EQUITIES

WHY VALUATION ALONE WON'T DRIVE LONG-TERM SUCCESS

By: Franz Weis, CIO, Analyst/Portfolio Manager

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Analyst/Portfolio Manager

Low P/E doesn't equal high potential. At Comgest, it's long-term earnings visibility and quality growth — not bargain valuations — that drive our conviction and portfolio construction.

— Is a company trading at 12x P/E really more attractive than one at 25x?

We all love a bargain, but is cheaper really better? It's tempting to think that a company trading at 12x price-to-earnings (P/E) is more attractive than one at 25x. However, that assumption can be misleading.

At Comgest, prospective clients sometimes view our equity portfolios as expensive, given they trade at a significant P/E premium to the market. But over nearly four decades, it's been earnings growth – not low valuations – that has powered our long-term performance.

Before we even consider valuation, we focus on the visibility and earnings dynamics of a company. Valuation matters, of course, but it's not the primary driver of our investment decisions or portfolio construction.

The Hidden Risks of Bargain Hunting

— Over-reliance on low P/E ratios can lead investors into a dangerous "value trap", which is particularly risky when evaluating quality growth companies.

Relying too heavily on low P/E ratios can lead investors into a dangerous "value trap", i.e., taking a P/E ratio at face value and making it an important factor in stock selection and portfolio construction. This is particularly risky when evaluating quality growth companies.

Why? The "E" in the P/E ratio can be fraught with uncertainty. Over the past few years, we've seen persistent downward revisions in consensus earnings forecasts.

Secondly, the P/E ratio is short-sighted, typically capturing just an estimate of the next 12 months earnings per share (EPS), while a company's value is a discounted cash flow of future earnings streams that go well beyond the next 12 months.

Although the popular P/E ratio is easy to understand and use, it is also built on assumptions, including that 100% of a company's earnings are paid out. Hence, it is only a fair yardstick for zero growth companies.

That is the opposite of what we do at Comgest. We look at companies such as EssilorLuxottica or Microsoft, which have delivered an annual earnings growth of over 10% over several years. This makes a one-year forward P/E meaningless as an isolated tool for portfolio construction.

— A lower P/E may reflect higher risk or weaker growth prospects.

Of course, we don't ignore valuation altogether — we monitor it and adjust position sizing accordingly. But we don't jump into low P/E stocks just because they appear on a screen. A lower P/E may reflect higher risk or weaker growth prospects. In contrast, we have conviction in the visibility and durability of growth in names like EssilorLuxottica or Microsoft.

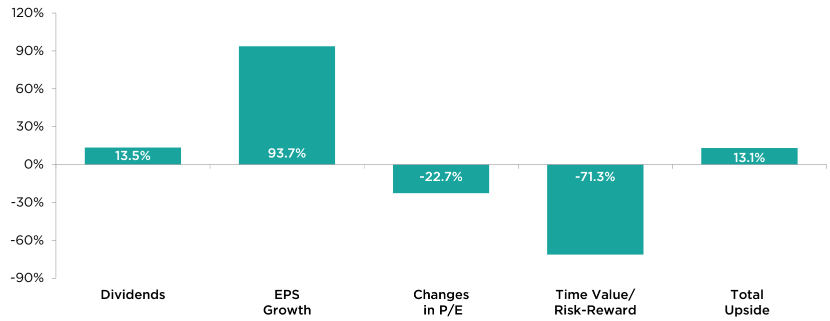
DCF Models and the Time Value of Growth

Even discounted cash flow (DCF) models — often viewed as more sophisticated — come with limitations. No one can predict a company's earnings or free cash flow five years from now with certainty. Discount rate assumptions are equally critical.

Take, for example, a high-visibility growth company in our portfolio. As per **figure 1**, at our fair value estimate, 71% of its value is "stored" in the *time value of money* over five years. This translates into an annual appreciation potential of 11% — a reasonable compensation, in our view, for holding a high-visibility growth company even if the DCF suggests fair value has already been reached.

At Comgest, we apply a conservative average discount rate of 10% for our European portfolio, despite a beta below 1 and a 0% risk-free rate. That reflects our caution — and ensures the time value of money is a meaningful part of our valuation process.

Figure 1. Typical Example of Valuation Components



Source: Comgest. This example is for illustrative purposes only and not a recommendation to buy/ sell any security. Valuation components and stock data are hypothetical or based on publicly available information and may not reflect current market conditions.

We're Growth Investors — and Proud of It

This is not a rejection of P/E ratios or valuation models — far from it. As outlined in my Comgest white paper, "**The Fair Value Folly**",[1] our point is simply that valuation should not be the focal point of stock picking or portfolio construction in a growth strategy.

— We focus on the visibility and durability of future earnings growth, qualities closely tied to fundamentals such as pricing power, innovation, recurring revenues, management strength, and capital efficiency.

As quality growth investors, we give our companies time to crystallise the value embedded in their long-term growth trajectories. Our focus is on the visibility and durability of future earnings growth — qualities closely tied to fundamentals such as pricing power, innovation, recurring revenues, management strength, and capital efficiency.

We maintain a highly selective approach, investing in a limited pool of companies we've followed and analysed — often for years or decades — to build conviction and monitor growth. Few companies meet our criteria, and that's exactly the point.

[1] To read this paper, please see the "Our Thinking" section on your local **Comgest website**.

Avoiding the Value Trap — By Design

At Comgest, we're not at risk of falling into the "value trap". Our European large-cap portfolio trades at a premium to the US market[2] — and we're proud of that. Why? Because our quality growth companies have paid it back with regular and multi-year double-digit earnings.

That growth — not valuation — has been the primary driver of our performance. It's why we continue to focus on the visibility and durability of superior earnings growth, rather than trying to outsmart the market on valuation alone.

[2] Source: Comgest/Factset.

Franz Weis joined Comgest in 2005 and is a Portfolio Manager specialising in European equities. In addition to being the Group's Chief Investment Officer (CIO), he is Managing Director of Comgest Global Investors as well as a member of the Group's Board of Partners and Executive Committee. Franz leads the firm's European research efforts and co-leads the management of the majority of Comgest's European equity strategies.

In his role as CIO, Franz oversees the firm's investment teams and chairs the Investment Committee, which is responsible for applying Comgest's philosophy on successful long-term investing. He started his career in 1990 at Baillie Gifford & Co. where he worked as a Portfolio Manager before joining F&C Asset Management as a Senior Portfolio Manager and Director of European Equities in 1996.

Franz graduated from Heriot-Watt University (Scotland) with a Master's degree in International Banking and Financial Studies and received the International Bankers in Scotland Prize in 1990.

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