Investing In US Equities

Concentration on quality

High quality franchises with a global outlook can deliver returns well ahead of the US market, finds **Joseph Mariathasan**. But it can be a bumpy ride

The US equity market is the largest in the world, and for US investors, it can be an effort to invest overseas, when even exposure to fast growing emerging market economies can be undertaken from the perceived safety and security of familiar domestic names with global operations.

"Roughly half of the profits of the companies we own are generated from outside the US, so we see ours as a globally diversified portfolio although we are a US-centric manager," declares CT Fitzpatrick, the founder and CIO of Vulcan Value Partners in Birmingham, Alabama. Brown Advisory based in Baltimore, a growth manager, has similar exposure with 55% of revenues from outside the US and only 12% from Western Europe. "The level of sophistication today of a typical US corporate executive is very different from the mid 1980s," argues Ken Stuzin, US portfolio manager. "Nowadays, typically, a new executive in a US corporation operating in the emerging markets would have originated from there but benefited from the US educational system. A US business school today is truly a multi-cultural experience. In 1993, when I was attending, Columbia Business School probably only had around a third of its intake from outside the US. Today it is probably close to half."

Stuzin adds that, with these globalised companies deploying global brands, the most important valuation multiple is probably 'PEG' – the ratio of the price/earnings to growth rates: "Good US companies might be a better bet for emerging market exposure in terms of the PEG ratio."

As such, the home bias of US investors inevitably leads many to regard this broad-based US marketplace as the core of their equity portfolios. But non-US investors are likely to adopt a different view of the opportunities in the US marketplace and the strategies of fund managers to outperform.

The US has led the way in characterising managers by style, growth, value or core. Growth managers have the image of seeking the next Google in their analysis, with a short-term horizon (and hence a high turnover). Value managers are stereotyped as looking for safe and secure stocks – utilities rather than tech. While benchmarks such as the Russell 1000 index and the Russell 1000 Growth and Russell 1000 Value indices include hundreds of stocks, many of the best performing managers in core, growth and value strategies have highly concentrated portfolios and long time horizons: Morgan Stanley Investment Management (MSIM) has around 40 names with a 20-30% annual turnover in its US growth strategy, according to lead portfolio manager Dennis Lynch; Brown Advisory, another growth manager, has 30-35 names with around 50% turnover; Brown Brothers Harriman (BBH) has 20-30 names and a 15-20% turnover in its Core Select strategy, according to co-manager Michael Keller; and Vulcan, a successful value manager, has 25 names. While these four managers represent styles encompassing value, growth and core, what is fascinating is the amount they have in common in their approaches to constructing US equity portfolios.

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Attributes

Producing a concentrated portfolio inevitably requires screening. BBH starts with a qualitative screen based on the philosophy that any investment must have six main business attributes: essential products and services; loyal customers; leadership in an attractive market niche/industry; sustainable competitive advantages; high returns on invested capital; and a strong balance sheet and free cash flow. This reduces the universe to around 150 stocks and this is independent of company valuations.

Vulcan also limits its search qualitatively. As Fitzpatrick says: "By our definition good businesses produce free cash flow. We want to invest in businesses that have sustainable competitive advantages that are becoming more competitively entrenched."

Warren Buffett's influence is felt strongly in all the firms, which want to invest long-term in businesses with deep 'moats' that are getting deeper. Brown Advisory, which explicitly cites Buffett's influence, has to follow a rigorous and drastic approach to reach a portfolio of less than 40 stocks selected from a screened universe of 3,000. In addition to a quantitative screening process that weekly reviews those names based on a variety of standard criteria, and another qualitative screen that turns 400 stocks into 250, it applies what Stuzin calls 'Darwinian capitalism': "We start off with a concentrated portfolio, and if we buy a new name, we need to sell something." It looks for companies with a growth rate of 14% or better over an economic cycle – double the 7% long-term earnings growth rate of the broad market. But despite weekly screening, the firm's target holding period is 4-5 years which, as Stuzin points out, compares with the average holding period of three months for S&P500 stocks.

Nonetheless, the key attributes of desirable companies do vary significantly, both in terms of philosophy and stock level, and these are not necessarily related to whether the manager has a growth or value style.

"We try to understand what it is that produces a sustainable growth rate for a company going forward," says Stuzin. "Is it intellectual patents? Is it economies of scale? What is unique about the business model that protects the company from competition?"

MSIM looks for sustainable competitive advantage and then the quality of the firm's business: does it have a renewable or contract business model; is there a diverse customer base; is there a rising return on invested capital? The quality of growth is also examined – organic is preferred over acquisition-driven, secular over cyclical, and low capital intensity and above-average revenue growth is best. It also tries to identify companies that are under-appreciated, perhaps because of a relative lack of coverage in the case of small-caps, or because they are special situations such as spin-offs or companies transitioning between market-cap categories. Stocks can fly under the radar because of conventional valuation bias (market participants' general reliance on metrics like P/E), coverage bias (misuse of traditional heuristics to evaluate companies with new or unique business models) or simple short-term bias (overemphasis on the next event).

"Monsanto is a case in point. The company was a chemical company but it shifted to genetically modified food for decades," says Lynch. "Experts found it difficult to understand how it could be so highly valued." Starbucks is another example. Lynch says: "We bought Starbucks three years ago after they had problems, having grown too quickly in the US and overreached themselves. They still had a premium P/E ratio to the market of around 20%, but most people said their growth potential was over. It was seen somewhere between a restaurant and a consumer staple, but we bought it at a lower P/E – closer to a restaurant. But Starbucks is unique, and similar to tobacco in the sense that coffee is addictive, [and coffee-drinkers tend to show] customer loyalty. Now they are becoming better understood."

The differences between styles do come out in specific decisions. Growth manager MSIM does not own Microsoft, for instance. "Microsoft has a lot of positive historical attractions and a strong balance sheet," says Lynch. "But with the rise in open-source software, it's more difficult to forecast the economics with confidence. Products which customers will pay a lot for right now could be given away for free in 5-7 years." Stuzin at Brown agrees: "Microsoft, Cisco, Dell, etc just do not grow fast enough for us as the law of large numbers kicks in."

By contrast, while it has lowest weighting in its portfolio core manager BBH does own Microsoft: "It still has the largest p latform in the marketplace with 600,000 or more developers working on it," says Keller. "There are millions of businesses who have standardised on it and would not move in a hurry, so there is a real annuity value to Microsoft with such a large footprint. The risk of it being unseated in even a decade by untested technologies is low." Value manager Vulcan is also an investor: "If you strip out the cash on the balance sheet, it is trading at 10-times earnings, and there are significant barriers to entry," notes Fitzpatrick.

Now let's take Apple. It is on Vulcan's list of companies to follow, but not in the portfolio because of its valuation. BBH's Keller feels that it could be heavily affected by shifts in consumer taste – like Google, it is on the firm's 'wish list' but not in the portfolio. But while Apple may not be attractive to a value investor like Vulcan, Brown does see it as attractive: "We bought a full position in Apple at $88.75 in the depths of the recession and today Apple is at $335 – but the future multiple is still the same or even cheaper," Stuzin marvels. "The reason is because of issues like the health of Steve Jobs. Apple did well, not because of P/E ratio expansion, but because of the earnings expansions. Its future success is not based on launching a new gizmo, but on executing its current business plan."

So while these concentrated high-quality portfolios necessarily share characteristics – macro-economic analysis counts for very little compared with bottom-up stock analysis at any of these shops, for example - it is clear that views on the sustainability of a major company such as Microsoft and the valuation of a company like Apple, for example, can be very different.

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Risk

There is more overlap when it comes to risk management. What most agree on is that market volatility is not the most relevant issue – again not surprising when they have long holding periods for quality growth stocks. Compare Vulcan's positioning in Mercer's tables over the shorter one-year and three-month time periods with its showing over three years. "We define risk as the probability of losing permanent page 74

capital over our five-year time horizon," says Fitzpatrick. "Market volatility is not risk. Market volatility creates opportunity for long-term investors who understand that price and value are not always equal."

BBH's Keller echoes this viewpoint: "Even a year is short-term, so we are not concerned about volatility. What matters is the risk of a permanent loss of capital." BBH believes there are two components to a margin of safety: first, the type of businesses it invests in; and second, the price at which it is willing to invest. It only buys at 75% or less of its calculation of a business's intrinsic value. "There are not that many opportunities so we tend to be opportunistic," as Keller puts it. Even so, companies need to be on the 'wish list' to be considered, so even as BP's price was plummeting, BP was not on BBH's radar, as it was "not a company that we would want to own for a long time".

For Brown Advisory's Stuzin, risk is "what happens to my stocks in a down market", and the solution is "being in bed with the best business models… I'm not smart enough to deal with macro events by changing the portfolio a lot during the year," he says. The firm sees itself as an anti-momentum investor. "In the US, there is a deep fear about being out of synch with the market and the peer group," he observes. "We take a different view based on two steps: firstly, a deep understanding and ownership of the best growth companies in the US; and secondly, optimising the positions to match the upside/downside profiles. Momentum investing, by contrast, is the exact opposite since it allows position sizes to grow in those stocks that have done the best."

What is evident is that for these managers, risk is very company-specific and mitigated by strong brands and franchises and tremendous free cashflow. "During the crisis in 2008 a lot of companies needed capital," notes Fitzpatrick. "Our companies did not. Instead, they got stronger and increased their market share."

This is not to say that portfolio-level risks above and beyond those idiosyncratic risks do not exist. For a start, such 'concentrated-quality' portfolios will inevitably suffer, relatively, during a 'dash to trash' such as that witnessed during 2009; and they can and do lead to entire sectors being left out – in some cases permanently.

BBH's wish list of 150 companies, for example, has remained fairly static. It does not invest in highly regulated electric utilities, nor airlines nor autos. It only found a handful of banks that were attractive as businesses and has invested in Wells Fargo and US Bancorp.

MSIM has never bought financial companies: "It is hard for an outsider to analyse large banks and really understand the risks so we would typically not own them" says Lynch. For a growth investor, growth rates are clearly also important: "We are underweight US consumer staples as it is difficult to find companies growing fast enough," says Brown Advisory's Stuzin. More positively, MSIM has a bias towards companies that use the internet, avoiding traditional software and hardware companies because of the risk posed by trends like cloud computing. "If there was something that disrupted the internet on a global basis, yes it would hurt us short-term, as it is more of a portfolio risk for us than for some others," Lynch concedes. "But we wouldn't expect this to be an event which caused significant impairment of value over the longer term."

But it is vital for a European investor to bear in mind that a US equity portfolio does not necessarily have to look like the US market, let alone the US economy. Finding managers able to produce outperforming concentrated portfolios gives the ability to produce portfolios that have much more to do with global growth opportunities.

MERCER US Equity Large Cap Core
All Funds: top 10 ranked by 3-year returns to 31.12.10

Manager/Fund	3 months		1 year		3 years		5 years	
	(%)	Rank	(%)	Rank	(% pa)	Rank	(% pa)	Rank
Crescat - Crescat Large Cap	12.84	28	24.92	8	4.95	1	10.26	2
Leylegian Investment Mgmt	-3.22	351	7.34	333	4.55	2	4.63	54
Nicholas Company - Large-Cap Growth	12.35	43	21.85	13	4.34	3	5.07	41
Brown Bros Harriman - BBH Core Select	7.94	328	16.07	96	4.19	4	7.99	6
Maverick Capital	7.22	334	16.45	84	4.11	5	8.60	3
Select - Great Jones Fund	6.81	339	16.16	92	3.96	6	na	
Wells - Berkeley Street Large Cap Equity	11.96	63	17.65	52	3.23	7	6.32	14
CE Asset Management - USA Quality Equity	11.01	146	18.64	40	3.13	8	7.19	8
Bel Air - Select Equity	10.37	237	12.38	268	2.75	9	7.12	10
Hillsdale - US 130/30	13.21	16	25.46	4	2.68	10	na	
Number of funds	351		342		322		279	
Upper Quartile	11.53		16.32		-0.73		4.31	
Median	10.87		14.65		-2.27		3.00	
Lower Quartile	10.06		12.63		-3.45		2.18	
Russell 1000	11.19	123	16.10	98	-2.37	173	2.59	180

MERCER US Equity Large Cap Value
All Funds: top 10 ranked by 3-year returns to 31.12.10

Manager/Fund	3 months		1 year		3 years		5 years	
	(%)	Rank	(%)	Rank	(% pa)	Rank	(% pa)	Rank
SaratogaRIM Value	8.89	255	14.29	144	7.90	1	10.48	1
Vulcan Value Partners Focus	8.36	272	13.37	189	7.11	2		
Vulcan Value Partners Large Cap	8.47	271	13.01	202	6.81	3		
Vulcan Value Partners Focus Plus	9.28	246	14.86	121	6.03	4		
O'Shaughnessy - Market Leaders Value	4.67	300	16.53	61	5.17	5	8.23	2
Coho - Relative Value	8.22	275	16.03	75	4.47	6	7.06	6
Harris Associates - Concentrated	12.90	38	19.59	13	4.42	7	7.08	5
Neuberger - Systematic Large Cap Value	9.74	223	13.45	185	4.30	8		
Equity - Large-Cap Value	8.52	268	16.82	54	4.06	9	6.34	11
Atlanta Life - Large Cap US Value Equity	11.60	84	19.23	16	3.42	10	7.01	7
Number of funds	301		293		279		261	
Upper Quartile	11.73		16.12		-1.15		3.93	
Median	10.65		14.23		-2.80		2.60	
Lower Quartile	9.70		12.49		-4.26		1.35	
Russell 1000 Value	10.54	159	15.51	92	-4.42	217	1.28	199

MERCER US Equity Large Cap Growth
All Funds: top 10 ranked by 3-year returns to 31.12.10

Manager/Fund	3 months		1 year		3 years		5 years	
	(%)	Rank	(%)	Rank	(% pa)	Rank	(% pa)	Rank
Brown Inv Advisory & Trust Co - Lrg Cap Eq Grwth	12.10	136	25.73	9	7.35	1	9.94	1
Morgan Stanley - Capital Growth	12.28	123	24.00	14	5.96	2	8.92	2
Polen Capital Mgmt	11.01	194	15.67	145	5.26	3	8.25	3
Atlanta Capital - High Quality Focused Growth	12.96	81	18.63	76	5.08	4		
Red Granite - Large Cap Growth Equity	12.07	137	17.48	100	4.94	5	5.59	32
Sands - Select Growth Equity	15.70	4	27.22	6	4.19	6	5.12	43
Wentworth - WHV Large Cap Growth	15.21	8	21.52	31	3.99	7		
ICC Capital Mgmt - Growth Performance	11.16	186	16.65	123	3.98	8	4.54	69
Oak Associates - Select Growth Portfolio	10.67	205	12.57	216	3.41	9	4.44	73
Natixis - Large Cap Value Equity	11.45	171	14.24	178	3.30	10	5.00	47
Number of funds	271		260		248		231	
Upper Quartile	13.18		19.02		0.20		4.78	
Median	12.10		16.28		-1.21		3.77	
Lower Quartile	10.80		13.43		-2.91		2.42	
Russell 1000 Growth	11.83	154	16.71	123	-0.47	85	3.75	118

All rates of return are before tax and before management fees in dollars. Rates of return are annualised for periods exceeding one year.

Source: Mercer Copyright 15 Feb 2010

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