**Investment Philosophy – Stock Selection (Draft 25/11/98)**

**Our beliefs about stocks**

1. The key long term driver of a company’s stock price is normally the growth in earnings per share.
2. As evidence of substantial change in a company’s prospects appears, market participants are generally slow to fully incorporate the new information into their expectations.
3. Market participants are generally over-optimistic in their earnings per share expectations. This over-optimism is normally greater for stocks that show high earnings variability.
4. Stocks with relatively consistent earnings progression are particularly likely to outperform in times of economic distress.
5. Markets are not always efficient, especially when conditions are changing rapidly. This gives scope for active management to add value.

**Our investment philosophy**

This follows on from the set of beliefs above.

* We are active managers.
* Growth. We seek to invest in companies which are expected to sustain above average growth in earnings per share.
* Business Momentum. We seek to invest in stocks where the outlook for the business is improving.
* Consistency. We seek to invest in stocks which are expected to show above average consistency in the progression of earnings per share.

**The related characteristics we are looking for in stocks**

* Growth

Strong competitive position within the industry

Good industry prospects

Organic revenue growth expected to be above average

Pricing power

Earnings per share growth expected to be sustained at an above average rate

Return on invested capital expected to be sustainably in excess of cost of capital

Management focus on shareholder value creation

Coherent strategy for growing the business and a management that we believe can do this

* Business Momentum

Improving competitive position

Improving industry prospects

Industry structure that is changing favourably

Improving organic growth prospects

Greater pricing power

Positive relative revisions to earnings per share

Improving return on invested capital

* Consistency

Product demand that is relatively insensitive to economic or other fluctuations

High barriers to entry and a stable industry structure

Strong balance sheet

Good earnings visibility

Good free cash flow generation

Low level of historic earnings volatility

The greater presence of the characteristics outlined above the more a stock is likely to be attractive to us. This does not mean that a stock must have each and every characteristic in order to be attractive to us.

Note that the above characteristics are not the only ones that we look for in stocks (valuation is a notable omission, see below), but they are the characteristics that relate to our investment style and will therefore be more important to us that to most other investors.

**The reasoning and evidence that backs our approach**

* Growth

The historic studies that have been done have tended to indicate that growth has underperformed value. However we would argue that:

1. These studies often define ‘growth’ as either backward-looking growth or as ‘negative value’ e.g stocks with high p/e or p/b ratios. Stocks can have high p/e’s because of earnings collapse (e.g. a steel stock) as well as strong growth prospects. Similarly high p/b ratios do not necessarily imply above average growth. Our definition of growth is more forward-looking and inevitably requires considerable judgement, especially for stocks that are changing or are affected by cyclical factors.
2. The ‘inflation bail out’ of weaker companies from the 1960s to the 1980s has heavily influenced the results of such studies.
3. More recent numbers show growth performing better.

* Business momentum

The evidence on estimate revisions across US, Continental Europe and the UK that we have seen backs up our approach. Even after revisions have been made and logged by IBES, First Call etc., those stocks with positive revisions tend to outperform subsequently and those with negative revisions underperform. This reflects, in part, the strong serial correlation that is normally found in analysts’ estimates. Stocks that have been upgraded are more likely to be further upgraded and stocks that have been downgraded are more likely to be further downgraded.

Within companies similar patterns emerge. A company that has issued a profits warning is more likely to subsequently issue another profits warning. Such trends often persist for longer than many market participants expect.

The behavioural finance literature contains many references to why investors’ response to change is often insufficient. In particular this can be due to the influence of ‘regret’ on decision-making where, as is usual, companies with poor business momentum have experienced poor price performance.

For example take a stock is currently priced at 100 and two investors, A & B, who hold identical negative views as to the outlook for that stock. The only difference is that A had previously bought it at a price of 50 whereas B had previously bought it at a price of 150. Since they hold equally negative views on the outlook for the stock they should be equally likely to sell the stock. Our contention is that B is less likely to sell the stock because it will cause him ‘regret’, having previously bought it at a higher price.

The American academic L Gross put it like this:

“Many clients, however will not sell anything at a loss. They do not want to give up the hope of making money on a particular investment, or perhaps they want to get even before they get out. The ‘getevenitis’ disease has probably wrought more destruction on investment portfolios than anything else”.

* Consistency

Studies in the US have shown that greater consistency in the historic progression of earnings has been associated with outperformance. This is rationalised as the result of the persistent over-optimism of analysts in their expectations for future earnings being greater for less consistent companies. Investors can therefore be more easily misled for companies with more volatile earnings. This is described by Hubert and Fuller:

“The less predictable the path of previous earnings, the more difficulty investors will have in detecting an optimistic bias in current estimates”.

The other rationale for the consistency element of our philosophy is that more consistent companies are particularly likely to outperform in times of economic distress. This will normally be the time when clients are most concerned about investment performance.

**Some questions we may be asked**

* What is the role of valuation?

Valuation plays an important role in assessing companies, but it is not the main driver of buy or sell decisions. We would not buy a stock that had poor growth, business momentum and consistency characteristics merely because it appeared ‘cheap’. We may, however sell a stock that had good growth, business momentum and consistency characteristics if we felt that the valuation was extreme.

The main valuation tool used is the P/E relative to the market or sector seen in the context of the stock’s relative growth prospects. Other tools such as EV/EBITDA, DY or DCF are used where it is considered appropriate.

* Are you price momentum investors?

No. Business momentum, along with growth and consistency, is a characteristic that we look for in stocks, and will tend to show a good correlation with price momentum. Thus price momentum for us will often be a confirmatory factor of our analysis of changes in the underlying business, but is not itself the driver.

* What is the role of judgement?

A substantial one. We will use quantitative factors to inform our view as to the extent to which a stock has the characteristics that we are looking for, but considerable judgement is also required. In particular when there is some evidence of a significant change in the outlook for a business (e.g. significant estimate revisions), judgement is required to assess whether the change is likely to be a substantial or enduring one. A key point though is that judgement is applied within the framework of our investment philosophy and process.

* What is your time horizon when arriving at stock views?  
  We seek to invest in companies that will make good long term investments and would expect many of them to remain in portfolios for long periods of time. However we are mindful that changes will inevitably occur that will alter our outlook on individual stocks.  
    
  In arriving at our outlook on a stock we are normally using a time horizon out to 2 years forward to project variables such as turnover and earnings. Projections made over periods longer than this tend to become less useful the further out the projection.  
    
  For some stocks where the pattern of sales, earnings and cashflows is more predictable (eg some pharmaceutical or utility stocks) using a longer time horizon can be appropriate.

**A possible quant input model**

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| --- | --- |
| **Weight** | Variable |
| 30% | 5 year historic earnings stability |
| 30% | Lower of FY2/FYO earnings growth and FY2/FY(-4) earnings growth |
| 20% | 12 month revisions to FY1 earnings |
| 20% | 3 month revisions to FY2 earnings |

## Other Possible Additions

Earnings surprise

Price momentum