From the desk of Amit Lodha

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The importance of management teams

Investing in quality management teams is one of the cornerstones of the Fidelity Global Equities Fund. Portfolio Manager Amit Lodha believes that companies with strong management teams typically drive long-term shareholder returns, above-average risk controls and less variation in cash flows and earnings. In this note, Amit shares his insights on how strong management teams with proven track record can create long-term value and guide the company through challenging times.

The key distinguishing feature of my investment toolkit is that we spend an inordinate amount of time not only on Excel spreadsheets, but also on evaluating the quality of management teams I look to invest with (in addition to industry analysis and valuations). In a world impacted by high levels of technological disruption, I seek long-term winners and growth compounders by spending time with all levels of the management team, making sure that innovation and technology permeates through the organisation, irrespective of the sector.

Management teams are crucial in both the short term and longer term

Corporate failures and fallouts such as Enron, WorldCom and Lehman Brothers have demonstrated the importance of emphasising the qualitative aspects of a company, in particular, their management teams. Management quality is critical at every stage of the investment cycle, whether we are thinking about the short term or planning for the long term.

As we stand today, we are late cycle, which means that on a theoretical basis the probability of a likelihood of a recession/economic slowdown falling within a three-year investment period is high, especially given the length of this economic expansion. This is our short-term concern. Longer term, disruption is a reality, confronting businesses across industries and regions, and the pace of disruption will only continue to rise. Against this backdrop, we need to look for a management team with the ability to prepare for a slowing economy and to have the right focus on investing for the future.

The sector matters when evaluating management

Most investors realise that the performance of a company is directly related to competence of the management, and it is important to invest with excellent management pedigree and track record. The problem is that evaluating management is difficult. Whilst we are evaluating managers, there are certain things that are common – their philosophies around capital allocation, incentive structures, etc. However, there are certain things which are unique to the industry they operate in.

Resource businesses: As a former mining sector analyst, there are two things we give utmost importance to when evaluating a resource management team. The first is their track record around safety, and second is how they think about resource replacement. A focus on safety, and evaluating the track record of safety of the management team, gives a clean lens around the operational strength of the business. Given the high-risk nature of the business, ensuring employee safety to us is the most important job of the management team and needs to be a key discussion point of every management interaction with stakeholders. A safely run business drives strongly motivated and engaged employees. British Petroleum had to learn this lesson the hard way, and more recently, we have seen the disaster at Vale again, confirming why it is so important for resources businesses to focus on safety.

The second thing management teams of a resource business need to be evaluated against is resource replacement. Both oil and gas and mining businesses utilise a depleting resource to generate cash flows of today and hence it is imperative to invest to make sure that the resource continues to grow, and seeds are sown for the future – an important measure of business success.

Technology: In the technology sector, the only thing that matters is how the management team is thinking about innovation and disruption. It is the fastest-moving sector in the markets with some of the shortest time cycles of company life yet, paradoxically, with some of the highest valuations. Satya Nadella, CEO of Microsoft, in one of his addresses had a great quote where he said, "The technology business is like a Formula One race – it is not how fast you drive down the track but how well you take the turns that differentiates the winners." Disruption is that turn and what systems and processes the management teams have put into place to navigate those turns, gives investors a sense of comfort around the longevity of those cash flows.

Financials: Running a financials business is only about managing risk. Hence the key criteria of a successful financial business is how well it is addressing regulatory risk and staying on the right side of the customer trust equation. Whether it be the Royal Commission in Australia or the mortgage crisis in the US, those companies which have always had a strong focus on ethics and run their businesses with a high degree of regulatory and compliance oversight will ultimately always have higher customer trust. So again, while the Excel spreadsheets might tell us one story, it is as important to get into the weeds and work to understand the regulatory perception and the customer trust that they enjoy.

Jamie Dimon, the CEO of JPMorgan Chase, a long-held position, navigated the bank exceptionally well during the Lehman financial crisis of 2008–09. JPMorgan's focus on risk and managing regulatory exposure was undoubtedly important in that. However, the bank and its management team did not rest easy. Coming out of the crisis, Jamie and his team realised that technological change was accelerating, especially with the ongoing fin-tech revolution. JPMorgan ratcheted up its investment spend on technology from US$4 billion pre-crisis to US$9.5 billion[1] post crisis. In an environment where everyone became fearful of investing, JPMorgan showed courage to invest for the future.

Fast forward to today, the bank has some of the best technological systems and it has created new business and revenue lines with its investments across business verticals – especially on the credit card and US home banking side. The management team has shown their ability to use technology to accelerate their business during those bends in the road, to manage both the regulatory risks and enhance customer trust.

Health care: On paper, no two sectors could be as different as resources and health care. But when evaluating the management teams, the criteria are strikingly similar. Number one is safety; obviously a health care company needs to make sure that the drugs or medical devices have a high degree of efficacy as well as balanced out by limiting harm to the patient, and also staying relevant over time.

Secondly, the key asset of a pharma company is a patent-protected drug or medical device. When the drug is protected by a patent it will have very robust earnings and very strong cash flow growth; however, as soon as the drug goes off patent, the earnings fall off a cliff as generic competition enters the market. Consequently, the health care industry is very much like the resources industry on this constant treadmill of resource replacement, whether they do this through in-house innovation and drug discovery or business development through Mergers and Acquisitions. And a management team is again very important to make sure that seeds of the future are planted today!

We recently invested in UK-based pharmaceutical company AstraZeneca, with a quality management team and a very strong product suite. For the last five years, Astra has been going through a poor earnings progression as it navigated patent expiries around its key drugs. The current management team is transitioning the company from a primary-care-focused business model to a more exciting oncology-focused business model. As we look forward, management believes that there is a significant revenue upside from drugs which have already been approved. The management team continues to focus on strong research and commercial execution, and with an attractive dividend and earnings growth profile, Astra provides stability to the portfolio with potential future dividend growth.

Automobiles: It is easy to make decisions and judgements of what is important; however, there are times when the industry is going through such an extended period of disruption and uncertainty that it is very difficult for even the management teams, let alone investors, to see through the fog. The automobile industry in our view is a case in point, where autonomous driving, electric vehicles and car sharing are likely to change the industry in ways unimaginable over the next 10 years.

Investing in the automobile industry today is very much like investing in the personal computing industry in the 1980s or the ecommerce start-ups of the 2000 technology bubble – a lot of capital thrown at the problem with a lot of start-ups, but unclear how it all shakes out. As participants, we continue to observe and learn along with the management teams but are very cautious about deploying capital into the industry at this stage of rapid disruption.

When moats are falling away at a fast pace, the importance of great management teams only increases

Investing is all about searching for those leaders and, once you find them, sticking with them as they evolve their strategy to fight against the growth and economic headwinds with constant innovation. If your choice is right, again compounding will be your friend. The constituents of what makes a great management team are constantly changing and evolving and are probably too exhaustive to list. In our investment process, while evaluating an individual management team, these are the important differentiators we focus on: company culture, capital allocation and incentives, confidence and paranoia, positive contribution to the world.

In investing for the long term, always "evaluate the jockey before you bet on the horse".

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1. Source: Company Annual Reports, press releases.