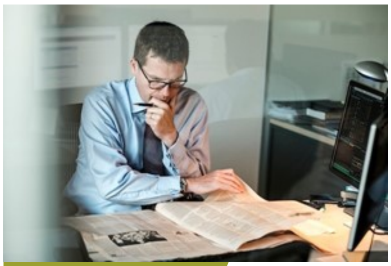


Friday Morning Coffee

Nr. 107 — The best of two worlds

In our last morning coffee (Nr 106), we described how we had made use of the time spent in our home offices during the lockdown to review our investment processes. There was indeed substantial time and energy invested into improving our proprietary screening tool over these last 2 months. We have included a set of 32 factors measuring both the fundamental quality and the valuation of the companies in our investment universe. This gives us for each company in our investment universe a quality score and a value score. The higher these 2 Z-scores, the better the potential investment opportunity and the more worthwhile it is for us to do a full-fledged due diligence on these ideas.

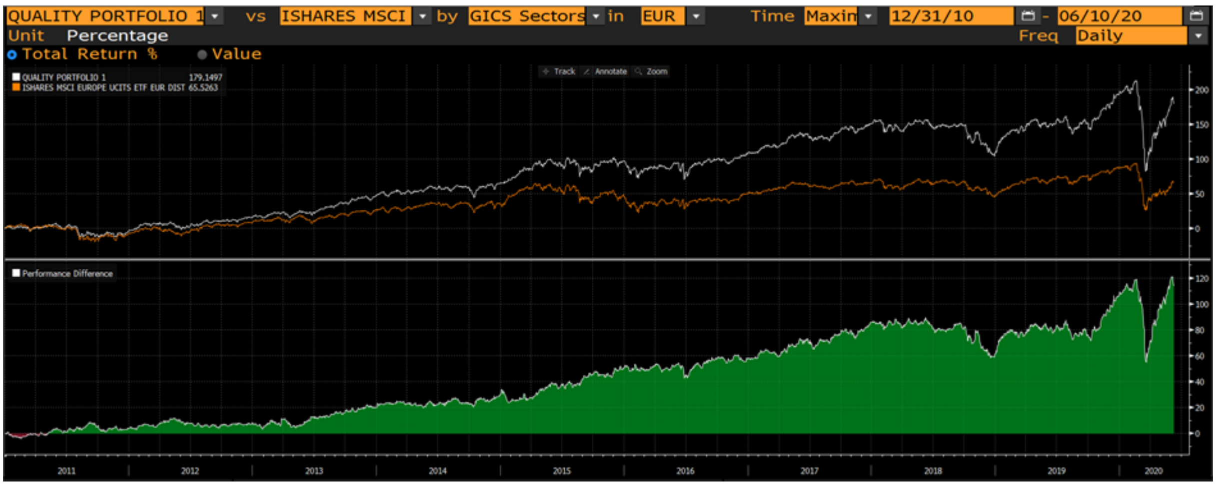
The main evolution of the screening is to bring in a solid quality component to our screening tool with the purpose of avoiding the so-called value traps, which are companies that appear very cheap, but they are cheap for a reason and may stay cheap for a long time.

We measure quality around 4 pillars: **profitability** in terms of ratios like return on equity, **growth** or improving profitability and cash flows over time, **safety** in terms of balance sheet strength and **pay-out**, i.e the ability to return cash to its shareholders.

So far, so good. You will probably argue that this screening tool sounds nice, but the real question remains how effective it is.

One way to show its effectiveness is back-testing. Here we use the usual disclaimer that past performance is no guarantee for future performance. Over the last 10 years we built a portfolio that is rebalanced annually (at the end of the each year), choosing the top 10% out of our universe of more than 1500 companies (ex financials) showing the highest quality scores. In a second step we removed from this selection the most expensive companies. There are no transaction fees in the yearly rebalancing and the performance is gross not taking into account any kind of fees.

As you can see below the comparative total return between thus portfolio and the European equity market.



Source: ECP, Bloomberg

European Capital Partners

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Historically, choosing a combination of high quality and reasonably priced portfolio of companies was a source of major outperformance in the long run against the market. As value investors we are particularly reassured by the fact that not overpaying for quality also created additional alpha.

We therefore see an opportunity to combine the best of the 2 worlds quality and value and improve our investment process with this screening. So it looks as if we have not wasted our time in the home office.

Special thank you to our investment analyst Mohamed Afifi for his help on the back-testing.

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
June 12 th, 2020