A Change in Tide?

May 2021

Investor optimism amid a strong recovery in corporate earnings continues to fuel the equity rally. Where that optimism was once mostly confined to 'growth' companies, particularly those leading the digital revolution of society, this optimism is now a broader theme throughout the market including the more economically-sensitive 'value' companies. As the stimulus taps continue to flow and economists rush to upgrade their GDP forecasts, outsized COVID-rebound growth rates have lured many investors who may extrapolate them too far into the future. Using Marriott as an example, despite a ~50% decline in revenues over the past 12 months and a possible permanent impairment to its corporate travel segment, the stock is trading near all-time highs today.

The abrupt change in market leadership over the past six months has reignited the value vs growth debate and raised the age old question 'does style matter'? We certainly have not lost any sleep over this; all styles move in and out of favor with the market and the key to any successful active strategy is the ability to outperform over a full market cycle. While the lure of rising growth rates, inflation, and interest rates may tempt one to re-up value equities, we pause to remind our clients of the highly unpredictable nature of the macro and caution against any dependence upon this in generating sustainable long-term returns.

We do not attempt to forecast the macro knowing that it will most likely lead to red faces (and a permanent impairment of our clients' capital). We focus first-and-foremost on company fundamentals when constructing portfolios. We believe there is far less risk with this approach and much more predictable returns. This does not, however, mean we ignore the macro; we are acutely aware of the macroeconomic variables at play and how they may affect our businesses. As an example, given the duration risk inherent in our portfolio of long-term cash flow compounders, we have made adjustments to the discount rates used in our valuation models to ensure the valuation risk of our portfolios is diligently managed against a scenario of rising rates. Careful management of our portfolio's valuation has resulted in the current yield (i.e. SGA Enterprise Yield) remaining stable in the ~2.6% range since June of last year despite significant appreciation since then. Keep in mind this current yield is anchored by our portfolio's *current* cash flows; investing in unprofitable companies with forecast cash flows in the long-distant future is a risky strategy, particularly against a backdrop of rising rates.

Regardless of the macroeconomic backdrop, our end objective is to translate earnings and cash flow growth into returns for our clients. Looking ahead, we forecast our portfolio to grow earnings by 23% p.a. over the next 3 years compared to 15% p.a. for the market. And looking back, over the last 10 years of our U.S. Large Cap Growth Portfolio we have translated approximately 16% p.a. earnings growth into 17% (gross) and 16% (net) p.a. returns to our clients. While we are not immune to forecast error, we have higher visibility into growth compared to most managers given the more predictable and sustainable business models of our companies. This is not a result of a recent positioning exercise but a longstanding discipline with the benefit to clients being more predictable earnings growth with lower volatility.

Inflation and Growth: A Farmer's Dilemma

By Rob Rohn

There is a growing debate in markets today about the direction of inflation and the longer-term level of nominal interest rates. This debate will continue and may intensify during this confusing period of unusual economic and company data related to comparisons with COVID-depressed levels of last year. We are not macro-economists but must evaluate the risks of exogenous factors on our portfolio companies and adjust our company forecasts accordingly. We also gain valuable insight into macro-economic factors through our regular contact with managements of companies on our Qualified Company List, which includes a broad cross section of significant global enterprises which we believe to be some of the best managed companies in the world.

As managers of portfolios of sustainable growth companies, which we think of as "Growth Bonds", high inflation and nominal interest rates can erode the value of the future cash flows of our long-duration growth businesses. Our primary criteria for investment and sustainable growth is Pricing Power, which provides an effective hedge to long term inflation, but we recognize that we must be vigilant, particularly with respect to the duration risk in our discounted cash flow valuation models. Our observations are as follows.

Recent events related to the COVID-19 pandemic are unprecedented and therefore the long-term implications are difficult to judge. Starting in March of last year we formulated a view that economic activity would cease and as much as a year of economic production would be lost. To use a farming analogy, we would lose a crop and have to wait for the next season for growth, which of course has resumed in the economy today. There will be some long-term implications in certain sectors, and we adjusted our expectations for our companies accordingly. Since then, our general view has not changed. We have attempted to use the short-term interruption in growth and the effect on financial markets to upgrade the secular growth and predictability of portfolios by adding companies that should emerge stronger, such as Disney, American Express, PayPal, Dassault, Ball and Kansas City Southern. At the same time, we have taken profits in and trimmed other companies which were beneficiaries of the pandemic.

We believe the economic impact is quite different from the previous global economic shock, the Global Financial Crisis (GFC), where asset values and capital were destroyed both in the financial system and corporate and household balance sheets. That left a big crater in the fields, so to speak, which would have to be refilled with soil and fertilizer, before replanting could even begin. At that time, the Fed responded by easing interest rates, and the relatively new monetary policy tool of quantitative easing was applied sparingly, at least in the US. Fiscal stimulus amounted to about 5% of GDP here and abroad, and was perceived at the time to be a "bazooka". Most policy makers have agreed since then, however, that the actions taken were not enough, as we experienced secular stagnation for years before growth resumed.

Today, policy makers, perhaps conditioned "to fight the last war" have responded with a playbook drawn up based on the GFC. Rates have been set at levels providing negative real returns, quantitative easing is being employed aggressively and Fed policy guidance has changed to signal tolerance of higher inflation than in previous policy goals. Fiscal policy has been much more aggressive, with stimulus spending now amounting to about 15% of GDP in the US and growing, perhaps tangled up with populist and progressive social policies. This seems excessive to us, especially as there is not really a financial hole to fill as there was then. Bank and corporate balance sheets are in great shape, for the most part, and consumers, the biggest engine of economic growth, now have an excess of savings after quarantine of over $5 trillion. And, recently, we have begun to hear our companies talk more about high and growing inflation in their cost mix. In fact, in some cases we are hearing them talk about double digit increases, possibly rising in H2.

Many economists and central banks argue the inflation issues visible today are transitory, and that they are ready to act if necessary. That may be the case. But, the excess government spending will eventually have to be paid for on the fiscal side, which will be an impediment to growth. Likewise, the extreme level of stimulus on the monetary side will eventually have to be withdrawn, perhaps suddenly, meaning higher interest rates which at a minimum will moderate economic growth. The big mound of stimulus dumped on the fields will have to be hauled away, impeding growth, and the extreme levels of monetary fertilizer will have to be withdrawn leading to a rate headwind and impacting lesser quality companies which have taken on more debt or are more economically sensitive. While long-duration growth businesses will also be impacted, our close attention to valuation has traditionally benefited us in such times. We are constantly focused on reducing our exposure to more expensive growth streams while reallocating our clients' capital to more attractively valued companies.

We started adjusting to this concern about rising inflationary expectations in the middle of last year when we raised the base discount rate we use in our cash flow discounting mechanism. As base interest rates dipped below 1% and valuations jumped, we worried that investors were anticipating too strong of a recovery in earnings and cash flows, using too low of a discount rate.

We also began emphasizing another valuation tool, which we refer to as a Terminal Test, to guard against the excessive reliance on value which occurs too far in the future. It is a measure of the amount of the current price resulting from cash flows in the terminal year 10 years out and beyond. The use of this and our other valuation tools in part led us to pare valuation risk, particularly duration risk, from our portfolios and reduce positions in Match.com, Adobe, Mercadolibre, Xilinx, Ecolab, Illumina, Linde, and Nike.

Today we are retesting our requirement that each of our sustainable growth companies have a high degree of pricing power to pass along inflationary cost increases that may be in the pipeline longer than many expect. We are also continuing to focus on owning those businesses that have real secular forces behind their growth beyond the rebound from the COVID crisis which we will lap next year. That combined with our work managing valuation risk, especially the duration risk, should result in one of the best investment options for the currently changing environment. Companies with strong secular growth rates not tied to the rebound in economic activity which possess the ability to pass along inflation cost increases may offer the best harvest in a period of re-emerging inflation and higher rates.