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VALUE JUDGEMENTS

Precise formulas for predicting the future worth of companies are often disproved by reality. Mark Urquhart, a Baillie Gifford partner, argues that investment managers should embrace uncertainty.

Two recent conversations prompted me to write this note. Both were about Peloton, the ‘connected fitness’ company and a recent addition to the LTGG portfolio. The first was a chat with an acquaintance at a competitor of ours who’d spotted that we were shareholders in Peloton. “It’s overvalued, 100 per cent definitely,” he told me, adding for good measure: “Typical Baillie Gifford to own it.”

The second was a Covid-compliant discussion with my neighbour over the garden wall. He’s a bond guy, who himself happily works out on a Peloton exercise bike. On the company itself, he was less keen: “It’s like me and Bulgarian debt – I love it, but it’s definitely overvalued.”

Such comments are normally water off a duck’s back. In fact, I see them as positive, as they reinforce my sense of the prejudices of many market participants. In this case however, something about the striking levels of certainty shown by both of my interlocutors got me thinking about valuation.

A QUICK RECAP OF OUR CAPM CRITIQUE

Approaching my 25th year of learning about investing, many things continue to surprise me. Chief among them is the resilience of the capital asset pricing model (CAPM), the accepted formula for calculating risk versus return. It remains a fulcrum of the Chartered Financial Analyst Institute and other qualifications bodies and underpins the methodology often used to determine value.

Such longevity is astonishing given the model's lack of intellectual rigour. Despite representing another spectacular failure of the dismal science, CAPM has come to dominate modern portfolio theory. Its flaws are too many to list in full here, but let's remind ourselves of its main shortcomings, with apologies to those who may have read this before.

At the core of CAPM is the idea that the only variable that matters to a stock's potential return is 'beta' – a proxy for relative volatility. Plug this into the alluring equation of risk-free rates, the equity market premium and expected returns, and we're promised an output that tells us if the price of a stock is consistent with likely returns.

That may sound logical, but it's based on several fallacies. There's no evidence that beta explains the performance of individual stocks over the short term or the long term. There is also the small problem of which risk-free rate one should use, with this picture muddied by a decade or more of very low interest rates. Also, the equity market premium can only be grasped by those who write equations in textbooks.

Despite having zero intellectual rigour and no empirical evidence to support it, the CAPM remains widely used. It is the modern equivalent of economists' rational agency. That it should underpin so much passive investment ('no point in seeking higher returns as that implies higher risk') results from the collective amnesia surrounding this topic. Meanwhile the idea of high and low beta relying on past correlations has surely been laid to rest by the coronavirus pandemic. If algorithms can't predict humans bulk buying toilet rolls, it seems unlikely that CAPM advocates can correctly predict the progress of stocks.

The real question is why we still think that a single number reflecting past price fluctuations can describe the risk and return of a security. My guess is that because investment is so hard and so uncertain, a simple equation is very alluring. But this is to fall into the trap with which we started: irrational certainty about future and current valuations. No number, on its own, can capture valuation.

BAILLIE GIFFORD'S APPROACH TO VALUATION: PART OF EVERY QUESTION

It's annoying if people think we ignore or skirt over valuation. We think deeply about it, albeit in an unconventional way. We are regularly asked: "Isn't X overvalued?" All of the questions have stemmed from the same root: a fetishisation of the spot number. In contrast, valuation is as intangible a feature of our process as the answers to any other questions we may ask during our research of a company. The reductionist apparatus of the spot price/earnings ratio, or of any other metric, relies on the same CAPM-based premise that a number can tell us the answer. This approach is not so much a panacea as an obfuscation.

In my view, valuation touches every part of our research framework. All questions are intertwined. I don't disagree that the five or 10-year returns of our holdings are based on the future cash flows generated, but in assessing the probabilities of those flows, we need to think about top-line growth, margins, the durability of competitive advantage, management culture and capital allocation.

To expand: looking ahead to those future cash flows, revenue growth is necessary but not sufficient. It's a far easier starting point for future cashflows to be substantially higher if revenues have gone up several-fold. This is an obvious arithmetical outcome of compound growth but one often forgotten by a market focused on the next quarter. Margins and returns are the cogwheels of valuation: we can add a lot of value by unearthing companies that not only grow over the long term but become much more profitable as they achieve scale. The drivers of such growth and profitability are to be found in companies' DNA: the culture set by management, their investment timeframe, their willingness to experiment, and their view of their societal contribution.

We seek to understand what the valuation of a company might look like in 10 years' time and why the market might not realise this. Of course, it's challenging to look a decade ahead, but that is our job. The use of probabilities helps us navigate this uncertainty and it's better to be imprecisely right than precisely wrong. We should revel in the ability to see valuation differently. It allows us to use the imagination essential to all successful investment.

LOOKING BACK TO LOOK FORWARD

This is not just a theoretical approach. What if we had fallen prey to thinking Amazon was fully valued in 2005 with its sales at $8.5 billion and that a market cap around $20 billion captured its future growth? Remember, this was the year that Amazon Prime was announced, locking in profitless growth in the eyes of many. Why would you own such a volatile, high-beta stock when you could buy Walmart or a retail ETF?

Of course, we have constantly asked ourselves what the valuation of Amazon implied (including conversations about companies being valued at more than $1 trillion). We continue to do so now. The point is that there were as many, if not more, people in 2005 saying that Amazon was 'overvalued' as there are saying this about Peloton today.

We could also run through Tencent's 50-fold-plus increase in sales since 2008 or Hermès' quadrupling over the last decade or so, at extremely high margins and with compelling longevity. In all these cases CAPM acolytes assured us the shares were overvalued a decade or more ago, just as my friends tell me about Peloton today. The same goes for Zoom, Cloudflare, Pinduoduo, Shopify or many other companies.

We have no crystal ball, but we are prepared to entertain long-tail outcomes in valuation. We'll also get investments wrong, in cases where operational outcomes tell us the companies were overvalued: from First Solar to Under Armour; from Belle International to UBS.

Peloton could achieve a wide range of outcomes. It is certainly possible for it to dominate the home fitness market, growing much more quickly now, allowing economies of scale and a profitable global franchise, and leaving gyms as old-fashioned curiosities. The possibility of a company whose sales rise very rapidly from around $2 billion this year seems to me over 5 per cent and makes the starting valuation of less than $20 billion potentially too low. Of course, the product could prove a passing fad with non-sticky customers and an eroded competitive advantage. In such a scenario it will be worth far less. What I do know is that I have no certainty about the myriad possible outcomes for this company or any of our other holdings.

Accepting that valuation is uncertain and intangible is one of the hardest things to do in investment. There is an alluring simplicity to a single number or equation bestowing faux certainty on our task. But a spot price/earnings multiple tells a long-term investor precisely nothing. It's not a form of shorthand that foretells expected returns, it's just a number. Moreover, it's a dangerous number because it creates many hostages to the short term and douses imagination about the long term.

There is a perception of safety in constructing a complex spreadsheet, which makes fund managers look clever to their clients. But thinking about outcomes over 10 years is inherently uncertain and should encompass a vast range of possibilities. Why are so many market participants in thrall to predictions precise to the last decimal place? Because it's the easy option, the percentage shot, the safety of the herd. Uncertainty is hard to compute and the risk of failure looms large. Easier to reach for the elixir of the CAPM, a ready-made solution to the eternal investment conundrum.

Only it doesn't actually work. Of that much I am certain.

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