Marketing material
for professional investors and advisers only

In focus

The Value of Growth

June 2021

It is a mathematical certainty that the higher the price paid, the lower the future return. Yet there are instances when investors should worry less about current valuation – much less, in fact – and those where it will determine almost everything.

James Gautrey
Portfolio Manager,
International Equities

Good growth investing should focus on businesses able to earn sustainable, superior Returns on Invested Capital (ROIC) with meaningful opportunities to reinvest at comparable rates. Over time, the compounding effects of such entities will most likely more than compensate the investor for any degradation in near term valuation multiples. A business growing its invested capital per share ten-fold could see that capital valued half as richly on exit and still return the investor a handsome five-fold return.

In contrast, companies unable to beat their cost of capital or even those able to do so but without the ability to reinvest will never be able to compound. Here the investor's return will be almost exclusively a function of entry valuation.

The "Good Growth" pitch

Consider a hypothetical business with $100 of Invested Capital (IC) selling for 6x that amount at the end of 2020. It is an exceptional business able to earn an 18% ROIC and an enormous addressable market in which to reinvest. After 30 years of full reinvestment, the invested capital would have grown just over 105x, equivalent to a 17% Compound Annual Growth Rate (CAGR) as illustrated in Figure 1. Assuming the business is valued similarly (6x IC), this 17% would be the investor's annual return. It is approximately equal to the ROIC multiplied by the Reinvestment Rate.

Now consider the same business suffers a tremendous setback to its valuation in the final year (Figure 2 on the next page) and the investor sells at just 3x IC – half the entry multiple. The annualized return compresses, but only to 14%; still a great result and likely significantly ahead of any long-term market return.

Figure 1: A hypothetical demonstration of the importance of CAGR over valuation alone

									Abridged		
	End 2020	2021	2022	2023	2024	2025	2026	2027	2028	2050	30y CAGR
Invested Capital	100	120	140	163	190	222	259	302	353	10,568	**17%**
NOPAT		20	23	27	32	37	43	51	59	1,766	
ROIC		18%	18%	18%	18%	18%	18%	18%	18%	18%	
Reinvestment rate		100%	100%	100%	100%	100%	100%	100%	100%	100%	
Dividends		0	0	0	0	0	0	0	0	0	
(pay out ratio)		0%	0%	0%	0%	0%	0%	0%	0%	0%	
EV / IC	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	
EV	600	719	837	977	1,141	1,331	1,554	1,814	2,117	63,405	
Cumulative dividends		0	0	0	0	0	0	0	0	0	
EV + Cumulative Dividends		719	837	977	1,141	1,331	1,554	1,814	2,117	63,405	**17%**
Annualized Return		**19.8%**	**18.1%**	**17.7%**	**17.4%**	**17.3%**	**17.2%**	**17.1%**	**17.1%**	**16.8%**	
"Wall Street Metrics"											
P/E		36.3	35.9	35.9	35.9	35.9	35.9	35.9	35.9	35.9	
Dividend yield		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	

Source: Schroders. For illustration only. Does not reflect any actual holding or portfolio. Return calculations based purely on mathematic principle.

Schroders

Figure 2: A second hypothetical demonstration of the importance of CAGR and dividend reinvestment

								Abridged		
	End 2020	2021	2022	2023	2024	2025	2026	2027	2028	2050	30y CAGR
Invested Capital	100	120	140	163	190	222	259	302	353	10,568	**17%**
NOPAT		20	23	27	32	37	43	51	59	1,766	
ROIC		18%	18%	18%	18%	18%	18%	18%	18%	18%	
Reinvestment rate		100%	100%	100%	100%	100%	100%	100%	100%	100%	
Dividends		0	0	0	0	0	0	0	0	0	
(pay out ratio)		0%	0%	0%	0%	0%	0%	0%	0%	0%	
EV / IC	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	3.0	
EV	600	719	837	977	1,141	1,331	1,554	1,814	2,117	31,703	
Cumulative dividends		0	0	0	0	0	0	0	0	0	
EV + Cumulative Dividends		719	837	977	1,141	1,331	1,554	1,814	2,117	31,703	**14%**
Annualized Return		**19.8%**	**18.1%**	**17.7%**	**17.4%**	**17.3%**	**17.2%**	**17.1%**	**17.1%**	**14.1%**	

Source: Schroders. For illustration only. Does not reflect any actual holding or portfolio. Return calculations based purely on mathematic principle.

Of course, the best scenario would be to acquire at 3x and sell for 6x, in which case the annualized return increases to almost 20% (a 211x return). This is the pinnacle of growth investing!

Valuation still matters for exceptional businesses but less than one might think. If the investor is able to identify such an entity but passes on valuation worries (the example in Figure 1 trades on 36x forward P/E), they risk missing out on what will still most likely prove a terrific long-term investment – even with valuation compression that may or may not occur.

The caveat is that focusing exclusively on annualized returns can belie underlying dollar effects. While highly likely that an investment delivering 14% or 20% per annum over 30 years should comfortably beat any benchmark, notice the dollar result at 20% is over four times better (Figure 3).

Figure 3: Conviction in good businesses is key

$100 after 30 years CAGR at.		
14.1%	16.8%	19.5%
5,284	10,568	21,135

Source: Schroders. For illustration only. Does not reflect any actual holding or portfolio.

In 1994, Charlie Munger summarized the principle well:

"In the long term, it's difficult for a stock to earn a much better return than the business which underlies it earns. If the business earns a 6% return on capital for 40 years and you hold it for 40 years, you're not going to do much different than a 6% return, even if you buy it at a huge discount. Conversely, if a business earns 18% return on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with one hell of a result".

For completeness, let's consider the 6% return business in the same template as above. The business starts with $100 of invested capital, as before, but is unable to reinvest anything in to future growth. Management sensibly pay out all the earnings as dividends – allowing the investor to potentially re-deploy elsewhere at more attractive rates. Furthermore, we assume the investor is able to buy this business at a "discount", selling at *twice* the entry multiple after 30 years. Sadly, despite all these seemingly favorable tailwinds, the annualized return is just a little better than 5% (Figure 4).

For this investment to match the 14% CAGR shown in Figure 1, the stock would need to re-rate approximately *50 times* from its entry valuation, a near impossibility.

Figure 4: Dividend Daddys – not all they're cracked up to be

									Abridged		
	End 2020	2021	2022	2023	2024	2025	2026	2027	2028	2050	30y CAGR
Invested Capital	100	100	100	100	100	100	100	100	100	100	**0%**
NOPAT		6	6	6	6	6	6	6	6	6	
ROIC		6%	6%	6%	6%	6%	6%	6%	6%	6%	
Reinvestment rate		0%	0%	0%	0%	0%	0%	0%	0%	0%	
Dividends		6	6	6	6	6	6	6	6	6	
(pay out ratio)		100%	100%	100%	100%	100%	100%	100%	100%	100%	
EV / IC	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	
EV	70	70	70	70	70	70	70	70	70	70	
Cumulative dividends		6	12	18	24	30	36	42	48	180	
EV + Cumulative Dividends		76	82	88	94	100	106	112	118	320	**5%**
Annualized Return		**8.6%**	**8.2%**	**7.9%**	**7.6%**	**7.4%**	**7.2%**	**6.9%**	**6.7%**	**5.2%**	
"Wall Street Metrics"											
P/E		11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	23.3	
Dividend yield		8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	4.3%	

Source: Schroders. For illustration only. Does not reflect any actual holding or portfolio. Return calculations based purely on mathematic principle.

Defining and identifying compounders

Compound stocks increase the net worth of the underlying business considerably over time. In order to do that, they must earn a ROIC in excess of the cost of capital (which can be thought of the as what the investor is able to earn on aggregate elsewhere). Furthermore, they require a sufficient opportunity set to redeploy these earnings at comparable rates. Simply earning a high return on capital alone is not enough.

This point highlights one of the long held misconceptions in the market; that asset light businesses are best. An investor should care most about the Economic Value Add (EVA) and, to a lesser extent, as shown above, what they are being asked to pay for it. As EVA is calculated by the spread of ROIC to cost of capital, multiplied by the invested capital itself, the astute reader will now appreciate the potential problem with asset light businesses, namely the small capital base is potentially a limiting factor.

It should be apparent that an investor is indifferent between a company earning a 1% spread on $1,000 of capital (EVA = 0.01 x $1,000 = $10) and a company earning a 10% spread on $100 of capital (EVA = 0.1 x $100 = $10). The former is "asset heavy" with a lower ROIC while the latter is "asset light" with a much higher return. Yet the result is the same.

Investors therefore should think in terms of ROIC, reinvestment opportunities and invested capital. Unfortunately (fortunately for those that do?), this is not what happens. The broader market tends to focus almost exclusively on P&L metrics such as operating margins and earnings per share. With scant regard for the capital required to deliver such metrics, or the cost of doing so, the common investor is likely to face disappointment over time.

Consider two well known consumer facing companies, Costco and LVMH. At face value, LVMH's operating margin was just over 19% in 2019 compared to just 3% at Costco. Is it the better firm therefore? Or could there be an incredible opportunity for Costco to somehow "close the gap" driving earnings 7x higher, a common Wall Street buy thesis?

The answer to both these questions is "No".

Figure 5: The fallacy of the "P&L only" approach

	Costco		LVMH	
USD mn	**2014**	**2019**	**2014**	**2019**
Revenue	112,640	155,703	40,702	60,083
Operating Profit	3,220	4,737	7,567	12,857
margin	2.9%	3.0%	18.6%	21.4%
NOPAT	2,415	3,553	5,675	9,643
Tangible assets	14,830	20,890	12,568	34,744
Intangible assets	0	0	26,427	37,332
Inventories	*8,456*	*11,395*	*11,464*	*15,402*
Accounts receivable	*1,148*	*1,535*	*2,751*	*3,874*
Accounts payable	*-11,937*	*-16,035*	*-7,014*	*-10,327*
Net working capital	-2,333	-3,105	7,201	8,949
Invested capital	12,497	17,785	46,196	81,025
Cash conversion cycle (days)	-8	-7	65	54
Inventory days	27	27	103	94
Fixed asset turn	7.6	7.5	1.0	0.8
ROIC	**19.3%**	**20.0%**	**12.3%**	**11.9%**

Source: Schroders, using most currently available data. Companies referenced are for illustration only and do not reflect any recommendation to buy/sell any security. Past performance is no guarantee of future results.

Costco's business model is very different to that of LVMH and an analysis beyond the P&L shows why. In short, Costco's fixed asset turns are over 7x better than LVMH and its cash collection 60 days faster. Once these vital differences are considered, the analysis shows that Costco actually earns 20% on every dollar invested, compared to LVMH's 12%.

In plainer terms, Costco sells everyday items that are frequently bought from reasonable, yet unglamorous, locations, at something of a discount to its competitors. Inventory is turned quicker than LVMH and they use bulk purchasing to affect better payment terms. In contrast, LVMH sells highly priced products (think $5,000 handbags) that sit on the shelves of their luxuriously appointed stores in the most prestigious of locations for almost three months before sale. The luxury mark-up requires significant marketing and brand investment to sustain it, too.

Both are actually great companies and a full investment analysis would consider the EVA dollars, what you are paying for them (valuation) and future outlook. In this piece however, the point is to identify the material flaw in the P&L-only analysis most market participants consider.

Not all Growth is created equal

Investors should also consider that growth is only worth something to them when it creates value i.e. the EVA is positive. A company investing in projects that merely return its cost of capital do not achieve this. In short, this is because whatever the company is able to add to its invested capital is discounted back at the same rate leaving the Net Present Value (NPV) unchanged. This is shown in Figure 6 in a four-year DCF discounting the 2024 IC back at 8% per annum.

Figure 6: Value-less growth!

Growth at cost of capital	2021	2022	2023	2024
Invested Capital	100	108	117	126
NOPAT	8	9	9	10
ROIC	8.0%	8.0%	8.0%	8.0%
Reinvestment rate	100%	100%	100%	100%
NPV	**100**			

Source: Schroders. For illustration only. Does not reflect any actual holding or portfolio. Return calculations based purely on mathematic principle.

A sensitivity table of the above example shows that when the ROIC dips below the cost of capital, growth actually decreases the NPV of the business.

Figure 7: Value-destructive growth in action

	ROIC (where cost of capital=8%)				
	6.0%	7.0%	8.0%	9.0%	10.0%
NPV	95	97	100	103	106

Source: Schroders. For illustration only. Does not reflect any actual holding or portfolio. Return calculations based purely on mathematic principle.

Market participants tend to focus on growth without considering whether or not it's actually a good thing. This is often compounded by management teams that fail to consider EVA and generally believe running bigger businesses is better.

Is cash actually King?

Most investors are told early in their careers that cash is king. Profits that do not translate into actual dollars of Free Cash Flow (FCF) are not worth paying for and may even indicate more serious underlying problems. While this is generally well-meaning in principle, investors must take care not to penalize companies investing in value-enhancing projects. If capital expenditures are running in excess of depreciation – a necessary condition for invested capital growth – FCF conversion is necessarily depressed. But if these investments are in projects delivering a fantastic ROIC they should be embraced, not shunned! Foregoing long-term value creation to deliver short-term cashflow is not in the investor's best interest, in our view.

Needles in the haystack

Armed with the above, investors must simply go forth and find firms sustainably creating value in a meaningful way, while not getting to bogged down in near term valuation multiples. But how easy is it to do that and what are the risks?

First and foremost, it's not easy at all. Few firms are able to sustainably earn superior returns on invested capital, fewer still can find meaningful opportunities to reinvest at similar rates over the long term. Firms require "an edge" to keep competition at bay and skillful management to navigate the inevitable trials and tribulations while deploying capital with a view to long term value creation. A surprisingly large number do not understand the principles behind this, probably hindered in no small part by many investors' predilection for near term EPS.

Large scale, statistical analysis over time would be ideal – how many companies have actually grown their IC 100x over 30 years while delivering excellent ROIC, for instance? But this task is riddled with data issues such as lack of common reporting templates, divestments and one time effects to name but a few.

Our best estimate of the US market – for which the data is most complete – suggests only a handful of firms, comfortably less than 1% of sample, have met our criteria over the past twenty years. This chimes however with the long term study from Bessembinder (2017) noting that just 4% of US companies have been responsible for all the net wealth creation of the US stock market since 1926. Clearly, selectivity is crucial.

Upsetting the apple cart

In Figure 1, valuation was shown to be a lesser concern for truly great companies. In practice, there are so few of these opportunities, even a 20-stock portfolio is likely to own at least 15 stocks that do not possess such characteristics. The problem tends to be lack of suitable reinvestment opportunities. Many more companies are able to sustain great ROIC, very few continue to find as compelling reinvestment. **As companies reinvest less (and return more cash to shareholders), valuation plays a larger role in the investor's return**. Hence, in practical terms, starting valuation does matter and periods of broad revaluation (early 1970s, late 1990s, late 2010s) pose considerable risk to the growth investor. In 1972, the "Nifty Fifty" – an unofficial basket of "one- decision stocks" – peaked at a forward P/E multiple of 42x, more than double the broader S&P 500 (19x). Per Siegel (1998), the annualized return of this group (12.2%) over the next 26 years was only in line with that of the broader market (12.7%). Further, the most highly valued half, returned only half that of the cheaper.

Some of the components (IBM, Xerox, Kodak, Polaroid) also raise eyebrows and highlight the difficulties of thinking about thirty year time horizons; investors should not get too caught up on this however. A portfolio only needs a couple of hundred baggers to offset many complete failures; though this raises obvious questions of risk tolerance and hence suitability.

"The most beautiful moments always seemed to accelerate and slip beyond one's grasp just when you want to hold on to them for as long as possible"

– **Bucchianeri, Brushstrokes of a Gadfly**

In early 2021, investors find themselves at a crossroads. Long-term interest rates have been pushed down to record lows through super easy monetary policy and could be used to justify the purchase of virtually any quality growth stock. A wave of disinflationary forces – most notably globalization and technological innovation – have allowed this to persist yet are unlikely to do so over the long run. Inflationary pressures are currently building, though these may prove transitory unless long-anchored expectations (wages and prices) begin to change.

For now, the picture is unclear hence a blend approach seems sensible. This allows an investor to participate in continuing long-term compounders without betting the farm on an area of the market prone to severe correction should inflation and rates turn structurally upwards.

Important Information

The views and opinions contained herein are those of the authors as at the date of publication and are subject to change and may become outdated due to market or regulatory developments. Such views and opinions may not necessarily represent those expressed or reflected in other Schroders communications.

This document is intended to be for information purposes only. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument or security or to adopt any investment strategy. The information provided is not intended to constitute investment advice, an investment recommendation or investment research and does not take into account specific circumstances of any recipient. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice.

Information herein is believed to be reliable but Schroders does not represent or warrant its completeness or accuracy.

No responsibility or liability is accepted by Schroders, its officers, employees or agents for errors of fact or opinion or for any loss arising from use of all or any part of the information in this document. No reliance should be placed on the views and information in the document when taking individual investment and/or strategic decisions. Schroders has no obligation to notify any recipient should any information contained herein change or subsequently become inaccurate. Unless otherwise authorised by Schroders, any reproduction of all or part of the information in this document is prohibited.

Any data contained in this document has been obtained from sources we consider to be reliable. Schroders has not independently verified or validated such data and it should be independently verified before further publication or use. Schroders does not represent or warrant the accuracy or completeness of any such data.

All investing involves risk including the possible loss of principal.

Third party data are owned or licensed by the data provider and may not be reproduced or extracted and used for any other purpose without the data provider's consent. Third party data are provided without any warranties of any kind. The data provider and issuer of the document shall have no liability in connection with the third party data. www.schroders.com contains additional disclaimers which apply to the third party data.

Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. Exchange rate changes may cause the value of any overseas investments to rise or fall. This document may contain 'forward-looking' information, such as forecasts or projections. Please note that any such information is not a guarantee of any future performance and there is no assurance that any forecast or projection will be realised.

European Union/European Economic Area: Issued by Schroder Investment Management Limited,1 London Wall Place, London, EC2Y 5AU. Registered Number 1893220 England. Authorised and regulated by the Financial Conduct Authority.

Note to Readers in Australia: Issued by Schroder Investment Management Australia Limited, Level 20, Angel Place, 123 Pitt Street, Sydney NSW 2000 Australia. ABN 22 000 443 274, AFSL 226473.

Note to Readers in Canada: Schroder Investment Management North America Inc., 7 Bryant Park, New York, NY 10018-3706. NRD Number 12130. Registered as a Portfolio Manager with the Ontario Securities Commission, Alberta Securities Commission, the British Columbia Securities Commission, the Manitoba Securities Commission, the Nova Scotia Securities Commission, the Saskatchewan Securities Commission and the (Quebec) Autorite des Marches Financiers.

Note to Readers in Hong Kong: Schroder Investment Management (Hong Kong) Limited, Level 33, Two Pacific Place 88 Queensway, Hong Kong. Central Entity Number (CE No.) ACJ591. Regulated by the Securities and Futures Commission.

Note to Readers in Indonesia: PT Schroder Investment Management Indonesia, Indonesia Stock Exchange Building Tower 1, 30th Floor, Jalan Jend. Sudirman Kav 52-53 Jakarta 12190 Indonesia. Registered / Company Number by Bapepam Chairman's Decree No: KEP-04/PM/MI/1997 dated April 25, 1997 on the investment management activities and Regulated by Otoritas Jasa Keuangan ('OJK'), formerly the Capital Market and Financial Institution Supervisory Agency ('Bapepam dan LK').

Note to Readers in Japan: Schroder Investment Management (Japan) Limited, 21st Floor, Marunouchi Trust Tower Main, 1-8-3 Marunouchi, Chiyoda-Ku, Tokyo 100- 0005, Japan. Registered as a Financial Instruments Business Operator regulated by the Financial Services Agency of Japan. Kanto Local Finance Bureau (FIBO) No. 90.

Note to Readers in People's Republic of China: Schroder Investment Management (Shanghai) Co., Ltd., RM1101 11/F Shanghai IFC Phase (HSBC Building) 8 Century Avenue, Pudong, Shanghai, China, AMAC registration NO. P1066560. Regulated by Asset Management Association of China.

Note to Readers in Singapore: Schroder Investment Management (Singapore) Ltd, 138 Market Street #23-01, CapitaGreen, Singapore 048946. Company Registration No. 199201080H. Regulated by the Monetary Authority of Singapore.

Note to Readers in South Korea: Schroders Korea Limited, 26th Floor, 136, Sejong-daero, (Taepyeongno 1-ga, Seoul Finance Center), Jung-gu, Seoul 100-768, South Korea. Registered and regulated by Financial Supervisory Service of Korea.

Note to Readers in Switzerland: Schroder Investment Management (Switzerland) AG, Central 2, CH-8001 Zürich, Switzerland. Authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA).

Note to Readers in Taiwan: Schroder Investment Management (Taiwan) Limited, 9F, 108, Sec.5, Hsin-Yi Road, Hsin-YI District, Taipei 11047 Taiwan, R.O.C. Registered as a Securities Investment Trust Enterprise regulated by the Securities and Futures Bureau, Financial Supervisory Commission, R.O.C.

Note to Readers in the United Arab Emirates: Schroder Investment Management Limited, 1st Floor, Gate Village Six, Dubai International Financial Centre, PO Box 506612 Dubai, United Arab Emirates. Registered Number 1893220 England. Authorised and regulated by the Financial Conduct Authority.

601454