SGA
Sustainable Growth Advisers

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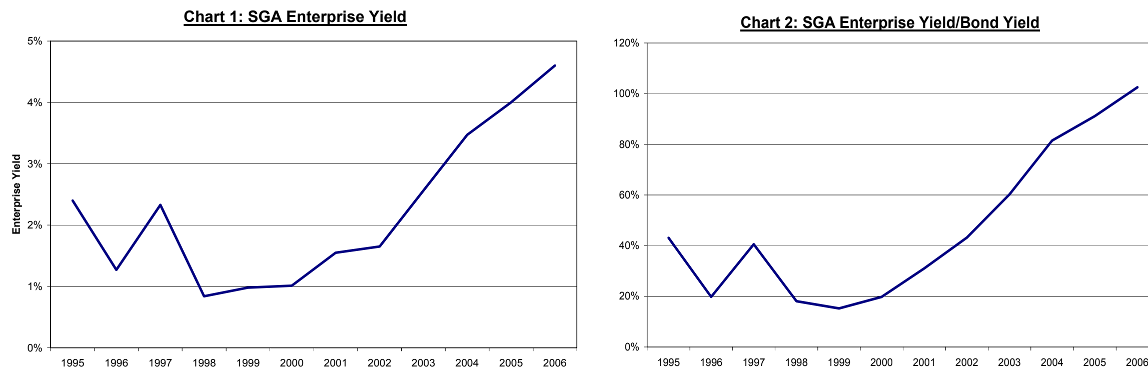
Have Your Beta and Alpha Too

By Rob Rohn, Principal

We have been writing for over a year now about the unprecedented opportunity in high quality growth company shares. After writing a piece as presumptuously titled as "Our Time" at the end of 2005, maybe another year of underperformance was inevitable in 2006. The overall stock market continued to be dominated by the momentum of continued strong corporate profit growth, surging oil and other commodity prices. High quality growth companies that simply sustain reliable double digit progress in earnings and cash flows remain largely unappreciated.

So, the valuation of the highest quality businesses in our portfolios remains at levels that are historically low in relation to their real earnings and cash flow, especially relative to bonds, the ultimate benchmark against which all investments must be measured. Our portfolios have a cash yield of over 4.5%, the highest level we have seen since we started managing the US Global Leaders Growth Fund in 1995. That is over 100% of the 10-year US government bond yield, the highest I have seen in my 20 years of experience managing quality growth portfolios.



Our friends console us after several years of underperformance saying "your long-term record is good, you didn't lose money over the last five years as others have, and you are a 'beta' play anyway". But I also get the feeling that they are politely tolerating our rants on the opportunity in names like Staples, ADP, Microsoft, GE and PepsiCo these days. They appear distracted and anxious to go talk to the real "alpha" players. After all, we do fundamental analysis, build discounted cash flow models, travel commercial, and don't get a carried interest. We can't be "alpha" managers.

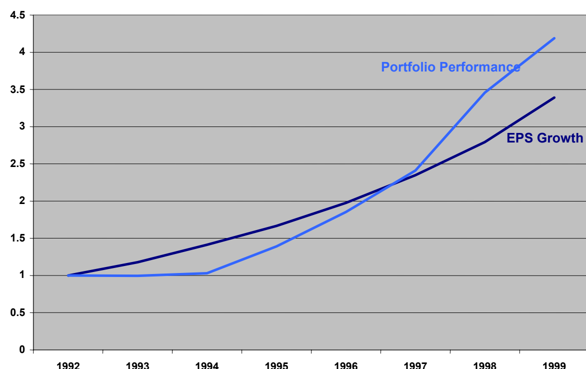
The fact is that our disciplined approach of investing in only the highest quality, most predictable growth companies for the long term, has generated some very big alpha in past periods. Those periods are often preceded by extensive periods of flat returns during strong economic recoveries and exciting moves in certain sectors. Probably the best historical example of that is the period from 1992 through 1994.

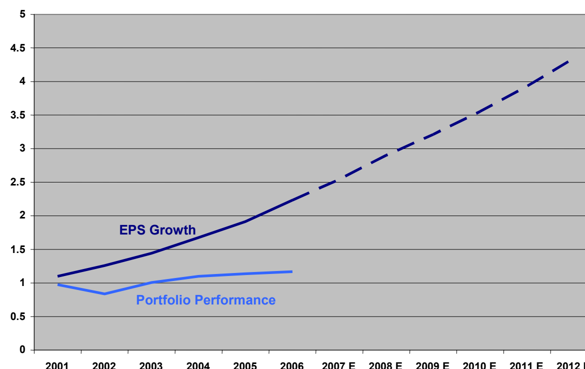
After the recession of 1991, and a collapse of corporate profits, the economy rebounded strongly in 1992 and that momentum continued through 1994. Corporate profits rose about 30% in 1992 and continued on a 20% pace in 1993 and 1994. The stocks of more cyclically sensitive issues like technology and materials did well during this period. More sustainable growth businesses in healthcare (which appeared to be threatened by a new Democrat administration), and consumer non-durables (which appeared to be threatened by private label after "Marlboro Friday") underperformed (see Chart 3).

I joined W.P. Stewart in 1991, a year when our accounts appreciated over 50% as sustainable growth shares were a popular safe haven during recession. However, my portfolios were basically flat for the next three years. The aggregate earnings of the companies in the portfolios compounded steadily at about 13% during that period but stock prices simply did not follow. Clients became impatient with my passion for quality growth businesses and some began looking for an "alpha" alternative.

In the succeeding period from 1995 through 1998, corporate profits decelerated from their unsustainable double digit pace and completely flattened out in the growth recession of 1998. Over that period of time, my accounts appreciated over 30% per year and more than doubled. The company earnings and share price lines converged and valuation actually overshot on the upside by the end of the decade.

There are pretty strong similarities between that period between 1992 and 1994 and the environment we have endured over the past three years. The economy has recovered strongly from recession; corporate profits spiked over 20% in 2003 and have been growing more than 15% since. And, there have been exciting moves in certain sectors, such as energy and materials. We have even had an election of Democrats again, this time to control of Congress, with renewed fears of medical price regulation leading to underperformance of healthcare shares. As you know, our accounts have been treading water over this period, despite the fact that aggregate earnings of the component businesses have compounded at their reliable mid-teens rate (see Chart 4).





Like in the post 1994 period, the lines will likely converge and the returns can be substantial. We believe that our accounts are now about 50% undervalued. The move to fair value combined with the steady profit growth of these businesses could provide outsized returns in the future as they did in the past. And, valuation moves don't usually stop abruptly at the mid point, but often overshoot equilibrium on the upside, as was the case in the 1995 to 1998 period.

Timing is uncertain as we know too well after our "call" of over a year ago. And, John Maynard Keynes said that "markets can remain irrational longer than you can remain solvent". The good news is that the current period of underperformance is growing even longer than the analogous period a decade ago. My mentors, Bill Stewart and Bob Kahn, have been keen observers of market disequilibria since they founded W.P. Stewart in 1975. For instance, they wrote in March 2000 "can two trillion dollars be wrong?" asserting that the valuations of a handful of "new economy" companies were overvalued. Those companies' stocks fell 90% in the next few years. Today they believe that the potential for 100% returns in the world's finest businesses over the next few years is "today's overwhelming truth". We agree. That would certainly provide some alpha to go along with our beta.

Until November 2003, Robert L. Rohn managed over $1 billion for client accounts comprised of college endowment funds, corporate pension plans, not-for-profit organizations, high net worth individuals and trusts while a principal with W.P Stewart & Co., Ltd. The record above reflects the performance history of a single, sizable client account under his discretionary management. The account was selected because it was representative of the performance of other accounts he managed while at W.P Stewart and had the longest performance history. Past performance is no guarantee for future results.

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