



## The “Growth Bond” Opportunity

By Rob Rohn, Principal  
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At Sustainable Growth Advisers (SGA), our investment discipline and research process are designed to produce one thing: a high quality earnings and cash flow stream that has sustainable, double-digit growth over a long period of time. We identify companies that have: repeat revenues making their sales growth more assured, pricing power resulting in stable margins, and global reach allowing plenty of headroom to grow. Very few companies have the predictability we seek. My former partners Bob Kahn and Bill Stewart called them “growth bonds” because their earnings were almost as predictable as a bond’s fixed coupon, but with the added benefit that the income stream grows and compounds steadily over time.

One might be skeptical that any one company can have long-term predictability comparable to that of a bond. To address this, our research work is focused on continuously testing the earnings sustainability of each portfolio holding and identifying new businesses with the predictability characteristics we seek. The result is a *portfolio* that we believe has characteristics worthy of the moniker “Growth Bond”. **While we are appropriately categorized as *Large Cap Growth Managers*, we think of ourselves more as “Growth Bond” Builders.**

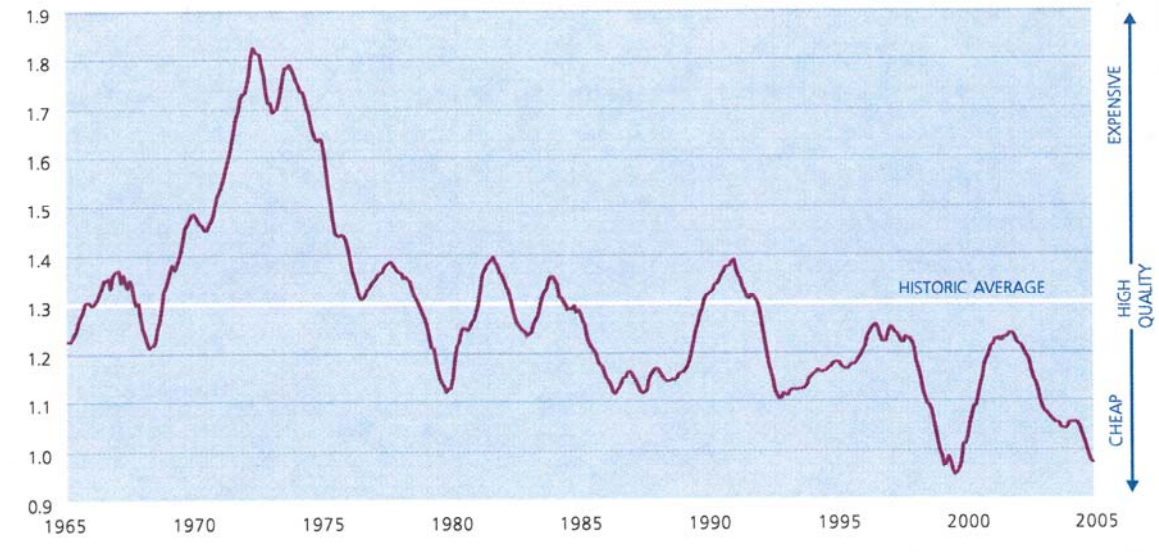
Empirical evidence demonstrates we have done a credible job at it. SGA portfolio earnings, in the aggregate, have grown consistently in the double digits (16.1% SGA vs. 7.1% SP 500\*). In addition, the standard deviation of the underlying historical earnings growth has been very low relative to the overall market (3.3% SGA vs. 11.3% SP 500). Since the fair market value of assets (stock prices in this case) must track earnings and cash flows over the long haul, portfolio performance has been superior over time as well. The US Global Leaders Growth Fund (USGLX), a mutual fund which we manage, has produced double digit annual compound calendar year returns over its 10+ year history (10.9% USGLX net).

The performance of our “Growth Bond” has not been impressive recently however. Over the past five years, the return on our portfolios has been in the low single digits, which was better than the market but significantly less than the earnings progress of the companies comprising the portfolio. Over the last three years, appreciation of the portfolio has been just about 10% annually, less than cash flow growth & significantly behind market appreciation. While the recent underperformance of our Growth Bond approach is explainable (i.e. greater interest in rebounding cyclicals and spiking energy), it is nonetheless inconsistent with the macroeconomic backdrop and the behavior of its sister instrument, the fixed coupon bond.

After the recession of 2001, the collapse of the technology valuation bubble and the events of 9/11, the primary concern of policymakers was deflation. The Fed lowered short rates to 1% and long bond rates fell to as low as 3.11%. As the economy recovered, the Fed steadily ratcheted policy back to neutral. Short rates are now at 5%, but long rates are only about the same. Despite the economic recovery and a spike in energy prices, the secular forces that have restrained core inflation remain in place, and it is still running only about 2%.

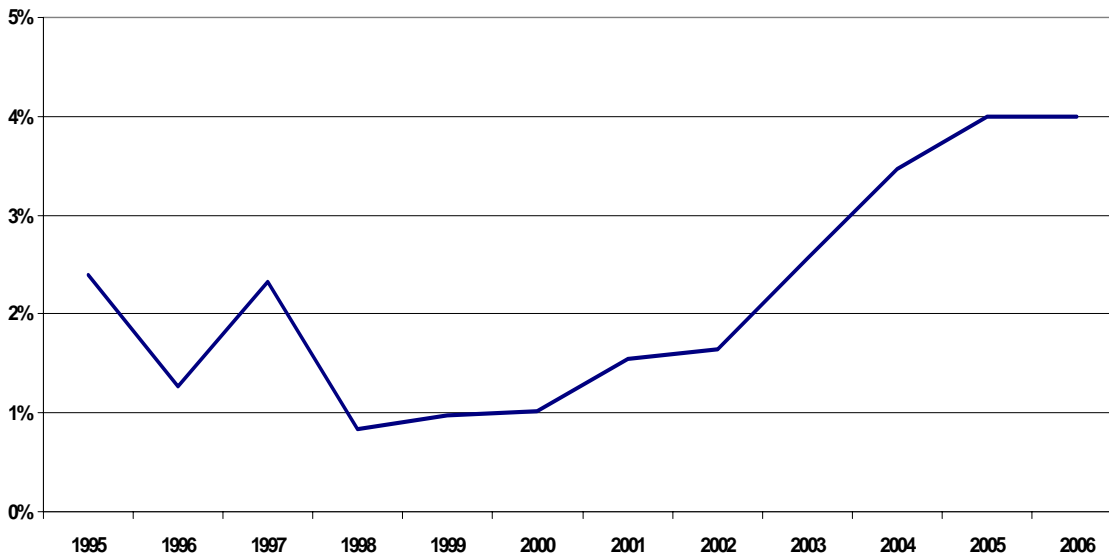
When inflation expectations remain low, US bond rates can remain relatively low, and other high quality long duration assets should also trade at premiums. To the contrary, high quality companies, which are very long duration assets, are trading at historically low valuations. The next chart shows that the relative valuation of quality companies are at 40 year lows, according to the data compiled by GMO LLC for our partners John Hancock.

### HIGH-QUALITY VALUATIONS ARE NEAR HISTORIC LOWS



And our “Growth Bond”, which we would argue represents the highest quality longest duration asset available, is trading at a historic low relative to its cash flow. As we communicated last Fall, the enterprise yield of our portfolios (the real cash flow available to investors divided by the market cap) currently stands at about 4%, the highest yield of the past decade.

### Sustainable Growth Companies Enterprise Yield



Therein lies the unique opportunity. One can buy the SGA “Growth Bond” at a cash yield of 4% today, about 80% of the 10-year government bond\*\*, currently at about 5%. Cash flow on the Growth Bond portfolio should reliably compound in the mid teens over time. In 5 years, assuming no change in price, the Growth Bond yield would be close to 8%. **Assuming a more normal relationship between the long bond and the SGA “Growth Bond” develops over the next 5 years an investor in SGA’s “Growth Bond” should earn a compound annual return of 15 to 20%.** This assessment is validated by our internal methodologies. Our discounted cash flow model currently indicates that the portfolio is more than 40% undervalued.

This opportunity exists at a time when many pension funds, endowments and individual investors are seeking high single digit portfolio returns while maintaining significant fixed income asset allocations. There is a compelling need for financial assets that combine some of the reliability of bonds with the opportunity for double digit compounding...i.e. an instrument like the SGA “Growth Bond”. **We submit that this valuation anomaly and the opportunity in our “Growth Bond” will not go unrecognized much longer.**

\* The S&P 500 Index tracks the stocks of 500 US companies. The returns include reinvestment of dividends.

\*\* The ten year bond is used because it represents the most liquid and readily available long duration asset with a fixed coupon.