Undefining Value Investing

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Equity Team

You have likely heard the saying that 'there is more than one way to skin a cat', which is intended to remind us, if rather morbidly, that there are many ways to achieve a goal. This adage translates well to many aspects of life, but it does not reflect our view of investing. While there are many different investment styles and approaches, we think we have found the best way to skin that poor cat: our value investment process. This fundamental, bottom-up process, and our strict adherence to it, has played and, we believe, will continue to play a critical role in our long-term investment success.

Within the constraints of our simple, elegant and, most importantly, repeatable process, our core role is to be exceptional analysts in feeding the process with Beutel Goodman-worthy investments. We are unapologetically dogmatic in our view that our process is the best way that we can achieve long-term investment excellence for our clients. That belief is ingrained in every stock decision, in every one of our U.S. and International equity funds, and by every analyst on our team.

However, with the dramatic gap that has opened between growth and value investing over the last 10-year bull market, some are once again questioning whether value investing – and by extension, our process – still works. While the emotional response of many would be to become defensive, that is not Beutel Goodman's style. In fact, our process is designed specifically to limit our emotional responses.

In addition to being disciplined investors, we are also untethered investors. Benchmark indices do not define our investment approach, and what is happening within these indices does not change how we invest. Our goals are absolute, as is our approach. We therefore are not concerned with the debate over whether value investing is dead or not, and in fact, find it somewhat misguided.

Reframing the Growth vs. Value Debate

There are two main reasons why we think the growth versus value debate should be reframed. The first is that there are many definitions of value investing. The following are a few of the broad categories of value investment styles:

- **Deep value:** With deep-value investing, the focus tends to be on present valuation, as opposed to factors such as quality, balance sheet strength, alignment with shareholders, competitive position, and industry structure. A deeply discounted valuation is thought to already reflect the perceived failings of the balance sheet, competitive position or industry structure, and thereby provides a margin of safety on the downside, as well as the potential for significant upside if the situation improves.
- **Relative value:** This approach aims more for relative outperformance of a stock compared to its peers. The focus is much less on absolute value and more related to buying a business that trades at a discount to what the market is willing to pay for a similar one.
- **Closet value indexers:** There are also large swathes of value investors that use a combination of relative and deep value, but actually invest with a keen eye to their value benchmarks and rationalize decisions based on being "overweight" or "underweight" a stock or sector. In essence, they are macro investors that impose their macroeconomic or sector allocation viewpoints on a value benchmark map.

Beutel Goodman does not fit any of these traditional value investing "moulds".

The second reason that we would modify the growth versus value debate is that we run concentrated and high-conviction portfolios that are unique compared to any benchmark, including value benchmarks. Quite simply, we do not own the market. We own 25 to 35 businesses that in our view, based on our strict investment research guidelines, are gems. As such, our active share is consistently high against any benchmark. Our U.S. equity portfolio will be almost as different from the Russell 1000 Value Index as it will be from the Russell 1000 Growth Index. Therefore, if "value" greatly underperforms growth, it does not mean that we, as value investors, will necessarily underperform growth, and vice versa. Again, we take an absolute approach to investing with the goal of providing downside protection and superior risk-adjusted returns over the long term.

We Define Value on our Terms

We take a unique approach to investing and it starts with the mindset that we are looking for exceptional businesses that we can own forever – as long as their valuations do not become excessive. If our investment theses on most of those quality businesses is correct, and we have limited the downside on the ones we get wrong (and we will get some wrong!), then our clients will do well over the long term.

We believe this simple perspective is incredibly powerful. It keeps us intensely focused on our current holdings and our search for the next 25-35 gems that may meet our high investment hurdle rates. We spend little to no time worried about what we do not own, and often pass on stocks that do well if the quality of the business does not meet our high thresholds or the margin of safety in terms of downside protection. Our focus is on getting the stocks we own correct and searching for the next group to add to our watchlists.

The Beutel Goodman Value Equation

Our definition of a value investment is a great franchise trading at a significant discount to intrinsic value. But what exactly makes for a great franchise, and how do you quantify a significant discount?

Emphasize Value, but Never Sacrifice Quality

For us, a great franchise is a business that generates high and sustainable free cash flows over a business cycle. Lots of companies can generate high free cash flows over brief periods, so this is where "quality" becomes important. Quality companies can sustain high returns on capital, and therefore high free cash flows, over longer periods of time. To expand, our view of quality is based on the following financial and competitive principles.

1. The less capital and the less leverage (debt) required to generate high and sustainable free cash flows, the more attractive the business is. That is, we look for businesses with high returns on capital that limit the use of leverage as an operational tool, as leverage may, over the long term, magnify risk more than it magnifies earnings. The attractiveness of high-return businesses is easy to explain – a business that requires $4 of investment to deliver $1 in free cash flows is far more attractive than a business that requires $8 of investment to deliver $1 in free cash flows. This differential in returns on invested capital tends to get reflected in higher-valuation multiples. For every dollar of incremental investment, there is more free cash flow available to compound shareholder value via reinvestments in the business, increased dividends, share buybacks and acquisitions of other companies.
2. The ability to sustain high cash flows and returns is a critical variable in our definition of a great franchise. Sustainability comes from having a strong competitive position with a wide protective moat. We love investing in companies in oligopolistic markets. Companies without fragmented competition, that dominate a specific market niche or that have high structural barriers to entry can sustain high returns over long periods.
3. Another critical defining factor of a great franchise is management alignment. All the free cash flow a business generates is useless if bad management fritters it away on bad acquisitions or by investing in the wrong areas. This happens more often when management alignment with shareholders is out of balance. For example, if management teams are paid to grow at any cost, they will invest whatever capital necessary to reach growth targets, no matter how destructive it is to the balance sheet or long-term sustainability of the business.

Significant Discount = 50% Return to Intrinsic Value

Relative valuation approaches are relative by definition: they change with time and views on value shift based on where markets drift. We are absolute investors. We focus on absolute share prices and are not occupied with broad market movements. We do our best to deal with what we can directly control, and limit factoring in variables that are out of our control. If we are content with the absolute returns offered in quality businesses, we do not need to "time" when markets are willing to overpay for stocks. We know what we do not know. That is, we know that there are too many variables involved in the decision tree to try to make the correct call on how valuations will move in the near term. The greater the number of branches, the lower the probability of success. We do not like probabilities that get close to zero. In our view, the best way to win is to refrain from betting.

We therefore focus on what is most in our control as investors: intrinsic value, which we define as the present value of sustainable free cash flows. For us, a significant discount to intrinsic value is a 1/3 discount over a three-year investment cycle, or stated differently, a 50% return to intrinsic value. We do not invest in any stock for which our models suggest we cannot obtain at least this return to our target price.

There is no great mystery about why we chose 50% as our return threshold. We deliberately set a high hurdle rate to ensure that only the highest quality ideas qualify. In addition to driving a high hurdle, that threshold is a great way to protect our downside. Specifically, if we can find a great franchise that is trading at a 50% discount to our estimate of its intrinsic value, your downside should be limited. We look for a 3:1 upside-to-downside ratio to provide a solid margin of safety. Regardless of why we chose 50%, this threshold has historically served our clients well over the long term.

Focusing on the Right Question

Rather than focusing on whether growth investing is better than value investing and vice versa, we believe the debate should revolve around the coexistence of growth, quality and value factors in investing. All three are in fact critically important.

As "value" investors, you may find it hard to believe that we are defending growth. To be clear, we are not defending high multiple stocks that discount high and long-term (practically perpetual, in today's markets) future growth estimates that will be very difficult to achieve. We are defending the notion that growth is important for value creation and in determining business value. We do not invest in declining franchises, but we are not afraid of investing in companies that face declines because of end-market cyclicality, as long as the company's long-term growth prospects are clear and positive. Growth is essential as a lever to, at a minimum, maintain profitability and cash flows, and can act as a multiplier that assists in compounding returns via better leverage of operating and capital costs.

Quality is also essential, as high-return businesses are worth more than low-return businesses. A business that generates high returns can be inexpensive if it trades at 13x free cash flows, while a low-return business can be expensive if it trades at 8x free cash flows. At returns below the cost of capital, the faster a bad business grows, the less it is worth!

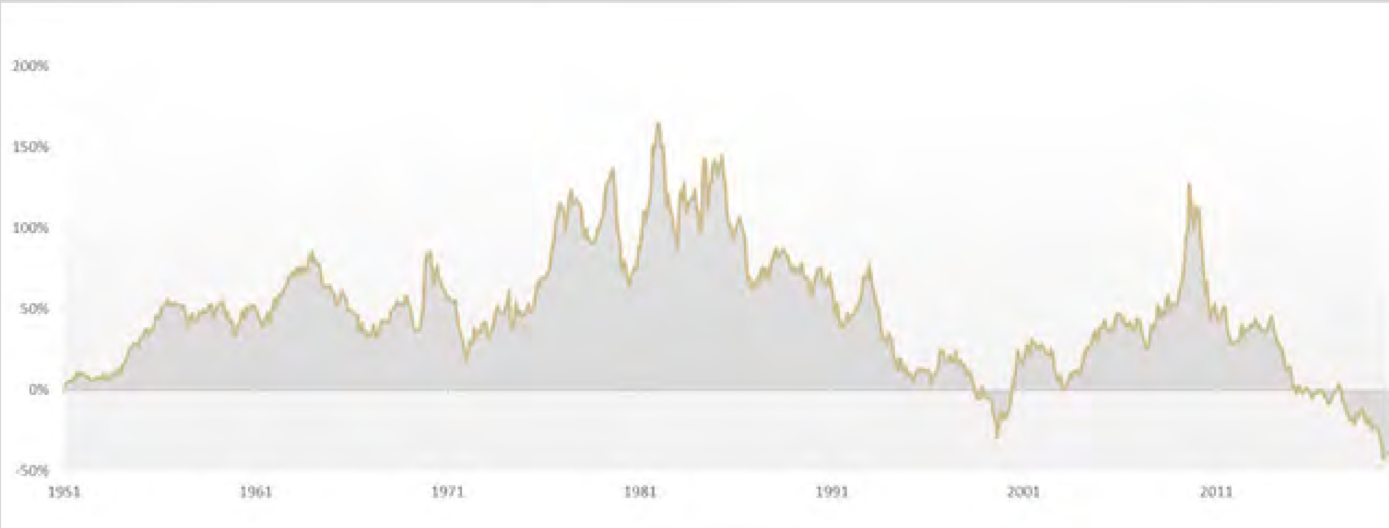
Finally, value is critical to deciding where to invest client capital. Investing is not just about finding great business models in excellent end markets, and that have wide moats that defend profitability. What you pay for implied growth and profitability is as important in the long term as what the growth and profitability actually become. It is a simple concept that generally gets ignored in momentum markets.

High valuations not only require high growth to endure, they also imply high returns on capital — and that growth and return levels are sustainable over a very long investment horizon. We believe it is difficult to forecast factors such as the growth of a company seven years out with any kind of precision. In addition, the farther out you forecast these high rates of growth and return on capital, the more your margin of safety declines. Great companies can continue to execute well even in situations where they face lower valuation multiples due, for example, to concerns arising about the rate and longevity of growth and returns. Companies that can compound earnings at 10% growth at 25%+ rate of return on invested capital (ROIC) for 20 years are extremely rare, yet large swathes of the market currently discount companies in this scenario. Valuation can be ignored for relatively long periods of time, but eventually fundamentals matter, and you run out of investors willing to overpay for stocks.

Regardless of who is winning the growth-versus-value debate at any given time, we think that our value style will continue to deliver strong returns over the long term while protecting capital.

Relative Performance of Low Price/Cash Flow Equities versus High Price/Cash Flow Equities

By the way, even though it is not relevant to this discussion, it may be worth pointing out that in the long term, the race is not even close. In looking at where we stand today in the famous Fama and French historical analysis of investing in low price to cash flow businesses, while shorting high price to cash flow businesses, value wins and by an extremely large margin. The only periods where growth has taken a lead were in the late 1990s tech boom period (not a great outcome for growth investors after that bubble burst), and over the last few years. Although value may not matter for long time periods, it has historically always mattered over the long term, and long-term investment excellence remains our focus. We believe we have the process and investment discipline required to achieve that, which does not bode well for that poor cat.



Source: Societe Generale, Fama & French. Data used with the express permission of Kenneth R. French

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