

Beware of a cheery consensus

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Fundamental equity investing is the art of dealing in uncertainty. For long-term investors like us it involves forming a view on the earnings trajectory of any company which we are considering part-owning, for at least a decade to come.

Along with analysing the prospects for growth, this includes understanding the strength of its competitive moats and assessing potential risks to the sustainability of its returns—whether self-inflicted (e.g. from poor capital allocation) or external (e.g. from the ever-changing competitive and regulatory landscape). It is an art rather than a precise science, as only some of these risks can be quantified. Others firmly lie in the Knightian uncertainty camp—outcomes that cannot be assigned probabilities.¹

To mitigate the risks that an uncertain future can bring, investors primarily have two instruments. The first is to look for businesses where the earnings outlook is more certain. You've heard us sing the praises of recurring revenues and pricing power as key ingredients for more stable earnings growth compounding. The second is to look for assets where the current valuation allows the prospect of a positive return on an investment, even with a degree of earnings deterioration—by being judicious on valuation. We look to use both instruments, being “double fussy” on both the earnings and valuation.

When constructing our quality equity portfolios, we spend most of our time debating the sustainability of returns and the robustness of earnings growth of every stock we may own. Predictable earnings compounding is no mean feat and simply sticking to current winners or the mega-caps is no shortcut. In fact, if you look at the top 10 constituents of the S&P 500 Index from 20 years ago (December 2004), three companies have delivered negative (!) earnings per share (EPS) growth over this period (to December 2024), two have gone through substantial mergers and therefore are no longer independently listed, another four produced a meagre EPS compound annual growth rate (CAGR) in the region of 1-6%, and only one (a U.S. software company that happens to be our largest current holding across our global portfolios) has delivered a very respectable double digit EPS CAGR (~12.6%).²

¹ Knightian uncertainty refers to situations where future market behaviours are fundamentally unpredictable and unquantifiable. www.linkedin.com/pulse/embracing-knightian-uncertainty-power-strategic-foresight-petric

² Source: Factset, Dec 2004-Dec 2024, S&P 500 top 10 weighted average by value.

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“The future is never clear, and you pay a very high price for a cheery consensus”

– Warren Buffett

Certainly, the last 20 years have had their fair share of challenges—the Global Financial Crisis, the default of a European sovereign and a worldwide pandemic, to name just a few. However, for the corporate sector as a whole this was a pretty good period: corporate pre-tax operating profit margins (helped by productivity gains and international supply chains) have expanded by about 40% from their 2004 levels (from ~12% to ~17% for MSCI World Index), while effective global corporate tax rates have come down by about a third in the same timeframe (from ~30% to ~20%).³ Despite these two powerful secular tailwinds, the MSCI World Index has delivered just 4.6% average EPS CAGR over the two decades.⁴

Where do things stand today? We can't help thinking that consensus expectations of +11% growth in MSCI World Index EPS this year and a further +13% in 2026 looks rose-tinted relative to the market's long-term earnings growth of just 5%.⁵ History doesn't repeat itself, but it often rhymes.

Only around 5% of the market's earnings growth is likely to come from top-line growth, given the growth in nominal GDP, with most of the rest coming from margin expansion. It is also not easy to grasp intuitively where this corporate margin expansion might come from, given how high margins already are relative to history. Margins also are yet to reflect any impact from the ongoing attempt by the U.S. administration to rebalance global trade flows, which (by design) require rewiring of the current supply chains for a decent chunk of the corporate sector.

Can investors at least find some comfort in multiples? After a wobble in the first quarter, global equity markets have rebounded quickly, taking valuation multiples to 19.1x 12m forward P/E by end May—close to 20-year highs.⁶ The only time when these multiples were meaningfully higher (~21.5x) was during COVID, but back then they were applied to cyclically depressed earnings (as the western economies were partially shut).

In other words, markets appear to be priced for *certainty*, leaving little cushion to absorb any hiccups to current upbeat earnings growth expectations.

As Mr Buffett has astutely observed: “The future is never clear, and you pay a very high price for a cheery consensus”. We continue to believe that global equity markets can be an excellent source of long-term wealth compounding for our clients. However, it seems to us that today a lot of certainty seems to be priced into the market on an optimistic earnings growth forecast. In this environment, with very elevated geopolitical uncertainty, we believe there are strong arguments for investors focused on long-term capital growth to build their equity exposure around a concentrated portfolio of high quality companies (thus seeking more certainty on earnings) that is priced to limit valuation downside (with a free cash flow yield roughly in line with the market). This should prove helpful if the world (yet again) proves to be less predictable than rosy forecasts suggest.

³ Source: Factset, Dec 2004-Dec 2024, MSCI World EBIT Margin (%) and MSCI World Tax Rate (Weighted Median %).

⁴ Source: Factset, Dec 2004-Dec 2024.

⁵ Source: FactSet, 31 March 2025.

⁶ Source: Factset, 31 May 2025.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect global franchise companies and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. **Stocks of small- and mid-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

DEFINITIONS

The **MSCI World Index (USD)** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets.

The **S&P 500® Index (USD)** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market.

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