EPIC Investment Partners

EPIC Global Equity Fund
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The long-awaited correction – but why are investors missing in action?

Human behaviour rarely changes. Time and again, the financial mistakes of previous generations are repeated.

All investors wait for a correction to allow them to buy high quality companies at attractive valuations, yet when the opportunity presents itself, many lack the confidence to act or find themselves waiting for even greater falls.

However, our experience demonstrates that starting with an understanding of what one owns is the best defence against market folly.

Take ASML, the market leading supplier of photolithography equipment for semiconductor manufacturers. The company was a major beneficiary of the pandemic boom, but the elevated inventories and weaker demand in the semiconductor industry resulting from recent economic headwinds has driven a share price crash from more than €700 per share in November 2021 to below €400 in October 2022.

We took advantage of this market weakness to add to our position in ASML. Our analysis of the company's financial results, order book strength and ASML's dominance in the EUV lithography space (one of the most critical technologies required by leading-edge chipmakers) indicates that ASML has suffered from investor overreaction to short term market headwinds. Notably, at the time of our buying the company had a ballooning order book and was unable to keep up with demand. Whilst more recent financial results have calmed investor nerves and the shares have recovered by over 50%, we believe they still offer good value.

ASML is by no means unique, and there are many other stocks which have the potential to rerate as strong fundamentals are priced in. Another example is Pool Inc, whose shares have in our view been unfairly impacted by fears that weakness in the US housing market will result in fewer pool installations and lower earnings. We are not debating the health of the US housing market, but our detailed understanding of the company means that we are aware that it is relatively insulated from this headwind given its core business is its consumable revenues.

Specific examples aside, I have increasingly seen and heard comments warning that despite the steep market drawdown, the US market is by no means cheap.

This popular point of view is supported by a price to earnings comparison to historical averages. Received wisdom suggests that bear markets do not bottom out at 18.5 times earnings (the recent S&P 500 P/E ratio) which is well above the average multiple for the S&P 500 over the last 40 years.

As a bottom-up investor, my time is spent analysing specific companies rather than indexes, but in our view the response to this interpretation of the US market is straightforward. Multiples can provide perspective, but investors have a propensity to use them to draw overly simplistic conclusions.

The problem lies in the fact that many investors consider a stock with a high P/E ratio to be expensive and a stock with a low P/E multiple to be cheap, irrespective of the company fundamentals. This approach can often be accompanied by a failure to understand what the right P/E ratio is and how is it derived.

To work out the P/E ratio a particular company can justify, one needs to understand the relationship between return on capital (ROIC), reinvestment rate (IR) growth rate (g) and earnings (E) for they are all interlinked.

A company's sustainable growth rate (g) is determined by its rate of reinvestment (IR) and the returns it generates on the investment (ROIC) or g = IR x ROIC

This formula demonstrates that high ROIC companies can achieve the same level of growth as low ROIC companies with a lower reinvestment rate.

The Vice Chairman of Berkshire Hathaway Charlie Munger explains:

"There are two kinds of businesses: The first earns 12%, and you can take it out at the end of the year. The second earns 12%, but all the excess cash must be reinvested – there's never any cash. It reminds me of the guy who looks at all of his equipment and says, 'There's all of my profit.' We hate that kind of business."

If the low ROIC company and the high ROIC company are growing at the same rate, the low ROIC company will have to retain more of its profits to sustain the same level of growth. Conversely, the high ROIC company can distribute more of the profits to shareholders and still grow at the same rate as the low ROIC company.

The excess income the high ROIC company can afford to distribute has value. This implies that companies that grow at the same rate can justify different P/E ratios depending on their ROIC.

For example, at a cost of equity of 10%, a company growing at 7% per annum, has an implied P/E ratio of 10.0 if its ROIC is 10% but an implied P/E ratio of 21.7 if its ROIC is 20%.

The higher ROIC company might appear more expensive, but they are both priced to provide the same level of return.

For the mathematically minded the formula is $P/E = (ROIC - g) / ((r - g) \times ROIC)$, but the implication of the analysis above is that the return on invested capital has a material impact on returns and valuation levels.

McKinsey conducted a study using financial data from Standard and Poor's, Compustat, and Capital IQ for the period between 1963 and 2017. They found that the median return on invested capital for US based non-financial companies, with inflation adjusted revenues greater than $1 billion was stable at about 10% at the turn of the century.

Post 2010, the ROIC of these companies increased to 17%, led by growth in the contribution to the aggregate market ROIC from the life sciences and technology industries from 19% in 1995 to 38% in 2017. These sectors have been primarily responsible for the growth of overall market ROIC over the study timeframe.

So whilst many market participants automatically conclude that the S&P 500 index is more expensive due to the higher P/E ratio, they are often not factoring in the higher ROIC.

In recent years, several companies have decided to delist from UK and European stock markets to relist on the S&P 500 or Nasdaq, in an effort to capture the valuation premium. To their dismay this costly exercise has often not had the desired impact on their share prices.

In our view the reason is simple…. the analysis challenges the assumption that there is a US premium.

If you remain unconvinced that the P/E ratio is not the final word in investment value and returns, consider this.

High quality companies within the EPIC Global Equity Fund such as L'Oréal and Pepsi could have been bought at P/E ratios of 281 and 100 respectively back in 1973 and even excluding dividends, would have still beaten the market.

Over time buying quality pays. When macro-economic factors distort share prices, it should pay more.

The EPIC Global Equity fund is ideally positioned to capitalise on this market opportunity.

Please do contact me if you would like to learn more and I would be delighted to go through our portfolio in more detail and explain the material upside we see in many of our holdings.

Malcolm Schembri
Fund Manager, EPIC Global Equity Fund

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