INSIGHT FROM POLEN CAPITAL

Wonderful Companies at Fair Prices – Part II in a Series on Valuation

"Even in those earlier times, finding the really outstanding companies and staying with them through all the fluctuations of a gyrating market proved far more profitable to far more people than did the more colorful practice of trying to buy them cheap and sell them dear."

— Philip A. Fisher, *Common Stocks and Uncommon Profits and Other Writings*

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Valuation Series Part II

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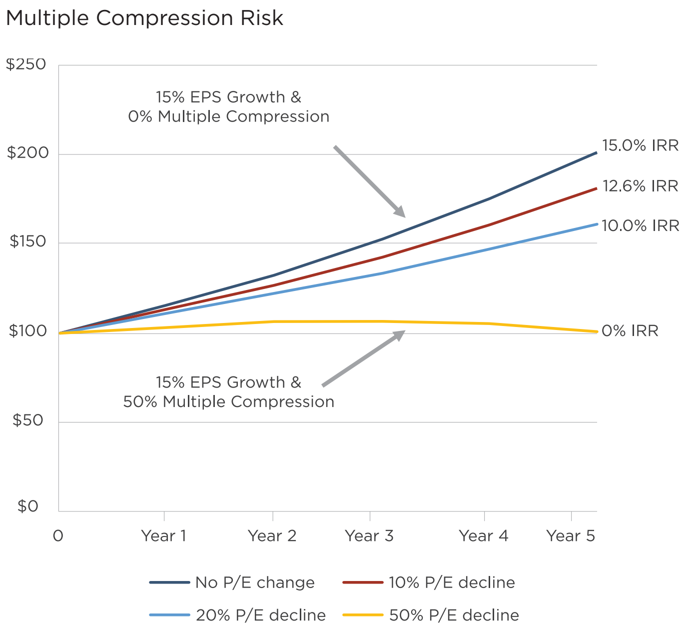
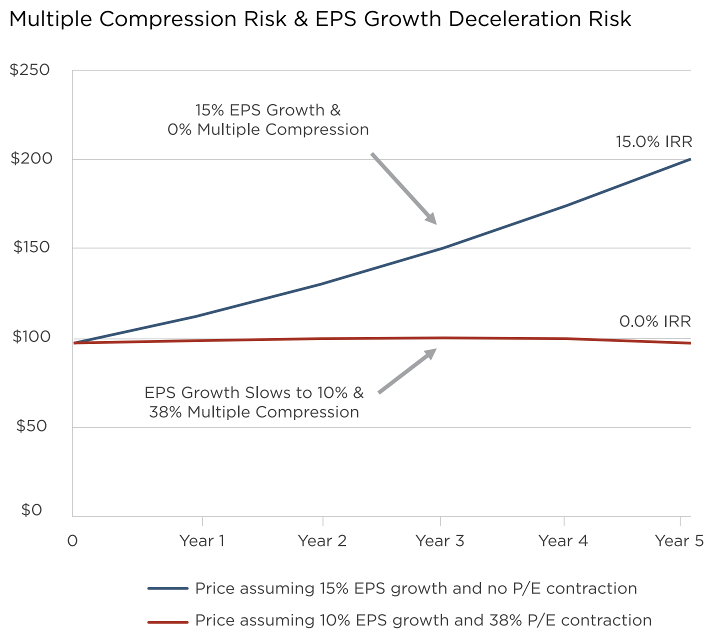
We are returning to our series on valuation. In Part I of our series, we addressed a question frequently received from clients regarding how we view the valuation of our portfolios in comparison to their earnings growth and relevant benchmarks. Now, in Part II of the series, we will spend some time exploring how we think about valuation and its overall role in our investment process.

We often tell our clients that valuation is the "last thing" we consider in our investment approach. However, this should not be misconstrued as "least important." Rather, valuation considerations are typically the final piece of the investment puzzle we construct on a particular business. All discussion up to that point is centered around the company itself, including the barriers to entry around its business model, the sustainability and overall level of its future earnings growth, management's allocation of shareholder capital and potential risks to its long-term success. In our way of thinking, there's no real reason to even discuss valuation until we fully understand these company-specific issues. That is, how do you determine a reasonable valuation for a company until you fully understand the business? If anything, a premature debate on valuation can be detrimental because it could allow bias to creep in, and it often proves to be a distraction before a company is fully vetted. So keen are we to prevent the valuation discussion from becoming the focus of our discourse, the head of our Large Company Growth team, Dan Davidowitz, insists that valuation not even be brought up during our investment team meetings. Rather, any conversation on valuation should be part of separate dialogue between the portfolio managers and the relevant company analyst(s).

We seek to produce attractive long-term returns for our clients while taking on less risk compared to the market. Finance 101 says: Long-term investment returns are a function of earnings per share growth, valuation and dividends. But at the risk of sounding cliché, we would harken back to a quote from Warren Buffet: "It's far better to buy a **wonderful company** at a **fair price** than a fair company at a wonderful price." In our way of thinking, a wonderful company is one that can generate consistent above average earnings growth over a long period of time. Thus, we spend far more of our time understanding the earnings potential of a business rather than trying to determine its fair value. Strong earnings growth is not only indicative to us of a potentially great business, but of a business that may be able to protect investor capital through a range of financial and economic circumstances. The charts in Figure 1 illustrate this point.

Figure 1





Source: Polen Capital

The chart on the left shows the effect of four different scenarios of earnings growth, P/E multiple compression and the resulting annual rate of return on a $100 investment in the same company. The first scenario (top line) is the most straightforward: assuming a company's EPS grows 15% per year for five years (with no dividend payments) and its valuation doesn't change, the investor's annual rate of return over the five-year period will be 15%. In the second and third scenarios, the company's EPS growth remains at 15% per year but the P/E of the company's stock decreases by 10% and 20%, respectively, over the five-year period. In these two scenarios, though the valuation works against you, the investor still realizes annualized returns of 12.6% and 10%, respectively because the EPS growth remained strong. In the last scenario (bottom line), the company's EPS growth is once again 15% but the valuation compression is more significant with a P/E ratio reduction of a full 50% over the five-year period, yielding a 0% annualized return for the investor. While not ideal, it is still worth pointing out the obvious: the investor didn't lose money.[1] Thus, even in the scenario where one arguably invested in an overvalued business, the underlying EPS growth provided a buffer and helped to prevent capital loss.

The chart on the right in Figure 1 presents the effects on the resulting annual rate of return for a $100 investment in the same company in a scenario where both the EPS growth of the business decelerates and the P/E ratio compresses. In this dynamic, over a five-year period the earnings growth could slow from 15% to 10% and the P/E multiple could contract by nearly 40% -- yet the worst outcome would be flat returns. Put another way, EPS growth and valuation projections would need to be overestimated by more than 33% for an investor to lose money over the five-year time horizon.

This is how we approach valuation. It's not overly complex nor is it meant to be. If, after thorough analysis, we have high confidence in a company's ability to deliver attractive investment returns over a sustained period, then it becomes a business worth considering for our portfolios. Importantly, this return

[1] Remember Warren Buffett's first two rules of investing: 1.) Don't lose money. 2.) Don't forget the first rule.

projection may very well assume that the stock's P/E multiple compresses over our time horizon. We will use a current portfolio holding, Visa Inc., as an example to further illustrate our thinking.[2]

Since its IPO in 2008, Visa has been a successful compounding investment by almost any measure. From its first trading day until the end of 2017, Visa's stock price has compounded at nearly 25% annually (including a small dividend). During this period, its P/E multiple contracted 18%, from about 40x to around 33x. Thus, valuation was only a modest headwind to the stock's total return over this period. Visa's adjusted EPS, on the other hand, grew substantially from $0.35/share in FY07 to $3.48/share in FY17, a 26% annualized increase. If you were astute enough in 2008 to have determined that Visa was well-positioned to deliver this level of earnings growth over the next decade, and thus a worthwhile investment, you would have almost certainly found yourself a very satisfied shareholder. But let's assume that both your EPS and valuation projections were too high. Instead of delivering 26% annualized EPS growth, let's instead assume Visa *only* delivered 15% annualized EPS growth while it's valuation contracted by 35% instead of 18%. In this scenario the investor would still realize a 10% annualized return. Not world-beating by any means but we would note that this would still be in line with the S&P 500's return over the same period. Thus, even if one had overestimated Visa's EPS growth by 73% (26% vs. 15%) and the stock's valuation contracted by over one-third, you still would have been left with market equivalent returns (please see charts in Figure 2 for this analysis) because of the sustained earnings power of the company.

Figure 2

Visa Inc: Actual EPS Growth and Returns (First trading day - Dec 2017)[3]

	FY 2007	FY 2017	CAGR
Adjusted EPS[4]	$0.35	$3.48	26%
Trailing P/E	40	33	-2%
Visa Annualized Return (incl. dividends)			**25%**

Visa Inc: Hypothetical 15% EPS Growth and 35% P/E Multiple Contraction (First trading day - Dec 2017)

	FY 2007	FY 2017	CAGR
Adjusted EPS	$0.35	$1.42	15%
Trailing P/E	40	26	-4%
Visa Annualized Return (incl. dividends)			**10%**
S&P 500 Annualized Return (incl. dividends)			**10%**

Source: Factset

This brings us to another question we often get from investors concerning valuation: Do you assign price targets for your companies? The answer is no. Price targets strike us as too precise and, as importantly, potentially limiting to total return if one feels compelled to sell once the stock reaches the price target. To illustrate this point, let's look at a chart of Alphabet Inc. since the stock's first trading day in 2004 (seen in Figure 3). Since it first began trading, Alphabet's Class A shares have an annualized compound return of 25% as of the end of calendar 2017.[5] Put another way, a $100k investment into Alphabet when it first began trading would have been worth nearly $2 million by the end of 2017. We cannot say for certain, but we feel confident that in 2004, when the stock was trading at $55/share, virtually no one would have estimated that just over 13 years later the stock price would be worth over $1000/share. Perhaps this is unfair as predicting a stock's price in five years is challenging enough, much less 13 years. The point is, however, that price

[2] Visa Inc. Class A shares were owned in the Polen Focus Growth portfolio from 2008-2010 and again from 2013 until present. It has been owned in the Polen Global Growth portfolio since 2015.

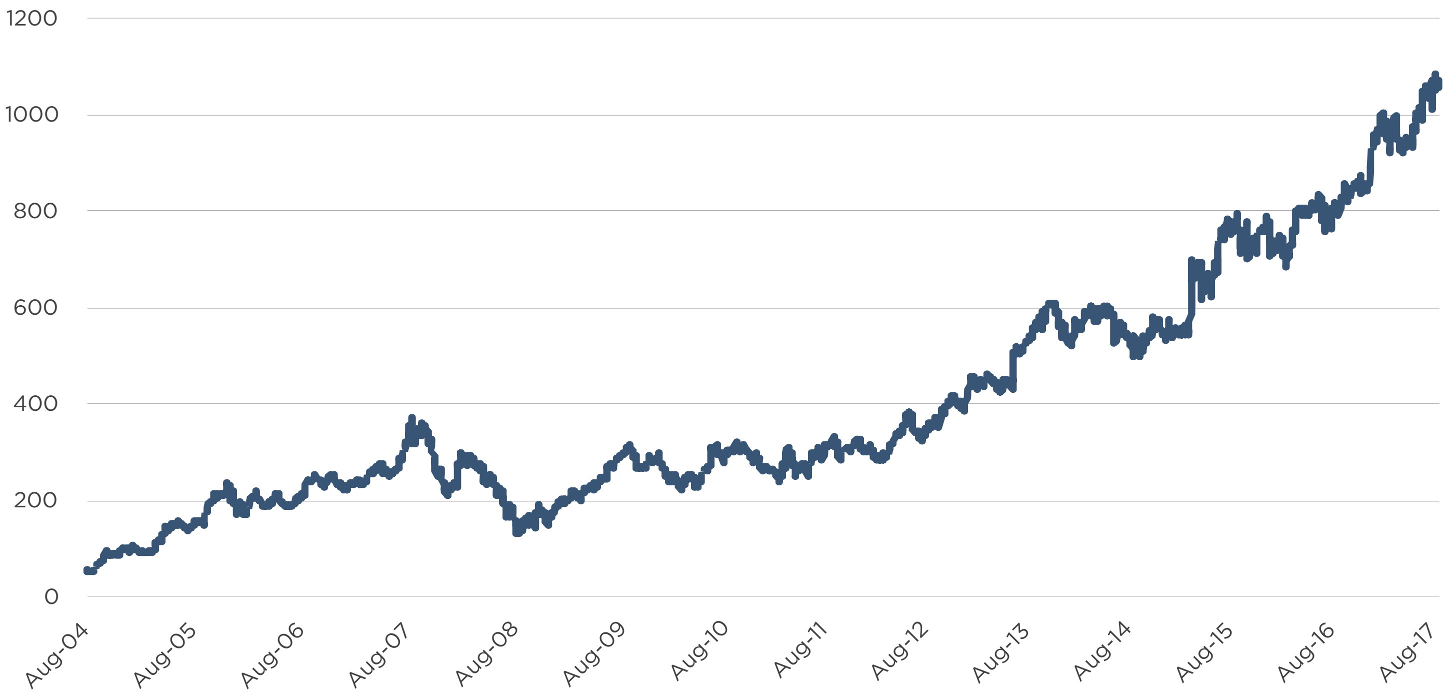
[3] First trading day of Visa Inc. shares was 3/19/2008.

[4] Adjusted EPS is a Non-GAAP number.

[5] Alphabet Class A shares have been owned in the Polen Focus Growth portfolio since 2008 and in the Polen Global Growth portfolio since 2015.

targets would not have been very useful in predicting Alphabet's growth trajectory and almost certainly would have continually underestimated the true value of the enterprise. An investor would have been far better off concluding that Alphabet was a high-quality growth company with durable competitive advantages and an enormous addressable market, and that they would be content to simply own their shares until something fundamentally changed with the business that caused (or might cause) it to deteriorate. The mentality behind this decision is critical for the following reason: the investor starts thinking less like an investor/trader and more like a business owner.

Figure 3: Alphabet Class A - Share Price History

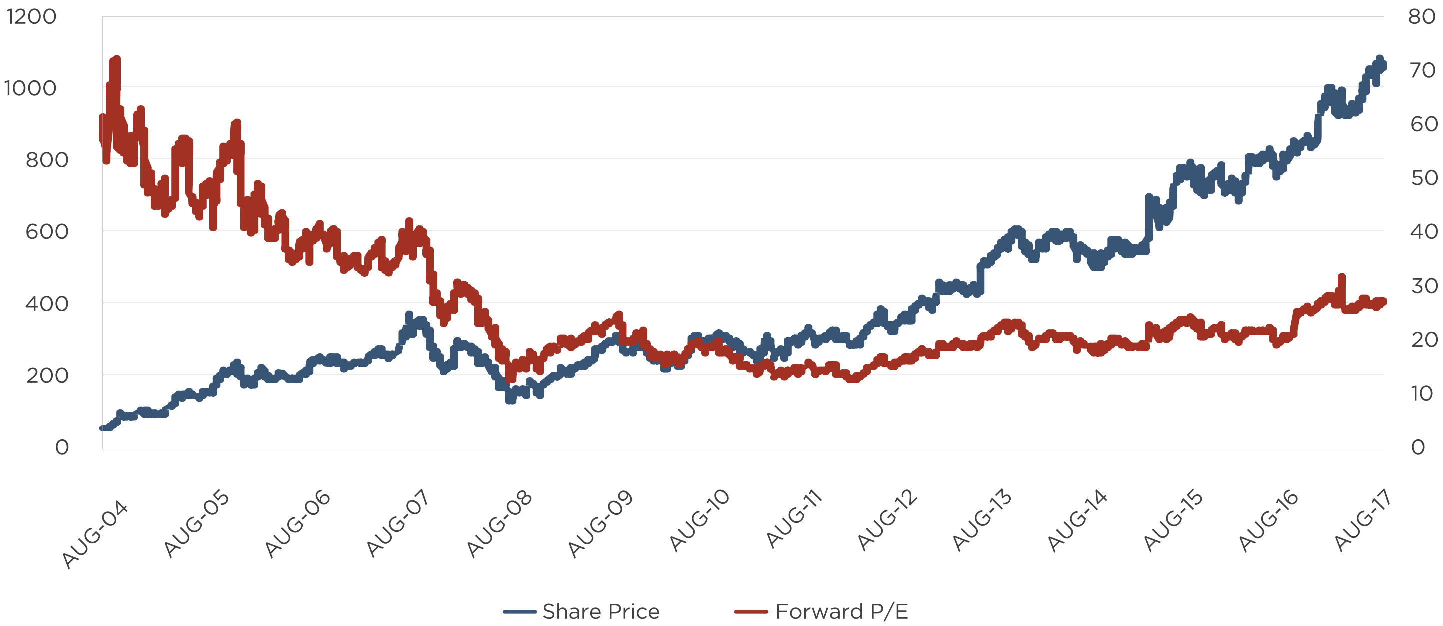


Source: Factset

Perhaps the most notable thing about the Alphabet example is that the 25% annualized return was achieved despite the stock's valuation compressing significantly. As illustrated in Figure 4, Alphabet's forward P/E ratio was over 70x at one point in 2004 but then steadily declined to as low as 12.5x by 2012 (an 80% decline in valuation) before steadily recovering. Even with that recovery,[6] Alphabet's P/E declined by nearly 60% over the entire period and yet that significant P/E multiple compression did not prevent the investor from achieving outstanding long-term returns.

[6] We use forward P/E in this case as it was easier to format in the chart compared to trailing P/E. The relative valuation compression was the same with either metric.

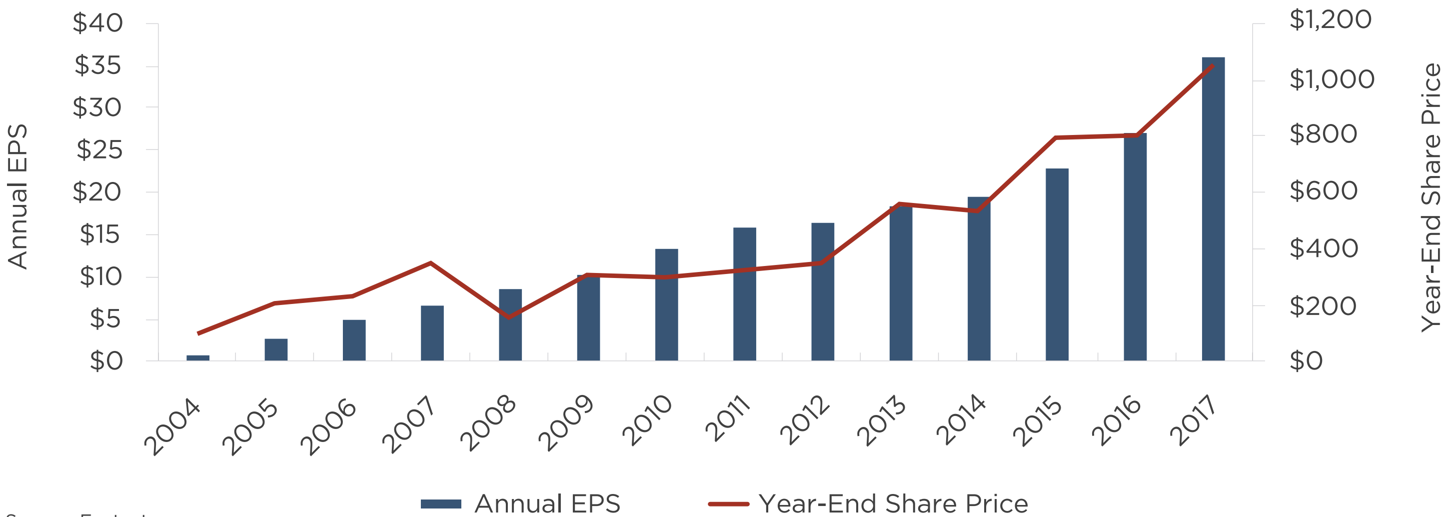
Figure 4: Alphabet Class A - Forward P/E vs. Share Price



Source: Factset

The reason why Alphabet has achieved these returns despite a valuation headwind is, in our view, simple: the company has generated extraordinary earnings growth. This last piece to the valuation framework can be seen in Figure 5 which plots Alphabet's annual EPS vs. its share price. Since its IPO in 2004, Alphabet's EPS has grown at a 35% annualized rate, which has more than offset the decline in the stock's P/E ratio. This brings up another important point about compounded earnings growth: the annualized rate of growth is constant across the time horizon but the growth in actual dollars becomes exponential as the raw numbers get bigger. Thus, Alphabet's adjusted net income dollars increased from $400 million in 2004 to $24 billion in 2017. And while the massive increase in earnings power seen with Alphabet is more atypical compared to your average company, we do not believe it is atypical for a great business. In fact, one of the hallmarks of the unique, competitively-advantaged businesses that comprise our portfolios is that we think they all possess the ability to grow their earnings base at a much greater rate, and for much longer, than the market typically expects.

Figure 5: Alphabet Class A - Annual EPS vs. Share Price[7]



Source: Factset

[7] Alphabet's EPS used in the example is a Non-GAAP number.

A common thread between the Visa and Alphabet examples is that the returns of both companies have been driven by robust earnings growth, which results from the companies' competitively advantaged business models and strong secular growth trends in their respective industries. In our view, the investor would have been best served by taking the time to thoroughly understand these businesses and what makes them unique and sustainable over the long term as opposed to spending hours agonizing over the appropriate valuation or price target for either company. Again, it's crucial to reiterate that we are not trying to diminish the importance of valuation or of value investing. There are clearly instances where the valuation of a stock becomes so frothy that justifying an attractive return in any reasonable scenario becomes challenging. And while both Visa and Alphabet's long-term returns have been achieved despite a valuation headwind, it would of course have been even better had their P/E multiples not compressed. But this scenario would have required good timing in terms of entry points, a strategy we view as difficult to consistently execute well. Instead, by recognizing the potential exceptionality of the business and the likelihood of durable earnings growth for a sustained period, it may be possible for the investor to realize excellent long-term returns while still largely protecting themselves from adverse outcomes.

Conclusion

In the evaluation of any business, we believe investors are best served by taking the time to fully understand the enterprise before giving appropriate consideration to its valuation. This is exactly the approach we take at Polen Capital. It is not meant to suggest that valuation is unimportant or somehow insignificant. Quite the contrary, financial history (and math) has made it clear that valuation can have a prodigious impact on investor returns. But history (and math) has also shown the effects of valuation on total return can be mitigated when the business in question can produce superior growth over long periods of time. These are the kinds of businesses we seek out for inclusion in our portfolios. Not only do they possess a proven ability to generate growth across market cycles, but the earnings growth they produce proves so powerful that it can overwhelm headwinds created by overvaluation. We continue to focus the vast majority of our research efforts towards identifying and understanding these types of businesses.

About The Author

Stephen Atkins, CFA, Portfolio Strategist & Analyst — Large Company Growth, 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 U.S. Small Company Growth and International Small Company Growth strategies. 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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