Eleon Capital Management Ltd.

- MARKET OUTLOOK -

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What does it mean to buy a stock at a fair price? One of the nuances of valuation that investors generally misunderstand can best be illustrated with an example:

Suppose there are two companies, Company A and Company B. Assume both companies have Invested Capital (IC) of $1000 and Company A earns a free cash flow of $100 whilst Company B earns $200, implying a Return on Invested Capital (ROIC) for Company A of 10%. In contrast, Company B has a ROIC of 20%. Finally, assume that the long-term discount rate for both companies is 10%. In this instance, the fair valuation of Company A would be $1000 ($100/0.1), whereas the fair valuation of Company B would be $2000 ($200/0.1). Thus, an investor in either Company A or B would earn a return of 10% on their investment if they had bought the shares at fair value, i.e. the discount rate, even though Company B earns a higher ROIC.

From this simple valuation example, we can deduce that: : a) all else equal, a company with a high ROIC should trade at a higher valuation than a company with a lower ROIC; b) buying at fair value implies the return to the investor will be the discount rate, not the ROIC that the business generates; and c) the greater the spread (both above or below) between the companies ROIC to the discount rate the greater the probability of value creation or destruction to the valuation of the business.

This then poses an interesting question: How would an investor that buys a stock at fair value choose between a multitude of stocks if the expectation would be to earn the discount rate applied?

In the January 2023 Net Assessment, I showed the empirical results of an investigation undertaken by Michael Mauboussin.

The two stand-out points of the analysis were: a) the stocks that had above average ROIC outperformed those with below average ROIC, and b) the stocks with above average ROIC and positive re-ratings to their ROIC performed the best. This analysis indicates empirically that high-quality stocks are generally and systemically underpriced. While there is a multitude of reasons for this, there are two factors that can be emphasized for now that partly account for this phenomenon: a) as noted previously, the greater the spread between the ROIC and the discount rate, the lower the risk of value destruction; and b) the economic principle of mean reversion, i.e. competition will drive the above average ROIC of a company to the mean. Most valuations of companies assume this. Whilst a very valid and plausible economic argument, there are some companies where this principle does not apply and such companies, because of a sustainable competitive advantage that they have, can maintain a high ROIC. Such companies with persistent ROIC will almost always be mispriced.

How should an investor construct better portfolios to outperform the market and maximize risk -adjusted returns:

- An investor's 'investable universe' should focus on companies with above-average ROIC and reasonable growth prospects to deploy retained earnings.
- Understanding companies' competitive advantages in the persistence of ROIC and the expectations embedded into the valuation should identify where mispricings are most evident.
- According to the Kelly Criterion formula, simply overweight those stocks in the portfolio with the highest expected return.

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Strong Roots, Sustainable Growth

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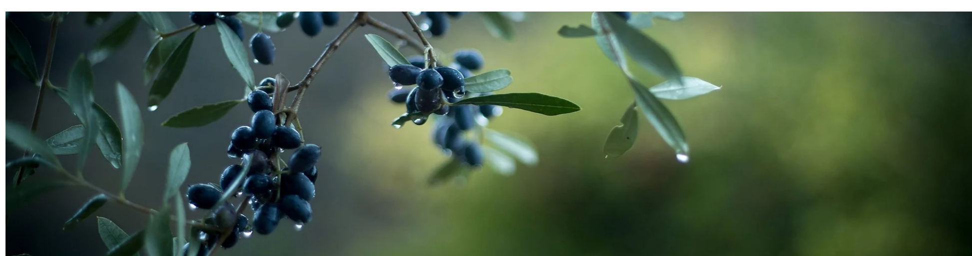

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