

## **Time Horizon – A Competitive Advantage**

By George Fraise - Principal

*“One of the more common mental biases that affect people is ‘recency’, the tendency to consider the most recent information as more important when making a decision. This cognitive trap can be especially harmful to investors because it causes people to extrapolate the most recent trends into the future without considering the likelihood that the trend will reverse.” Morningstar – 4/21/06*

Most investment managers don't have a long time horizon. It is no secret that the average large cap growth manager turns his or her portfolio close to 100% every year. In addition, many growth portfolios often hold more than 100 companies (many more in some cases). ***The combination of a short investment horizon and a large number of investments makes it inherently more difficult to perform in-depth fundamental research on each company, resulting in quick sell decisions. Every investment decision in turn raises the potential for error and the more frequent the decisions, the higher the probability that client capital is misallocated.*** By contrast, **Sustainable Growth Advisers' (SGA)** holding period is in excess of four years on average and only about 25 companies are held in our portfolios at any point in time. To put it in context, since 1995, our portfolios have held only 58 companies in total, including the ones we hold currently. By contrast, the average large cap growth manager invests in a different group of 58 companies every 9 months or so! In addition to the obvious benefits of high tax efficiency and low transaction costs, our disciplined, patient approach allows for the development of strong conviction about the long-term strength of a particular business model. This conviction can only come from diligent, focused first-hand fundamental research. Armed with such conviction, the true long-term investor can properly take advantage of price dislocations.

***At SGA, the premise of our investment approach is that diligent first-hand research and sound investment judgment combined with a long time horizon and an unwavering focus on high quality, predictable, sustainable growth companies results in superior long-term returns with meaningfully lower risk.*** Our investment results bear that out. Over the past decade, this approach (as measured by the calendar year results of the John Hancock US Global Leaders Growth Fund that we have managed since its inception in 1995) has produced compounded annual returns, net of all fees, that exceed those of the Russell 1000 Growth Index (R1000G) by over 50% (10.5% vs. 6.7%). Importantly, those returns were generated while taking on 20% less risk than the R1000G as measured by the standard deviation of those returns. While recent returns have lagged, providing an unprecedented opportunity we recently highlighted in a white paper, over the years, the soundness of such a disciplined approach is clear.

An important tenet of the basic investment proposition is the long-term component of the equation. ***After all, even the most predictable and sustainable high quality growth companies will experience stock price dislocations at times.*** These can result from temporary concerns about the success of a product line, a potential or actual deceleration of the growth rate, increased competition, dilution caused by an acquisition and other factors. These events can cause the stock price to be under significant pressure for some time. ***This is where we believe our approach affords us a significant advantage.***

### **The Long-Term Benefits of Sustainability – Johnson & Johnson (JNJ)**

Take Johnson & Johnson for example. The company holds one of the most enviable records of growth in corporate America with more than 100 years of compounded annual revenue growth of more than 12%. Over the past 20 years, the company has grown earnings at a compounded annual rate of 19% and has provided investors with compounded annual returns in excess of 14%. The maker of Johnson's Baby products, Band-Aid, Tylenol, Acuvue contact lenses, Splenda sweetener, anemia drug Procrit and

rheumatoid arthritis drug Remicade achieved these results through a combination of predictable businesses, strong management and a culture of growth. The path of the stock price was not a smooth line, however. There have been four major stock price dislocations during this period of more than 20% (two of them greater than 30%), the most recent taking place between 2002 and 2004. Some were caused by a temporary slowdown in the growth rate which lasted for a few years, others by environmental factors. In all cases, the long-term investor who focused on the quality of the franchise and the predictability of the business model and was not swayed by the temporary shifts in investor perception was handsomely rewarded. In three of the cases the subsequent 2-year return following the dislocation was between 55% and 155%. In the most recent, the stock is up more than 20% after 18 months.

*Not all price dislocations are buying opportunities, however. The key is being able to differentiate between those that are harbingers of a change in the secular trajectory of a franchise from those that are simply a reflection of the short-term focus of the investment community.* For that, there simply is no substitute for first hand research paired with seasoned investment judgment.

### **A Tale of Two Dislocations - Home Depot (HD) and Marsh & McLennan (MMC)**

In 2002, **Home Depot** was beset by concerns about increased competitive pressure from Lowe's, a slowdown in comparative sales growth and early stumbles from a new management team. As a result the stock price declined by over 50% over the course of the year. In the fall of 2004, **Marsh & McLennan**, the leading insurance broker came under significant pressure as a result of a complaint by the attorney general for the state of New York, Elliot Spitzer, regarding the then widely used practice of contingent commission payments by underwriters to insurance brokers to secure underwriting business. MMC's stock declined over 40% in a matter of a couple of weeks.

In the ten years prior to the dislocations, both companies had outstanding performance and both stocks had produced stellar returns for investors, handily outperforming the broader market. In both cases, the reaction of the investment community was clear. One dislocation provided a buying opportunity while the other did not. Research and judgment were critical to understanding which was which. In the case of Home Depot, our research led us to conclude that the long-term value of the franchise was underappreciated, that the issues were short-term in nature and would not impede the ability of the company to return to a double digit sustainable growth rate. We added significantly to the position in 2002. Since then, HD's stock is up 98%. In the case of MMC, our research quickly determined that the company's business model was impaired and that the growth was no longer predictable or sustainable. We quickly sold the position out of the portfolios. Since then the stock has weakened further.

### **The Benefits of a Long Time Horizon Are Clear**

There is little doubt, in our mind, that a long time horizon offers a number of benefits. *First, it allows the power of compounding to work for clients.* There is little value in looking for predictable double digit earnings and cash flow streams only to exit those streams before the power of compounding has a chance to work its magic. *Second, it opens up access to companies' managements and allows for robust and frequent exchanges that fall outside the framework of the SEC's Regulation FD.* Third, combined with first rate fundamental research and sound investment judgment, it affords the opportunity to develop strong conviction to take advantage of those stock price dislocations borne out of the inherent short-term focus of the investment community. *Finally, it minimizes portfolio turnover and transaction costs and fosters tax efficiency.* We are faced today with an unprecedented opportunity in many of those high-quality, predictable, sustainable growth companies. The category is presently unloved and investors are chasing returns in more speculative and far riskier corners of the investment universe. We are staying the course and are confident that the current dislocation in high-quality large-cap growth will be viewed in hindsight as one of the great investment opportunities of this decade.

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