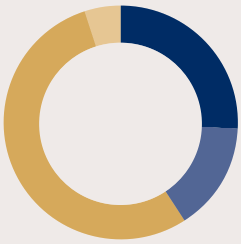
STRENGTH OF SWITCHING COSTS (%)



High	58
Medium	32
None	10

By weight in portfolio, excluding cash

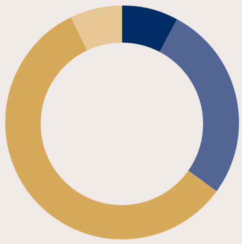
ESG RATING BREAKDOWN (%)



Very strong	26
Strong	15
Medium	54
Weak	5

By weight in portfolio, excluding cash

CARBON EXPOSURE RISK BREAKDOWN (%)



Negative/mitigating	8
Neutral	27
Low	58
Mid to high	7

By weight in portfolio, excluding cash

Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

To follow a wide set of timely and insightful publications, podcasts and videos please visit our Wealth Insights www.rothschildandco.com/insights

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