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HOW STEADY COMPOUNDING OUTPERFORMS IN THE LONG TERM

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Companies that can compound their earnings at steady growth rates for more than a decade are the unsung heroes of the market, according to James Dow, Head of the Global Income Growth Team

INTRODUCTION

Watsco, the Miami-based distributor of air conditioning equipment, is a classic example of a steady compounder. Over the past decade (to the end of 2021), it has grown its earnings at a compound annual rate of 12 per cent. It has never made a loss, and from year to year, its profits have shown steady progress.

The shares have always traded at a premium to the market price-to-earnings (P/E) multiple: a premium that it maintains to this day because its growth runway remains so long and its execution so strong. As a result, growth in the share price has broadly followed its earnings and on top of that, the company's capital-light growth model has allowed it to return significant excess cash via dividends.

All-told, the total return to shareholders has been 21 per cent annualised since the end of 2011, outperforming the MSCI ACWI index by about 9 per cent per annum (pa).

Other examples of steady compounders in our Global Income Growth portfolios include names such as Fastenal, Admiral, Starbucks, Edenred, Sonic Healthcare, Valmet and Atlas Copco. The outperformance of these companies over long periods of time has been grounded in their relentless high-single to low-double-digit compounding of earnings and dividends, rather than exceptionally fast rates of growth. On average, they have delivered nominal earnings growth of about 10 per cent pa.

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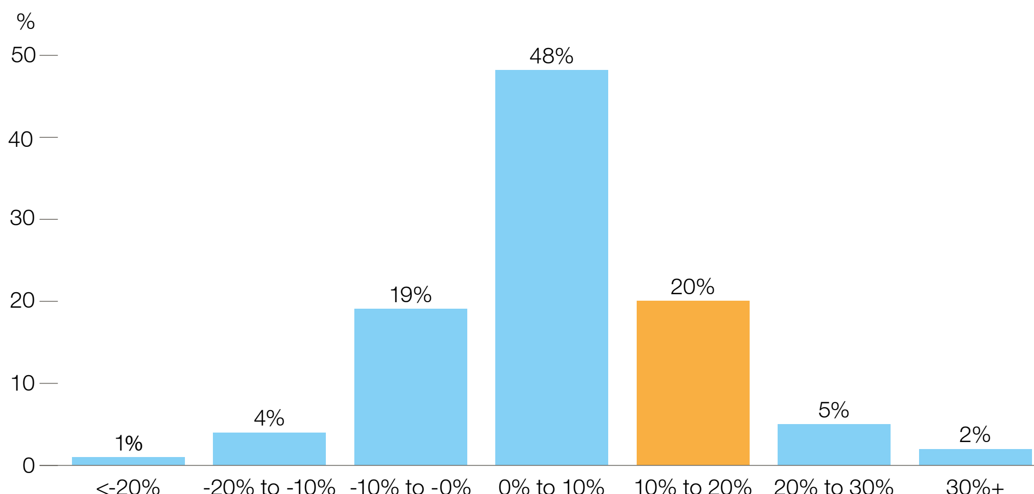
I do not believe in the efficient markets hypothesis. What I do believe is that companies which can compound their earnings at 10 per cent-plus for a decade or more are relatively unusual. We know this from an analysis done by Michael Mauboussin, a finance professor at Columbia University, in 2016.

Using a global dataset with over 37,000 observations, Mauboussin found that over 70 per cent of listed companies grew earnings by less than 10 per cent pa over rolling 10-year periods. Only one-quarter compounded their earnings at 10 per cent pa or higher for a decade. Of these, the 'steady compounders' are represented by the orange bar in the bell curve below:

'Base Rates': 10-year earnings compound annual growth rates (CAGRs) of stocks (37,000 observations)



Source: Mauboussin (2016)

These stocks are frequently under-priced. What typically happens is that these stocks hold their P/E multiples over time, and their total returns broadly mirror their earnings growth and dividends.

A decade ago, Watsco traded on a P/E of 25x, a premium to global equities that led many to believe its steady growth was 'in the price'. But as its earnings have compounded relentlessly higher, it has held its multiple, its share price has followed its earnings, and it has outperformed. It's a similar story for companies such as L'Oréal and Atlas Copco. Their total returns have beaten the returns from a passive investment in global equity indices.

Why isn't this steady compounding fully discounted by the market? I believe it boils down to short-termism. A company which can compound its earnings at 10 per cent plus for a decade and then, most importantly, still have the ability to keep growing at 10 per cent for another decade, is intrinsically very valuable. In theory, and using a sensible discount rate, it should trade on a P/E multiple above 50, but most investors are unwilling to pay that valuation multiple, and these companies usually trade on high-teens or low-20s P/E multiple.

If you are a fund manager incentivised on short-term performance – say, less than three years – as many managers are, a P/E that is substantially higher than the market represents a downside risk that could hurt your performance.

Many investors will have looked at Watsco's P/E of 25x a decade ago and argued it looked 'expensive'. That was true for managers who worried about a short-term wobble leading to a lower P/E multiple, which could hurt their performance over the next three years. But it was false for long-term investors thinking about the intrinsic value that would be revealed over the next decade.

Put another way, wouldn't it be remarkable if long duration compounders were all fairly priced, given that so few investors are trying to price them that way?

The hard part of picking steady compounders is not the maths. The hard part is distinguishing between those stocks which are genuinely able to grow their earnings at 10 per cent for a decade-plus, from those which are not. Every company has a slide deck and most management teams will tell you that 10 per cent growth pa is eminently achievable. The challenge for the stockpicker is deploying the judgement that discriminates between story and reality. A good stockpicker can distinguish the Watscos and Atlas Copcos of this world – companies that genuinely have a high probability of achieving 10 per cent growth for a very long time period – from the General Mills and Sanofi's, which are far more likely to fall into the morass of 0-10 per cent growth in the middle of Mauboussin's bell curve.

PICKING LONG DURATION STEADY COMPOUNDERS

So, how do we go about trying to identify these long duration compounders? A great question to ask is: 'After the company has grown 10 per cent pa for a decade, why should it be able to grow 10 per cent pa for a decade more?' Companies where we have a positive answer to this question, with some level of conviction, will be relatively unusual.

In Watsco's case, the answer was its ability to take market share through superior service, from a small starting point in a very large market. The air conditioning distribution market in the US is enormous. The company started operations in Florida, giving it density. Even after a decade of volume growth from customer and product range expansion across the US, it still represented a relatively small part of a growing market. Which meant that another decade of market share gains and continued growth at 10 per cent pa was still possible.

© Starbucks.

Starbucks is another example: even after its second decade in operation, it was still small enough in the context of global, on-the-go beverage consumption to keep adding outlets and menu items, in a market which was expanding, and by doing so deliver 10 per cent growth pa for another decade.

A second type of company that can positively answer the 'second decade' question is what can be called 'adjacency growers'. These are companies with exceptional organisational flywheels and a management able to keep finding adjacent markets and moving into them.

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Atlas Copco is the classic example. From its foundation in industrial compressors, it used its engineering expertise and customer base to enter the industrial power tools market and then, more recently, the industrial vacuum market. Fastenal is another example: from its original range of fasteners, it has added adjacent product categories and different sales channels. This is a different type of long duration growth from the model of '5 per cent new stores and 5 per cent like-for-likes' of a Starbucks or Watsco. It is also harder.

I believe the odds of picking long-duration steady compounders increase exponentially when we identify companies with strong organisational flywheels, spun by great people who plan to stick around for a long time to make sure the flywheel keeps spinning. This is why founders are so valuable. I believe the difference between Starbucks (30-year double-digit compounder) and Peet's Coffee (not) was Howard Schultz and the organisation he built around him. A large part of the difference between Atlas Copco and its peer Sandvik has been the organisational flywheel that has been carefully cultivated at the former and conspicuously absent at the latter. Jim Collins has documented many paired case studies like these in his 2001 book, *Good to Great*.

Baillie Gifford's edge in finding these companies starts with long-termism, one of our greatest advantages in picking stocks. Another is the seriousness with which we take the task, continuously trying to improve our self-calibration while staying humble about the difficulty of the work. A third is the ability to isolate ourselves from the noise of financial markets, focusing instead on inputs that really matter: such as reinforcing competitive advantages and company cultures that are special. Input diversity is surely a fourth.

STEADY COMPOUNDING AND BESSEMBINDER

Readers familiar with Baillie Gifford have probably heard of Professor Hendrik Bessembinder. The Arizona State University academic's research on long-term stock market returns has shown how a tiny percentage of stocks deliver truly extraordinary ('outlier') returns.

Bessembinder, however, does not say 'outliers are the only way to out-perform'. And not all clients want outlier returns. Some are quite happy with 'very good' returns, outperforming the market meaningfully over long periods. Some clients also struggle with the volatility that can come with the pursuit of extraordinary returns. Steady compounders tend to exhibit lower volatility.

I don't believe that volatility equals investment risk, but it can introduce 'behavioural risk'. By this I mean that it can clash with the natural tendencies of investor behaviour. Retirees can be genuinely spooked when their life savings fall dramatically. They are understandably prone to taking their money back, crystallising paper losses at the trough, simply to sleep at night. These clients need access to investment products offering above-market returns but with lower volatility.

It is instructive to study Bessembinder's top-performing stocks of the past 30 years. Many belong to the 'steady compounders' category. Companies such as Procter & Gamble is among them. What explains the exceptional value created by these stocks is not the exceptional rate of their earnings and dividends growth, but the remarkable duration of that growth. It is the fact that Procter & Gamble delivered compound returns of 13 per cent a year for 30 years that made it a special investment, not the annual rate itself.

Wealth creation by country, top 20 United States Firms

Firm Name	Permco	Wealth created ($millions)	% of global gross wealth creation	% of national gross wealth creation	Annualised dollar weighted return	First month	Last month
Apple	7	2,674,231	2.74	5.34	23.51	199002	202012
Microsoft	8084	1,910,085	1.95	3.81	19.16	199002	202012
Amazon	15473	1,569,085	1.61	3.13	31.09	199706	202012
Alphabet	45483	979,133	1.00	1.95	19.34	200409	202012
Tesla	53453	639,266	0.65	1.28	65.44	201007	202012
Walmart	21880	568,713	0.58	1.14	13.51	199002	202012
Facebook	54084	553,675	0.57	1.11	30.39	201206	202012
Johnson & Johnson	21018	535,317	0.55	1.07	13.86	199002	202012
Berkshire Hathaway	540	504,079	0.52	1.01	11.68	199002	202012
Proctor & Gamble	21446	451,109	0.46	0.90	13.05	199002	202012
Exxon Mobil	20678	437,083	0.45	0.87	10.65	199002	202012
JP Morgan Chase & Co	20436	414,080	0.42	0.83	9.76	199002	202012
Home Depot	5085	399,790	0.41	0.80	16.55	199002	202012
Visa	52983	384,977	0.39	0.77	23.77	200804	202012
Mastercard	50700	374,932	0.38	0.75	32.98	200606	202012
United Health Group	7267	370,220	0.38	0.74	21.23	199002	202012
Altria Group	21398	364,636	0.37	0.73	17.03	199002	202012
Intel	2367	340,219	0.35	0.68	15.95	199002	202012
Coca Cola	20468	329,515	0.34	0.66	12.93	199002	202012
Oracle	8045	318,543	0.33	0.64	19.50	199002	202012

Source: Bessembinder (2020)

Another finding in the Bessembinder dataset is worth highlighting. Two of the best-performing stocks in the table above are Apple and Microsoft. Both companies have been held in our core Global Income Growth fund. In both cases, we have owned them as steady compounders. It has turned out that the attributes which we believed made them high-probability steady compounders – their impregnable competitive advantages and their further growth potential – have delivered outlier returns. So, looking for steady compounders doesn't preclude spectacular results.

HOW ABOUT ESG?

There's also a strong link between steady compounding and environmental, social and governance (ESG) priorities. Companies that do real damage to the environment, or treat employees badly, are unlikely to steadily compound earnings and dividends for a decade and more. They may stay in business for a few years, but over the long run, they're unlikely to thrive. They certainly seem less likely to deliver long-term growth.

I seriously struggle to believe that companies which do real damage to the environment, or treat their employees badly, or have narrow and ineffective boards, are likely to deliver steady compounding of earnings and dividends for the next decade and more. Perhaps companies could get away with this in the past, but the world has changed. (I doubt it was true even in the past… some of Jim Collins' corporate failures were ESG failures before ESG was an acronym).

Attending to ESG factors raises the odds of picking 10 per cent-plus steady compounders. In turn, considering a company's ESG profile is part of the Global Income Growth team's fiduciary duty to shareholders, not a nice little add-on to please regulators or marketing teams.

Again, our long-term investment horizon here is critical because the positive impact of these factors tends to play out over many years.

…AND DIVIDENDS?

So far, I've said nothing about dividends, which might seem strange for a dividend growth strategy. I don't believe that companies must necessarily pay a dividend to deliver 10 per cent-plus steady compounding for a decade and more. But I do believe that, as with attention to ESG, good dividend payers are much more likely to succeed.

Paying dividends is a strong signal of the presence to the factors that make long-duration compounding likely. We're looking out for: an established business model with a deep competitive moat, earnings that don't swing wildly about, capital discipline, a capital-light growth opportunity that generates surplus cash flow, shareholder alignment, and so on.

Of course, some dividend payers are ex-growth, over-distributing or simply capital-intensive value stocks. They are essentially investment disasters waiting to happen and end up populating the left-hand bars of Mauboussin's bell curve. But many of those special companies in the bucket labelled '10 per cent-plus compounding' do pay strong dividends, and those dividends tell us something.

Dividends can also significantly enhance long-term returns. Returning once more to the Watsco example, its capital growth of 17 per cent per annum was significantly enhanced by dividends to produce a total return of 21 per cent. Buffett observed years ago that a company that can grow while returning much of its earnings to shareholders is far more valuable than a company which needs to plough all its earnings back into the business to achieve the same rate of growth.

Long duration steady compounding is unusually valuable. It can drive outperformance, it is an area where long-term investors can have several edges as stockpickers, and it can provide excellent outcomes to clients who are happy to seek market-beating returns but are wary of volatility. It is not the *only way* to outperform, but it is certainly one way to outperform over the long term.

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Annual Past Performance to 30 September Each Year (Net %)

	2018	2019	2020	2021	2022
Global Income Growth	10.0	11.7	8.9	18.5	-1.2
MSCI ACWI Index	13.5	7.9	5.8	22.7	-3.7

Annualised returns to 30 September 2022 (Net %)

	1 Year	5 Years	10 Years
Global Income Growth	-1.2	9.4	11.1
MSCI ACWI Index	-3.7	8.9	11.9

Performance source: FE, StatPro, MSCI, total return in sterling.

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