Publication: Investor Daily
Date: 30 June 2020
Journalist: N/A

InvestorDaily
First for investment industry news

Growth, not value

When economic conditions are favourable, most businesses including the average ones are able to do well. However, in less robust conditions where overall economic growth has stagnated, average businesses struggle to meaningfully grow their earnings because they rely on economic growth to do so.

COVID-19 has brought with it a new set of challenges which we think will exacerbate the pre-existing headwinds of an ageing population, high levels of debt, rising wealth inequality, natural resource constraints, and technological disruption including automation and artificial intelligence.

We believe this sort of environment is set to continue for the next decade and we have therefore positioned our global and domestic portfolios accordingly to capture superior EPS growth from the structural leaders.

These are modern businesses with strong value propositions, competitive advantages, large and growing addressable markets, low debt and high levels of R&D. Elite companies with these attributes will be able to take market share away from their competitors and will be able to grow their revenues in the absence of overall economic growth.

Less winners
We believe future returns will be concentrated in a small number of winners and our investment process is focused on identifying these sorts of businesses and the key themes which will deliver alpha.

Among these are the shift from traditional media to online/digital media, the transition to SAAS and the cloud, the move from cash to electronic payments (which has accelerated during COVID-19) and the transition to sustainable energy and transport.

Within the Australian market, we particularly like healthcare and technology stocks and the Hyperion Australian Growth Companies Growth Fund has a significant international tilt with many of the businesses including CSL, ResMed and Xero having diversified and global revenue streams with large addressable markets.

On the opposite side of the coin, we look to avoid average-quality old world businesses within industries which are in structural decline or are vulnerable to technological disruption.

These include traditional retail businesses, highly discretionary products and services, commodity-based businesses, banks and other highly leveraged lending businesses, as well as capital intensive and debt-heavy businesses. As a result, we currently have no exposure to oil or gas and our exposure to the banking sector remains low within the overall portfolio.

The long view
Our investment thesis is long-term in nature and focused on fundamental quality and growth at a reasonable price. We take a research-driven approach and think of ourselves as business owners, not share traders. Our view is that it is very difficult to predict short-term movements consistently because share prices are highly unpredictable in the short-term.

We don't buy stocks with a particular exit strategy in mind because we want to own them over the long-term and benefit from sustainable growth in positive free cash flows. Over time, the businesses in our portfolios tend to compound their sales at double-digit rates and this strong underlying structural growth also results in double-digit earnings per share (EPS) growth. This in turn tends to see share price appreciation.

Growth not value
While some value companies may look cheap compared to growth companies, we think investors need to take a long-term view on the intrinsic value of a company to really determine if it is expensive or not. This is because in an increasingly winner-takes-all environment, beaten down companies will likely continue to be beaten down in the absence of a growing economy.

Average returns on equity have materially declined over the past two decades, but more than that, financial reward is becoming less and less equally shared. Marginal businesses will struggle, and many will not survive.

While many of these businesses may look "cheap", if you get caught in those sorts of businesses that are being disrupted and that are sensitive to economic growth rates, investors can easily lose a lot of capital.

For successful and profitable businesses to remain so during weaker periods, the need for structural tailwinds like a strong value proposition, a large and growing addressable market and a talented and committed management team with a long-term outlook and "skin in the game" are all required.

In the end, good things happen to good businesses and while economic conditions will remain difficult overall, we believe a growth-based investment style will provide investors with exposure to the right companies which will deliver alpha for their portfolios.

Mark Arnold, CIO, Hyperion Asset Management