Resilient Compounders: Worth Every Penny

The International Equity Team’s three global strategies, on average, have earnings that are flat year to date, versus a 15% fall for the MSCI World Index as a whole. Bruno Paulson muses why high quality compounders don’t command a larger premium.

Compounders do compound better
The key to compounders is that they grow, or ‘compound’, earnings better than ‘average’ companies across cycles, largely because their earnings hold up better in tough times… such as 2020. Our three global strategies on average have earnings that are flat year to date, versus a 15% fall for the MSCI World Index as a whole.

Mystery is the lack of a larger premium
Merely growing earnings faster at high returns is not enough to outperform, it also depends on the starting valuation—after all growth stocks are well known for trading at a premium in anticipation of the faster progress in earnings. The sustained outperformance of compounders over decades implies that the market does not give them enough of a premium to make up for the stronger cross-cycle earnings growth, an anomaly that we would argue continues up to the present day.

It should not be a mystery that sustaining high returns on capital should drive superior earnings growth over time, as the combination of pricing power and recurring revenues at low capital intensity is a naturally attractive one. Compounders are also generally pretty well known and well researched companies in contrast to, for example, mysterious small caps.

“The combination of pricing power and recurring revenues is an attractive one”
In our view, the success of the sub-asset class of compounders is best explained as a failure, or rather failures, of the market as a whole. These failures are driven by measuring the wrong things, namely short-term relative performance and forward price earnings multiples.

**The industry structure pushes focus onto relative performance**

The first measuring failure is driven by the industry structure. There are generally multiple parties in the investment value chain, which, for example, might include the board of a corporate with a pension scheme, to the professional pension fund staff at the corporate, to the consultant to the pension scheme, to the portfolio managers. In addition, even if all such participants remained in place unchanged over the measurement period, the skill of participants in the chain is very difficult to measure as style and idiosyncratic factors can be significant contributors to performance in the short and medium term.

As a result, the industry ends up focussing on relative performance, and fairly short-term performance at that, as participants all the way along the chain try to justify the value they are bringing, and ultimately seek to avoid being fired. This leads to ‘relative’ risk-averse behaviour with participants having limited risk budgets built around tracking error, rather than focussing on the absolute risk—the risk of losing money. Given these incentives, strategies that have high relative risk, or tracking error, but low absolute risk may be neglected. Particularly, as in the case of compounders, when the outperformance may be episodic and concentrated on periods of market turbulence, with more ordinary performance, at least in relative terms, during the periods between the crises.

**Price Earnings ratios can be deceptive**

The second measuring error is focussing on forward price earnings measures. These are flawed for a host of reasons. We like to refer to the earnings part as ‘guesses about lies’. ‘Guesses’ because the forward estimates are systematically too optimistic: actual earnings disappoint by an average of 8% one-year forward and 15% two years forward. And ‘lies’ because these are adjusted earnings, or as we prefer to call them, earnings before the bad stuff, be it write-offs or paying staff with shares. Over the last five years (2015-19) 15% of MSCI World Index adjusted profits, the measure used for consensus and often for paying management, have disappeared before reaching the ultimate profit number at the bottom of the profit and loss (P&L) statement (Source: Factset). That is $1.7 trillion vanishing over the 5 year period.

“High quality companies are less likely to disappoint, having more predictable earnings and less of a tendency to be hit by below the line write-offs”

Combine the guess and lie elements and forward earnings estimates two years out are likely to be 30% too high on average, and thus the notional multiples 40% too low. High quality companies are less likely to disappoint on both grounds, having more predictable earnings, as shown this year, and less of a tendency to be hit by below the line write-offs, not least because their intangible assets are less likely to be on the balance sheet than the tangible assets owned by other companies, be they factories or oil reserves, as intangible assets are built through the P&L rather than capex.

The points above suggest that the wrong earnings number is being used, but that is not the only issue. Using the multiple of earnings is problematic, even if the right earnings number is used. The two concerns are leverage and cash conversion. We prefer to look at the multiple on an unlevered basis as well, comparing the Enterprise Value (EV), the market value of the equity plus the value of the debt, with the NOPAT, the earnings of the company if it had no debt, i.e. adding the interest cost back. Looking at EV/NOPAT removes the benefit of juicing of earnings through leverage, and as a result leveraged companies, quite rightly, will look more expensive.

We also like to focus on the Free Cash Flow, with Free Cash Flow Yield and discounted cash flows mutually cross-checked. Our focus on cash is a natural one, as earnings (an accounting measure) do not actually deliver anything. Cash is required to invest in the future, pay dividends, execute buy-backs, or acquire other companies. Having a higher return on operating capital also means that more of the earnings actually turn into cash, as capital expenditure and working capital requirements do not soak it up. High operating returns also means that there is less need for leverage to get to a respectable return on equity. Contrast that with Utilities, which have an average 8% return on operating capital, or banks where it is often below 1% for unlevered returns.
On an adjusted basis, the portfolio’s premium to the market is very low

Adjusting for leverage and cash conversion is useful when comparing valuations of potential investments for the portfolios, but it also suggests that compounders are cheaper than the simple price earnings data suggests. Our three global strategies currently trade on an average premium of 15% to MSCI World on forward earnings. Shifting to EV/NOPAT takes 4% off this premium, and the move to cash 5%, meaning that only 6% of the 15% premium is left, even if you accept the ‘guesses about lies’ produced by the analyst community as discussed above. This does not seem high enough at any time, given the far higher quality and track record of compounding earnings. It seems even less sufficient at present, given the myriad economic and geopolitical uncertainties. In a very fragile world, anti-fragile companies such as the compounders we own definitely have their attractions.

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