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INVESTMENT MANAGERS

The Fallacies of Our Mind – IV

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'Mythbusters' is a popular Australian-American TV show which, for 16 seasons, investigated various myths or science-defying scenes from TV shows, movies, or from around the world. Ultimately their findings were labelled as 'Confirmed', 'Plausible' or 'Busted'. On similar lines, under the 'Fallacies of Our Mind' series, we have been investigating heuristics that are hard-coded in our minds. In the current chapter of this series, we test a long-lasting convention - **Buy Cheap, Avoid Expensive.**

Price to earnings multiple (P/E) and Price to Book multiple (P/B) are some of the primary tools used by analysts to value stocks. However, more often than not, investors look at historical earnings and price multiples to estimate value and future performance. However, historical performance is not a good indicator of how multiples change over time, rather they are determined by the expected future cash flows of a business.

Cigar butt investing, an investing strategy once propounded, quite successfully, by the greats such as Benjamin Graham and Walter Schloss, involves investing in companies which are trading much below their book value. Purchasing such businesses at a significant discount offers a margin of safety (optically) and the potential to make decent returns once the gap between the price paid and the value narrows or if the business liquidates for a higher value. These investors expect mean reversion will occur which will cause a re-rating in the stock.

Such a strategy works well when the markets are cheap and there are a lot of low priced opportunities available. Further, given that a large number of cheap stocks usually represent troubled businesses, such a strategy would require one to ignore business quality (except for times when a quality business is undergoing a short-term stress). However, the very act of ignoring the quality of the business may create a risk, as expounded by Warren Buffet in his 1989 letter to shareholders:

> *First, the original "bargain" price probably will not turn out to be such a steal after all. In a difficult business, no sooner is one problem solved than another surfaces - never is there just one cockroach in the kitchen. Second, any initial advantage you secure will be quickly eroded by the low return that the business earns. For example, if you buy a business for $8 million that can be sold or liquidated for $10 million and promptly take either course, you can realize a high return. But the investment will disappoint if the business is sold for $10 million in ten years and in the interim has annually earned and distributed only a few percent on cost. Time is the friend of the wonderful business, the enemy of the mediocre.*
>
> *You might think this principle is obvious, but I had to learn it the hard way - in fact, I had to learn it several times over. Shortly after purchasing Berkshire, I acquired a Baltimore department store, Hochschild Kohn, buying through a company called Diversified Retailing that later merged with Berkshire. I bought at a substantial discount from book value, the people were first-class, and the deal included some extras - unrecorded real estate values and a significant LIFO inventory cushion. How could I miss? So-o-o - three years later I was lucky to sell the business for about what I had paid. After ending our corporate marriage to Hochschild Kohn, I had memories like those of the husband in the country song, "My Wife Ran Away With My Best Friend and I Still Miss Him a Lot."*

In order to minimise such a risk, the investor will have to hold a highly diversified portfolio of securities. Additionally, given that the strategy bets on a mean reversion over the short term, rather than over many years, the investor faces a high re-investment risk. Net-net, while buying cheap works, it requires a very high effort on the part of the investor in having to find a large number of cheap stocks all the time. As mentioned earlier, while such a strategy might work favourably in the cases of a sharp downturn in the markets (in which case the investor's willingness to invest may be extremely low, although that is a separate discussion altogether), the investor may struggle as markets start to rise.

On the other hand, the long-term investor that invests in high quality businesses, need not worry about reinvestments, so long as the business continues to deliver on his expectations. However, it is generally believed that high quality businesses seldom trade cheap. Should the investor then ignore valuations altogether and focus only on quality or should the investor look for high growth businesses so that the earnings growth makes the valuations look cheap in the future (p-e-g ratio)?

Ignoring valuations can be detrimental to portfolio returns. While business quality can prevent a permanent loss of capital over the medium term, extreme valuations can lead to sub-optimal returns in the near term. While in 'Predictions, Timing, and Time in Market' we noted that '*good quality businesses, even if bought at the peak of the subprime crisis, would have given enviable returns till date*', we note that such returns have come over a period of 7-8 years.

On chasing higher earnings growth to justify higher valuations, consider the following:

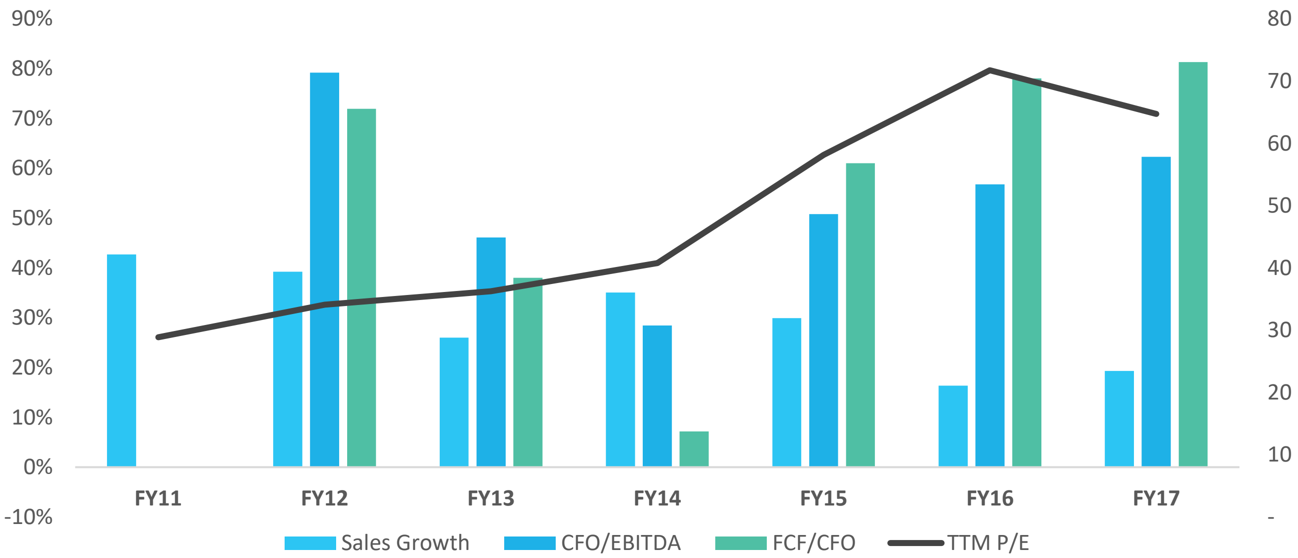
Figure 1: Historical Financial Performance (FY11-17)

	FY11	FY12	FY13	FY14	FY15	FY16	FY17
YOY Sales Growth (%)	43	39	26	25	30	16	19
EBITDA Margin (%)	21	21	20	22	21	21	21
ROCE (%)	48	60	64	65	62	62	60

Source: AceEquity, Tamohara

The above table is a small extract of Page Industries' journey in India. What we can notice is that the company's high growth phase started tapering off after FY15 into a moderate growth phase. However, throughout these phases, the company has maintained steady operating margins and ROCE.

Figure 2: Historical Metrics (FY11-17)



Source: AceEquity, Tamohara

Conventional wisdom suggests that high growth companies should have high P/Es and low growth companies should have low P/Es. However, the above chart would suggest otherwise. The P/E ascribed to the company skyrocketed despite sales growth tapering off. One will notice that the company's free cash flow conversion significantly improved in the second phase. This would explain the company getting re-rated despite its sales growth slowing down.

You would re-collect that we carried out a similar exercise in 'Cash is King' where we demonstrated cash flows are a better return metric than profit margins or sales growth alone.

Thus, on a trailing basis, Page Industries has never been cheap and yet, it has displayed robust earnings growth consistently. An investor would have missed out on an 81x wealth creation journey since 2007 if they had avoided the stock because it was expensive.

While Page Industries is an oft used example, it is not an isolated case study. The following quality stocks have been staunch wealth creators while continuing to remain expensive.

Figure 3: Comparative Financial Performance (FY10-17)

	P/E (FY07)	Median P/E (FY07-FY17)	Wealth Creation* (CAGR)
Asian Paints Ltd	26	30	30%
Berger Paints India Ltd	13	20	35%
Bosch Ltd	27	29	20%
Castrol India Ltd	20	28	16%
Colgate-Palmolive (India) Ltd	28	34	20%
Hindustan Unilever Ltd	27	29	15%
Pidilite Industries Ltd	26	28	29%
Procter & Gamble Hygiene & Health Care Ltd	27	42	27%
Zee Entertainment Enterprises Ltd	45	25	17%

Source: AceEquity, Tamohara | * Does not include dividends; Data upto 31 March 2017

Rarely in real life will you find compounders for cheap. However, what may look expensive on the basis of earnings, may not eventually be that expensive if cash flows are accounted for. Eventually, even Warren Buffett, after meeting Charlie Munger, moved on from cigar butt investing. For decades now, Berkshire Hathaway's investing style involves looking for high quality businesses with durability of earnings and being willing to pay a premium for it. The following is an extract from the same 1989 letter to shareholders:

> *It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price. Charlie understood this early; I was a slow learner. But now, when buying companies or common stocks, we look for first-class businesses accompanied by first-class managements.*

Until next month…

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