

A good company versus a great investment

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For as far as we can remember, the quest for finding a great investment has always started with the search for a great company. We define a great company as one that grows earnings and free cash flows at a predictable click, has a leadership position within the industry that it operates in, generates free cash much beyond its growth requirements, and distributes that to shareholders consistently. Along these lines, different fund managers have developed their own version of the holy grail of processes they follow to arrive at their pick of a great business.

India has had a limited equity investing history (25 years in the overall scheme of things is not long enough), and for most of that time, a great company has always stayed a great investment. But the externalities then and now are very different. In this article, we want to convey our views on how that belief leads to market cycles, and we can have a more successful investment experience by understanding that cycles exist and investing through them.

It starts with a prediction problem — it is a problem because we think we can predict accurately, when in fact, we cannot.

"Credit ratings help facilitate an efficient capital marketplace. They provide transparent third-party information that's not only forward-looking but standardized for consistency" says S&P Global Ratings on their website. Ratings range between AAA (the highest rating – the obligator has an extremely strong capacity to meet its financial commitment) and D (the obligator has defaulted on obligations).

Typically, the AAA rating is reserved for a handful of the world's most solvent governments and best-run businesses. Just before the global financial crises started (around 2007), S&P had awarded an AAA rating to thousands of mortgage-backed securities (they were the financial instruments that allowed investors to bet on the likelihood of someone else defaulting on their homes). A AAA paper signalled that there was only a 0.12 per cent probability (or one chance in 850) that it would fail to pay out over the next five years. As the crises hit, S&P's internal figures suggested that around 28 per cent of AAA-rated CDOs (collateralized debt obligations) defaulted (some independent estimates are higher). That means that the actual default rates for CDOs were over two hundred times higher than S&P had predicted.

Let's take another example. In December 2007, economists in the Wall Street Journal forecasting panel predicted only a 38 per cent likelihood of a recession over the next year. We know what transpired, but this was especially remarkable because the data would later reveal that the economy was already in recession at the time of the forecast!

In 1971, it was claimed that we could predict earthquakes within the decade, a problem that we are no closer to solving fifty years later. And the list goes on.

The 'prediction problem' is then compounded because we are so convinced about our ability to predict that we leverage our bets to the hilt.

In 2007, the total volume of home sales in the United States was only about $1.7 trillion, but the total volume of trades in mortgage-backed securities was about $80 trillion. Every time someone was taking out a mortgage worth one dollar, Wall Street was making a side bet worth $50.

Or take nuclear power plants. World Nuclear Association calculated the life cycle costs of different sources of power and concluded that nuclear power is cost-competitive with other forms of electricity generation. Seismologists then looked at past data and built the Fukushima nuclear reactor to handle a magnitude 8.6 earthquake, because "anything larger was impossible". In March 2011, Japan witnessed a horrible 9.1 magnitude earthquake, and the resulting tsunami damaged the plant's three active reactors. Loss of backup power led to overheating and meltdowns. According to the International Nuclear and Radiological Event Scale (INES), it was a scale 7 major accident (highest possible accident) and the only one other than Chornobyl to date. After the accident, the authorities shut down the nation's 54 nuclear power plants. The Fukushima site remains radioactive, and some 30,000 people had to be evacuated. The clean-up job will take 40 or more years and will cost tens of billions of dollars.

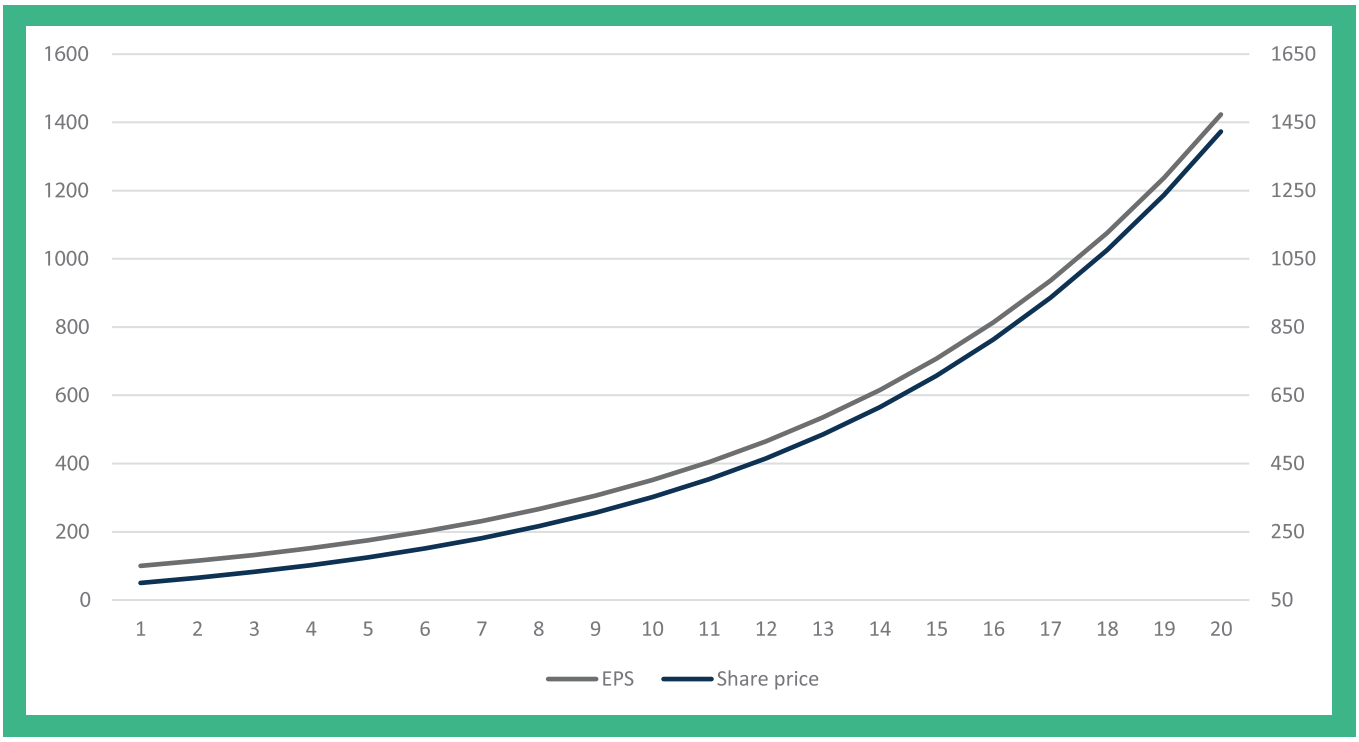
In the context of markets, this situation (prediction problem compounded by leverage) gets exacerbated by its unique features. Add to this the fact that the marginal/most motivated buyers and sellers decide the pricing in markets; the majority's opinion does not matter. Finally, technological advancements have compounded that problem. Now, algorithms and fast computers rush to execute the trade if the suggested rule is triggered.

Now let's put that all together. We 'predict' that the stock will rise, talk to several people who agree with our prediction, and look at research by analysts who believe the stock is a Buy. We then 'leverage' ourselves to take the maximum advantage. Predictions are based on things that have happened in the past, but things that have never happened before are happening all the time now. When that transpires, the majority of stockholders who were positive continue to be positive, but the one with the biggest leverage (marginal/most motivated seller) is forced to sell. Algos chimes in too because they are told to run if certain rules are triggered. The stock falls below its fair value and the cycle then repeats in reverse. That creates the cycles.

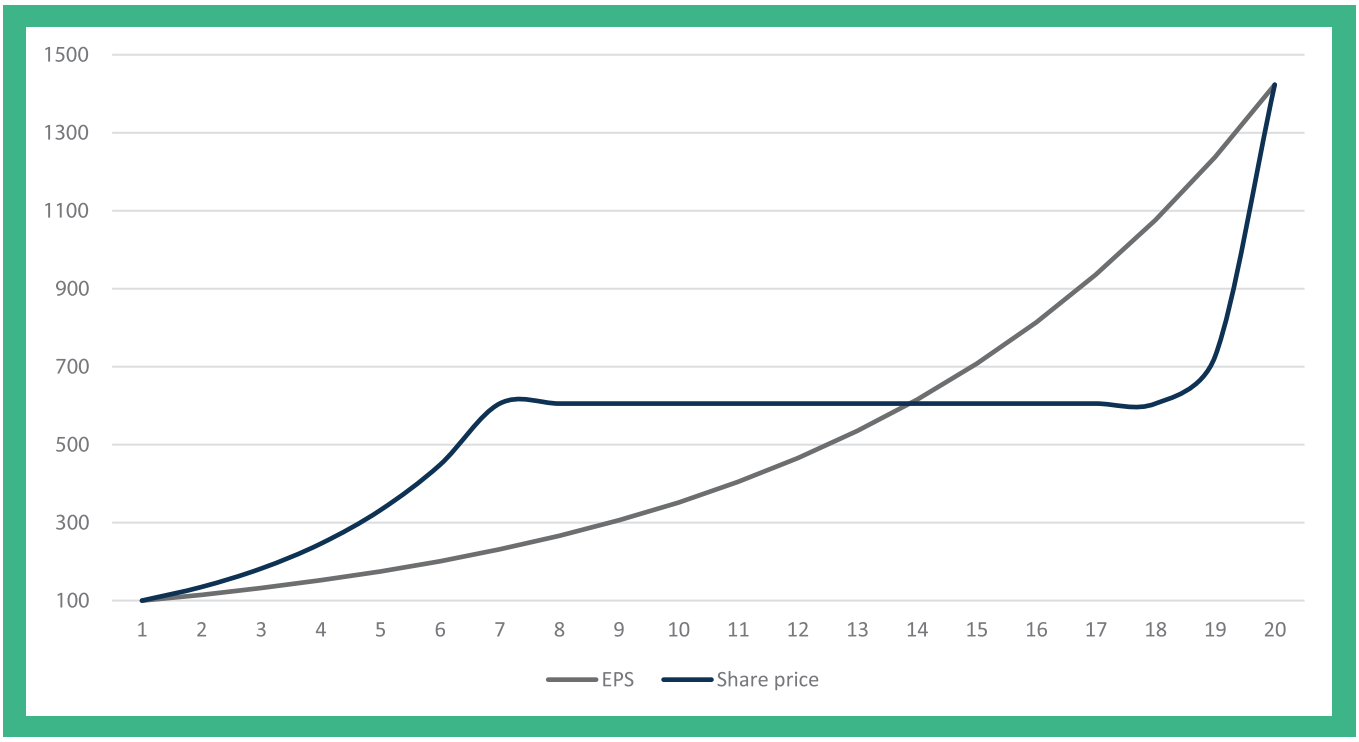
So how does one counter this?

First, being aware that cycles exist is extremely critical. For a company that is growing its fundamental value (say EPS or FCF growth) by, say, 15 per cent each year, the assumption that the stock price will also steadily rise, at the same rate each year, is fraught with risks.

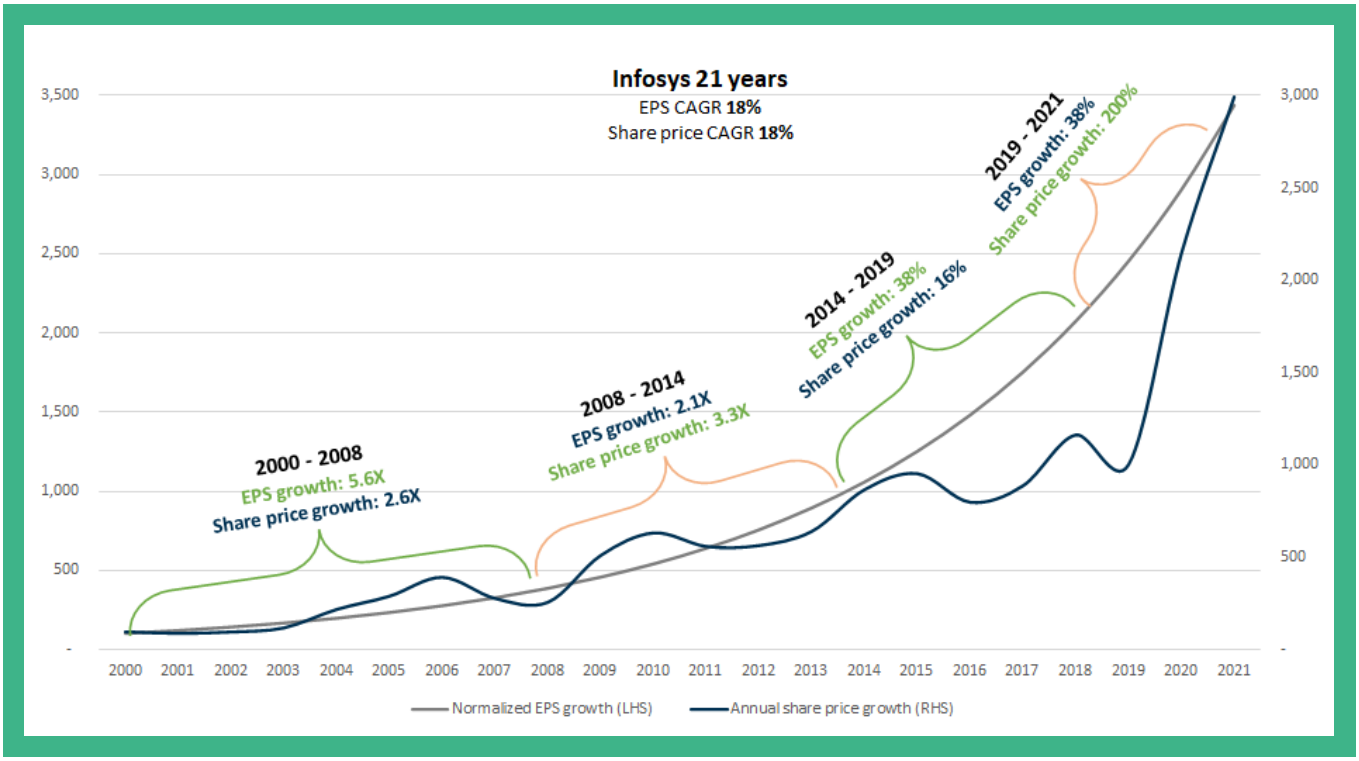
The exhibit below is what "a good company is always a great investment" theorists believe. If earnings are growing at a certain rate, the stock price "must" also follow the same rate of growth.

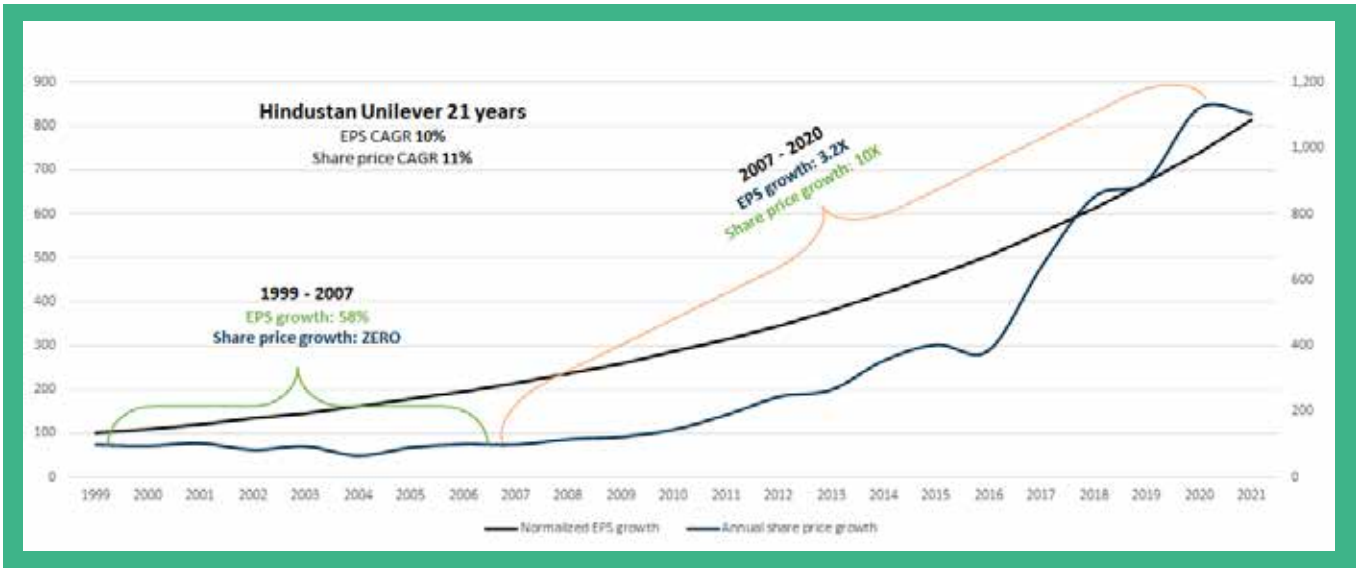


In practice, however, the exhibit below is what the relationship loosely looks like. The markets get excited to "discover" a business that is growing and start ascribing higher multiples, which, in turn, pushes the value of those businesses higher than fair value. At a certain point, the markets realize that valuations have moved ahead of fundamentals, and the correction phase starts. During this phase, the earnings of the business are still growing, but the stock price starts stagnating (or even falling).



Let us look at a few practical examples now. As the two charts below show, we could be following shorter cycles (as in the case of Infosys), or much longer cycles (as in the case of Hindustan Unilever). Enter at the wrong time, and we underperform for years, if not decades.

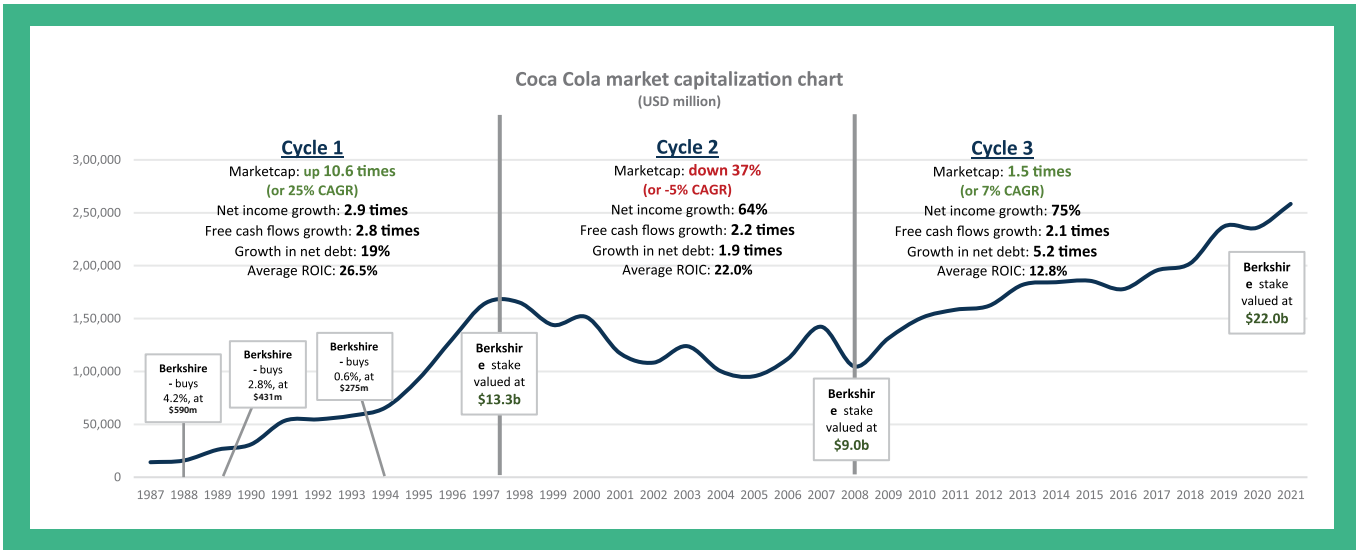




Second, applying the reasonableness filter helps. I might believe that iOS offers better privacy than Android, and hence choose to use the iPhone. But I am a potential consumer only until the iPhone is offered to me at a marginal premium to Android. If the iPhone costs five times the rival's price, they lose me as a consumer. What we pay for what we buy matters. As consumers, we know it; as investors (when buying a business), we sometimes tend to forget it.

All investors, professionals and budding alike, like to follow Warren Buffett and emulate his investment philosophy. Many often point out that Berkshire Hathaway bought Coca-Cola Inc in 1988 and it continues to feature among its top holdings even now. The chart below breaks the path of Coke over three cycles, with valuations moving ahead of fundamentals in cycle one, and then reversing in cycle two. The point that I would like to note is that the majority of Berkshire's investment in Coke happened by 1989.

It is true that it hasn't sold any of those holdings, but unlike many investors who incessantly quote (often misquote) Buffett, they did not increase holdings even when the stock fell close to 40% in cycle two.



In the end, as human beings, we are wired to recognise the patterns that we see. We may not have many natural defences – we are not very fast, or all that strong. We don't have claws or fangs or body armour. We cannot spit venom or camouflage ourselves. And we cannot fly. And yet, we are at the top of the natural food chain, and a baby can recognise the basic pattern of a face within months of birth. It's not the learning of the individual, it has been learned through evolution. Our investment experience would be much better if we let evolution take over and recognise how these cycles have always existed and incorporate that into our journey instead of fighting it.

