INSIGHT FROM POLEN CAPITAL

PEG Ratios in Context – Part I in a Series on Valuation

Executive Summary

Valuation metrics must often be placed into context. A case in point is our Focus Growth strategy's forward P/E multiple, which at times raises questions due to its 20-30% premium to the benchmark. Typically, this P/E premium is examined relative to the *expected* earnings growth of our underlying holdings (the so-called PEG Ratio) but in our opinion this level of analysis does not go far enough. More instructive is comparing our P/E premium to the *actual* level of earnings growth that has been produced over time.

VALUATION SERIES
Part I

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In the presentation book that we regularly provide to clients and prospects, one of the more scrutinized charts in the book is our portfolio characteristics. This chart includes important statistics about our portfolio companies, including the weighted average forward P/E multiple of our Focus Growth portfolio and how it compares to our most relevant benchmarks (see Figure 1).

Not surprisingly, our P/E multiple, which is higher than the benchmarks, tends to invite questions given its roughly 20-30% premium. One of the more common questions is whether this premium valuation is typical. The short answer, as detailed in the chart on page 2 (see Figure 2), is yes.[1]

Figure 1:

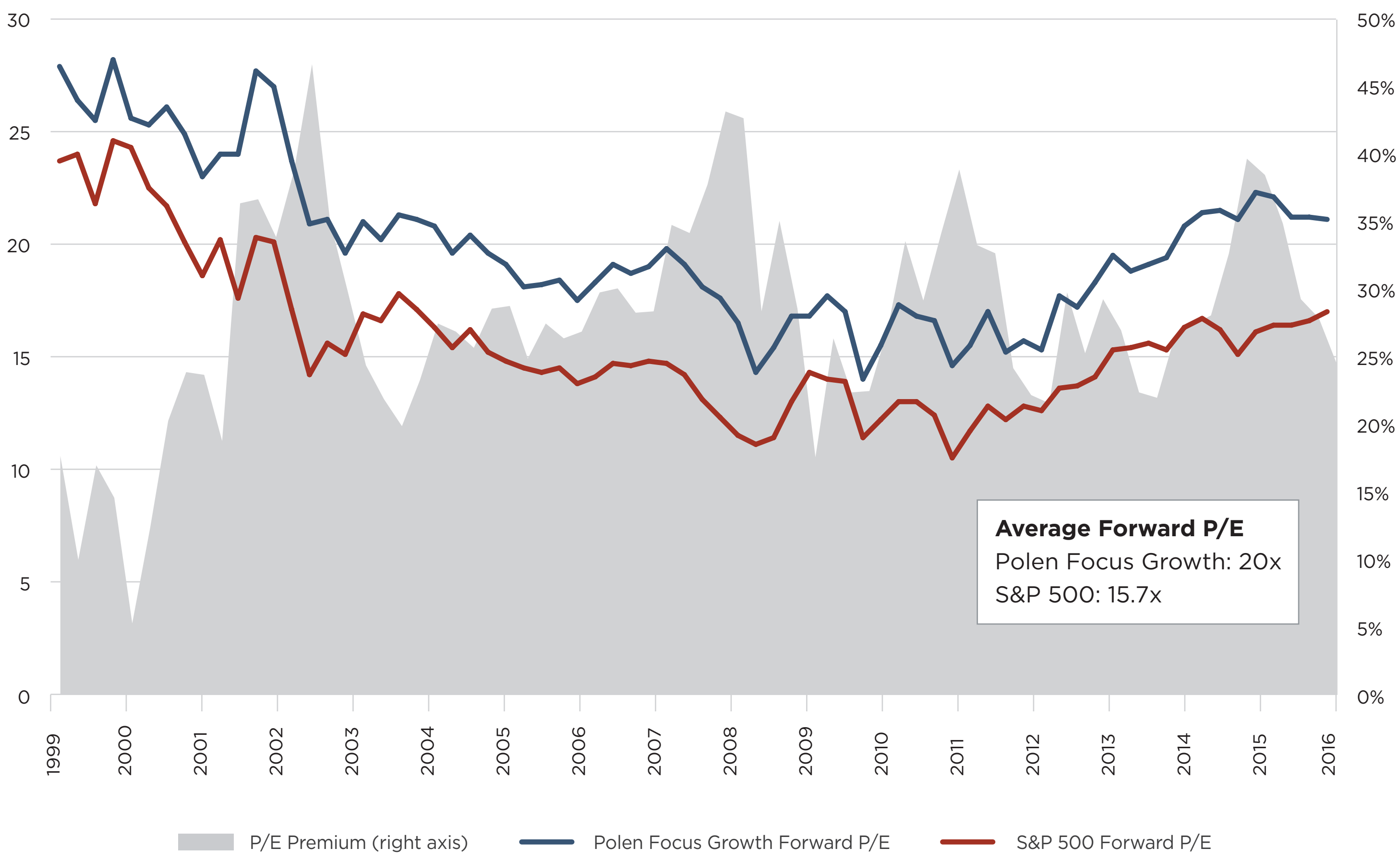
Name	% of Portfolio	Market Cap (Millions)	P/E Forward 12 Months
Accenture Plc	4.8%	74,335	19.4
Adobe Systems Incorporated	5.5%	64,431	30.3
Align Technology, Inc.	3.3%	9,126	36.7
Alphabet Inc. Class A	4.4%	586,078	24.4
Alphabet Inc. Class C	6.4%	573,469	23.8
Automatic Data Processing, Inc.	5.8%	45,963	25.9
Celgene Corporation	5.4%	96,881	16.4
Dollar General Corporation	2.8%	19,191	15.3
Facebook, Inc. Class A	7.0%	410,809	24.7
Gartner, Inc.	3.6%	8,926	32.5
Mastercard Inc. Class A	2.1%	121,580	25.4
Nestle S.A. Sponsored ADR	4.0%	238,236	21.5
NIKE, Inc. Class B	5.8%	92,066	21.9
Oracle Corporation	4.8%	183,570	15.9
O'Reilly Automotive, Inc.	3.7%	25,055	21.1
Priceline Group Inc.	5.0%	87,554	23.2
Regeneron Pharmaceuticals, Inc.	5.3%	41,079	28.2
Starbucks Corporation	5.5%	85,086	25.5
TJX Companies, Inc.	4.8%	51,111	20.0
Visa Inc. Class A	7.8%	206,341	24.8
Cash	2.2%		
Polen Focus Growth (Weighted Average)		**164,638**	**23.3**
Russell 1000 Growth		**176,479**	**19.6**
S&P 500		**164,658**	**17.6**

3/31/2017
Source: FactSet

And perhaps this is to be expected. After all, we are a growth manager and it seems only reasonable that our faster growing portfolio companies would carry higher valuations. But given our investment philosophy and approach we argue that it's a bit more nuanced. Our portfolio companies aren't just growing their earnings faster than the average company in the S&P 500; these companies are superior businesses overall. They have more durable competitive advantages, better balance sheets, higher returns on capital, stronger secular growth potential and they typically produce more free cash flow. In our opinion, it is the sum of these factors that has led to our portfolio companies being valued at a collective premium to the market over time.

One measure that growth managers often use to put any valuation premium into context is the ever-popular PEG ratio (P/E multiple of a stock divided by its expected earnings growth rate). One drawback with this metric is that it typically incorporates the current P/E multiple with the estimated earnings growth of the business, estimates that can often prove to be overly optimistic or pessimistic (usually the former). What is far more important to the investor is the actual earnings growth of the business and how that growth compared to the valuation paid.

Figure 2: Forward P/E: Polen Focus Growth vs. S&P 500

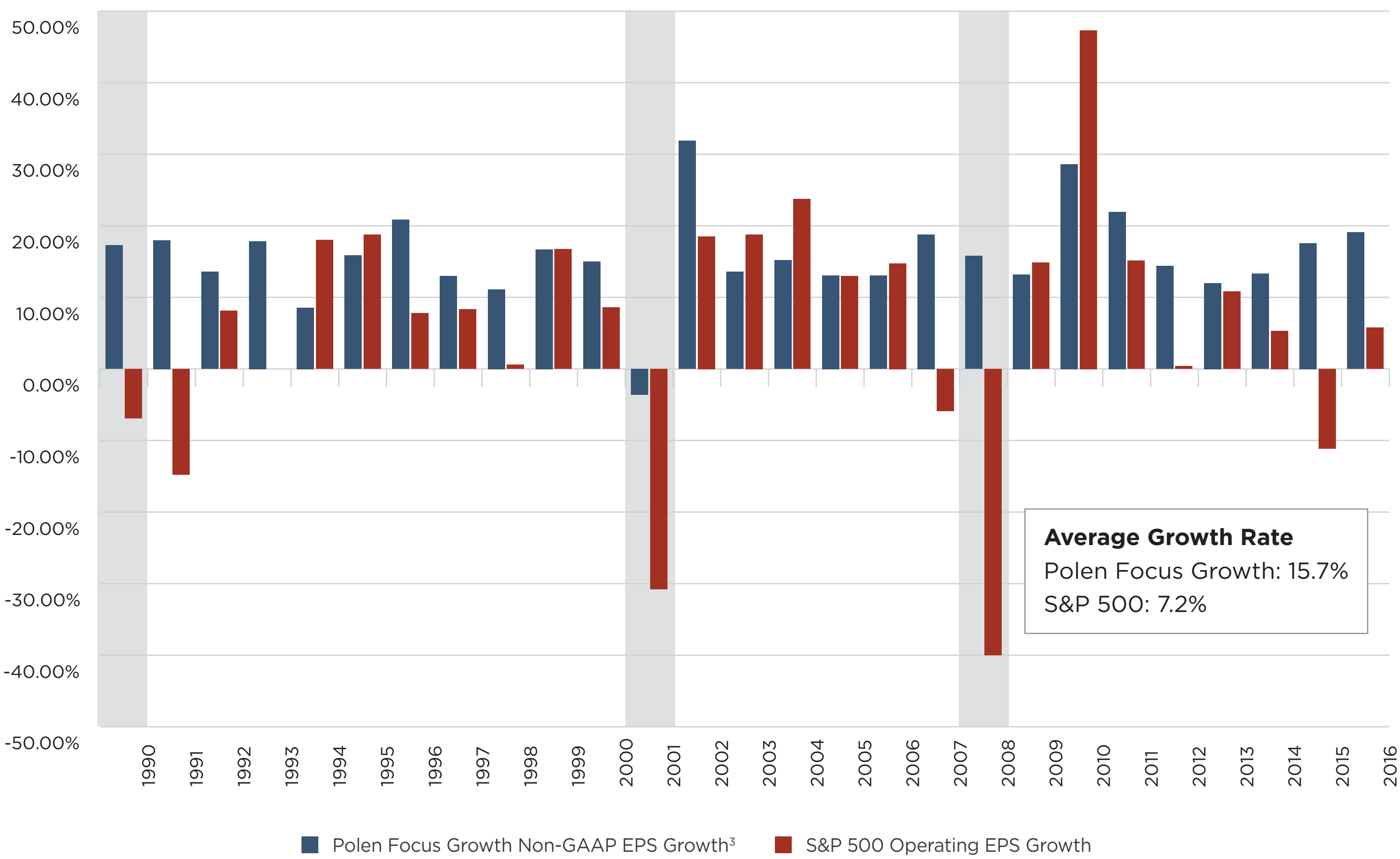


Source: FactSet

1 Getting reliable forward P/E multiple based on estimates is more difficult the further back in time you go. We believe the results would look similar if one goes back to inception of our Focus Growth portfolio in 1989. The S&P 500 was used as the comparator index rather than the Russell 1000 Growth due to availability of data.

For many investment managers, compiling the historical earnings growth of their portfolio with any reasonable precision is a daunting project unless they have been recording it all along, especially when you consider that for the earnings data to have any real meaning it should span at least one recession. This alone would require a minimum ten-year track record. In many cases, it could also mean compiling the earnings growth of hundreds of stocks that have been owned over the years as well as having to account for thousands of transactions (the timing of buying or selling a stock during a calendar year can materially alter the result) along with the weight of each position during the period it was held. For example, imagine a portfolio with 100 holdings and 50% annual turnover. A 20-year track record would imply a minimum of 1,000 transactions that would need to be accounted for (i.e., 20*100*50%). Add in the fact that many companies disappear over time through M&A, making it challenging to track down the earnings growth, and one can see why collecting this much data is no easy feat. But for a concentrated investment manager with a low turnover portfolio, the goal is far more achievable. Even still, we spent an entire summer meticulously recording the EPS growth for the historical holdings of our Focus Growth portfolio.[2] The results are shown in Figure 3.

Figure 3: Annual EPS Growth: Polen Focus Growth vs. S&P 500



Source: S&P, Polen Capital Estimates

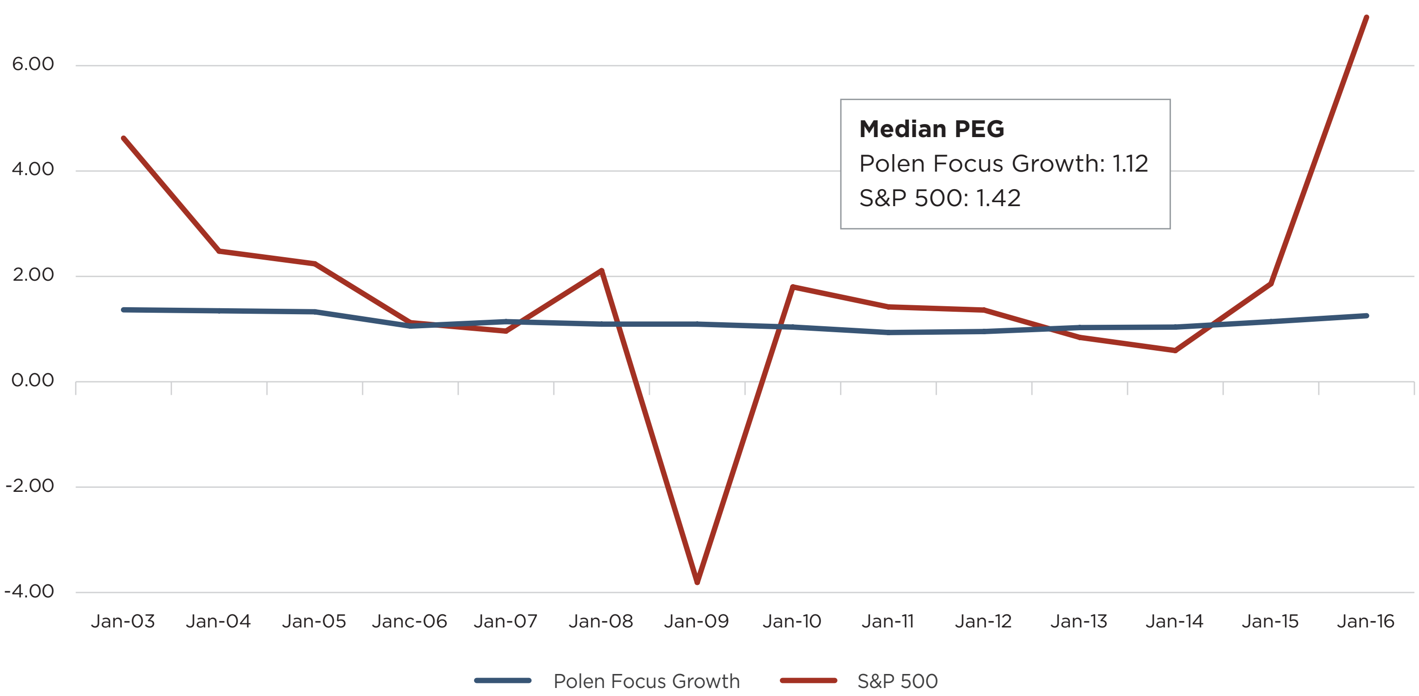
2 Hat tip to one of our former summer interns, Michael Beer. With 20 holdings on average and historical turnover around 25%, the number of transactions for our Focus Growth portfolio was closer to 150.

3 Polen Focus Growth EPS growth is portfolio weighted. While not perfectly apples to apples, the S&P 500 operating EPS growth is the closest comparator to our non-GAAP calculations.

Three observations from the chart are notable. The first is how much better the earnings growth of our portfolio companies fared during recessions (shaded areas) when compared to the market. Superior businesses generally produce superior results, even during difficult economic periods. Because the earnings growth of our companies held up better during these downturns, so did our investment returns.[4] Second, the lower variability of the earnings growth of our portfolio companies compared to the market is one of the primary reasons why the standard deviation of our long-term returns is significantly lower than the S&P 500. The third observation is the average annual rate of earnings growth of our portfolio companies when compared to the market. If anyone is curious as to the primary factor that has driven our excess returns over the long-term, this chart provides the answer. It also underscores how our Focus Growth portfolio has produced such competitive performance despite its classification as a U.S. large cap equity fund (arguably the most efficient portion of the equity market). Over long time horizons shareholder returns track earnings growth. Hence, it's quite logical that a portfolio of companies whose earnings have grown at a 15% average rate would generate compounded returns at a similar rate. Of course, the key is identifying exceptional businesses capable of delivering this mid-teen level of growth consistently over long periods of time (spoiler alert: there aren't that many of them). *Our insistence on only owning a handful of these types of franchises, as well as our willingness to patiently hold them for a very long time, is perhaps, the defining characteristic of our investment approach.*

The historical earnings growth data also allows us to place our valuation premium versus the market into further context. The chart in Figure 4 shows our trailing PEG ratio versus the S&P 500 on a 5-year rolling average in order to smooth out any earnings volatility (mostly the market's).[5] But in this case, we are incorporating actual earnings growth rates instead of estimates.

Figure 4: PEG Ratio: Rolling 5-yr Average



Source: S&P, Polen Capital Estimates

4 "Polen Capital Focus GIPS Disclosure," http://www.polencapital.com/pdf/Strategies/Polen-Capital-Focus-GIPS-Disclosure.pdf

5 Though it's a rolling average, the data points are only shown on an end-of-year basis. This was necessary due to the prodigious volatility of the S&P 500 earnings growth during the last recession, which caused a huge spike in the index's PEG ratio in 2009 and disproportionately skewed the scale of the chart.

When the forward P/E of our portfolio is compared to the actual growth of the portfolio's underlying earnings, a different picture emerges. Rather than a premium valuation, our Focus Growth portfolio has typically traded at a discount to the market based on this PEG calculation. Furthermore, this PEG discount comes with far less volatility relative to the index, the result of much more stable earnings growth in the denominator. What is also striking is just how volatile the PEG ratio is for the index even when smoothed out to a 5-year rolling average. Note that one reason why the median PEG of the S&P 500 isn't higher in this analysis is because of the 2008-2009 time period when the market's EPS growth was highly negative. On a more basic level we know that over the period studied, the average forward P/E of the market has been 16x with an average EPS growth rate of 7%, implying a 2.2x PEG ratio. Meanwhile, our Focus Growth portfolio has had an average forward P/E of 20x relative to an average EPS growth rate of 15%, implying a 1.3x PEG ratio.

Conclusion

The concluding point is straightforward: valuation, like so much else in life, needs to be placed into its proper context. In this case, the premium valuation of our Focus Growth portfolio should be viewed through the lens of the qualitative attributes of the individual businesses, the underlying earnings growth that these businesses have generated and we believe will likely continue to generate in the future, and the volatility of this growth (or lack thereof). When viewed through this lens our portfolio valuation seems quite reasonable, and possibly a very good long-term bargain.

About The Author

Stephen Atkins, CFA, Research Analyst, joined Polen Capital in 2012 after a 12-year tenure as a portfolio manager at Northern Trust investments—including eight years as a mutual fund co-portfolio manager. Mr. Atkins also spent two years at Carl Domino Associates, LP. He received his B.S. in Business Administration from Georgetown University and a General Course degree from the London School of Economics. Mr. Atkins is a CFA Charterholder and a member of the CFA Institute and CFA Society of South Florida.

About Polen Capital

Founded in 1979, Polen Capital is a global investment management firm that provides high value-added quality growth investment strategies to sophisticated clients around the world. The Firm is committed to attracting experienced, disciplined investment professionals to add value to client portfolios. Polen Capital's Large Company Growth Team oversees a global equities universe of high-quality growth companies and manages the flagship Focus Growth strategy, as well as the Global Growth and International Growth investment strategies. The Firm also has an autonomous Small Company Growth Team that manages a U.S. Small Company Growth strategy. Polen Capital's strategies are offered through various investment vehicles to accommodate a broad range of client mandates. For more information visit **www.polencapital.com** and connect with us on **LinkedIn.**

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