Eleon Capital Management Ltd.

- MARKET OUTLOOK -

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It has long been advocated that the best financial investment is buying stocks in a company with a high return on invested capital (ROIC), that has reasonable growth prospects in which the retained earnings can be deployed and whose free cash flow/economic fundamentals can be projected with a relatively high degree of predictability and bought at a fair price.

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In recently studying the fundamentals of a fund manager, [Michael J. Mauboussin](), postulated to his audience the choice of two stocks. Stock A had a high ROIC (say 20%) and Stock B had a low ROIC (10%) – he also assumed a long holding period and that neither stock pays a dividend. As expected, overwhelmingly, the audience chose Stock A over Stock B. He went further and told the audience that Stock A was selling at 4 x book value, whereas Stock B was selling at 2 x book value. In this instance, the responses were mixed – the perceived value factor confused the audience. Next, he told the audience that after the long holding period, Stock A had rerated down and sold at 2 x book value, whereas Stock B had rerated upwards and sold at 4 x book value. The audience overwhelmingly chose stock B. Surprisingly the correct answer in all three scenarios was always Stock A. He reasoned that people make such mistakes because: a) they do not intuitively appreciate the power of compound interest over a long period of time, and b) misjudge the contribution to company performance of the reinvestment of retained earnings – in fact, in a separate study that a fund manager found that an investor with perfect foresight who bought the market index at its low and sold at its high over a long period would only account for 20% of their overall return achieved whereas the reinvestment of retained earnings would contribute the balance.

In a separate study, Michael Mauboussin (ROIC Patterns and Shareholders Returns 2008) found that the performance of the highest-rated ROIC stocks in the Russell 3000 index (segregated into ROIC quintiles) did not outperform the index over a ten-year holding period. In fact, quintiles 2, 3 and 4 did better with lower volatility. He then broke down the universe of stocks into 25 groups based upon their initial ROIC and their final ROIC at the end of the holding period, e.g. Q2, Q1 would comprise those stocks whose initial ROIC was in quintile 2 but eventually move to quintile 1 by the end of the holding period.

The results were quite interesting:

- *The* market rewards improvement and punishes worsening ROICs. In other words, going from Q3 to Q1 yields higher average returns and vice versa.
- *Companies* that defy the powerful force of mean reversion and sustain either good or poor performance also deliver noteworthy, i.e. significantly above or below-average returns.
- *Finally*, there are clear return implications for companies that sustain unusually good or poor ROIC performance.

The author concluded by saying: "This analysis suggests a simple commonality in extreme returns: expectations for future ROICs were mispriced.

…Central to exploiting this opportunity is an ability to correctly anticipate a company's future competitive position that is better or worse than what today's price implies."

My conclusion based on these studies would be that

…our 'hunting grounds' should almost always be in stocks that can sustainably earn above average ROIC and identify where these are most mispriced -

there are very few companies that meet such criteria – in fact, most fund managers who believe in such an investment, have the strategy and have a very small investable universe comprising of at most 80 to 100 shares. To further put this into context, the entire market cap of the US is comprised of approximately 3000 stocks.

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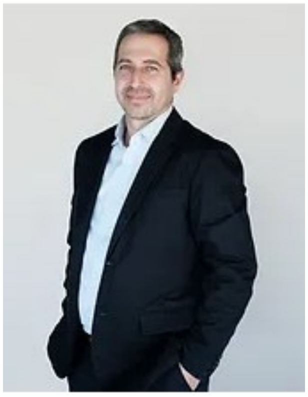

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