OUR TWO CENTS

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After graduating as a chemical engineer, Garrett pursued his master’s degree in finance and investments and is currently writing his CFA exams. Garrett gained experience in the modelling and optimisation of financial data through his postgraduate research. As one of the newest members of the New Road Capital team, he enjoys his role as an investment analyst, where he gets to follow his passion in solving challenging problems using mathematics and technology. In his free time, Garrett never misses a Grand Prix, and has been doing Brazilian Jiu Jitsu for more than 10 years.

Growth and Valuation

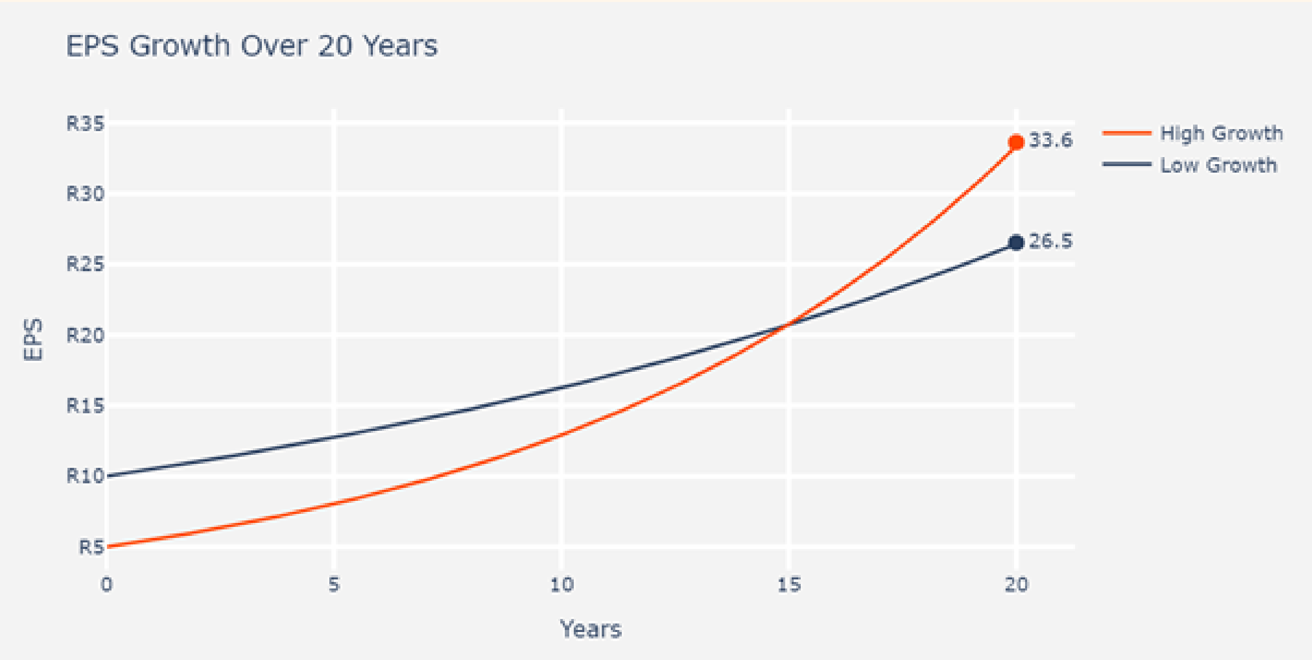
By Garrett Nel

The idea of Value investing traditionally refers to buying undervalued stocks with the hope that they will later be valued more fairly and thus be sold for a higher price. A common proxy for the "value" of equities, is their price-to-earnings (PE) multiple, which refers to the price you pay for every Rand earned by the business. Although the intuition makes sense that stock prices should tend to follow earnings, too much focus must not be placed only on the PE metric. While valuation multiples capture how expensive the stock is at that time, it fails to consider how much earnings may grow in the future, which is the true driver of long-run returns.

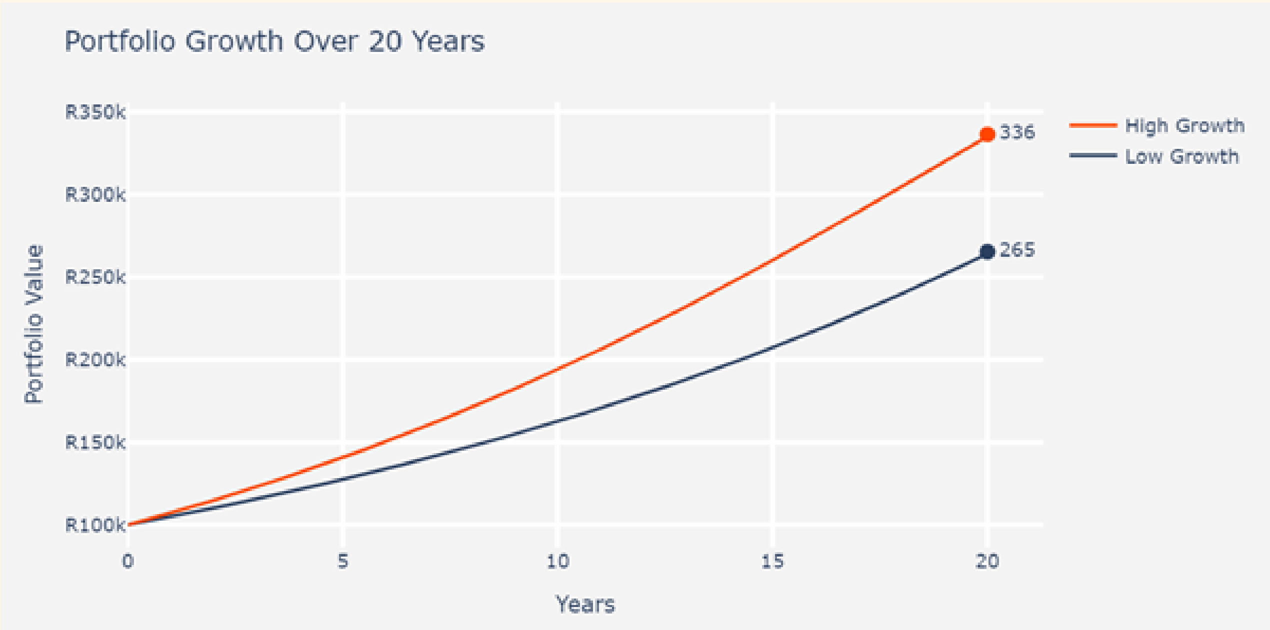
The following example illustrates this concept: two fictitious stocks are simulated—one with a high valuation multiple and high growth expectations, while the other has a lower valuation multiple and lower growth expectations. The PE multiple and long term earnings growth (LTEG) is summarised in the table below.

Stock	PE	LTEG
High Growth	20	10%
Low Growth	10	5%

The figure below illustrates the earnings-per-share (EPS) growth of the two stocks over the next 20 years. The Low Growth stock starts at a higher EPS as the market in which it operates is mature and well established with existing demand. This is in contrast with the High Growth stock, which enters a new market that is yet to be developed. The EPS of the High Growth stock only surpases that of the Low Growth stock after 15 years; however, thereafter the compounding effect of growth starts to have a significant impact on increased earnings.



Over the same time period, it is assumed that the PE multiple of the High Growth stock normalises by reverting back to 10, while the PE multiple of the Low Growth stock remains constant at 10. The portfolio value of an individual invested in the High Growth stock is compared to the portfolio value of an individual invested in the Low Growth stock in the figure below. It is clear to see that, even though the valuation of the High Growth stock was initially "exensive", the High Growth investment still comfortably outperforms the Low Growth investment. It is also important to note that this is a "worst case" scenario in which the PE multiple of the High Growth stock reverts back to normal market levels. In equities exhibiting strong and consistent growth, it is often the case that the PE multiples remain elevated, which would further increase the total return of the investment.



Although it is important to consider the price one pays for an investment, valuations should not be the only factor under consideration when choosing an investment. The effects of compounding over long periods of time are difficult to counteract, even through a halving in valuation. Finding great investment opportunities is not as simple as buying the cheapest equities with the expectation of a rerating in the future—more thought should rather go into what the growth prospects of the company or industry are as this is where most of the long-term returns lie.