Yeah hey, they say two thousand zero zero party over, oops, out of time.
So tonight I'm gonna party like it’s nineteen ninety-nine.

Prince, 1999
Portfolio Managers

Ian Lance, Nick Purves and John Teahan have managed funds together for over 10 years. Their loyalty and experience is leading within the industry and has awarded them a number of accolades. Ian, Nick and John joined RWC Partners in 2010 to establish the Equity Income team and now manage c. £2.7 billion for their clients.

The team’s approach fully integrates conviction led, value-based stock selection with a distinctive and technical approach to stabilising assets, with the aim of delivering investment solutions that both grow investors’ assets and protect the purchasing power of capital and income.
1999

Investors are no longer taking their advice from investing legends such as Ben Graham or John Templeton and instead seem to be taking it from the musical legend Prince and are ‘partying like its 1999’ with their own or their clients’ assets. Those of us who have been around long enough have seen this movie before and suspect we know how it ends (unless, of course, ‘it’s different this time’).

This has been one of the worst starts to the year for value investing in history. Year to date MSCI World is +15% with MSCI World Growth +20% and MSCI World Value +11%. The complete flip-flop on interest rates and quantitative tightening by the US Federal Reserve in response to a decline in the stock market has been followed by poor economic data worldwide which has convinced investors that rates have peaked. The outperformance of value over growth in Q4 2018 has been reversed as investors have piled back in to stocks which are meant to respond best to falling rates (bond proxies and growth stocks) despite their valuations which, in many cases, are the highest they have been since 1990.

I believe that investors are almost certainly doing exactly the wrong thing now by bidding up expensive stocks and shunning cheap ones and I hope to show this by looking at some of the empirical evidence, drawing on anecdotal evidence about the behaviour of market participants and finally giving a few stock specific examples. In my opinion, many investors are looking a gift horse in the mouth by ignoring the opportunities that are being created as value stocks are driven down to the same levels they reached in 2000 and from which they posted outperformance of the wider market.

**FIGURE 1:**
The Record Outperformance of ‘Growth’ vs ‘Value’

![Graph showing the record outperformance of 'Growth' vs 'Value'.](source: Bloomberg, 31 May 2019)

Past performance is not a guide to the future. The price of investments and the income from them may fall as well as rise and investors may not get back the full amount invested.

No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.
Echoes of 1999 Part 1 – Massive flows in to growth funds

In 1999, the Technology, Media and Technology (TMT) heavy NASDAQ index had risen by 20% in the first nine months of the year at which point many investors (lots of whom were supposedly ‘professionals’), became jealous of missing out on the giant party being thrown by Wall Street, and capitulated by starting to indiscriminately throw money at technology stocks. The result was that the index rose by an astonishing 88% in the next six months. A handful of funds that were packed with these growth stocks enjoyed incredible eighteen month returns (so good they actually translated to amazing five and ten year numbers) and they attracted the vast majority of the new money flows. The US asset manager Janus whose growth orientation helped them take $38bn of new business in 1999 and specifically the Janus Twenty Fund was closed at $50bn in September 2000. From that peak, the NASDAQ index went on to lose two thirds in the following year and of course so did most investors as the bulk of the money had flowed in close to the top. Investors pulled $12bn out of Janus funds in 2001 and the Twenty Fund was eventually merged with another fund having lost three quarters of its assets.

Jim Grant, the author of ‘Grant’s Interest Rate Observer’ once commented that ‘Progress is cumulative in science and engineering, but cyclical in finance.’ i.e. the lessons in finance are never learnt. Within five years, the terrible losses of 2000-01 were forgotten as investors poured money in to funds that had ridden the China/commodities boom. Yet again, I felt completely out of touch with the market as stocks like Central African Mining, Eurasian Natural Resources and Kazakmys soared whilst my boring old value stocks languished. Once again, however, the cycle turned and many of these stocks were crushed. Shortly after this period, US hedge fund manager Seth Klarman wrote ‘The Forgotten Lessons of 2008’ which also contained ‘Ten False Lessons’ the first of which was ‘There are no long-term lessons – ever’.

For the third time in twenty years I feel completely out of touch with the market but in my opinion, investors in general are currently proving both Mr Grant and Mr Klarman correct. The behaviour that led to the devastating losses in 2001 and 2008 are seemingly being repeated once more as investors take money out of funds that have lagged the market; £18.4bn has been redeemed from UK Income Funds since 2016. Conversely they are pouring money in to a small number of funds who have enjoyed strong recent performance by virtue of the fact that they hold growth stocks which have enjoyed substantial re-ratings and appear to be breathtakingly expensive by historic standards. One growth manager who has had £2bn of flows in to his funds year to date started his latest factsheet with the words ‘A rather spectacular month’. This type of hubris usually comes just before the end but when you are buying £20m of your own stocks every day, it can keep going for quite some time.

I read another growth manager’s factsheet and in which he noted that 16 of his 20 holdings rose double digits in the month of April whilst 5 had increased by over 25% in the month. When I looked at his portfolio, it seemed that many of his holdings trade on price to sales multiples over 10x but despite this they continue to go vertical. He congratulated himself on attracting £145m of new money in to his fund in the month. We appear to have entered full scale growth stock melt up which is being exacerbated by these growth managers attracting all the flows and going in to the market to buy their own stocks and drive them up further.

![NASDAQ Chart](image-url)

Source: Bloomberg, 1 June 2002

No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment. The names shown above are for illustrative purposes only and is not intended to be, and should not be interpreted as, recommendations or advice.
Echoes of 1999 Part 2 – Speculative IPO’S

Just as in 1999, if we want to see the egregious example of the growth bubble it usually shows up in the IPO market where the newness of the company leads to an asymmetry of information in favour of the investment bankers. This will be eerily familiar to anyone who was investing in 1999 and remembers the IPO’s of stocks like Boo.com and Scoot in the UK and Pets.com and Webvan in the US. Below are a few of this cycles vintage.

• They say that history doesn’t repeat but it certainly rhymes, however, in the case of recent IPO’s, it is actually just repeating. One of the poster children for the craziness of the dot.com boom was the IPO of Pets.com fondly remembered for its sock puppet used in its advertising and less fondly remembered for wiping out investors wealth as it filed for bankruptcy only nine months after its IPO.

To prove how short memories are in investing, another online pet product retailer has just IPO’d. Shares in the snappily named Chewy shot up nearly 60% on its first day of trading. At this price it was valued at $14bn which would place it 366 in the S&P500 and make it larger than Deutsche Bank. This is despite losing $270m last year and the fact that last time I checked most of their products seem to be available on Amazon.

• Look no further than Beyond Meat which develops plant-based protein food products. The stock IPO’d at $25 and has now risen by 330% in its first month of trading! Its market capitalisation is now $6.4bn which means that it trades at a staggering 73x revenues (note that was 73x sales not earnings – it doesn’t have any earnings at the moment).

As the Financial Times commented:

“And competition is coming. Tyson is developing its own line of alt-protein products, while $294bn Nestlé has already launched a range of meat-simulating products. Then there is Impossible Foods, whose recent success with Burger King has seen its “Impossible Whopper” earmarked for a US rollout by the end of the year. That is a lot of firepower to fight against for a business yet to prove it can scale.”

FINANCIAL TIMES

• To this, one might add the appropriately named Zoom which IPO’d at $36 before soaring 150% in the first month and now sports a valuation of 40x revenues (as an aside, the algos got confused on the first day of trading and bought the wrong company, thus driving the share price of Zoom Technologies (ticker ZOOM) up 450% rather than Zoom Video Communications (ticker ZM). So much for artificial intelligence!

• Then we have Tradeweb the online dealing platform that has soared 65% since its IPO in April and now trades at a punchy 13x sales.

• Pinterest which rose 80% in the first few days after its April IPO and trades at 13x sales.

• Uber Technologies Inc., which in its first financial report as a public company, posted a $1.01 billion quarterly loss, among the largest of any public company but is valued at $75 billion.

• The share price of Slack (a messaging software business) rose by 60% on the first day after IPO to a market capitalisation of $25bn which is 63x last years sales of $400m.


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Echoes of 1999 Part 3 – Fundamentals no longer matter

After the flip flop from the Fed – at its recent peak NASDAQ was +33% from 24 Dec with stocks like Netflix +65%. Apple rose by 50% in the first few months of the year even though their earnings forecasts for 2019 were reduced from $13.20 to $11.50 (-13%). Nobody worries about old fashioned irrelevant things like earnings in this type of speculative market.

This, of course, is a microcosm of the whole US stock market which has seen earnings forecasts cut throughout the year (to a level that now shows no growth on 2018) whilst the index itself has soared by 17% seemingly responding more to the President’s tweets than anything to do with fundamentals.

FIGURE 3: Apple

![Graph of Apple stock price and earnings forecast]

Source: Bloomberg, 18 June 2019

FIGURE 4: S&P500 has diverged from earnings forecasts

![Graph of S&P500 index and earnings forecast]

Source: Bloomberg, 14 June 2019

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Echoes of 1999 Part 4 – Bargains to be had in the unpopular areas

The flip side of this desire to own growth stocks is desire to get rid of value stocks at any price and, of course, it is this reduction in starting valuation that sows the seeds for future strong returns. In the late nineties, the opportunity lay not in the high-flying TMT stocks but in the boring old economy stocks in sectors like tobacco and utilities which investors were willing to sell despite, in some cases, price to earnings ratios of 5-6x and dividend yields of 8%. In 2008, it was not the miners where the best opportunities lay but in beaten down retailers, airlines and insurance companies. Today, I feel certain the opportunities are not in the quality growth trading on ten times sales but once again in the sectors being shunned such as energy, retail, support services. As figure 5 shows, the dispersion in valuation between value and growth stocks strongly suggests value will deliver better returns in the future.

Some of the stocks that we own have been marked down to what we regard as very attractive levels (we suspect in some cases because value managers are getting redemptions and being forced to sell them). A few examples are highlighted below.

- Capita is a business that we think can produce earnings per share of 20p in a few years’ time being marked down to just over £1 i.e. 5x normalised earnings.
- RBS trades on 8x this year’s earnings but this ignores the potential for them to return 50p of capital meaning that adjusted for this they are on about 5x earnings.
- Standard Chartered Bank having traded at 3.5x tangible book post the financial crisis now sits on a lowly 0.6x and yet no-one is interested. We now believe they can make £1 of earnings per share in a normal year and hence trade today on only 6x this level.

The list of stocks in our portfolio trading at what we feel are very low valuations is long and yet all the money pours in to growth funds when all the empirical evidence suggests that you should do the exact opposite. Warren Buffett suggested that buying highly valued growth stocks is not investing but speculation.

THE LINE SEPARATING INVESTMENT AND SPECULATION

“...nothing else could be more fundamentally wrong. The line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money. After a heady experience of that kind, normally sensible people drift into behavior akin to that of Cinderella at the ball. They know that overstaying the festivities – that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future – will eventually bring on pumpkins and mice. But they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There’s a problem, though: They are dancing in a room in which the clocks have no hands.”

WARREN BUFFETT
BERKSHIRE HATHAWAY 2000 CHAIRMAN’S LETTER
Buying expensive stocks is like betting against the house at the casino

Growth investing is a fabulous marketing strategy. I sat at a conference recently whilst a growth fund manager transfixed the audience with tales of $10,000 bottles of brandy sold by one of the companies he was invested in and predicted how many Ferrari’s were going to be sold in China in the next decade. By comparison, my narrative about the turnaround going on at Standard Chartered not being reflected in its valuation of half its tangible book was as dull as ditch water. But who said that investing is meant to be exciting?

“Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas.”

— PAUL SAMUELSON

If investing is entertaining, if you’re having fun, you’re probably not making any money. Good investing is boring.

— GEORGE SOROS

A good investment strategy means admitting that you don’t have a crystal ball and therefore playing the odds. The historic evidence, compiled over decades, suggests that buying cheap stocks, based on almost any metric, delivers better returns than buying expensive stocks. Figure 6 below shows data for the US equity market between 1980 and 2014 and shows how irrespective of whether you use price-to-cash, price-to-book or price-to-earnings, cheap stocks produce better returns than expensive stocks. Armed with this basic fact and working on the assumption that an investor’s objective is to maximise their risk adjusted total returns, one must ask why anyone would knowingly choose to buy expensive stocks and thus knowingly tilt the odds against them?

FIGURE 6:
Rolling 5-Year Annualised Returns of Valuation Deciles, Global Sample, 1980-2014

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No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.
The answer is that a compelling narrative usually takes hold that convinces people that the old rules no longer apply and hence even though the stocks they are buying look expensive, they believe that their future growth rate will be so attractive that this high valuation is justified. Sometimes this narrative can be based around a single stock with a new killer product or service whilst at other times it takes grip of whole swathes of the market. In the nineties, the narrative was growth of the internet, in the noughties, it was the growth of China whilst today’s one is more nuanced. In the case of the FAANG stocks, it is based around the belief that these companies will dominate their respective industries, crushing the opposition as they do and paving the way to future super profits (somewhat similar to the narrative attached to the Nifty Fifty stocks in 1960’s and 1970’s). This both justifies the valuations of the disrupters (Amazon on 65x earnings) as well as companies considered ‘undisputable’ or as Warren Buffett would describe them, companies with wide moats (Diageo on 6x revenue forecast).

In a more general sense, there seems to be a belief amongst many investors in the Goldilocks economy and the omnipotence of the Central banks. Hence investors believe that low growth will perpetuate low interest rates which justify the higher valuations of ‘quality growth’ stocks. This view has certainly worked for a while and who is to say that it won’t carry on working but, in my opinion, buyers of these stocks (or investors in funds buying these stocks) need to ask themselves the following questions:

1. Am I one of the first to see the growth potential in this business or does the already high valuation suggest that lots of others have already seen it?
2. Most of my returns have come from re-rating – am I confident that this source of returns is sustainable in the future? Is there really no limit to valuation?
3. Could it be that this growth is therefore already discounted in the share price?
4. What would happen to the share price if this growth disappoints these already very high expectations?
5. The base rate for buying expensive stocks is not good (people do win the lottery but the odds of your numbers coming up next Saturday are not high). Given that I am taking a long shot here, do I (or my fund manager) have a demonstrable track record in being able to identify future growth before others and before it has been priced in?
6. Could I be the person who gets sucked in close to the top?

In investors’ tendency to chase styles of investing after they have done well that detracts from the returns they receive as shown in Figure 8. Investors throughout this period would have received 8.4% in growth funds (which is less than the S&P500 index) but only receive 5.2% because they buy growth after it has done well – exactly as many investors are doing today.

FIGURE 7: DIAGEO – Market Cap/Total Revenues

Source: S&P Capital IQ, 5 June 2019

FIGURE 8: Chasing performance erodes returns (1991-2013)


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Conclusion

Despite all the evidence that it is the wrong thing to do, investors are throwing money at growth stocks like never before. Instead of tilting the odds in their favour, they are tilting against them as they are seduced by stories of economic moats and unstoppable growth. But worse than that, they are currently being offered the ability to secure attractive mid to long term returns by buying a portfolio of undervalued stocks and they are turning the chance down. I wonder how much regret investors will feel if they look back at the opportunity they missed because they were waiting for the catalyst?

A really good fund manager that I worked with once said to me ‘some of the best investments I have ever made made me feel physically sick at the time that I made them’. The point that he was making is that taking a contrarian stance was often the route to producing good returns whilst buying the same stocks as everyone else rarely achieves this. We have been trying to make the same point for many months now and with a few notable exceptions, I get the impression that no-body is really listening. I have therefore listed below a series of quotes from some of the greatest investors of the last century on the importance of being contrarian. I hope that these might encourage a few investors to think about following the same strategy.

Appendix

On the importance (and pain) of being a contrarian

“The central principle of investment is to go contrary to the general opinion, on the grounds that if everyone agreed about its merit, the investment is inevitably too dear and therefore unattractive.”

John Maynard Keynes, Letter to Jasper Ridley 1944

“If you believe … that the value approach is inherently sound… then devote yourself to that principle. Stick to it, and don’t be lead astray by Wall Street’s fashions, illusions, and its constant chase after the fast dollar. Let me emphasize that it does not take genius…to be a successful value analyst. What it needs is, first, reasonably good intelligence, second, sound principles of operation; and third, and most important, firmness of character.

Benjamin Graham, Barron’s, Sep. 23, 1974

“It is the long-term investor, he who most promotes the public interest, who will in practice come in for the most criticism… For it is the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy.”

John Maynard Keynes, The General Theory of Employment, Interest and Money

“It is the one sphere of life and activity where victory, security and success is always to the minority and never to the majority. When you find any one agreeing with you, change your mind.”

John Maynard Keynes, The General Theory of Employment, Interest and Money

“No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.
“The market can remain irrational longer than you or I can remain solvent.”
*This quote has been attributed to Keynes after he performed a series of highly leveraged trades, and he was humbled by the market but there is actually little evidence of it before 1990 and other have attributed it to A. Gary Shilling in a Forbes article in 1993*

“If you buy the same securities as other people, you will have the same results as other people.”
*Sir John Templeton, Templeton’s Maxims*

“It is impossible to produce a superior performance unless you do something different from the majority. To buy when others are despondently selling and to sell when others are greedily buying requires the greatest fortitude and pays the greatest reward.”
*Sir John Templeton, Templeton’s Maxims*

“When any method for selecting stocks becomes popular, then switch to unpopular methods. Too many investors can spoil any share selection method or any market timing formula.”
*Sir John Templeton, Templeton’s Maxims*

“Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria.”
*Sir John Templeton, Templeton’s Maxims*

“The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.”
*Sir John Templeton, Templeton’s Maxims*

“Too many investors focus on outlook and trend. Therefore, more profit is made by focusing on value.”
*Sir John Templeton, Templeton’s Maxims*

“In the stock market the only way to get a bargain is to buy what most investors are selling.”
*Sir John Templeton, Templeton’s Maxims*

“To buy when others are despondently selling and sell when others are greedily buying requires the greatest of fortitude and pays the greatest reward.”
*Sir John Templeton, Templeton’s Maxims*

“Investors should remember that excitement and expenses are their enemies. And if they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy when others are fearful.”
*Warren Buffett, Letter to shareholders, 2004*

“Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can’t buy what is popular and do well.”
*Warren Buffett*

“..Built into the speculative episode is the euphoria, the mass escape from reality that excludes any serious contemplation of the true nature of what is taking place. Contributing to and supporting this euphoria are two further factors little noted in our time or in past times. The first is the extreme brevity of the financial memory. In consequence, financial disaster is quickly forgotten. In further consequence, when the same or closely similar circumstances occur again, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. There can be few fields of human endeavour in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present.”

“Investors do not make mistakes, or bad mistakes, in buying good stocks at fair prices. They make their serious mistakes by buying poor stocks, particularly the ones that are pushed for various reasons. And sometimes – in fact very frequently – they make mistakes by buying good stocks in the upper reaches of bull markets.”
*Ben Graham, Ben Graham Lectures: Current Problems in Security Analysis*

“The investor’s chief problem – and even his worst enemy – is likely to be himself.”
*Ben Graham, The Intelligent Investor*
Three Myths of Growth Investing

Myth 1

Does compounding high rates of return on capital offset change in valuation?

<table>
<thead>
<tr>
<th></th>
<th>Return on Capital</th>
<th>Valuation at Start</th>
<th>Valuation at End</th>
<th>CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Return Company</td>
<td>20%</td>
<td>4x Price / Book</td>
<td>2x Price / Book</td>
<td>18%</td>
</tr>
<tr>
<td>Low Return Company</td>
<td>10%</td>
<td>2x Price / Book</td>
<td>4x Price / Book</td>
<td>12%</td>
</tr>
</tbody>
</table>

The above table represents a purely hypothetical scenario and is provided for illustrative purposes only.

We were recently sent the above table by someone as evidence of why value investing does not work. The theory being shown here is that if a company can compound at very high rates of return, starting valuation is almost irrelevant as it will offset any de-rating.

This looks great in theory and is the sort of thing often used by growth investors to justify paying high valuations. There are, however, several problems with this:

1. **In practice**, we know that over the long-term low price to book stocks produce greater returns than high price to book stocks so that should cast immediate doubt over this theory.

2. This is something often trotted out by growth investors and it is quite disingenuous because what you need to focus on is the **return on marginal capital deployed** NOT the return on the starting asset base. There are very few companies who can deploy new capital at 20% every year and this is why, on average, high returns fade down. Probably THE company that everyone focuses on as having a fantastic moat and which therefore should be able to beat the fade in returns is Coca Cola. Let’s look at what actually happened to its returns. As Figure 9 shows, they more than halved from 35% in 1999 to a low of 14% in 2014 because they could not deploy new capital at that 35% level. New capital was being deployed at a much lower rate and dragging the group average down. This is the rule not the exception and in the case of Coke is reflected in the fact that the company’s EPS has been stuck around $2 per share since 2011.

Coke is also a wonderful example of what happens when you over pay for these ‘quality’ businesses. If you bought it in 2000, it was fourteen years until you got back to break even (2007 with dividends included).

**FIGURE 9:**
Coca Cola Cash Flow Return on Investment 1998-2018

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Myth 2

Do wonderful businesses produce wonderful returns?

Another popular narrative today is that some businesses are so wonderful that valuation is irrelevant. However, this assertion does not stand up to scrutiny when tested empirically. This was quantified in a study by Credit Suisse HOLT which divided companies up by CFROI and then looked at how TSR was influenced by moving between quartiles (or staying in the same one). Invariably these wonderful businesses that everyone believes will never fade are priced to do exactly that and deliver market returns, whilst those that disappoint deliver far worse returns. With value stocks expectations are very low and hence if they exceed them, they deliver greater returns.

<table>
<thead>
<tr>
<th>Total shareholder returns 2003-2012 for all 2002-2012 quartile combinations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ending quartile</strong></td>
</tr>
<tr>
<td>1st quartile (quality)</td>
</tr>
<tr>
<td>4th quartile</td>
</tr>
</tbody>
</table>

Source: Economic Returns, Reversion to the Mean and Total Shareholder Returns by Michael Mauboussin (Credit Suisse HOLT) December 2013

Note that a stock which starts in the top quartile and stays in the top quartile produces the same return (19%) as one that starts in the fourth and finishes in the fourth. This is as expected because they were priced correctly ex ante and then met expectations. The biggest returns are generated in stocks were the CFROI improves with those moving from where the fourth to the first quintile generating a 27% return. The worst returns of only 6% were generated by those stocks which fell from the first to the fourth quartile over the period. This is one way of explaining why we believe value beats growth. With value stocks, expectations are very low, and this increases the chances of them being exceeded, with growth stocks the reverse is true; expectations are high and even if they are met, you should just expect the market return. When they disappoint, you get significantly less.
Myth 3

Change in rating dominates returns and produces a disadvantage for high rated stocks

A final way to think about why value beats growth in the long run is as follows; the total return of a stock can be estimated by looking at its free cash flow yield (the cash the company produces after its interest, tax and capital expenditure i.e. what is potentially available to shareholders) plus the growth in that free cash flow. Consider a company with a market cap of £1bn that generates £100m (a 10% free cash flow yield) and then grows that free cash flow by 5% in a year. Assuming no change in valuation, total return will be 15%.

Using that template, we can see the basic mathematical advantage that value stocks have over growth stocks. In the table below, we take a value stock on a FCF yield of 10% and re-rate it to 8% over a period of five years.

<table>
<thead>
<tr>
<th></th>
<th>Value stock</th>
<th>Growth stock</th>
<th>Diff.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Starting FCF yield</td>
<td>10.0</td>
<td>4.0</td>
<td></td>
</tr>
<tr>
<td>Ending FCF yield</td>
<td>8.0</td>
<td>6.0</td>
<td></td>
</tr>
<tr>
<td>Potential re-rating p.a.</td>
<td>4.0</td>
<td>-8.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Plus starting FCF yield</td>
<td>10.0</td>
<td>4.0</td>
<td>6.0</td>
</tr>
<tr>
<td>Plus underlying FCF growth p.a.</td>
<td>0.0</td>
<td>4.0</td>
<td>-4.0</td>
</tr>
<tr>
<td>Total 5 year annual return</td>
<td>14.0</td>
<td>0.0</td>
<td>14.0</td>
</tr>
</tbody>
</table>

This on its own equates to a 4% p.a. return. We then start a growth stock on 4% FCF yield (co-incidentally the current FCF yield of stocks like Unilever and Diageo) and de-rate it to 6% over the same time period. This produces a loss of 8% p.a. and so the growth stock starts with a 12% p.a. disadvantage to make up. Now, of course, we have to factor in the higher rate of growth of the growth stock, so we assume the value stock has no growth whatsoever over the period whilst the growth stock produces 4% p.a. Our total return over the period is given by the starting FCF yield, plus the growth in FCF plus or minus the change in rating. As we can see, the value stock beats the growth stock by 14% p.a. as a result of its higher starting FCF yield and its re-rating despite having no growth.

The above table represents a purely hypothetical scenario and is provided for illustrative purposes only.
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The Confidential Private Placement Memorandum, the Articles of Association as well as the annual report may be obtained free of charge from the Representative in Switzerland.

RWC Partners Limited Verde, 10 Bressenden Place, London, SW1E 5DH | T +44 (0)20 7227 6000 | F +44 (0)20 7227 6003 | www.rwcpartners.com

E invest@rwcpartners.com | W www.rwcpartners.com

Please contact us if you have any questions or would like to discuss any of our strategies.

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