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When Quality Stumbles

In November, the investment world lost one of its greatest minds – Charlie Munger. He was not only a brilliant investor in his own right, but he was also a partner alongside Warren Buffett, and together they produced market-beating returns, rather consistently over many decades, in what uncontestably became the most successful investing duo ever. Arguably, Charlie's greatest contribution to the partnership was his belief in what is now commonly referred to as "quality investing", which he introduced to Warren early on in their business relationship. Back then it was simply described as the act of buying wonderful businesses at a fair price and owning them forever, as long as the protective moat around the business remained intact. This approach, in contrast to Warren's earlier leanings towards buying mediocre or poor businesses at heavily discounted prices and then waiting for a turn in fortune, was without question the better path to long-term riches for the Berkshire partnership. Many investors would argue this approach to be the best path always. The flaw in this argument, which is very much on display in today's market, is that everyone loves a "quality compounder", and has for some time. This affection is reflected in prices, which points to lower returns in the years ahead.

'Quality' as a distinct category or style of investing is relatively new, growing in popularity during the early part of the century and gaining a strong foothold amongst the investment world post the global financial crisis. Quality has really captured the minds of the investment world with its focus on businesses delivering high returns on capital, stable and consistent earnings growth through the cycle with solid balance sheets and seemingly no problems in sight. The market rewarded the consistency and stability of the earnings offered by these 'quality' companies. The thinking being that the stocks deserved their growing valuation premiums given the certainty and protection they would seemingly continue to deliver. This was a comforting offer for investors in a highly volatile world. What perhaps has been lost on many investors though is the fact that, like all assets, quality needs to be underpriced to outperform in the long run. Valuations matter!

The strong returns delivered by quality investing in the post global crisis period was largely the result of the underlying businesses being attractively priced entering the period. World-leading consumer products companies such as Diageo and Nestle, to name a couple, could have been purchased in the early years of the century at low double-digit P/E multiples, exceptionally attractive levels for such high-quality businesses offering stable and consistent growth. By 2021, these stocks were changing hands at north of 25x earnings. Lower interest rates most certainly played a role in the higher valuations, but nothing monumental occurred in the business structure of either of these companies to suggest a new, higher, permanent level of margins or returns. Quality as a style has been one of the brighter spots within the investment industry over the past 15 years or so in terms of gathering assets. The increasing investor demand for businesses with quality credentials acted as a strong catalyst in driving these stocks even higher.

While the proliferation of quality as a standalone investment style has been more of a recent event, we have seen periods in the past where the fascination with superior businesses led to a mindset of "no price is too much" to pay for quality, superiority, and almost assured growth. The most prominent period being the 1970s when investors were fascinated with the Nifty Fifty – a group of 50 large-cap, "blue chip" growth stocks including such prominent companies as Coca-Cola, IBM, McDonalds, and Proctor & Gamble.

In his 1994 book, *Stocks for the Long Run*, author Jeremy Siegel said of the Nifty Fifty, "*The nifty fifty were often called one-decision stocks: buy and never sell. Because their prospects were so bright, the only direction they could go was up, so money managers claimed. Since they made so many rich, few, if any, investors could fault a money manager for buying them*".

From the January 1973 peak, the Nifty Fifty stocks fell roughly 50% on average over the following years, and for many, it took roughly 25 years to regain those early 1973 price levels. A good example would be Coca-Cola, a stock that ended 1972 at a split-adjusted level of $1.55 a share and sported a 48x price to earnings multiple. By the end of the decade, Coca-Cola's stock had fallen a near 54% from the 1972 closing level and was being valued at just over 10x earnings. Clearly there must have been a structural change in the fortunes of this quality business for its multiple to contract as much as it did – not at all. In fact, during what was a very challenging inflationary environment, Coca-Cola was able to grow its earnings at more than 11% per year on average over the period in question while maintaining a pristine balance sheet. The quality attributes that drove investor interest to heightened levels pre-January 1973 were still intact for Coca-Cola the business, it was the stock itself, like others within the Nifty Fifty that collapsed under their own heavily inflated expectations. A perfect example of When Quality Stumbles.

Quality as a style can work very well, but as stated above, it needs to be underpriced to outperform over the long term, which isn't the case today. We at Sionna see better opportunities in classic value, where historically depressed valuations provide an opportunity for outperformance in the periods ahead. The beauty of being a "value" investor is the flexibility it provides to move within all pockets of the market to where value is showing best. As mentioned, today we may be finding classic value an area of great opportunity, but there will come a time when the quality compounders will be on sale, just like Nestle and Diageo were some 20 years ago. That will be the opportunity for value investors like us, because at that point, quality will be value and it will be priced for long-term outperformance.

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