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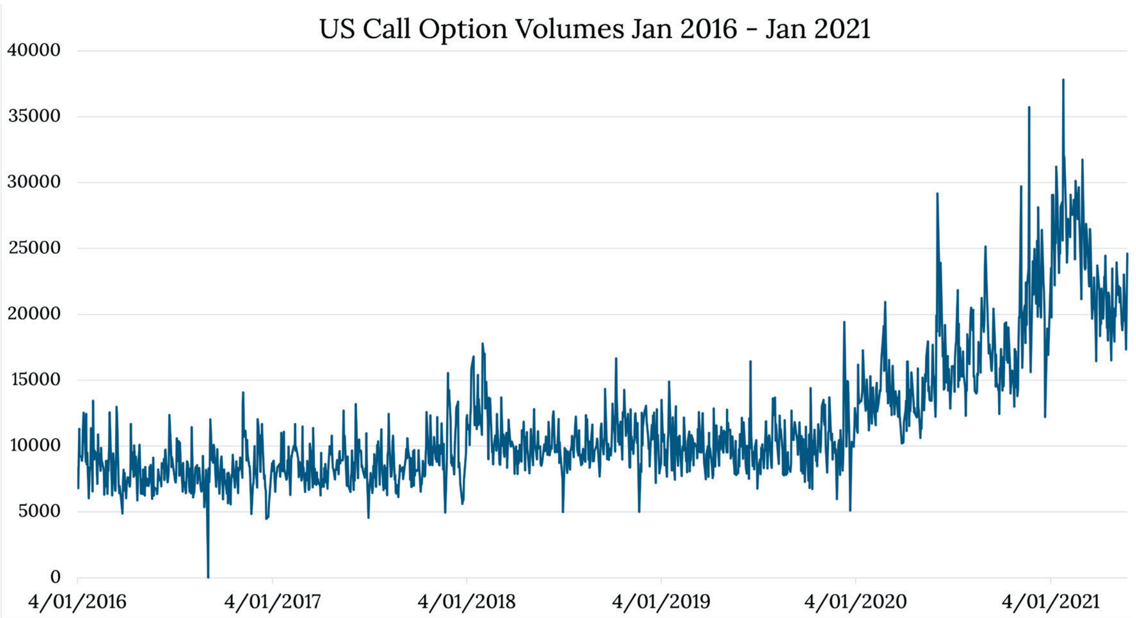
CERTAINTY EMPOWERS YOU

3 stocks, 3 stories

May 31, 2021

In the current environment of low interest rates and massive fiscal support alongside an improving economy, there has been a significant amount of speculative activity. This has been evident in many areas, but one in particular is the increased participation in equity markets by 'retail' day traders.

This is reflected in the huge increase in call options over the past 12 months - particularly short-dated call options. Here the investor is simply deploying capital to achieve an expected gain based on their prediction of how future prices will differ from the market's expectations. Or to put another way taking a punt on the value of an asset going up or down.



Source: Bloomberg

In stark contrast to this, at Talaria we are patient, bottom-up, value investors. As part of our fundamental analysis of companies, we assess the individual components of long-term share price returns. We show this breakdown visually to highlight stocks we think are sustainable compared to stocks possibly subject to reversion. We start at revenue and go right down to changes in P/E multiples to see what has really driven shareholder value creation (and whether it looks reasonable!).

So, we thought we'd share a comparison of 3 stocks to show how sometimes you can justify the price and sometimes you can't.

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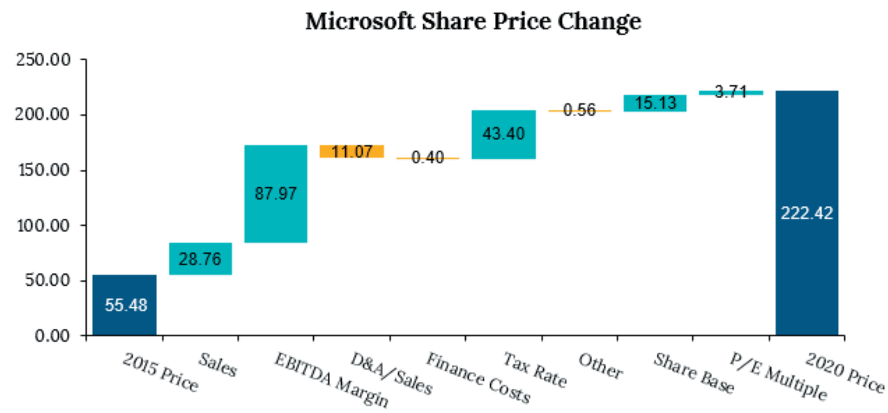
1/ Microsoft

If you bought a share in Microsoft in 2015, you would be a very happy investor today! The share price of this mega-cap business has increased 32% per year, going from $55 in 2015 to $222 in December 2020. Roughly $88 of this uplift can be attributed to higher margins and $43 to lower taxes. These two factors have been the dominant driver of EPS which has also grown ~32% p.a. since 2015. Put another way, the increase in Microsoft shares has been entirely driven by the company delivering strong profit growth and not much in the way of a re-rating in the stock.

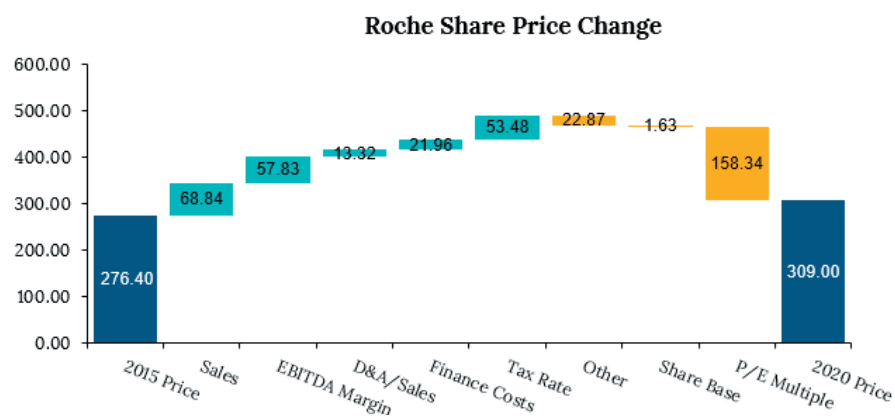


Microsoft CAGR 2015-2020	
Sales	8.9%
EBIT	24.1%
NPAT	29.7%
EPS	31.6%
S/P	32.0%

Source: Talaria, Bloomberg

2/ Roche

Roche, the Swiss Pharmaceutical company that we hold, has faced a different set of circumstances over this period. Since 2015, Roche has managed to deliver EPS growth of ~11% p.a. A respectful number in any sense, with growth driven by many factors (higher sales, margins, lower tax, finance costs). Despite this, the market has seen fit to de-rate Roche's stock since 2015, and in the process wiping off a potential ~€160 in the share price.



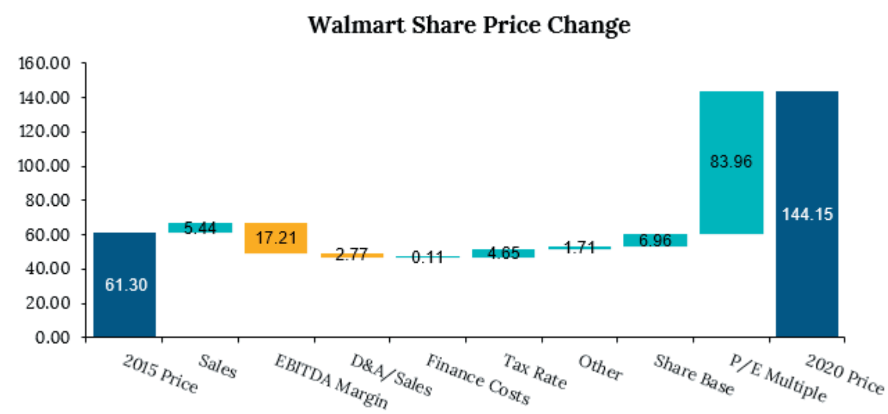
Roche CAGR 2015-2020	
Sales	3.9%
EBIT	7.4%
NPAT	11.2%
EPS	11.1%
S/P	2.3%

Source: Talaria, Bloomberg

These are the types of companies we like. The ones that have consistently delivered growth for investors (and where we think can continue to deliver) and are currently out of favour with the market. They are offering good value, and so are the opportunities we look for.

3/ Walmart

Then there are share price journeys like Walmart's. Like the previous investor who bought Microsoft in 2015, the investor who bought Walmart in 2015 would also be a very happy individual today.



Walmart CAGR 2015-2020	
Sales	1.5%
EBIT	-4.6%
NPAT	-2.8%
EPS	-0.4%
S/P	18.7%

Source: Talaria, Bloomberg

However, the reasons why are completely different. Unlike Microsoft, Walmart has failed to grow its business since 2015. EBIT has fallen ~5% per year and EPS has been flat. Despite this, the share price has gone from $61 to $144 (or growth of 19% p.a.) The key driver, you ask? A huge expansion in the P/E multiple driven by the market's desire to pay up for the potential that Walmart's business fortunes improve over the next few years. As value investors we don't tend to want to pay up a lot for the potential growth of companies!

There is plenty of risk out there in the market, from inflation to concentration and duration, and so understanding the true fundamental drivers of a company's performance helps us reduce investment risk. In doing so, it improves the chances of successfully navigating periods of uncertainty to deliver for investors.