FCI ADVISORS

PERSPECTIVES

Second Quarter 2024

Compound Quality

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In his most recent annual letter to shareholders, Warren Buffett credited the late Charlie Munger with being the "architect" of the present day Berkshire Hathaway. In the earliest days of Berkshire, Buffett's "cigar butt" approach to investing led him to buy stocks at bargain prices, typically the result of an unfortunate turn in business prospects. In contrast, Munger preferred investing in higher-quality businesses and told Buffett as much in 1965: "Warren, forget about ever buying another company like Berkshire. But now that you control Berkshire, add to it wonderful businesses purchased at fair prices and give up buying fair businesses at wonderful prices."

Defining Quality

Identifying a quality business can be both art and science. Evaluating traditional financial metrics such as net profit margin and return on invested capital are one method for assessing quality. Monitoring actions which enhance shareholder return such as stock repurchases and dividend increases are another. Comparing these metrics to peer companies or the broad market is a scientific way of ranking high-quality and low-quality businesses. FCI's equity strategies employ multi-factor screening models that rank stocks in their specific discipline based on many of these quality factors. The more artful approach examines the various ingredients generating quality businesses and top-tier financial metrics. Our research process requires a deep understanding of a company's business model, their long-term strategy and their industry structure. We also firmly believe a strong management team and corporate culture are critical, yet often overlooked, components to assessing the quality of a company. Ultimately, the handful of stocks that meet the strict criteria of both approaches can become powerful compounders in client portfolios.

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Magnificent Seven

The market's latest fascination is a group of seven stocks in the S&P 500 driving a significant portion of performance – Apple, Microsoft, Alphabet, Meta Platforms, Amazon, Tesla and NVIDIA. Combined, these stocks make up a staggering 29.4% weight in the S&P 500. Since the S&P 500 is a market capitalization weighted index, the largest and most valuable stocks rise to the biggest weights over time. Over the next five years, these stocks are expected to average 13% revenue growth and 17% earnings growth per year. This growth is significantly faster than the market, suggesting their influence over the S&P 500 may continue to grow in future years if estimates prove correct. Many in the financial community are bemoaning the success of these stocks believing it is a bubble set to burst. However, these stocks are a classic example of high-quality businesses and the power of compounding.

According to a study by Empirical Research Partners published in February 2024, in the last 70 years just over 100 large-cap stocks have actually delivered a five-year, hyper-growth run similar to what is forecast for the Magnificent Seven over the coming five years. However, one key difference between the Magnificent Seven and their 100 ancestors is profitability, or lack thereof. The 100 large-cap stocks had negative free cash flow margins going into their hyper-growth run and after five years of meteoric growth only finished with 3% free cash flow margins on average. As a group, the Magnificent Seven currently have greater than 20% free cash flow margins, which is twice the overall market's average. Perhaps their share of the S&P 500 market capitalization is justified after all.

Index Construction Matters

Small-cap stocks offer exciting compounding potential in a diversified portfolio. The small-cap market is filled with recent initial public offerings (IPOs) and early-stage growth companies that have the potential to move up the market-cap scale rapidly, such as Priceline.com, now Booking Holdings Inc., did in the mid-2000s. However, there are many small-cap stocks which face challenges to reaching profitability and ultimately obtaining a higher market valuation. While small-caps have historically provided one of the highest long-term annualized returns of any asset class, we can still differentiate within the small-cap space to further maximize returns. Weeding out the companies that can't transition to profitability is one way to add value. Currently, 42% of the underlying companies in the Russell 2000 Index are unprofitable, which is up from around 10% in the mid-1990s. The secular rise in the number of unprofitable companies has been linked to zero or near-zero interest rate policy, which has now likely ended. The S&P 600 on the other hand utilizes an earnings screen – companies must have a track record of positive earnings before they are added to the index. This quality factor likely explains why the S&P 600 has outperformed the Russell 2000 Index by over 1.6% per year for the last 25 years.

Dividend Signal

In addition to price appreciation, the dividend component accounts for a significant source of the market's total return. Over time, high-quality dividend payers tend to outperform non-dividend payers. The best performance within dividend payers, though, is clearly seen in the companies which initiate and raise their dividends annually, as opposed to maintaining or cutting the dividend. Management teams that raise their dividend consistently are projecting a positive signal about the future prospects of their business. The quality of the dividend, backed by a highly profitable and growing business, combined with a sound dividend philosophy is key. Interestingly, Magnificent Seven constituent, Meta Platforms, announced their first quarterly dividend in February, providing another compelling reason for investors to own the stock.

Let It Be

Munger's advice to Buffett about buying wonderful businesses at fair prices came with an important rule: Don't unnecessarily interrupt the compounding of these stocks. Trying to avoid every 10% pullback in the market, of which there have been 25 since 1980, is nearly impossible and would have likely resulted in missing out on incredible long-term performance. Focus instead on letting high-quality investments compound in your portfolio. Having this quality bias, as we have at FCI, can provide attractive long-term returns and give you peace of mind during difficult market conditions.

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