

“Compounding is boring – b-o-r-i-n-g. Or I should say it’s boring until (after seven or eight years) the money starts to pour in. Then, believe me, compounding becomes very interesting. In fact, it becomes downright fascinating!”

Richard Russell

Here’s a fact that says a lot about how it feels to be a participant in today’s stock market. Going back to the beginning of August, the US Market is roughly unchanged, but over that period the index has seen *eight* declines of 5% or more, and *eight* advances of 5% or more. To put this volatility into perspective there were (incredible as it might seem today), two 12 month periods in the 1990s where the US market went without a single decline of 5%*.

Heightened levels of volatility in the UK market have been similarly pronounced of late, but should investors care about this wild volatility? Not really, I say! Not, at least, for long-term investors who’s aim is to compound their savings in good businesses year-in, year-out. In my August investment view, as markets hit their intra-year lows, I wrote the following:

“Diageo shares have fallen -13% over the last three weeks, but our view on the future cash generation of this business is unchanged, and we expect the business to continue compounding shareholder value at a market-beating rate. Several other shares we own, of similar predictability, have fallen by as much or by more than this, but our view on long-term values is unchanged.”

Since the day I wrote that, 4 months ago, Diageo shares have risen +19.0%, and our view on its long-term value *still* remains unchanged. Stock prices behave a little like tuning forks after they’ve been struck. At first, over the short-term (i.e. days, weeks and months), they oscillate wildly, generating high overtones (‘noise’). Today’s market resembles a tuning fork that has been struck with particular vigour. But looking over longer time periods (i.e. years), these oscillations diminish in importance as share prices move towards their ‘pure musical note’ (i.e. more and more closely to underlying business fundamentals). If you take any company with a twenty-year trading record, and overlay a share price graph with the fundamental progress of that company’s free cash flow per share they will – almost without exception – be very closely correlated.

How to beat the market over 10 years

Over the last ten years the UK market has returned a somewhat pedestrian +58% (+4.5% a year). Over this same period though, plenty of stocks (while often fluctuating wildly in the short-term) have shone through the noise of short-term market moves and changing economic conditions, to make multiple times this amount. So what are the characteristics of these big winners? And how have they made their shareholder’s money? Below is an analysis of three stocks in our investable universe that have been great friends to shareholders over the last decade.

Exhibit 1: The Stalwart - Unilever

+143% 10 Year Total Shareholder Return vs 58% for the UK market

- 1) Sales growth = +34%
 - 2) Operational/Financial leverage = +68%
 - 3) Dividends = +63%
 - 4) Devaluation (the balance) = -22%
- = +143%**

That Unilever has managed to outperform the UK market by 85% over the last decade (a record that any fund manager would be proud of) is impressive, particularly given that it spent much of this period struggling for strategic direction. Back in December 2001, Unilever was heavily indebted (£14bn net debt) after its Bestfoods acquisition, and referred to by many as a branch of the British civil service – slow to make decisions, lacking focus etc. However, its strong portfolio of brands and its steady ‘cash compounding’ credentials have allowed it to grind out a very solid +9.3% p.a. return regardless, compared to +4.5% p.a. for the market.

So how did it do it? For the purpose of this exercise, as shown in the summary above, I’ve broken Unilever’s total return down into four main elements: 1) Sales growth 2) Operational/Financial Leverage 3) Dividends 4) Valuation (the balance).

Unilever's sales over the last ten years have been unremarkable at +3.0% per annum (we think the business can do significantly better than this over the next decade). This adds up to a +34% contribution to total return over the ten year period. Operational leverage has had a more significant effect, adding another +68% (mainly thanks to a steady increase in margins over the period). A great characteristic of Unilever, which we look for in all the businesses we invest in, is its ability to grow without much need for incremental capital. This leads to very high returns on equity, and lots of excess cash flow. Thanks to this characteristic, Unilever has been able to pay a high and growing dividend, whilst also paying down debt levels by more than £8bn (!). As a result, dividends have contributed another +63%.

So sales growth, operational leverage and dividends have delivered a fundamental return of +165%. The balancing item, valuation, has dragged down the total return -22%, as the PE multiple contracted from about c18x to c14.5x over the period. Many analysts would have suggested selling Unilever in 2001 because of its high PE multiple. However, they would have been right in detail but wrong in substance. The PE multiple has indeed fallen but, despite this, the stock has still outperformed the market by nearly +5% a year, due entirely to the solid fundamental progress it has achieved.

Exhibit 2 : The Hidden Champion - Diploma

+607% 10 Year Total Shareholder Return vs 58% for the UK market

- 1) Sales growth = +197% contribution
 - 2) Operational leverage = +129% contribution
 - 3) Dividends = +208% contribution
 - 4) Revaluation (the balance) = +73% contribution
- = +607%**

Diploma is not, on the face of it, a terribly exciting stock. A specialist distribution business, the group operates in three main areas – life sciences, industrial seals and electronic controls. Diploma is the business you turn to when you need anything from a replacement part for your dump truck's hydraulic cylinder to a chemical reagent for a diagnostic blood test. However, these businesses, while dull, operate in very niche markets which Diploma has come to dominate over the years. These markets have several attractive characteristics for the shareholder. Margins are high due to large elements of customer service and technical support, while revenues are relatively resilient - Diploma has chosen to focus on essential products and services funded by customer's operating budgets, rather than capital budgets. This meant that despite being exposed to some pretty awful markets in the 2008-9 downturn (such as US construction equipment), sales only fell by -7% in 2009, before growing by +15% and +26% in the subsequent two years. Finally, Diploma exhibits very high returns on capital. Without much in the way of assets to maintain, Diploma has generated very healthy excess cash flows over the years, which have been deployed in both growing dividends and making small, sensible acquisitions.

Thanks to all the above, Diploma has been able to grow sales by a total of +197% over the last ten years. Operational leverage has added an extra +129% to return as margins have grown. Financial leverage has not come into it at all – Diploma ran a cash balance in 2001 and continues to run one today, and its share count has remained constant. All this tells you that the very impressive +16% p.a. earnings growth has been generated entirely from reinvestment of internally generated cash flow. Dividends have simultaneously marched higher at a rate of +17% per year - contributing another +208% to total return. Finally, unlike Unilever, Diploma has benefited somewhat from a revaluation in its shares. However, this element (+73%) is a still a relatively small percentage of the overall +607% return. The rest has been delivered the hard way - by steady fundamental progress.

Peter Lynch would have called Diploma a '7-bagger', making you more than 7 times your money in ten years. If you searched around the market looking for 7-baggers, you might think the only places to look would be high-growth 'concept' stocks, small-cap oil or mining shares, or recovery stocks where the risk of bankruptcy was high. But it's surprising how many of the 'dull plodders' of the world – like Diploma - have steadily turned their shares into 7-baggers or more. In Diploma's case, only a small portion of its return came from a revaluation of its earnings stream.

Exhibit 3: The Haymaker – Weir Group

+970% 10 Year Total Shareholder Return vs 58% for the UK market

- 1) Sales growth = +108% contribution
 - 2) Operational/finance leverage = +253% contribution
 - 3) Dividends = +299% contribution
 - 4) Revaluation (the balance) = +310% contribution
- = +970% Total Return**

If you bought Weir shares back in 2001, it has been more than a ‘10-bagger’ for you. So how did Weir Group do it? As with Unilever and Diploma, fundamental performance has accounted for a good chunk of total return. Weir has a very strong position in the markets it operates in (pumps and valves for the mining and energy sectors). A large portion of its revenue is derived from spare parts and servicing its equipment once installed. These qualities, combined with a favourable backdrop in its underlying markets, have led to a +108% contribution from sales growth. Operational leverage has contributed another +253% as margins have expanded and a little debt has been taken on. Dividends have contributed another +299% to total return. So on fundamentals alone, Weir Group, is a 7-bagger. However, a revaluation of Weir Group’s earnings has turned the stock from a 7-bagger to a 10-bagger.

We owned Weir Group in 2009/10, but subsequently sold it as its forward cash returns dropped to a level we weren’t comfortable with. We are also concerned that currently earnings are buoyed by some ‘Chinese froth’, which we think will dissipate in coming years industrial metals demand from China wanes. But this takes nothing away from the inherent strengths of Weir’s business model, The interesting point here is that Weir has steadily come up with the goods thanks to its intangible strengths - intellectual property, a strong reputation and a market leading position. It would have been a great stock for shareholders on fundamentals alone. As it happens, favourable markets and the subsequent upward valuation in its shares have turned Weir into one of the great haymakers of the last ten years.

Focusing On Intangibles

In summary, the three businesses above all own strong intangible assets (strong brands, intellectual property etc.) that give them three great characteristics, all of which are key for long-term wealth creation:

- 1) Good, resilient growth
- 2) High returns on equity
- 3) High excess cash flows

The great investor Charlie Munger underwent something of a conversion in the 1970s. He realised that investing in this type of high return, intangible business was far more enjoyable than investing in low return, asset heavy businesses - even if the latter often looked statistically cheaper on conventional measures such as price to earnings and price to book multiples. His investment results over the next 30+ years verify the logic behind his decision. As he puts it *‘over the long term, it’s hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6 percent on capital over 40 years and you hold it for that 40 years, you’re not going to make much different than a 6 percent return – even if you originally buy at a huge discount. Conversely, if a business earns 18 percent on capital over 20 years or 30 years, even if you pay an expensive looking price, you’ll end up with a fine result.’****

In the current stomach-churning market, it’s worth remembering this key concept – *quality delivers in the end*. The best businesses can ‘push on through’ the short-term noise on their journey to long-term wealth creation, and should therefore be cherished. As they steadily compound cash flows, many will turn into multi-baggers over time, even if the process may sometimes feel a little like watching paint dry!

A very Happy Christmas to you all and I hope 2012 treats you well, whatever it may bring....

Hugh Yarrow
December 2011

*Please note, these views represent the personal opinions of Hugh Yarrow as at 14 December 2011 and do not constitute investment advice. Share price data from Financial Express (as at 8 December 2011). Company fundamentals from Wise, Bloomberg and Collins Stewart. *Source: Bespoke Investment Group **Source: The Conscious Investor.*