

## Growth, Quality and Valuation: No Compromises Necessary

By George P. Fraise – Principal

*“Compromise is but the sacrifice of one right or good in the hope of retaining another  
--too often ending in the loss of both.”*

-Tryon Edwards

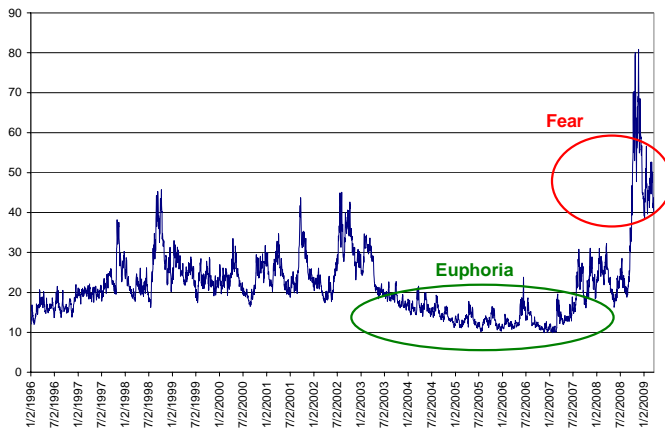
Almost two years ago, we penned a piece titled “Risk and Complacency: A Dangerous Proposition” which bemoaned the carelessness underpinning a lot of investment decisions across many asset classes. Granted, at the time, our discipline (some would call it stubbornness) of focusing on quality growth businesses that can deliver sustainable above average earnings and cash flow growth had caused our results to lag the returns of riskier strategies. Thus our frustration could have been perceived as a self-serving rant. It was however, fueled by what we strongly perceived to be reckless behavior on the part of many in the pursuit of higher returns. Back then, leverage, any form of it, appeared to be an almost aspirational component of many investment decisions. As a result, what were in hindsight obvious perversions of risk management became acceptable investment behaviors. The spread between the yields of junk bonds and government bonds narrowed to less than 100 bps, the VIX index (a widely used measure of expectations of future volatility) declined to its lowest level in more than 20 years and hedge funds and alternative asset managers experienced a tsunami of capital from individuals and institutions looking for their share of the gold rush. Corporate profits were growing at a 15%-25% annual clip (far above the historical long-term average in the mid-to-high single digits) and were expected to continue to grow above trend. Euphoria was everywhere.

How the world has changed. Today, easy credit, the fuel of the prior excesses, has vanished like Cinderella’s chariot at the strike of midnight. Equity markets have recorded their steepest declines since the Great Depression. Bond spreads between junk and government obligations have skyrocketed to record levels. The VIX index shot up 5-fold and has remained elevated (Chart 1). Hedge funds experienced their greatest losses in 2008 and have been plagued by scandal and redemptions. Corporate profits plunged 40% in 2008 and are widely expected to drop another 20% or more in 2009. Plainly, we are struck today by the decibel of the negativity. Everywhere you look, investors and media pundits seem to be in a race to outdo one another with their latest dire economic and market predictions. We find it ironic that the biggest star on today’s economic stage is New York University’s Nouriel Roubini whose forecasts are so gloomy it is hard to resist the urge to hide in a cave with a spear and some canned goods. Fear is everywhere.

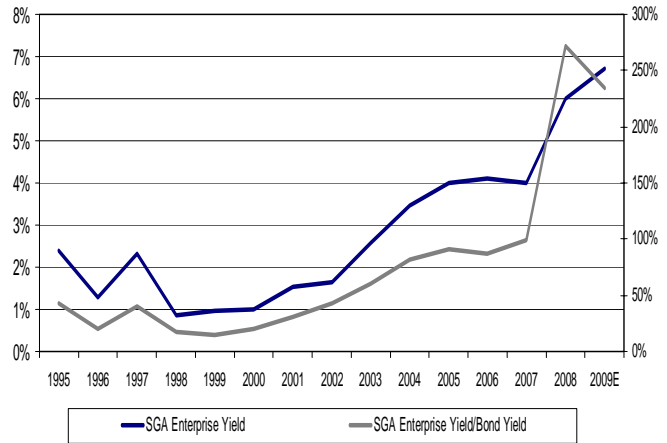
As we contemplate today’s investment landscape, we are hard pressed to fall into the cauldron of pessimism which seems to have engulfed many. Just as we felt that the euphoria of a couple of years ago was dangerous, we think that today’s paralyzing fear is shortsighted. We should note that we are not Pollyannaish in our view of the current environment and recognize the difficulties facing many businesses and the economy as a whole. Far from expecting a V-shaped economic recovery, we believe it is quite possible that the rebound will be muted, at least at first and we do not see a return to the careless ways of the recent past anytime soon. Nevertheless, there are good things happening: mortgage rates are now at the lowest level since World War II and likely headed lower with the additional “quantitative easing” initiatives recently announced by the Federal Reserve; there is a massive global monetary and fiscal stimulus underway and the U.S is experiencing an enormous inventory reduction across all channels which will end and then reverse at some point. In other words, now is not the time for the cave and the spear.

While we are clearly encouraged that our performance over the past two years, certainly on a relative basis, has again validated the long-term merits of our investment approach, it is not the primary source of our confidence. Rather, two factors are driving our enthusiasm. First, in a world of collapsing corporate profits, there is still growth out there. The businesses that are in our client portfolios recorded an impressive aggregate earnings growth rate of 14% in 2008 and most are expected to **grow** in 2009. This is worth repeating. Over a two year period when profits for the broader market will be down more than 50% in aggregate, the earnings of the companies in our client portfolios are expected to rise by roughly 15%! Talk about divergence. Moreover, in 2010 and 2011, we are currently expecting portfolio companies in aggregate to return to their more customary mid-teens growth rates. More important in our view is the fact that the underlying cash flows generated by those businesses set them apart from many in this environment that are struggling

**Chart 1: CBOE VIX Volatility**



**Chart 2: Enterprise Yield**



to raise capital or maintain funding commitments. Cash is truly the final arbiter of value – this has become clear in the current environment - and the companies we are invested in generate a lot of it. The portfolio’s Enterprise Yield (our measure of the true free cash flow yield of a business after all capital expenditures, acquisitions and other future claims on cash flow) is currently just shy of 7%. This is a record, both on an absolute basis and relative to the 10-year bond (Chart 2), since we began measuring it in the early 1990s. With strong returns on invested capital (ROIC) and lean balance sheets these companies are in control of their destinies and are often gaining share from weakened competitors. In a world where growth has become very scarce and access to capital is so difficult, this is quite exciting.

Second, the unprecedented collapse in stock prices in the last 18 months provided us with irresistible opportunities to add to the portfolio higher growth businesses at wonderful valuations without having to sacrifice quality. Armed with the conviction that can only come from diligent fundamental research (the cornerstone of our investment process) we took advantage of those opportunities. Solid franchises with strong long-term growth prospects such as **Apple, Amazon, Monsanto, Visa** and **National Oilwell Varco**, to name a few, saw their stock prices come down very sharply, allowing us to add them to the portfolio. In fact, looking at the changes in the top 10 positions in the portfolio (Chart 3), we can see that compared to May 2007, we have been able to add growth to the portfolio both on an absolute basis and relative to the broader market while not sacrificing quality. Furthermore the P/E ratio of the portfolio is markedly lower than it was back then. Admittedly, our 60% portfolio turnover last year was the highest we have experienced, but it is not often in one’s investment career that such opportunities present themselves without having to compromise between growth, quality and valuation. Today, we are enthusiastic that the strengthened underlying growth rates in future earnings and cash flows we have built into the current portfolios will stand out markedly over the next few years and we believe the current valuation will prove to be very rewarding for those able to look slightly ahead. The stage is now set for a strong period of both absolute and relative performance.

**Chart 3: Higher Growth, Lower P/E, High Quality**

May 2007	Quality	EPS Growth	Current	March 2009	Quality	EPS Growth	Current
<u>Top Holdings</u>	<u>Rating</u>	<u>3-Year</u>	<u>P/E Ratio</u>	<u>Top Holdings</u>	<u>Rating</u>	<u>3-Year</u>	<u>P/E Ratio</u>
ADP	A+	13%	22.4	Visa	A+	22%	18.0
GE	A+	13%	15.9	Staples	B+	19%	12.0
Genzyme	B-	16%	18.6	ADP	A+	11%	13.2
PepsiCo	A+	11%	18.7	Genzyme	B-	18%	11.8
P&G	A	13%	18.2	Teva Pharmaceuticals	B+	16%	12.3
Staples	B+	15%	15.4	State Street	A	4%	5.5
Microsoft	B+	13%	16.8	Amazon.com	B-	19%	34.0
Medtronic	A-	13%	17.7	Qualcomm	B	9%	20.3
Colgate	A+	11%	19.0	Sysco	A+	11%	11.4
J & J	A-	6%	15.0	Coca-Cola	A	7%	12.5
<b>SGA Top 10 average</b>	<b>A</b>	<b>12%</b>	<b>17.8</b>	<b>SGA Top 10 average</b>	<b>A-</b>	<b>14%</b>	<b>15.1</b>
<b>S&amp;P 500 average</b>	<b>A-</b>	<b>9%</b>	<b>16.0</b>	<b>S&amp;P 500 average</b>	<b>A-</b>	<b>-8%</b>	<b>12.9</b>

Source for S&P 500 EPS: Merrill Lynch

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