LET'S TALK STOCKS
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Do multiples matter?

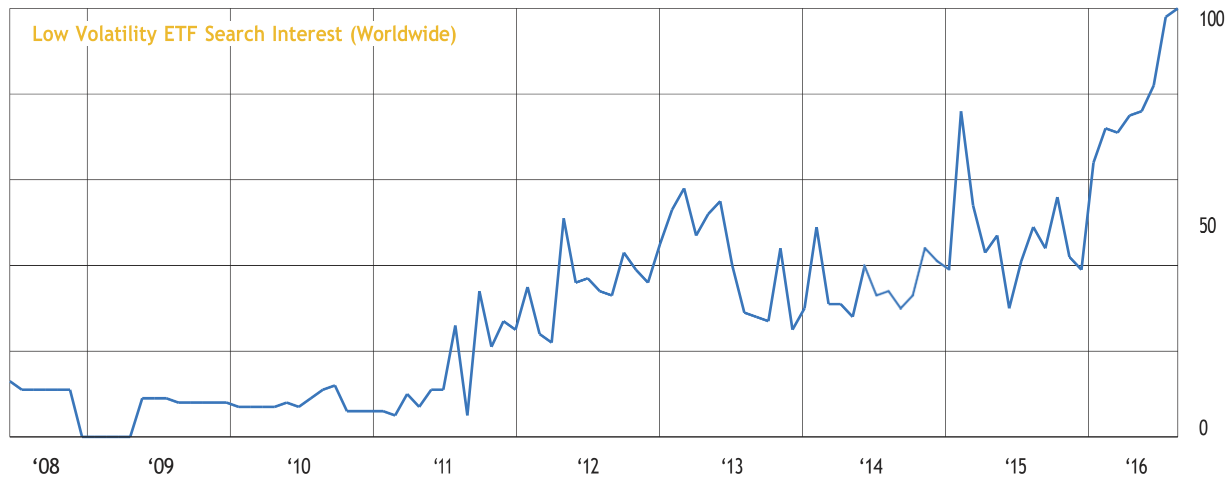
A Cautionary Tale for Quality Growth Investors and Refugees from Bond Land

Let's Talk Stocks will be a periodic discussion on GQG's favorite subject—stocks! Dictated by global events rather than by the calendar, we will make our best effort to explain the thinking behind GQG's investments in as transparent a manner as possible.

One of the questions I've repeatedly received over the years is, "How much do you care about prices, or rather, valuations?" My response has always been that growth and value are joined at the hip, therefore it's foolhardy to look at one without looking at the other. The most important factors influencing my views on valuation are anticipated growth and the return on equity that a business can generate over the long run (which I think of as longer than five years). The incremental returns on capital matter, and so does the headroom the business has in the long-term. If the growth slows down, we have to analyze whether the deceleration is cyclical or secular. If it seems to be structural, then how much slower is it going to be?

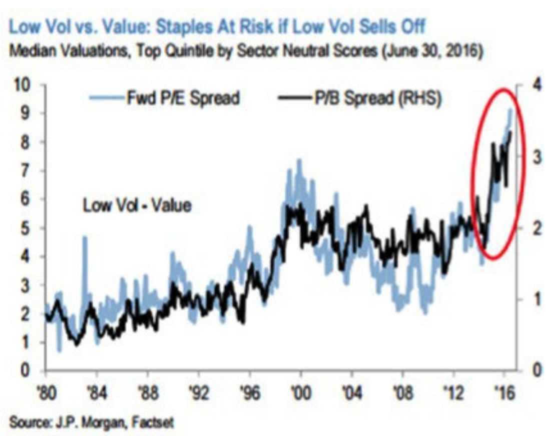
Since early this year, I've become increasingly worried that some of the larger consumer staples companies, who have seen strong stock price appreciation, might be getting a free pass. This free pass was purely because they have a very stable earnings profile, and as their payout ratios went up, their dividend yield became attractive versus bonds. The somewhat predictable nature of these companies has also caused them to be included in the proliferation of low-volatile or "smart beta" products. These products are on the receiving end of significant inflows, which in turn has led to these stocks taking on momentum characteristics simply because of their outperformance. As the saying goes, nothing succeeds like success!

To get a feel for the impact of "smart beta," just take a look at a Google search on "low volatility ETF" and you'll get the idea! It seems to be increasingly popular:



Source: Google Trends. Search term: Low Volatility ETF. Data represents search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. Likewise, a value of 0 means that the term was less than 1% as popular as the peak.

With popularity comes some risk, however, as seen in the chart below.

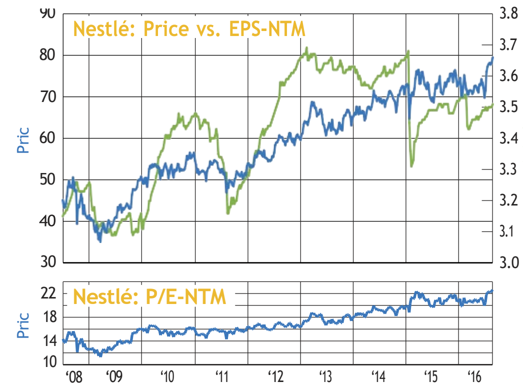


As any seasoned investor will tell you, it's the inflection points that count in defining which portfolio managers survive over the long run. Having invested in global equity markets for over two decades, I have seen periods of sharp price appreciation and depreciation. I think we are at the onset of yet another inflection point. Times like these require us to pay extra attention to valuations.

So back to the question: How much do I care about valuations? Valuations are always important; but when earnings growth starts to falter, they become even more important. Valuation alone is insufficient, particularly when it comes from the dogma of style purity. I have seen this a number of times over my career – especially over the last decade as many value managers suffered greatly by buying financials despite weakening fundamentals, ostensibly driven by "discipline." Over the past decade, many managers have performed well by letting their horses in the consumer staples sector run. I think it may now be time to give those horses a rest.

Since launching GQG Partners in June, I've sold out of a number of names that I had owned for 10-plus years! That might well hurt short-term performance as these names have momentum right now. I note that my performance suffered in 1999 when I sold names that continued to run after I'd sold. But I'd rather sell too early than be the last to leave the party. I would rather suffer short-term underperformance any day than risk permanent capital loss for our clients. The good news is that I have shifted our portfolios like this before – moving to other quality but much less expensive names (because of maybe slightly higher earnings volatility), like in the 2004-2007 era, and believe the time is right to do it again.

So let's talk stocks! While I do not own Nestlé, it is a very high-quality company with a strong track record of consistent growth. When you look at Nestlé from 2000 to today, not much has changed from an operating profile: the company remains a dominant player in its product categories, generates decent return on equity (13.7% last year) and pays a hefty dividend (at today's price, the dividend yield is 2.9%). Unfortunately for Nestlé, not much has changed when looking at their earnings estimates either. At the end of 2010, the consensus estimate for Nestlé over the coming 12 months was just over $3.50 per share (in USD, so normalizing for the Swiss Franc strength). And at the end of 2015, the consensus estimate for Nestlé over the coming 12 months was just over $3.50 per share. Is this déjà vu? The forward earnings estimate today is the same as it was five years ago. What has changed is the price of Nestlé shares, which has risen by over 50% since the start of 2010. The shares are now trading at close to 22 times next year's earnings. At the end of 2010 they were trading at about 16 times forward earnings.

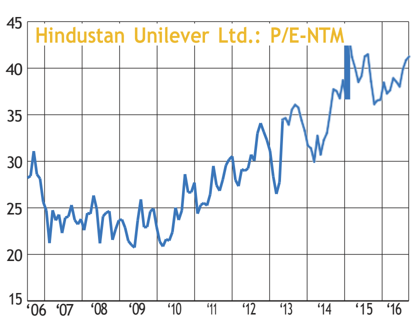


Source: FactSet. Past performance is no guarantee of future results.

Nestlé is only one example of a company with a solid core business where growth has been difficult to come by in recent years, but whose shares have nonetheless appreciated sharply. (Unilever is another example.) The result is that these companies sell at higher multiples than they have historically, often despite the fact that growth has slowed. These companies' shares are being viewed by some investors as bond proxies. But equity is not debt, and shouldn't be priced as if it were.

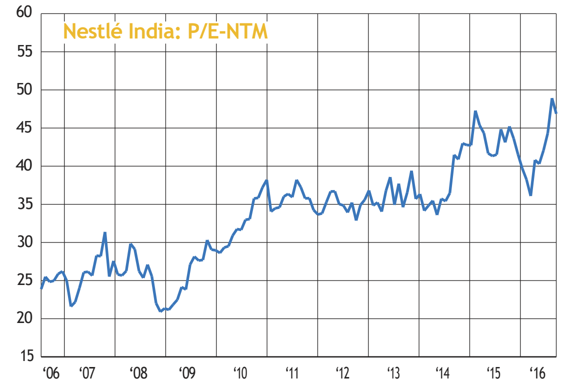
Do these multiples make sense? My team and I did the math, and for fixed income investors the current multiples on some of the consumer staples companies might indeed make sense. Let's return to Nestlé. We don't think the company's broken, only that it's struggled to find profitable growth lately. Developed markets have been slow to recover from the financial crisis, and results from emerging markets have been hurt not only from demand headwinds but also from substantial currency devaluation. Let's assume that better days are ahead and that the company can get back on a growth track, delivering 7% growth in earnings over the coming five years. From today's expectations for forward earnings around $3.50, earnings five years out would grow to about $5.00 a share. If we apply a multiple of 16 to those earnings, we arrive at a year-five price target of about $80.00 a share. Nestlé currently is priced at just under $79.00. So if we assume that Nestlé grows earnings at a pretty healthy clip over the next five years, and assume further that the multiple on Nestlé earnings returns to where it was five years ago—a not unreasonable assumption—then the expected share price five years out is pretty much exactly what the share price is today. Someone holding Nestlé over that five-year period would receive dividends, but they wouldn't realize a gain on the sale – a bond proxy indeed!

If you're a *refugee* from Bond Land who finds him or herself searching for yield in the Equity World, then buying stocks for current income at today's elevated multiples might make sense. But if you're an equity investor with the expectation of earnings-driven share-price appreciation, today's high multiples are a powerful argument against committing capital to these companies.



Source: FactSet. Past performance is no guarantee of future results.

It's the same story in emerging markets. Look at names like Hindustan Unilever, Unilever Indonesia or Nestlé India. While they have had quite a tailwind from the decline of oil prices, their earnings growth has been muted while multiples keep expanding. During the nifty-fifty era of the early 1970s, similar stocks did well because of the seemingly unlimited growth opportunities they were offering. This time around, these names have done well because interest rates have gone down while there is muted organic earnings growth. Again, as an equity investor it is hard to make sense of this.



Source: FactSet. Past Performance is no guarantee of future results.

Why is organic earnings growth muted? Local competition is increasing at a much more rapid pace, e-commerce is eroding brand value and market participants keep pursuing margin improvements. That focus on margins, we believe, will turn out to be a flawed strategy as it is creating room for local players to get a toehold. Look at Patanjali in India (started by a yoga guru of all people!). Founded in 2006, Patanjali has gone from under $10 million USD to sales of over $1 billion USD projected for the next fiscal year (source: *The Hindu*). As a reference point, Hindustan Unilever has sales of around $5 billion after operating for over 100 years! (source: *The Hindu*)

When we invest money for ourselves and our clients, we estimate earnings five years out and apply a multiple to those earnings. That terminal multiple reflects our confidence in the ability of the company to continue growing beyond year five. We then discount back the year-five price target, as well as the dividend stream over the next five years, and compare that sum to today's price. For us to assign a high multiple to prospective earnings five years out, we must have a high degree of confidence in the ability of the company to grow profitably for the extended future. Many consumer staples companies have struggled to grow earnings over the past few years. Given their recent financial results, we've become less convinced that many of the consumer staples companies that we've owned will grow their earnings at the rate expected when we first established positions.

Nestlé, Unilever and their corporate peers aren't going out of business anytime soon, but we aren't sufficiently confident in their ability to grow earnings over the next five years and beyond to apply a multiple to year-five earnings anything like the multiples they currently command. Each of these companies faces challenges. For example, the potential damage to the value of established brands as e-commerce takes market share from established retailers is a challenge that Unilever will have to work through. Our increased skepticism regarding future growth has led us to assign a lower multiple to these companies' future earnings at the same time that the market has been assigning a higher multiple to these companies' current earnings.

While the consumer staples companies have appreciated in price even as our confidence in their ability to grow has been shaken, companies in other sectors have become more attractive.

As such, we find that the composition of our portfolios is changing. It's important to note that this shift is not the result of some grand market call regarding sector valuations, but rather driven by a bottom-up substitution of names that we believe offer solid upside potential in exchange for names that have risen in value even as our confidence in their long-term prospects has declined.

One consequence of the move out of these consumer staples and into other names is an increase in the portfolio beta coefficient. We are quite comfortable taking on more volatile names so long as we believe that we fully understand the business risks our investees face and the growth prospects that they enjoy. People who have invested with us in the past may wonder if we're somehow changing our style. In fact, our style remains exactly the same. This is the same song playing all over again. We have previously been both underweight and overweight in consumer staples based on whether share prices adequately reflected our view of their growth prospects. We are now reducing our holdings in consumer staples because we feel that their current share prices are rich based on their growth prospects. Price does indeed matter for a growth investor.

At this point I've gone on way too long, but once I start talking about stocks it's hard to stop! Thanks for letting me share our insights on pricing and valuation. In the next issue of Let's Talk Stocks, I'll discuss where we're finding new opportunities.

As always, thank you for your support.

Rajiv Jain
Chairman & Chief Investment Officer
GQG Partners LLC

Definitions

Beta is an indicator of the price volatility of a stock or other asset in comparison with the broader market. It suggests the level of risk that an investor takes on in buying the stock. The higher the beta number, the higher the risk.

Smart beta is a way of investing that combines the benefits of passive investing and the advantages of active investing strategies. It derives from the capital asset pricing model (CAPM) to define the relationship between risk and return. In this model, beta is a measure of volatility or systemic risk of a security compared with the broader market.

Low volatility ETFs are exchange-traded funds that hold stocks with historically lower price fluctuations and slower, more stable movements compared to the broader market. Low volatility ETFs do not eliminate risk, but rather serve as a tool to manage exposure to market volatility.

The P/E (Price-to-Earnings) ratio is a valuation metric that measures a company’s current share price relative to its earnings per share (EPS), indicating how much investors are willing to pay for $1 of earnings. A high P/E ratio can indicate a company is overvalued, or that investors have high hopes for future growth. Conversely, a low P/E might suggest the company is undervalued or that it is expected to underperform.

The Price-to-Book (P/B) ratio compares a company's market capitalization to its book value (net assets), indicating whether a stock is overvalued or undervalued relative to its accounting value.

Earnings per share (EPS) is the amount of a company’s profit allocated to each share of its common stock.

NTM: Next Twelve Months

Forward earnings are a company's projected net income for a future period, typically the next 12 months or upcoming fiscal year, based on analyst consensus or management guidance.

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