



# SIGnet

## Part 1 – Investing in Compounders My Journey So Far

Bill Fawkner-Corbett  
February 2024

# Background

- My background was investing in Investment Trusts and ETFs
- I started investing seriously in individual shares in late 2008 / early 2009
- Started as a Value Investor
- Over time, I have moved towards investing in Quality / Growth / Compounders

# Characteristics of a Compounder

**Charlie Munger.** “If a business earns 18% return on capital over 20 or 30 years, even if you pay an expensive price, you'll end up with a fine result. So the trick is getting into better businesses. How do you get into these great companies? Find them small get 'em when they're little.”

- Such a business grows by retaining a high proportion of their earnings and invests it wisely (ie high rate of return).
- Typical characteristics include
  - A growing Total Addressable Market
  - A defendable competitive advantage
- A company which grows its valuation by 18% per year would be an 8 Bagger in 12 years
- This could typically be achieved by:

Double sales \* Double margins \* Double PE = 8x

# Market value v Intrinsic Value

- Market value = Market capitalisation = number of shares in issue x share price
- Intrinsic value is calculated through a fundamental analysis of the company based mainly on the company's historical financial performance and expected future performance.
- The efficient market hypothesis (EMH) states that share prices reflect all available information. Hence, if you believe in the EMH, you believe that Market Value always equals Intrinsic Value.

# What is a cheap PE?

Joel Greenblatt. “Price fluctuates more than value – so therein lies the opportunity. Buying good businesses at bargain prices is the secret to making lots of money.”

US	PE Dec 1972	PE May 1992
Sony	92	12
Polaroid	90	9
McDonalds	83	18
UK	PE July 1968	PE May 1992
General Elec’c	27	12
Tesco	43	14

# Margin of Safety

- “Because investing is as much an art as a science, investors need a margin of safety. A margin of safety is achieved when securities are purchased at prices sufficiently below underlying [Intrinsic] value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable, and rapidly changing world.
- According to Graham, the margin of safety is always dependent on the price paid. For any security, it will be large at one price, small at some higher price, non-existent at some still higher price.”

(Seth Klarman. Margin of Safety)

Typically a prudent investor looks to buy at a Market Value which gives a 30-50% discount to the Intrinsic Value

# Method 1 – The PEG

- Jim Slater (The Zulu Principle) promoted the concept of the Price Earnings Growth factor (PEG)
  - $PEG = PE / \text{Annual eps growth rate}$
  - Recommends we use the prospective (forward) growth rate rather than historic
- He recommends buying:
  - Small companies on a PEG of less than 0.6.
  - Large companies on a PEG of less than 0.75
- So buying at a forward PE which is calculated from (0.6-0.75 x forward EPS growth rate)

But he recommends not to buy if Forward PE is over 20.

- In “Beyond the Zulu Principle” he shows data that between 1995 and 1996 this strategy produced returns of 23% in 6 months, compared to 9% for the market.

# Microsoft (a past mistake)

Bought February 2009. Average price \$18.4

Sold

- 33% March 2010 at \$30.3 (PE of 16)
- 33% July 2011 at \$27.9
- 33% October 2016 at \$60.4 (Historical PE of 29, PE(f) 20, PEG (f) 1.1)

Price now over \$400. If I had held on to the final 33%, I would have achieved 29% CAGR since October 2016.



# Method 2 – The Graham Formula

Benjamin Graham, known as The Father of Value Investing.

But reputedly a growth share (Geico) earned Graham far more money than all his value share transactions combined. He bought at \$27, and held to over \$54,000.

From “Benjamin Graham and the Power of Growth Stocks” by Frederick Martin.

- $PE = 8.5 + (2 \times \text{growth})$
- So a company growing 10% per annum deserves a PE ratio of 28.5
- He caps Growth Rate at 20%

# Margin of Safety / Internal Rate of Return (IRR)

Martin's book states that Graham did not use his famous Margin of Safety for growth stocks. His methodology is:

- To develop reasonable 7 year forecast
- To calculate Year 7 intrinsic value from year 7 earnings x PE calculated from the formula.
- To calculate an IRR.
- To compare the IRR with a hurdle rate.

This is the same method I use for assessing shares. Small differences are:

- I use 4 years rather than 7.
- I use 15% hurdle, the book mentions 10%
- The book does not include dividends – I do.

IRR is the discount rate at which the [present value](#) of the sum of annual nominal cash inflows equals the initial net cash outlay for the investment.

# Example of IRR (no change in PE)

Year	1	2	3	4	5	
eps	11.4					
Growth	15%					
Eps		13.1	15.1	17.3	19.9	
Dps	0.5%	0.1	0.1	0.1	0.1	
Entry PE	24.7					
Purchase price	-282					
Exit PE	24.7					No change in multiple
Sale price				492		
Total Cash Flows	-282	0.1	0.1	0.1	493	
IRR	15%					

# Example of IRR (PE from Graham formula)

Year	1	2	3	4	5	
eps	11.4					
Growth	15%					
		13.1	15.1	17.3	19.9	
Div	0.5%	0.1	0.1	0.1	0.1	
Entry PE	24.7					
Purchase price	-282					
Exit PE	38.5					Using the Graham Formula
Sale price				768		
Total Cash Flows	-282	0.1	0.1	0.1	768	
IRR	29%					

# Is all Growth Beneficial?

- The previous two methods seem to assume that all growth is beneficial.
- Is it?
- “Growth obsesses investors. If you were to ask why, nearly all would say growth in sales, profits and earnings- and little else – is what drives share prices.” UK Buffettology Fact sheet June 2023.

# Value Creation

- If the return on capital is the same as the cost of capital, no value is created by growth.
- If the return on capital is less than the cost of capital, growth destroys value.

## Analogy

- Would you borrow money at an interest rate of 6% to put it in a savings account paying 5%?

# Cost of Capital

- Depends on
  - Risk free rate (determined by rates paid by government bonds)
  - Equity risk premium.
  - Capital structure (i.e. mix between equity and debt)
  - Industry
  - Size of the company
  - Liquidity of shares
  - Country
- Typically between 6% and 15%:
  - 8% for a large US company with modest debt in a stable industry
  - 15% for a small UK company with a high level of debt in a volatile industry

# Return on Capital Employed (ROCE)

- The “interest rate” that a business is earning.
- ROCE needs to be safely above Cost of Capital. I target:
  - 15% for FTSE 250 company in a stable industry
  - 20% for a smaller company
- For a Compounder the major source of capital is retained profits. Incremental Return on Capital is the key metric. Direction of change of ROCE is of equal or even more importance than absolute value



# Method 3 – Credit Suisse

- **What Does a Price-Earnings Multiple Mean? By Michael J. Mauboussin & Dan Callahan of Credit Suisse**
- They calculate the value of a company as a Steady state (no growth) value + future value creation
- ROCE, cost of capital and growth are part of their calculation.
- They also include a fade rate. They assume a time for company to lose its competitive advantage, after which growth falls rapidly and ROIC fall to the Cost of Capital.

<https://mjbaldbard.files.wordpress.com/2020/09/michael-mauboussin-e28093-research-articles-and-interviews-2014.pdf>

(page 26)

# Credit Suisse Results

Exhibit 5: P/Es Given Different Scenarios for ROCE and Growth

		ROCE			
		4%	8%	16%	24%
G		4%	8%	16%	24%
R	4%	7.1x	12.5x	15.2x	16.1x
O	6%	3.3	12.5	17.1	18.6
W	8%	NM	12.5	19.4	21.8
T	10%	NM	12.5	22.4	25.7
H					

And for a company growing at 25% with ROCE of 56%, PE=70

Source: Credit Suisse. Note: Assumes all equity financed; 8% cost of capital; 15-year forecast period

# My table (based on 12% cost of capital)

		Return on Capital Employed							
Earnings Growth	8%	12%	20%	28%	36%	44%	52%	60%	
4%	7	12.5	15	16	17	18	19	20	
6%	3	12.5	17	19	21	22	24	25	
8% NM		12.5	19	22	25	27	28	30	
10% NM		12.5	22	26	29	31	33	35	
12% NM		12.5	25	30	33	35	38	40	
14% NM		12.5	28	34	37	40	42	45	
16% NM		12.5	31	37	41	44	47	50	
18% NM		12.5	34	41	45	48	52	55	
20% NM		12.5	37	45	49	53	56	60	
22% NM		12.5	40	49	53	57	61	65	
24% NM		12.5	43	53	57	62	66	70	

# Microsoft (How I would make my decision today)

- Based on CS method, in October 2016 MSFT had cash adjusted ROCE of 16%, forecast growth of 15%. Using Credit Suisse method, I estimate Intrinsic Value PE of just below 40; Graham Formula gives 38.5.
- Historical PE of 29 and PE(f) 20 indicate Market Value is significantly below Intrinsic Value. I would not have sold.
- I would have achieved 29% CAGR since October 2016.

# Two Recent Examples

- Synopsys (SNPS)– presented to Central London Group, June 23
  - PE 37.5
  - CS PE 41, Graham PE 48
  - Expected IRR < 10%. I did not Buy
- Share Price has risen from \$446 (15/6/23) to \$553 (17/2/24)
  
- Super Micro (SMCI) – presented to Leicester Square Group, September 2023
  - PE 25
  - CS PE 47.5, Graham PE 38.5.
  - Assumed Exit PE of 30, giving expected IRR of > 33%. I Bought
- Share Price risen from \$282 (2/9/23) to \$803 (17/2/24)



**SIGnet**

Part 2 - SIGnet

# SIGnet

- A national network of investor groups
- Our Mission – to enable individual investors to improve their skills, and investment knowledge
- Members' main area of interest is quoted shares (including Investment Trusts and ETFs)
- A not for profit organisation, part of ShareSoc

# SIGnet Groups

- 35 groups across the UK, typically 10-15 members per group, meeting every month.
  - Historically all groups had only physical meetings
- *Covid* – switched to virtual meetings.
  - Removed constraints of geography
  - Specialist groups (e.g US, Options)
- *Post covid*
  - Physical meetings only - 60% of groups
  - Virtual only – 20% of groups.
  - Hybrid – 10% of groups



# SIGnet New Groups

- Recently added
  - Three London Evening Groups
  - Worcestershire Group
  - New Beginners and Intermediate Groups
  - Scottish Technical Traders (virtual)
- Future plans
  - Reading
  - West Sussex
  - Taunton
  - Technical Analysis (virtual)
- If there is no Group near you, would you be interested in starting one?

# SIGnet – Why join us?

- Meet and interact with experienced like minded investors
- Learn with and from peers to become a better investor
- Social element

# SIGnet – How to join

- <https://www.sharesoc.org/signet/>
- [info@sharesoc.org](mailto:info@sharesoc.org)
- £50 p.a., 3 month trial period

# SIGnet – How to join

