Skate to Where the Puck is Going

October 4, 2016

In late June, when the United Kingdom voted to leave the European Union, the market reacted strongly. As large-cap growth managers, we didn't panic, and we didn't feel compelled to make any trades. I'd like to explain why, because it's a cornerstone of our investment philosophy, and is somewhat unusual among investment managers.

Today, it seems like everyone has a short-term focus. Many managers de-risked their portfolios in June after Brexit. In their minds, the world had changed. But three weeks later the market came back, and the same managers were re-risking their portfolios.

Indeed, while many managers say they have a longer-term focus, we actually do. When it comes to short-term macro events like Brexit, we don't overreact, because our portfolio is all about quality companies, and when it comes to evaluating those companies, we take a long-term view—a three- to five-year outlook.

Consider high-dividend-yield stocks, which are generating a lot of cash that is being given back to shareholders in the form of dividends. This creates a perceived sense of safety, so many of these stocks are currently trading at all-time highs on a P/E basis. High-dividend-yield stocks are basically momentum stocks right now.

But little consideration is being given to the value of the security. Two large beverage manufacturers, for example, have had declining revenues the past two to three years, but are trading at a 30% premium to the market because investors like them for their 3% dividend yield. Compare that with a major technology company trading at a 20% premium to the overall market but growing at a rate of 15% to 20% a year.

As long-term growth investors, we don't chase the beverage manufacturers because that's what the market wants today; we take a step back and say, "This doesn't make sense." We'd rather own the technology company on a long-term basis.

We see this short-term approach, which we believe is misguided, in some of the best-performing sectors of the year, such as utilities, REITs, and telecom services.

We also see this short-term approach in bonds. Investors want safety given the perceived risks in the world, so they're willing to accept a very low income stream. But that's shortsighted because there's risk to the value of the bond given that rates probably won't go much lower, in our opinion.

What it comes down to is that many investment managers aren't willing to look past the next couple of quarters given performance pressures. Instead, investors chase the latest fad in the market, which are dividends and income today. We've seen this before, in 2011 and 2014. Then, as is the case today, dividend yield was appealing, but as investors gain more confidence that the world isn't ending, that's when our style of investing can benefit.

We take a three- to five-year view, doing a lot of up-front research work to determine which companies should be in our portfolio. We don't wake up one day and say, "We have to buy this stock." We talk about a company for several weeks. This year we've added only about six stocks to our large-cap growth portfolio.

Our investment process is dynamic and involves constant re-assessment of the fundamentals. We believe having some turnover is healthy, because the world changes and you have to anticipate and react. Our selling discipline is driven by valuation and a change in long-term fundamentals.

In some cases, the short-term news can be negative, but the long-term story is still solid. In those cases, market volatility may create an excellent buying opportunity. In other cases, the short-term news may be positive, but the longer-term fundamental picture is deteriorating. So, we might use the short-term strength in a stock to either reduce or eliminate the company from the portfolio.

This long-term approach can seem contrarian, because at times we go against the market tendency, but it has the potential to generate excess return for our clients' portfolios.

No one wants to own a large supermarket chain right now, for example, even though the P/E ratio is compelling, because of grocery deflation. But we don't think that deflation will go on for years; it will end at some point, as demand reduces excess supply in certain categories. So on a three-to-five-year basis, we think the grocery stock is compelling.

It’s a contrarian mindset because we’re buying a stock when no one else wants it, but we’re not doing it simply to be contrarians. Eventually the market reverts and we get the benefit of multiple expansion and increased earnings expectations.

To use a hockey analogy, it’s about skating to where the puck is going, not where it is.

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