Sustainable Growth Advisers

6/30/07

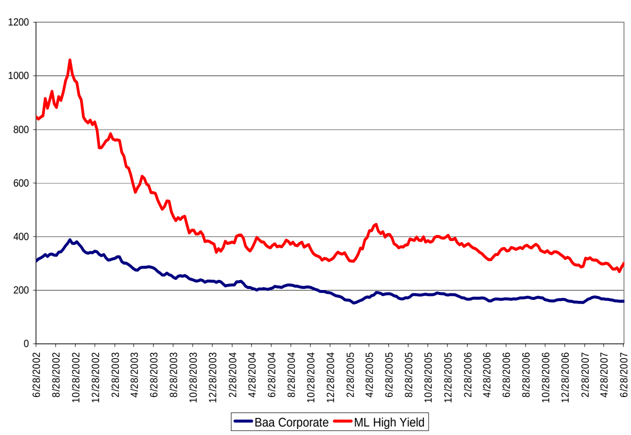
Risk and Complacency – A Dangerous Combination

By George P. Fraise – Principal

Risk, in financial markets, is customarily defined as an assessment of the possibility that a given investment will fail to achieve a return and may result in a loss. In other words, risk is simply a measure of uncertainty about the magnitude of future rates of return. The higher the risk, the greater the uncertainty of the returns and vice versa. For a company, financial risk is the measure of likelihood that a firm will be unable to meet its financial obligations. A business with low variability in the growth of its cash flow and little debt is less risky than one with higher variability in its cash flows and higher levels of debt since it will more than likely be able to meet its financial obligations and be less subject to the vagaries of the environment. Investing in such businesses therefore is less risky. Now, risk is not inherently a bad thing. A higher risk investment strategy should not necessarily be avoided. It must, however, be accompanied by a commensurate level of expected returns to make it an attractive alternative to a lower risk strategy. Risk can become dangerous when it is accompanied by a high level of complacency about the variability of potential future returns. All else being equal, a premium should be placed on the lower risk of two similar investment alternatives. When the lower risk alternative carries no premium, the stage is set for an eventual return to equilibrium.

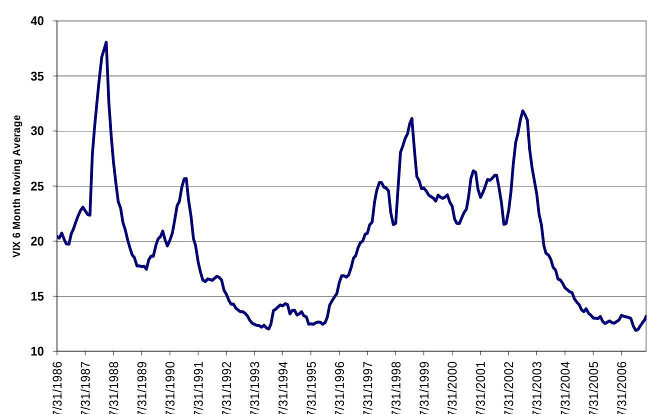
Today, we are struck by the apparent level of complacency prevalent in financial markets. Risk has morphed into a barometer for future returns in the minds of too many market participants – the higher the risk, the greater the return – without consideration of the high potential variability of that return. Inebriated by more than four years of benign global monetary policies, unsustainably high levels of corporate profit growth and giddy returns from emerging markets, hedge funds and private equity vehicles, investors have been flocking to higher risk strategies blissfully disregarding the pitfalls represented by their higher risk profile. Over the past five years, junk bonds have outperformed investment grade obligations by a factor of almost three to one. As shown in Table 1, this resulted, until very recently, in a dramatic narrowing of spreads between junk and government bonds. Emerging markets have outperformed the Dow by a similar margin. Perhaps most disconcerting is the fact that the VIX index (a widely used measure of expectations of future volatility) has been declining since 2002 and is now near the lowest levels in more than 20 years, indicating to us a pervasive level of complacency (Table 2). Low quality companies have outperformed their high quality brethren also by about three to one during this time period, resulting in the widest sustained valuation gap between high quality and low quality in more than 20 years (Table 3). Assets are pouring into 2/20 hedge fund strategies (the manager takes 2% fees and 20% of gains) and private equity funds at such a rate that the firms managing those investments are themselves rushing to file their own IPOs.

Table 1: Corporate Bond Spreads



Source: Merrill Lynch

Table 2: CBOE VIX Volatility

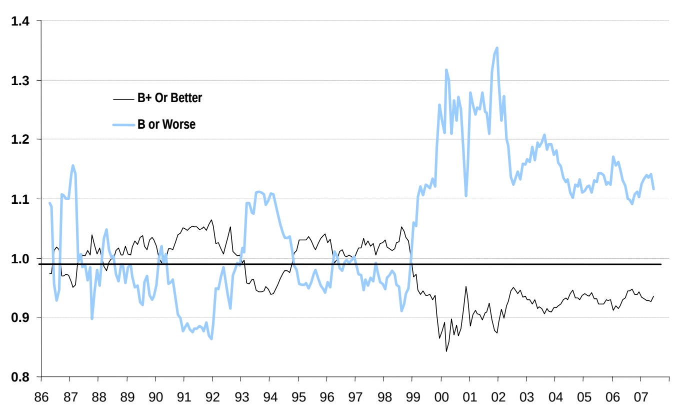


Source: Merrill Lynch

All of this does raise a logical question: is investing in high quality businesses that benefit from meaningful long-term competitive advantages and low variability of earnings and cash flow growth an antiquated investment strategy? The market environment of the past few years would certainly lead one to that conclusion. After all, in addition to the trends mentioned above, in sector after sector, we have been struck by the dramatic outperformance of the lower quality companies. Fueled by turnaround expectations and short-term momentum, those companies have seen their stocks appreciate markedly in the past few years. Meanwhile, the stocks of high quality, dominant franchises whose long-term growth prospects are not in doubt have been ignored. Take office supplies for example: Staples, the undisputed leader has seen its stock price rise 6% since the end of 2004 while Office Depot, a far lesser competitor that has struggled to compete against Staples has recently benefited from shorter-term expectations of a turnaround in its operations which drove its stock price up 75%. In the software sector, the story is similar. Microsoft and SAP, the industry's gold standards, are up 10% and 16%, respectively, again since the end of 2004. Meanwhile, Oracle, BMC Software and Red Hat are up 44%, 63% and 67%, respectively, in the same timeframe. In the multi-industry sector, GE is up 5% while smaller competitors Honeywell and United Technologies are up 59% and 37%. What is exciting today are short-term momentum and turnaround stories, not predictable, high quality long-term growth businesses.

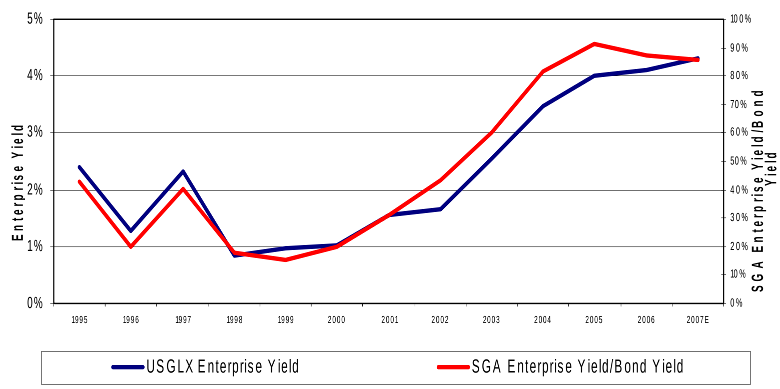
Sustainable Growth Advisers is in business to protect and compound client capital by investing for the long-term in the most predictable, the most sustainable high quality growth companies and then watching the cash flows generated by those enterprises compound for clients. Over the past 11 plus years, the companies in our portfolios have grown earnings at roughly twice the rate of corporate profit growth as measured by the S&P 500 index companies. Meanwhile, the standard deviation of that earnings growth has been two thirds lower! This is worth repeating. The companies our clients are invested in have grown their earnings at twice the rate of the average company out there while the volatility of that growth has been minimal. Yet, over the past 4 years, these companies have underperformed dramatically. The result is that today you can buy some of the world's best businesses at very attractive valuations. Consider if you will that over half the companies in our client portfolios are now trading at P/E ratios more than 25% lower than their 20-year average. In aggregate, the earnings yield (the inverse of the P/E ratio) of our "growth bond" portfolio has risen significantly and now exceeds that of the broader Russell 1000 Growth Index. This is counter to the basic premise of risk taking. Today, not only have the lower risk companies lost their premium price, they are now trading well below higher risk alternatives! Looking at cash flows, as we do, it is striking that that the enterprise yield of our portfolios (the true free cash flow yield) is about equal that of the 10-year bond, as shown in Table 4. While it may be tempting to conclude that this recent trend is indicative of a tectonic shift in the investment landscape and will continue indefinitely, all of us at SGA remain steadfast in our conviction that buying great companies and sticking with them is the best way to achieve superior results while incurring a lower level of risk. This segment of the market is currently glaringly undervalued in our view.

Table 3: Valuation Spread Between High and Low Quality Companies



Source: Merrill Lynch

Table 4: Enterprise Yield



Source: Baseline

Historically, increases in the volatility index have resulted in the significant *outperformance* of high-quality companies. It is logical to expect that volatility will pick up from today's historically low levels. It is worth noting that the reminders of risk are increasing and could become catalysts for the long awaited rebound in the category we are focused on. The sub-prime crisis is not over and could still have broader ramifications on the overall economy. Emerging markets have recently shown that downside is possible. Corporate profits have started to decelerate and economic growth is moderating. Interest rates are rising and financial leverage may become harder to bear. Some private equity deals have recently hit bumps in the road as bank consortiums are starting to tighten their lending practices. A few hedge funds have required the help of large financial firms to bail them out of potentially catastrophic unraveling of their illiquid positions. Many claim that these are only temporary setbacks in a long upward trajectory. Perhaps. We would still rather be on the side of the great businesses that comprise our investment portfolios. To quote French philosopher Jean-Jacques Rousseau, "Patience is bitter, but its fruit is sweet."

3 Stamford Plaza, 301 Tresser Blvd., Suite 1310, Stamford, CT 06901 tel: 203.348.4742 email: jkolanko@sgadvisers.com