Beyond the Style Box

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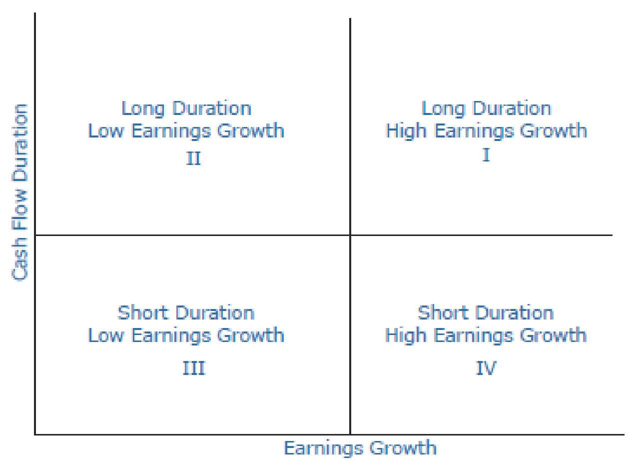
As growth stock investors who focus solely on owning good businesses, we accept the notion "growth" comes in many forms and is interpreted and accessed very differently from one growth manager to the next. This partially explains the significant range of returns within a universe of growth stock managers. Examples of sub-styles include cyclical growth, stable growth, second derivative momentum, durable growth, busted growth – the list goes on. The investment industry's ubiquitous adoption of equity style boxes skims the surface in recognizing these style differentials. In this paper, we discuss our view of businesses through a more detailed lens which is valuable to us both as a framework for analysis and a means to communicate our approach to clients and their advisors. Additionally, this tool may be valuable to a broad spectrum of equity investors as a "second level" perspective which adds precision beyond the traditional style box construct.

We refer to our analysis as cash flow duration, and the tool we use is the four-quadrant chart identified below. Individual companies are located within quadrants based on their combination of expected cash flow duration and earnings growth. The purpose of our paper is to describe this analytic framework as a means for examining individual stocks, portfolios, and investment styles, within the broad universe of equity investing.

Exhibit 1: The duration-growth quadrants



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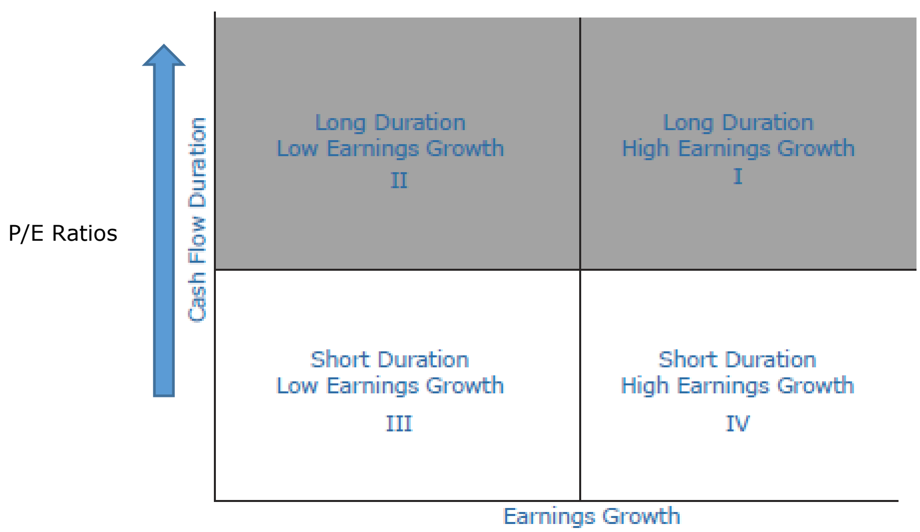
A crucial mindset of our investment approach is that superior returns are generated by discovering where consensus is incorrect. We seek to arbitrage consensus perception with reality. For this reason, our process actively integrates the duration–growth quadrants utilizing two different lenses. First, we use the concept to understand *market expectations* for cash flow duration and earnings growth. A stock's valuation can tell us much about the market's assumptions for both. Second, we use the framework to compare *our expectations* to the market's expectations. Significant value-added is achieved when our fundamental and valuation expectations place a company in a different quadrant, or in a different location within a quadrant, versus the market's expectations. We can also add significant value if we correctly predict a company will migrate toward another quadrant before the market recognizes the transition.

There are significantly different attributes to stocks across each of the duration-growth quadrants. Growth investors will focus most often on Quadrants I and II. However, we find growth investors who dabble across all the quadrants – looking for special situations, cyclical growth, or busted growth. Quadrant I stocks are most often associated with high quality, high growth investors. Current stock examples include Amazon, Facebook, and Google. Quadrant II stocks are known for their defensive nature. They may not have the high earnings growth expectations, but their Competitive Advantage Periods are typically quite long, and they can provide a defensive port during volatile times. Stocks include Proctor and Gamble, Coca-Cola, Consolidated Edison, and Johnson & Johnson.

Market expectations for long cash flow duration are reflected in the higher P/E ratios for Quadrant I and Quadrant II companies. Describing and understanding valuations among and within the quadrants is one of the most appealing and useful aspects of the duration-growth quadrants. The longer implied cash flow duration for both Quadrant I and Quadrant II companies explains why they have higher P/E ratios versus Quadrant III and Quadrant IV: Cash flow duration incorporates the market's expectations for growth, profitability, sustainability and risk (see appendix). The real investment opportunity occurs when we have a different long-term valuation view versus the market. For instance, the potential value-added return can be substantial if you correctly predicted a company is in Quadrant I when the market assumed it was in Quadrant IV. In this case, you would have benefited from the P/E expansion related to longer realized duration.

Exhibit 2: Quadrant I and II companies' higher P/E ratios reflect higher cash flow duration expectations



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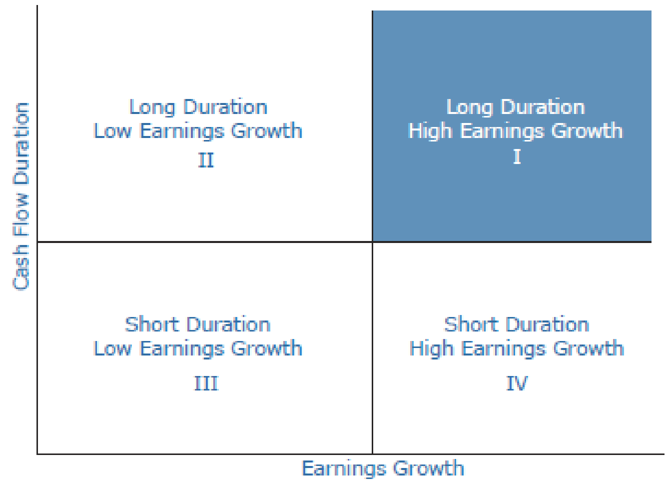
We have chosen to focus our philosophy, process and stock selection exclusively in Quadrant I companies, identifying longer cash flow duration and/or higher earnings growth versus long-term market expectations. Quadrant I companies offer several advantages for growth investors the other quadrants may not provide – higher potential growth driven returns, significant optionality, and less fundamental risk. However, due to high market expectations for both duration and growth, there may be more valuation risk associated with Quadrant I. It is paramount to correctly identify Quadrant I companies. If the company fails to achieve Quadrant I status when the market was expecting it, the failure can be painful to returns. However, correctly identifying Quadrant I companies early in their lifecycles has historically been consistently rewarding, over long periods.

Exhibit 3: We focus exclusively on Quadrant I companies



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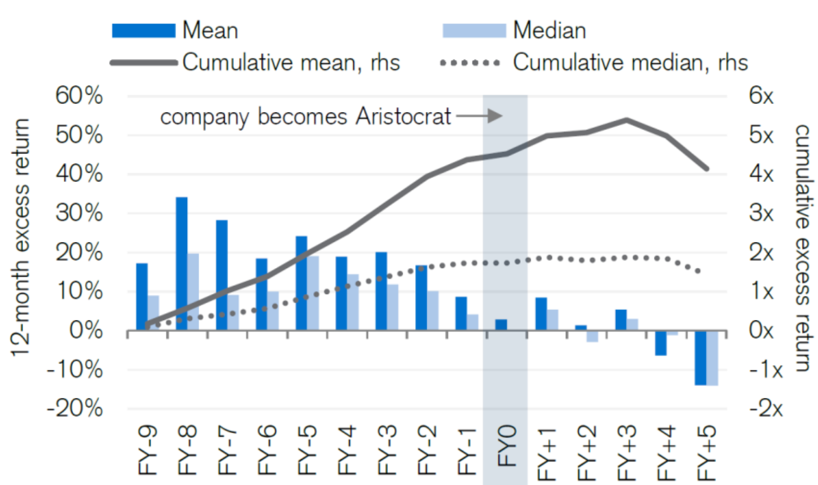
Quadrant I companies provide the best opportunity for long-term earnings-growth driven total shareholder returns. To deliver truly outsized investment returns, sustained for years, earnings growth must be the key driver. We remain focused on Quadrant I because these superior secular growth opportunities are not available in the other quadrants. Quadrant II companies may be appealing in times of turbulence; however, they do not offer the superior growth driven total shareholder returns over the long-term.

Quadrant I is the home of HOLT's Economic Profit Aristocrats[1]. These companies compound long-term wealth by having the ability and opportunity to reinvest at high rates of growth and profitability for at least ten years. They have historically produced tremendous returns above the market. It is necessary to identify them early in their Quadrant I status. By trying to identify them early, however, one takes the risk that they are not actually Quadrant I companies. The following chart shows that by identifying EP Aristocrats early in their life cycle, above-market returns are substantial and consistent. However, ten years into their Quadrant I existence has historically reduced the probability for outsized future returns. In other words, after ten years they may be transitioning to Quadrant II.

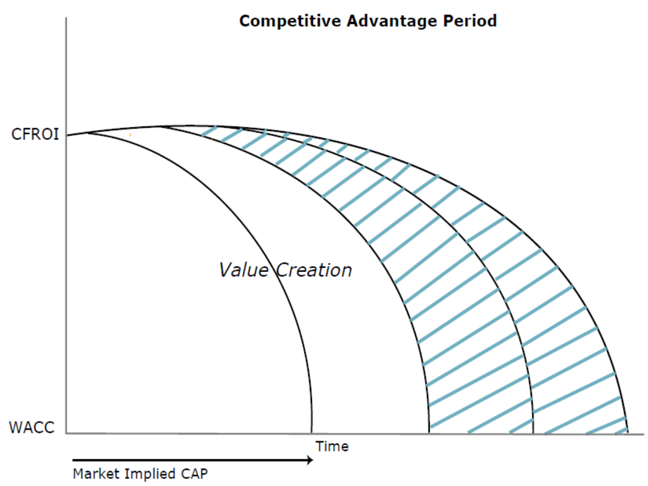
Exhibit 4: Shareholder Returns of Eventual EP Aristocrats (look ahead bias)[2]



Source: HOLT, Credit Suisse

The primary mode of lengthening duration is through an expansion of a company's Competitive Advantage Period. The Competitive Advantage Period is the period when the company's cash flow return on investment (CFROI) is above its weighted average cost of capital (WACC). For a firm to grow or sustain cash flows into the future and produce shareholder value, CFROIs must be above the WACC. Otherwise, the company is destroying shareholder value by continuing to grow. As the firm progresses through its Competitive Advantage Period, the duration is typically declining. However, to remain in Quadrant I, firms add additional layers of competitive advantage to extend the length. In Wiggins and Ruefli (2005) the typical mode of extending Competitive Advantage Period is through serial advantages such as scale economies, network effects, switching costs, etc.[3]. Given the rarity, the market typically discounts this potential lengthening of the Competitive Advantage period, providing opportunity for a variant view.

Exhibit 5: Competitive Advantage Periods are lengthened through serial advantages



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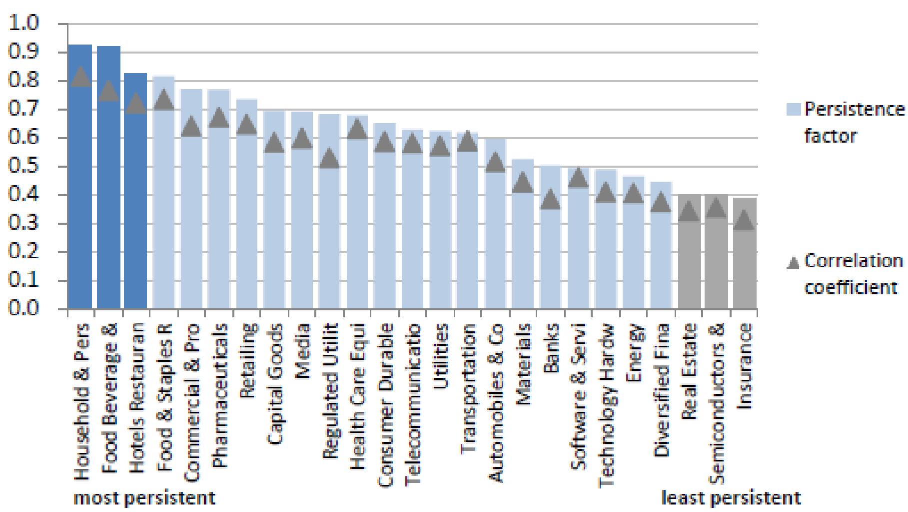
Successfully identifying Quadrant I companies means lower fundamental risk for the portfolio. To achieve Quadrant I status, companies must eventually achieve high returns-on-capital, earnings consistency, and sustainable competitive advantages. In times of recession or economic instability, Quadrant I companies' cash flow and earnings growth should hold up better than other quadrant companies. In difficult times, fundamental risk can rise substantially among Quadrant III and IV companies. Quadrant II can provide a defensive harbor, but will lack the growth engine when economic concerns subside.

Due to the long cash flow duration and high earnings growth characteristics, portfolio turnover can remain low. By correctly identifying a Quadrant I company early, the period of rapid earnings growth and strong investment returns can be quite long. Holding periods can be extended for many years. As we discussed in a previous white paper, portfolio turnover can be costly to growth stock portfolio returns. This is because growth managers often need to make dilutive transactions, selling a lower P/E and buying a higher P/E company, to maintain the portfolio's high underlying earnings growth rate. With fewer dilutive transactions, lower turnover can lead to higher overall portfolio earnings growth. Quadrant III and IV companies would likely not allow for lower turnover.

We invest in opportunities where our expectations differ substantially from market expectations. A critical tenet of this paper is that there are two lenses to locate companies within the universe: the market lens and our lens. Often, both we and the market will expect a holding to be in the same quadrant; however, we will assume a different location within the quadrant. We may expect the cash flow duration to be longer, the earnings growth to be faster, or both. Due to the long duration coupled with growth expectations, much more of a Quadrant I company's valuation is based beyond 5-7 years. In fact, more than 80% of a Quadrant I company's valuation could be in the "terminal growth rate" assumptions of a typical DCF model. This provides a natural optionality to the earnings growth rate, returns-on-capital potential, competitive advantage period, and certainty of cash flows.

It may be difficult to hold a variant view for Quadrant II stocks. Given the consistency, predictability and persistence of the cash flow stream, the market's expected cash flow duration of Quadrant II stocks will likely be more closely linked to the actual realized duration—much more like a bond. Therefore, the opportunity is less to have a substantially different view from the market. Historically, there was evidence both Quadrant I and Quadrant II stocks were systematically undervalued. Tools such as HOLT's CFROI analysis have allowed analysts to predict with higher probability which companies will sustain long duration-only characteristics. Therefore, the opportunity to have a variant view and long-term returns above the market for Quadrant II companies has likely declined over time.

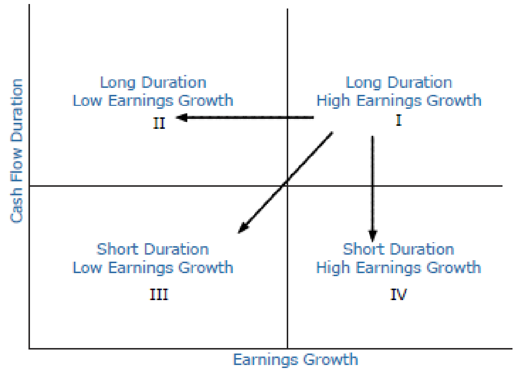
Exhibit 6: CFROI Persistence by Industry[4]



Source: HOLT, Credit Suisse

The migration path of companies across sectors provides a significant opportunity for a variant view. It is rare for a Quadrant I stock to remain in Quadrant I for many years**.** Companies mature and growth fades as they progress through their life cycle. The speed and direction of Quadrant I migration helps dictate long-term realized returns. If a Quadrant I company matures peacefully to a Quadrant II company, then the cash flow duration and P/E ratio can remain stable, while the growth and expected returns may fade. In fact, in the best cases, as companies mature, their CFROIs can rise dramatically through improved margins and productivity, increasing the probability of maintaining long duration and a high P/E through the transition. The earnings growth may fade, but the fade might be slower than expected, and/or the no- or slow-growth stream of cash flows might last longer than expected. If a Quadrant I company migrates to Quadrant III or IV, the transition to a lower cash flow duration and P/E ratio could be quite painful. The expected migration path must be planned and accounted for in expected returns. Apple is an example of a company that has moved across all four quadrants over the past three decades and has provided opportunities both on the upside and downside many times.

Exhibit 7: The migration paths of companies across quadrants provide opportunities and risk



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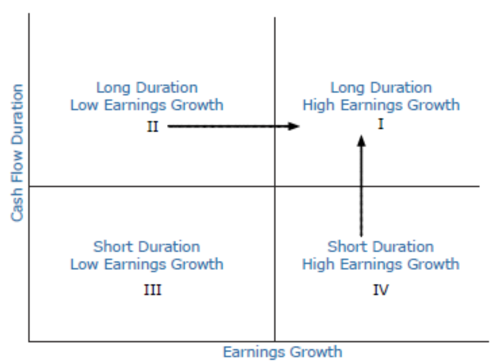
The migration back to Quadrant I can be quite rewarding. If the market is valuing a company as Quadrant II or IV, but we correctly recognize the company will successfully regain its Quadrant I growth status, returns are typically well above the market for extended periods. First, there is a low probability of Quadrant II companies migrating back to Quadrant I. There are several reasons: 1) companies become too large for new initiatives to make a difference to the growth rate; 2) firms may want to protect high margins and CFROIs, so they don't make the necessary investments; 3) they simply don't have the opportunities to reinvest. Companies such as Adobe, Equifax, and Monsanto were slower growing companies that gained a new competitive advantage and reaccelerated their earnings growth to regain Quadrant I higher growth, higher P/E status. Second, there is also a low probability of Quadrant IV companies returning to Quadrant I. Typically, significant upheaval will cause a stock to move to Quadrant IV – a broken growth stock. It is the low probability of these migrations that leads to the outsized returns when correctly predicted.

Exhibit 8: The migration back to Quadrant I is a low probability, highly rewarding path



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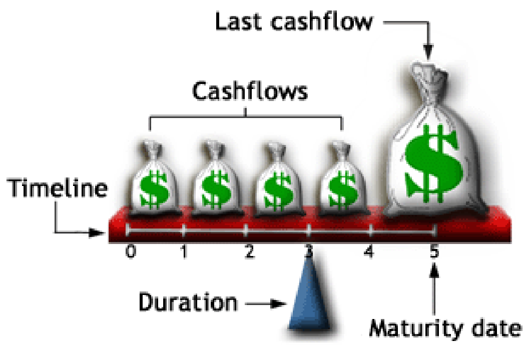
In summary, the duration-growth quadrants can be helpful to equity investors, clients, and advisors. First, cash flow duration can help investors understand valuation. While growth is important, the magnitude, timing and certainty of cash flows – all incorporated in the cash flow duration – are critical to understanding investment return expectations. Second, the duration-growth concept frames the variant view. To produce investment returns above the market, investor expectations must be different than those embedded in today's stock price. Whether it's the location within quadrants, or the migration across quadrants, the concept can help investors understand the source and probability of their variant view. Finally, it can help managers articulate their style, philosophy, and process to clients and their advisors. The framework tells a lot about an equity manager by the types of stocks they are choosing, and the bets they are making across the equity universe.

Appendix: What we mean by cash flow duration

Cash flow duration incorporates the growth, magnitude, timing, and certainty of cash flows. For bonds, duration is the weighted average term to maturity (stated in years) of the bond's cash flows. For U.S. Treasuries, the cash flows are level and the timing is very certain. The end payoff at maturity is also predictable. A stock is nothing more than a bond with added variability in its future cash flows.

Exhibit 9: The Concept of Duration



Source: Investopedia

Equities lack a bond's cash flow certainty in terms of size, timing, and known maturity date. This has prevented its adoption in equity investing with the same specificity as its application in the fixed income field. Yet as a concept for orienting company analysis, duration can have a place in the equity investor's tool box much the same as discounted cash flow analysis. Duration's use in equity investing orients an investor to a company's cash flow generation (magnitude, growth/decline, timing, and certainty), and the importance of considering the longer-term horizon. It is not important to get caught up in the academic research or debate the calculation of years; the usefulness is in the broad concept.

[1] Rones, David, "Economic Profit Aristocrats", HOLT Market Commentary, August 15, 2016
[2] Rones, 3
[3] Wiggins, Robert R., and Timothy W. Ruefli, "Schumpeter's Ghost: Is Hypercompetition Making the Best of Times Shorter", *Strategic Management Journal,* May 2005, 23
[4] Matthews, Bryant and David A. Holland, "Modeling Persistence in Corporate Profits by Industry and Estimating a Company's Fair Price", HOLT Wealth Creation Principles, October 2013, 2-6