

# T H E L O N G V I E W

March, 2000

## *Value, Time and Temperament*

One of the more important purposes of *The Long View* is to inform our readers how we at Manitou think about investing. Central to our approach is the fact that, when examining a potential investment, we do indeed take a long view.

### *Two Styles of Investing*

People who buy stocks can be divided into two groups – based upon their time horizon.

One group tries to predict the current demand and supply for a stock. These are the day traders and other momentum players. They don't spend much time thinking about the underlying company. They are happy to buy a stock that is moving up because they believe they will be able to sell it to someone else at a higher price. This behaviour, which is based on what is called the Greater Fool Theory, can, of course, lead to substantial and quick profits – and has often done so in recent years.

It will also occasionally lead to an asset bubble – a market that rises so fast or for so long that prices lose any relationship to the earnings likely to be generated by the underlying assets. The U.S. stock market in the late 1920's and the Japanese stock market in the late 1980's were both examples of this. And we think that, notwithstanding the huge positive impact that the Internet will have on society, today's market for Internet stocks also constitutes a massive bubble.

This technique of momentum investing does not fit our temperament. We would not be comfortable investing our own money in a manner that could lead to a substantial loss of capital, and so will not invest our clients' money in that way.

The other – currently less fashionable – approach, to which we subscribe, is to view shares of a company as a piece of an on-going business.

When we buy a piece of such a business, we minimize the risk of loss in two ways. First, we buy only businesses that we know well and that we believe have excellent long term prospects. Second, we buy those businesses only when they are trading below our estimate of their economic value – thereby building into the investment what Ben Graham called a margin of safety.

We then hold these investments for the long run, allowing their value to increase over time and the market price to reflect that value. This buy and hold strategy postpones the payment of tax so that the full amount invested is compounding for the benefit of the investor.

### *But What is Economic Value?*

We said earlier that we buy shares of a company only when the market price of that company is less than our estimate of its economic value. But what exactly *is* the economic value of a company?

A company is ultimately worth only what you can get out of it. And so the economic – or intrinsic – value of a company is simply the value of the cash that could be taken out of the business during its remaining life. It is the present value of the free cash flow – the cash produced by the business which is not required to maintain the business – that will be earned by the company.

To use an analogy, imagine a bond which never matures, but which pays a fixed amount of interest forever. The value of this bond is simply the value of all payments investors expect to receive in perpetuity, discounted at an appropriate rate. A useful way to think about a share of a company is to view it as a perpetual security from which investors receive the benefit of, not a fixed, but rather a variable (and usually increasing) stream of money – the company's free cash flow.

But, you may well ask, how can anyone hope to predict the cash flow of a company over the very long run? Of course, you can't do so with any degree of precision. But if you confine your attention to a reasonably small number of good companies and, in each case, you have an in-depth knowledge of the business and an informed view of management, you can make a reasonable estimate of future cash profits.

### *A Real Life Example*

Using a real life example has two advantages. It provides a practical perspective. And it gives us an opportunity, over the next several years, to demonstrate publicly the validity of our approach.

Investors Group Inc. is a large Winnipeg-based company that has been selling financial products, in particular mutual funds, since 1950. The sales force consists of well trained employees who help Canadians – often across a kitchen table – to set and achieve their financial goals. Senior management – including the Chairman, Robert Gratton, and the President, Sandy Riley – are just the sort of people you would want to have running a company which you own. About two thirds of the outstanding shares are owned by Power Financial Corporation – a dominant owner with an excellent track record and a long term view.

Generally speaking, the Canadian mutual fund industry is divided between fund companies such as Trimark and Mackenzie which provide the investment product, and sales companies – typically financial planners or stock brokers – who sell the product. Investors Group, however, provides both the investment product and a dedicated sales force to go along with it. Consequently, it is able to earn a significantly higher profit for each dollar of assets under administration. Return on equity over the past 10 years has averaged in excess of 20% – putting it easily in the top 10% of Canadian companies. And history has proven that, in market downturns, Investors' revenue suffers much less than that of other fund companies – largely due to its strong client relationships and its wide range of financial products.

Investors Group's revenue is a function of the market value of its assets under administration – currently about \$40 billion. Revenue rose from \$200 million in 1989 to over \$1 billion in 1999. Over those ten years the company increased its free cash flow per share by more than 13% per annum.

### *Estimating the Real Value of Investors Group*

Looking forward for the next 10 years, we will make the conservative assumption that net sales will increase assets under administration by about 4.5% per annum (versus about 10% per annum for the past 10 years) and the assets managed by Investors will increase, as a result of market price appreciation, by about 5% per annum. So revenue would increase by about 9.5% per annum. We will assume that free cash flow (currently \$230 million) will grow at the slightly slower rate of 9%. We will also assume that the number of shares outstanding will remain constant.

Of course, no company's revenue and cash flow can outgrow GNP forever. The growth of a component part cannot forever exceed the growth of the aggregate. So, in the very long run, Investors' revenue growth will have to decline to the level of, or more likely below, GNP growth. Let us assume, somewhat arbitrarily, that after the free cash flow grows at 9% for ten years, the growth rate declines steadily for another 10 years until it reaches 3% - where it remains.

Based on these conservative assumptions, and using a discount rate of 10%, a rough estimate of the economic value of Investors Group would be \$27 per share, or almost twice the current market level of \$14.

### *Why Does the Market Undervalue Some Companies?*

Why does our conservative estimate of economic value vary so greatly from the market price? One of the principal reasons for this discrepancy is that the stock market is short sighted. It doesn't look very far back into the past or forward into the future.

In the short run, the market will often focus on recent earnings rather than long term factors. So a drop in earnings growth over the past year (or even the past quarter) may result in a substantial drop in market price. If there has been no fundamental change to what is a good business, this can provide a wonderful opportunity.

We think Investors Group is a case in point. Many of its mutual funds have underperformed the market over the past two years. This has resulted in slower growth in assets and therefore revenue. Over the next five or ten years, however, the company's investment performance is highly likely to match that of other fund companies, and its growth in revenue is likely to return to its former level.

Also, the stock market appears to take the practical view that it's too hard to predict future earnings for more than about five years. The market price is often based on the assumption that earnings will grow at their current rate for another five or so years, and then remain constant. In fact, most public companies will continue to build their earnings for considerably more than five years - in which case the value derived from the growth after five years costs nothing. And it is the highest quality companies - those with an enduring competitive advantage - that have the greatest likelihood of increasing their

earnings for many years. These are the companies that have the greatest discrepancy between price and value.

So, in valuing a company, time is arguably the most important – and the least appreciated – factor.

### *Value is Tied to Long-term Earnings*

To illustrate the importance of time, let's look at the time profile of our estimate of the economic value of Investors Group.

Given our assumptions, less than 4% of the economic value of the company is based on profits to be earned in 2000. The five years from 2000 to 2004 inclusive collectively account for only 19% of the total value. And we would have to reach 12 years into the future to the year 2012, to account for one half the company's economic value. Consequently, and this is an absolutely essential point, if this valuation is to have any validity we must be reasonably confident that Investors Group is going to survive and prosper for many years to come.

### *Price Will Ultimately Reflect Value*

The economic value that we are estimating is, of course, a theoretical concept. It is the value that an investor would receive if he held his investment forever – an impossibility. But understanding this concept is a powerful tool. This is because, although the market price of a company will often be materially lower or higher than its economic value, over time the market price will move toward that value.

Investors and speculators will continually sell each other shares of Investors Group – i.e. pieces of the business – at increasingly higher or lower prices. And, over time, the names of the shareholders will change. But the collective experience of the shareholders will not change. Their investment will remain as inexorably tied to Investors Group's profits as would an investment in any private business.

You can substitute Cisco Systems or JDS Uniphase or Amazon.com for Investors Group. The valuation model will not change. A company's value is not a function of how much the business is going to affect society, or how much it will grow, but rather its future profitability.

*In the case of each and every company, the price at which the shares will be exchanged will move over time toward a price that reflects the company's free cash flow.*

### *Characteristics of the Best Companies*

At Manitou our goal is to identify companies with excellent long-term economics. Examples of companies with steadily increasing free cash flow over the past 25 years include General Electric, Coca Cola and Fannie Mae in the United States and, in Canada, George Weston, Thomson Corporation and Gennum Corporation. These companies represent six totally different businesses and, in most cases, businesses that have changed radically over the period. But each company possessed characteristics that enabled it to substantially increase cash earnings over time.

However, no one should assume that these companies will necessarily perform well in the future. In trying to find exceptionally good companies for the *next* 25 years, our approach is to begin with businesses having a strong balance sheet as well as a high return on equity and reasonably high growth in free cash flow per share.

We then look for qualities which we believe will provide the company with an enduring competitive advantage. We can't say too often (although our clients think we try) that honest and highly effective management is essential. The ideal company will also dominate its marketplace through an unassailable brand, strong client relationships, superior know-how, or some other factor which will prevent it from becoming just another commodity business. The product that the company produces will not be at risk of becoming obsolete due to technological change. And the company's values will include a strong shareholder orientation, which is often reflected in the clarity of financial reporting and the company's compensation system.

### *Operating Results Signal Success*

Once we have invested in a company, we let that company tell us by its operating results – not by its market price – whether we have made the right decision. The speed with which the stock market recognizes business success is much less important to us than the success itself.

And we won't sell a company just because it has become fully valued by the market. So long as the prospective return on equity of the underlying business

remains high, we are happy to watch the investment compound on a tax-deferred basis for many years.

### *A Question of Temperament*

History has proven that this philosophy of disciplined and patient investing is enormously rewarding for those who follow it.

Why do more people not invest this way? One reason may be that to successfully practise this approach, or even to be entirely comfortable with it, you must have a certain temperament – a temperament that approaches not just investing, but life itself, with a reasonably long view.