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## Growth Bonds at the Wrong Price

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Over a year ago, my partner George Fraise wrote that we were seeing a great opportunity to make money in the “cauldron of pessimism” at the time. Frozen credit markets caused economic activity to stall, investors panicked, and all financial assets crashed. We saw great opportunity in our high quality equities, and the overall stock market at the time. Since then, markets have rebounded strongly as credit markets stabilized and the world economy started to recover. The U.S. stock market is up about 50% since March 2009 as manic investors celebrated the anticipated earnings recovery from last year’s economic stall.

Our portfolios have also risen about 50% since then, but have lagged in recent months. Lesser quality issues seem to have been the biggest winners in the market recovery. Companies rated “C” by S&P are up over 100%. Steve Mandel of Lone Pine recently described this as a “dash for trash”. This is not completely unexpected as lesser quality, more cyclical companies suffered the biggest drop in earnings in the recession and therefore enjoyed the biggest bounce off the very depressed levels. And, higher quality growth companies do sometimes under-perform in periods of exuberance when short term corporate profit momentum is high. This has been the case recently as you can see below.

	<u>Q4 08</u>	<u>Q1 09</u>	<u>Q2 09</u>	<u>Q3 09</u>	<u>Q4 09</u>	<u>Q1 10</u>
<b>Corporate Profit Growth (S&amp;P 500)</b>	-28%	-31%	-13%	-5%	+47%	+52%

Source: Baseline

Nonetheless this “dash for trash” is strangely inconsistent with movements in the credit markets where there is a clear flight to the safety of US government bonds. And this anomaly in equities should change as prospects for aggregate profit growth fade with more difficult compares. After the big jumps of the last few quarters, the current estimate for corporate profit growth in the second quarter is for **just a single digit gain**. And, unlike the previous two quarters, there have been fewer positive pre-announcements so far. **It appears the big cyclical earnings recovery is now behind us and investors will have to confront lower secular growth in corporate profits from here.**

We believe this leaves a big opportunity for what one of my mentors, Bob Kahn, called “growth bonds”. Bob and his partner Bill Stewart compounded capital at a rate of about 20% from 1975 thru 2003. I know of only one other investor who has achieved that, another disciple of Ben Graham. Bob’s investment strategy was to just hoard growth bonds, companies whose earnings are almost as reliable as a bond’s fixed coupon, but also grow over time, providing the opportunity for significant compounding. He also used to say that our job is to find the “wrong price”, a stock that was mis-priced, offering great opportunity.

Our strategy at Sustainable Growth Advisers is similar and we focus only on those businesses that can produce sustainable growth in earnings and cash flow. Our process is to constantly test our conviction in our companies, refresh the portfolio with new growth ideas and tune it to capture the best price opportunities in our Universe. So, we believe our portfolios, with their very reliable and growing free cash flow, are comparable to bonds, and can be thought of as growth bonds.

Our record shows we have done a good job building that predictable and growing cash yield behind our portfolios. Over 10 years, the aggregate earnings of our portfolios have compounded at a 13% rate and the consistency of growth has been quite high. **Portfolio earnings have never been down, and the standard deviation of growth has been just 4%.** By contrast, profits of the Russell 1000 Growth companies, our benchmark, have averaged 5% growth over that period, with **3 down years and a standard deviation of over 12%, 3 times as high.**

We have not always been paid fairly for that growth: we have delivered a **positive 1.8%** compound annual returns (GIPS gross of fees) over 10 years, producing about **20% cumulative appreciation.** But remember this has been a decade characterized by valuation compression. The Russell 1000 Growth index has produced a **negative 4%** compound annual return over that same period, resulting in a **35% cumulative loss.**

Looking ahead, the time seems ripe for our growth bond portfolio. While the credit crisis may have passed, we are left with the legacy of the credit bubble. Household debt has spiked and **is now greater than personal income** in this country, so consumer spending will be more muted. While the financial system may have healed, the engines of liquidity and credit markets are sputtering. And, many of the problems in the financial sector have been assumed by the public sector, so that **government debt is near all-time highs relative to GDP** in most of the developed world. This situation will also have to be repaired, either through spending cuts, tax increases or inflationary policy...**probably all of the above.** As a result, global GDP growth will likely average in the very low single digits, and **corporate profits, which have enjoyed high single digit growth in the post-war period, will struggle to attain mid single digit growth on a secular basis.**

**So, growth will be scarce and investors will have to confront that reality as the recent corporate profit rebound fades.** That should result in a similar flight to quality that we have seen in credit markets and a premium for sustainable growth. And, the recent “dash for trash” has left a big valuation gap. We always view the valuation of our growth bond in the context of the two major alternatives, the 10-year US government bond and the overall stock market. Today, a 10-year government bond earns just 3%, which will contribute very little to a portfolio, and could produce losses when yields back up. The overall stock market is trading at about a 4% yield on free cash flow but that cash flow is only likely to grow in the mid single digits, along with corporate profits. It is hard to see the market valuation improving given the corporate profit headwinds, so single digit gains seem about all you can expect investing in the overall stock market or the S&P 500.

Our Growth Bond has reliable cash flow growing at a mid-teens rate and is trading at more than a 5% cash yield, a discount to the market and almost twice the bond yield. **That is just the “wrong price”.** In contrast to the situation at the bottom in March of 2009, equity investors must now be selective, and we are convinced there is a unique opportunity in growth bonds. If our portfolios deliver our expected mid-teens growth, which they have done reliably in the past, and valuation improves to a more normal premium, they could produce more than 20% returns annually, returns in Bob Kahn’s league.

	<b>Current Cash Yield</b>	<b>Secular Growth</b>	<b>Future Cash Yield</b>	<b>Expected Annual Return</b>
<b>US Govt. 10-Year Bond</b>	3%	0%	4%	3%
<b>S&amp;P 500</b>	4%	5%	4%	7%
<b>SGA Growth Bond</b>	5%	15%	3%	22%

Source: SGA Estimates

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