Growth at *Any* Price?

The more frustrating part of not being able to buy great companies because they're ridiculously over-valued is watching them get even more ridiculously over-valued. This is what we have been doing this year with the likes of Cisco, Oracle, and Sun. So, what are we missing? After all, these are among the largest and most financially sound companies in the world. To boot, they are among the most rapidly growing companies in the world. Average annual earnings per share growth over the past 5 years was 47%, 26%, and 35%, respectively. Sounds good to me!

At least on the surface. The earnings growth *is* terrific. It's even more exciting in the optical networking industry. ***But earnings growth is not everything. Mathematically, it is simply an integral part of the equation.***[*] Let us assume a company grows earnings per share at 24% per year for the next 20 years. Thereafter it reverts to a normal company paying out 50% of its earnings in dividends and growing 5% per year. To get a 10% return in such a company, you would pay about $105 for each dollar of earnings (a P/E of 105). So, outstanding long run earnings growth is worth paying up for. The only problem with this analysis when applied to the above stocks is, who else but God knows what the Tech landscape is going to look like in 5 years, much less 20? Yet, these companies are selling at an average P/E of 105 (115, 106, and 94, respectively).

This brings us to Proctor & Gamble. Now here is a safe company if there ever was one. Laundry detergent and diapers are unlikely to go out of style anytime soon. So, one could make a credible argument that you'll know what this company will look like in 10 years, perhaps even 20. However, what's the chance P&G will grow at 15% per year over the next 20 years? Probably not much. For starters, over the past 20 years they've grown earnings per share at 9% per year. Moreover, the company would have an improbable $650 billion in sales (the entire U.S. economy today is about $7 trillion). Nevertheless, at $118 per share or 49x its earnings, this is how much the company would have to grow for one to earn a mere 9% return on investment.

Yet, as we intimated before, great companies rise to over-valued levels, and their high prices rise even more as their earnings continue to rise. One *can* make money riding the wave. ***We are willing to miss that type of price and earnings growth for one simple reason: we don't want to be there when one day, everyone wakes up and realizes the Emperor is wearing no clothes.*** Alas, this happened with Proctor & Gamble. One of the most admired companies in the world is now selling at a price 50% lower than it was just 6 months ago. Will it rebound? Of course. However, the investor's return from its high of $118 will very likely be sub-par for many years to come. So even the greatest and the safest are risky, when one ignores the element of price.

Fortunately, there are easier ways to make money. Take our top performer last quarter, Nvest, LP. Although not a household name, this $130 billion asset management firm, formerly a subsidiary of Metropolitan Life, produced a stable stream of earnings and had very little debt. Its dividend yield was over 10% and its growth rate in double-digits. Most importantly, it was cheap. Our purchase

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price was between $15 and $20 per share, or only 6-8x its earnings. As many of you know, Paris-based financial conglomerate CDC also thought it was cheap, and decided to buy the entire company for $40 per share.

Unfortunately, opportunities to earn 10% in dividends coupled with double-digit earnings growth are few and far between. And someone willing to buy you out just a few months after purchase at 2x market is an event best placed under the heading 'dumb luck'. ***Nevertheless, opportunities to earn attractive long run returns in high quality companies do exist without having to fear that a giant shoe is about to drop.*** While such companies may be lacking in sex-appeal, in a speculative market environment like today's, the Wall-Flowers will eventually have the last laugh.

Nick Tompras
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* It is indisputable in investment theory that the value of any investment is equivalent to the present value of its future cash flows. This is compounding in reverse. All of a company's future dividends or free cash flow are reduced to a present value by the compound return which equates them.

Specifically: Value = Σ [Free Cash Flow * (1 + Growth Rate)$^{\wedge N}$ / (1 + Return)$^{\wedge N}$]

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