QV UPDATE

Weekly Commentary | October 31, 2014
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Roman Poets and Investment Legends Agree

"*Many shall be restored that now are fallen, and many shall fall that now are in honor*." Horace – Ars Poetica

Taken from a 2000 year old treatise on the art of writing poetry, this sage maxim adorns the opening passages of *Security Analysis* by Benjamin Graham. In adapting the wisdom of Horace to the capital markets, Graham was attempting to impart upon his readers the concept of mean reversion and its critical importance to successful investment. More simply, today's stock market winners are seldom tomorrow's. Over time, many companies enjoying above average profits often find them eroded by competition, complacency and secular shifts while those whose profits are suffering from transitory and cyclical pressures often claw their way back to better prospects.

Good Companies Aren't Necessarily Good Stocks

The broad based excesses of the Nifty Fifty prior to the market crash of 1974 exemplify why Graham quoted Horace. The Nifty Fifty were a group of high quality growth stocks with strong track records of increasing dividends, rising earnings and stock market returns. In betting on the unwavering long term strength of their business franchises and the assumption that historical growth rates could perpetuate themselves indefinitely into the future, investors bid these stocks to an eye popping average of 42x earnings by 1972 in the belief that they would compound out of any valuation no matter how high. The following crash of '74 swiftly humbled such miscalculation however, as the group's stock prices plummeted back to reality with some even losing as much as 90% of their market capitalization.

Great Fortresses Can Fall…

The ongoing tragedy of UK based retailer **Tesco PLC (TSCO)** is a more contemporary reminder of Horace's honor fallen. By revenue, Tesco is the second largest retailer in the world. Over the last 20 years Tesco has enjoyed many of the hallmarks of a strong franchise including economies of scale, an attractive return on equity and stable dividend and earnings growth. Yet the last few years have proved a devastating barrage upon its ramparts. Under siege by a tepid domestic economy, food price deflation, mismanagement and aggressive new entrants waging a price war, the great fortress that was Tesco appears to be tumbling down. Market share and margins are crumbling away and the stock price has collapsed 53% in a single year. Even Warren Buffett, who popularized the concept of corporate moats, now says that investing in Tesco has been a big mistake and has been selling what was once a 4% stake in Tesco.

…And Ruins Restore

Citigroup (C) is a recent addition to the Global Equity Portfolio. Once the biggest bank in the world, Citigroup went on to lose 98% of its market capitalization from peak to trough during the financial crisis. Were it not for a $20 billion government bailout, the company would have drowned in toxic assets accumulated from undue risking taking leading up to 2008. Fast forward to today and Citigroup has a new management team, is in a very strong financial position, has a venerable global banking network and a clear path to sustainably grow earnings but is still trading below tangible book value. As the company's return on equity normalizes over time, we think this fallen giant will be restored once again.

Sure Things Seldom So

How often do investors and the media accept prevailing opinion as truth only to find the stories consensus weaves too soon unravelled? Not long ago many believed peak oil an inevitability or that China could extend historical growth rates unabated for decades to come. Too frequently ex ante certainty finds itself at odds with ex post reality.

Successful investment demands that we remain heedful of Horace's words. Sure things are seldom so. Great empires rise and fall. Good businesses can too. Investors must constantly ask whether the franchises they own are strengthening or weakening lest they suffer the fate of Tesco's shareholders. Even the best companies are only good investments if purchased at a reasonable price. A great track record forecast indefinitely into the future can be the harbinger of ruin; whereas overlooking diamonds fallen to the rough for discomfort of the time it takes to clean them can sometimes be precious opportunity foregone.