US Equities

Quality, quality, quality

April 2015 - By Wolfgang Fickus, CFA

Why bother with the US market with an upcoming rate cycle and strong USD? A good place to start is that the US market's growth and cash fundamentals over the past decade have been superior to any other region. We found that looking at free cash conversion and EPS growth indicates the US market actually does not look overvalued from a pure fundamental point of view and likely remains an attractive long-term opportunity. Currency has had a large impact recently, but at Comgest we distance ourselves from things we can't control such as unpredictable currency fluctuations and we don't think a strong USD is a threat to the fundamentals of our portfolio holdings' competitive positioning. With the US market's strong fundamentals our US portfolio has terrific. Portfolio holdings' cash returns (80-90% free cash conversion) and strong EPS growth (double-digit) have helped us beat a tough benchmark over the past three years (2% annualized outperformance), pushing our Growth America fund amongst the top 10 of its Morningstar US large cap growth peer group.

Currency has had outsized impact on investor returns

Along with the collapse in oil prices, the USD move has been dominating financial headlines over the past nine months. It has to a large extent disturbed the view for organic and underlying growth trends, especially in the US and – as a mirror image – European equity markets.

For equity investors the currency swings mean that currency decision has a key driver of returns over the past 6 months as evidenced in the table below.

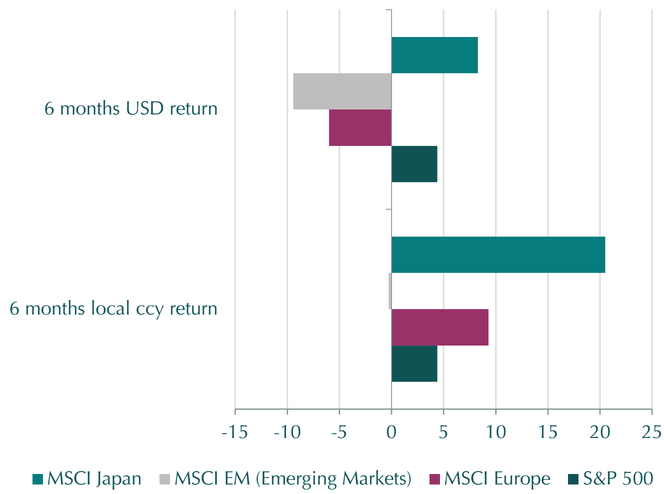

Figure 1: USD and local currency returns (%)
Source: Factset

USD strength has started to cause difficulties for the US stock market. A strong USD bites into reported earnings figures, as has become evident with the latest reporting season, when earnings momentum for the US equity market turned negative.

The US equity market has suddenly switched from being one of the most loved to one of the most hated markets. More and more market participants are now saying the US market has become too expensive. Short-term earnings momentum and anticipation of the Fed rate policy are prompting equity flows out of the US and into the European equity market, where reported earnings figures are starting to be boosted by the EUR weakness.

The US equity market – abundant quality and growth

Is the US stock market really too expensive now, and how will it perform in the course of the year? We believe the first question can be answered by looking

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at the growth and cash fundamentals, but the answer to the second question is of course that we don't know! What we do know, though, is that an exposure to US equities makes sense – with a long-term investment perspective as is our credo at Comgest – in view of the strong quality and growth track record of this market. We believe it makes sense to look beyond the short-term currency and interest rate dynamics, which can drive short-term valuation swings, and to focus on the long-term quality franchises and growth available in the US equity market, which is how Comgest has built a high-quality US growth portfolio.

Strong growth and better quality earnings over the long-term relative to other geographies have valuation implications both for our US portfolio as well as for the wider US market. While our stock picking is very concentrated and independent of benchmark considerations (i.e. our US, European and EM investment universes only represent 9%, 12%, and 8% of S&P 500, MSCI Europe, and MSCI EM constituents), it is clear that our US team selects stocks from a comparatively large pool of what we believe are quality-growth companies. The strong exposure of the US equity market to the IT and healthcare sectors with world market leading franchises in both sectors (Google, Microsoft, Qualcomm, Facebook, Visa, Adobe, Amazon, J&J, Pfizer, Merck and Medtronic to name a few) as well as its large pool of dynamically growing mid-caps are elements of this equation.

So, how should we determine quality? Free cash conversion captures the quality of net earnings, and is hence a good yardstick in our view. From a fundamental point of view, a stock is worth more the more cash the business throws off and the higher the earnings growth. Two businesses growing at the same pace, one accumulating cash, the other accumulating debt, are worth very different amounts. It is also possible that a stock with a lower growth rate is worth more, of course, for instance if it generates substantially more cash every year. This simple equation holds true for a basket of stocks, i.e. a stock market index, as well.

The tables below illustrate the growth and free cash fundamentals of today's MSCI Europe, S&P 500, MSCI Emerging Markets and MSCI Japan indices. We calculated the free cash conversion rate for every index as well as the realized EPS growth over the past 10 years and the US equities market leads the geographical comparison by a rather wide margin both in terms of earnings growth (EPS CAGR in local currency) and cash earnings (average free cash conversion[1]) delivered over the 2004-2014 time period.

1 Free cash conversion defined as operating cash flow minus capital expenditures divided by adjusted net income

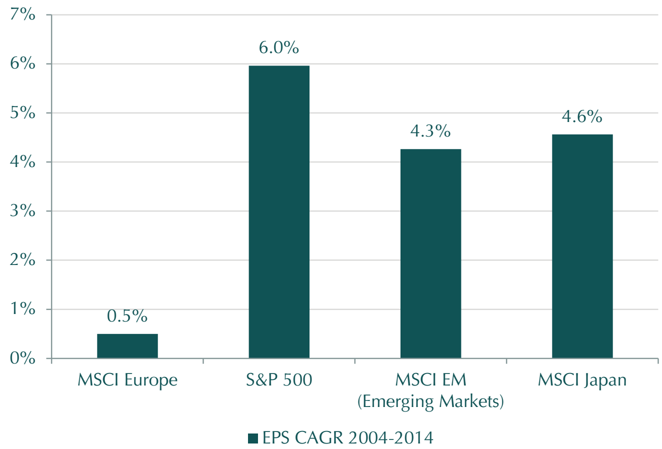

Figure 2: 10 year EPS growth CAGR (in local currency) USA vs. RoW (2004-2014)
Source: Factset

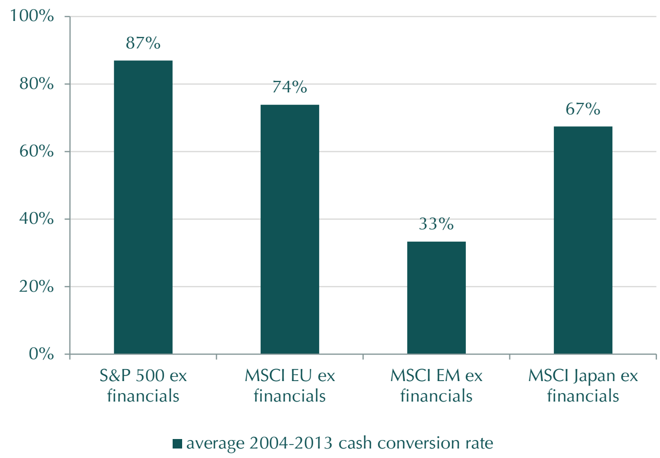

Figure 3: Free cash conversion - USA vs. Europe vs. Emerging Markets (2004 - 2014)
Source: Factset

The table below shows, from a purely theoretical, long-term and fundamental standpoint, the relationship between cash conversion, EPS growth and a justified one-year forward price earnings multiple (P/E) for an index assuming an 8.5% return expectation by the equity investor. To calculate the 'justified' P/E, we use the average cash conversion rate calculated above and combine it with its past 10 year EPS growth CAGR as input factors for a dividend discount model (DDM)[2].

2 In this exercise we have used a DDM and equated the free cash conversion to the payout ratio for every market. The inputs are cost of equity = 9%, growth = 10-year CAGR achieved over the 2004-2014 time period, terminal growth after 10 years = 2%.

	average 2004-2013 cash conversion rate	EPS CAGR 2004-2014	Justified PE
S&P 500 ex financials	**87%**	**6.0%**	**18.2**
MSCI EU ex financials	74%	0.5%	11.3
MSCI EM ex financials	33%	4.3%	11.6
MSCI Japan ex financials	67%	4.6%	14.7

Figure 4: 'Justified' P/E as a function of earnings growth and cash conversion
Source: Factset

Assuming the past is a good guide to the future, this exercise anecdotally indicates that the US market does not look overvalued relative to other equity markets from a pure fundamental point of view. In fact, the US market seems to warrant a certain premium to Europe, Japan and EMs. More importantly, the US market has been a "must-have" for investors with a long-term investment horizon, as long-term growth and cash fundamentals have generated substantial value for long-term investors. We think there is no reason to think the character of the US market substantially changes in the years to come, and thus think the US is a core holding for long-term investors.

The Comgest Growth America fund

With that in mind, let's now focus on both the growth trends and cash conversion inherent in our portfolio holdings, as well as examine the short-term impact of the strong USD.

What does USD appreciation mean for our US holdings? While a sustained change in exchange rates can affect a company's long-term cash generation, upon which its valuation is based, it is important to distinguish between translation risk and transaction risk. We argue that for the large part of our portfolio holdings currency swings are a translation issue without lasting impact on cash generation, and less a transaction issue (please see our note 'Does a weak Euro matter' from February 2015 for further details), which would impact cash generation in the longer term. We add that in line with the US economy, where exports represent only 13.5% of its GDP[3], the European economy is much more exposed to exports. The Euro area boasts an export ratio of 42.7%[4] in 2013. Consequently our US portfolio has more of a domestic footprint than our European strategy, for example, which limits currency exposure at the root. A number of our mid-cap companies such as Verisk Analytics (US insurance software), J.B. Hunt Transport Services (US transportation), Paychex (US payroll software) or Whole Foods (US organic food retailer) are 100% exposed to the domestic market. Large cap company Comcast (US cable), the 2nd largest position in the Comgest Growth America fund, boasts 94% US revenue exposure.

3 Source : OECD and RBC Capital Markets, trailing past 4 quarter average

4 Source : Worldbank

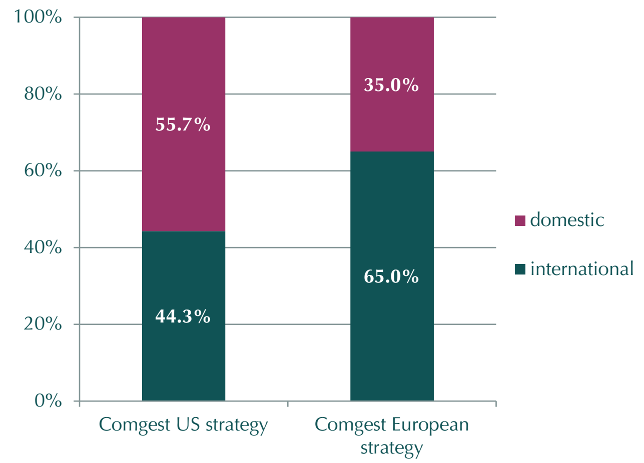

Figure 5: Regional revenue breakdown - Comgest US vs. European strategy
Source: Factset

Even so currency moves have started to negatively impact our holdings' reported sales and earnings figures and will likely do so over the remainder of the year. Over the past three months the EPS for the fund has been revised downwards by 4% (as of 31/03/2015) mostly due to currency translation effects. On the other hand, domestically exposed stocks such as Verisk, Whole Foods and Cinemark have witnessed earnings upgrades. Despite the negative impact on short-term earnings, we overall do not see the USD affecting the fundamentals of our portfolio holdings over the long-term.

Indeed the Comgest Growth America fund has delivered a strong quality of earnings and good growth over the past several years. The free cash flow conversion rate of the Comgest US portfolio hovered in a close range of 83% to 94% over the past three years. This cash conversion rate compares favorably with the S&P 500 ex-financials.

In terms of earnings growth the Comgest Growth America fund also compares favorably with the index. The fund has delivered double-digit EPS growth over the past three years and is forecasted to grow EPS by 6.6% in FY2015 and 11.8% in FY2016, while our analysts forecast a 5-year EPS CAGR of 12% for the portfolio. The S&P 500 is forecasted to grow EPS by 2.4% in FY2015 with 12.8% currently forecast for FY2016, while it grew earnings over the 2011-2014 period with a CAGR of 6.2%. Overall growth of the Comgest Growth America compares favorably with the benchmark index.

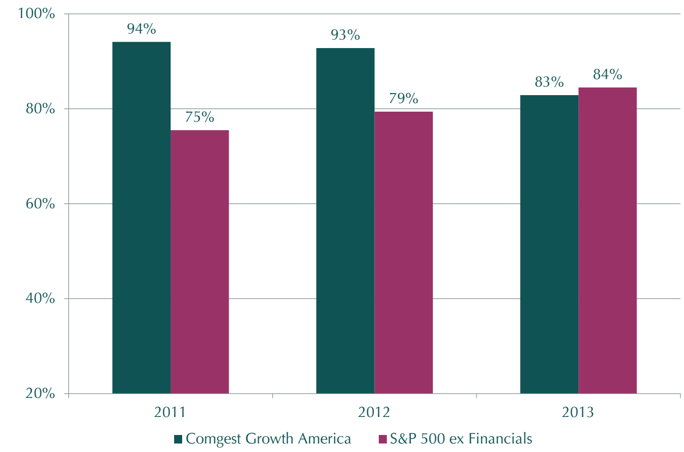

Figure 6: Free cash conversion rate - Comgest US vs. S&P 500 ex financials
Source: Factset

Portfolio positioning

Just under two-thirds of the Comgest Growth America portfolio is exposed to the IT, health care and industrials sectors.

Two mega-trends sustain the overall growth in the healthcare sector: the number of people over 65 will increase by 2 to 3% annually in developed markets for the next 20 years and emerging markets are embracing advanced medical treatments at a very quick pace. A short-term boost to the sector also comes from the implementation of the Affordable Care Act, also called "Obamacare", leading to an increase in healthcare consumption in the US. Besides these tailwinds we believe that our companies have company-specific characteristics that should help them to outgrow their peers.

For instance, Becton Dickinson remains the clear leader in needles and syringes. These mundane healthcare consumables are difficult to manufacture at scale and therefore at an attractive cost. Furthermore they are among the first items used in emerging markets when health budgets allow for vaccinations and blood tests. Becton has expanded from this core business to testing equipment for infectious diseases and blood tests as well as more recently infusion pumps used in hospitals. Becton could possibly grow earnings at more than 10% per annum for the foreseeable future.

BioMarin has tripled its revenue in a few years by focusing on a single niche market: the treatment of genetically-defined metabolic disorders. There are hundreds of these metabolic disorders, some affecting only a few hundred patients. The clinical development risks are very low, and BioMarin has never failed a clinical trial. By keeping its focus the company is able to attract the best scientists in this space both as employees or partners. Its rich pipeline could enable the company to double in size in the next three years.

We use the same bottom-up, stock-specific approach to investing in technology companies.

For example, Cavium and Microchip operate in a sector – semi-conductors – where growth has decelerated over the past 15 years, now barely growing faster than nominal GDP. Despite this, these two companies have outgrown their peers for the past decade and given their products and strategy we believe this trend could continue.

Cavium has developed a lead versus peers in its multi-core processors, which are finding an increasing number of applications, such as security appliances, cellular base-stations and in the future in data-center servers. Servers are particularly exciting, because going forward we think Cavium could be positioned as the only credible dual-source manufacturer to complement Intel. We estimate that the company could keep growing its top-line at a 20% pace.

Microchip sells tens of thousands of different micro-controllers and analog components to tens of thousands of customers. These components are typically cheap ($5-10) but perform critical functions in products as diverse as consumer electronics, cars, and medical equipment. Microchip has been able to double its market share in the past 15 years not only by having the best products but also by helping its customers integrate the Microchip products very early in the design stage. All of the company's customers are now trained in using its proprietary design tools, making many of them recurring buyers. We estimate that the company could be able to keep growing its revenue at 5-7% per annum.

We own two unique assets in the transportation space. Simply put, the US is a big country, which makes the use of rail for freight transport the most economical option for distances above 1000km. Kansas City Southern is one of two railroad operators in Northern Mexico in addition to owning a large north-south network in central US. Mexico is now cost-competitive with most Asian locations for manufacturing for the North American market, and integrating Mexican production into the US distribution network in only becoming more important. For instance automobile manufacturing is estimated to jump from two to five million cars per year by the end of the decade, driven in large part by production by Mexican factories. Kansas City has the network to accommodate this growth and on current estimates could be able to keep growing its earnings at a 15% annual rate.

JB Hunt is far and away the leader in intermodal transportation, which consists of transporting containers by rail before delivering them by truck to their final destination. This saves on time, energy and on overall costs. The market for intermodal transportation grows at 7 to 10% annually and JB Hunt is likely to continue to take share.

Performance of the Comgest Growth America fund

As of 31 March 2015, the Comgest Growth America fund has delivered a 2.0% USD total return YTD versus 0.8% for the S&P 500. Its annualized three-year performance of 17.4%, more than 200 bps ahead of the S&P 500, has been aided by the fund's superior EPS growth versus the benchmark.

Consistent with the low volatility generally achieved with Comgest's quality-growth investment approach, the fund's Sharpe ratio over the past three years ranks #7 out of 568 large cap US equity funds in the Morningstar universe.

As of the end of February, Comgest Growth America is amongst the top 10 funds of the Morningstar US large cap growth equity peer group for performance over one and three years, achieving a top decile ranking.

Over the past three years, the top five contributors to this performance have been BioMarin, Medtronic, Ecolab, Comcast and Visa. Stock picking in the healthcare segment has been one of the key drivers for the fund's relative performance as well as a minimal exposure to the energy sector, which has largely underperformed the US equity market.

Wolfgang Fickus graduated from the University of Cologne (Germany) where he majored in business administration. He holds a business graduate (Diplom-Kaufmann), a CEMS-Master and is a CFA charterholder. Wolfgang started his career in 1995 at Paribas Asset Management Paris as a European-equity fund manager. In 2000 he moved to WestLB where he worked until August 2012 as an analyst for European Technology stocks before becoming Head of Mid-and Small Cap Research. Wolfgang joined Comgest in September 2012 and is a Member of the Investment Committee.

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