

Total Returners

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The late Charlie Munger believed it’s better to pay a fair multiple for a quality business, than a cheap multiple for a so-called cigar butt. *“Over the long term, it’s hard for a stock to earn a much better return than the business which underlies it earns. If the business earns six percent on capital over forty years and you hold it for those forty years, you’re not going to make much different than a six percent return - even if you originally buy it at a huge discount. Conversely, if a business earns eighteen percent on capital over twenty or thirty years, even if you pay an expensive looking price, you’ll end up with one hell of a result.”*

Munger was not wrong. All else being equal, a company’s sustainable growth rate is a function of its Return on Equity (ROE) and the pay-out ratio. The total return will tend towards the company’s ROE if (and only if) all the retained capital can be reinvested at the ROE. These “compounders” are what he was referring to. However, if all the capital were paid out (as a dividend, or share buyback), the total returns would tend towards the earnings yield (like a perpetuity) since no rate of Earnings per Share (EPS) growth could be sustained. Warren Buffett aptly refers to profitability as “earning power” because it measures the latent potential for growth, though not necessarily the actual growth. By way of analogy, a Porsche has a bigger engine and higher top speed than a Volkswagen Beetle; however, a Porsche in a 60km/h-speed zone is limited to the same speed as the Beetle.

Paradoxically, Berkshire’s own ROE averaged a meagre 7% over the past 37 years, which would rank it amongst the dogs of the Dow. However, over that same stretch, Berkshire’s book value per share (BVPS) compounded at over 15% per annum, thereby achieving what Munger thought impossible and ranking it amongst the diamonds. So, what gives?

Berkshire’s disparity relates to how “GAAP” (Generally Accepted Accounting Practice) accounts for investment returns. Accounting rules require income (interest and dividends) to be booked in the profit and loss statement (P&L) but unrealised capital gains on long-term investments to be booked to the balance sheet - total returns be damned! To illustrate how absurd this is, consider two scenarios, where a company invests in the same fund but two different share classes; the first pays out income, whereas the second accumulates income as capital gains. Notwithstanding the underlying economics are identical, an investment in the first share class would inflate GAAP earnings per share, relative to the second. However, BVPS would be identical under both scenarios, unencumbered by GAAP policy. Merrill Lynch analyst Joshua Shanker, refers to *“total return underwriters... who actively manage both underwriting and investing functions of their operation often with a longer-term investment horizon and ‘under reported’ income”*. Berkshire is but one glaring example.

Financials companies are very different from operating companies (non-financials) in terms of accounting and performance metrics. Financials are more balance sheet centric, because book value reflects the accountant’s estimate of net worth (liquidation value) at each reporting date; hence ROE represents a realistic measure. In contrast, an operating company’s book value indicates historical cost, which is distorted by inflation and time, hence ROE is often obtuse. The financial sector is small and diverse with banks and insurers comprising only 3.4% and 2.3% weights in the S&P 500. For many managers, who cut their teeth elsewhere, the juice is simply not worth the squeeze.

Unfortunately, investors fixating on Berkshire’s eyewatering Price to Earnings (P/E) ratio, averaging 22.6 times over the past four decades, might have “missed the boat”. However, those pondering Price to Book (P/B), which averaged 1.5 over the same stretch, might have bitten on Berkshire. That seems undemanding for a company which consistently compounded in the mid-teens. Blatantly, BVPS growth was a better barometer of Berkshire’s shareholder value creation, considering many listed stocks (American Express, Coca-Cola, etc.) have been held for 40 or 50 years without any capital gains realised as GAAP “earnings”.

Credo’s equity managed portfolios have above average exposure to property and casualty (P&C) insurance. When it comes to separating the “wheat from the chaff”, we concentrate on companies which have consistently “reaped” their ROE, “sowing” capital and compounding (tangible) BVPS. To the extent they cannot, we’ll credit them for capital returned. Our preferred measure of shareholder value creation, over the long haul, is BVPS growth, plus dividend yield. When considering prospective candidates, we dig deeper into how management’s track record was achieved and the extent to which we believe it is repeatable going forward. In other words, was it luck because of a risk-seeking CIO betting on Bitcoin, or do we think that there exists a competitive advantage, due to underwriting expertise, or scale, etc. whereby superior profitability can be sustained going forward.

When evaluating prospective returns (IRR) from investment, we decompose total return into three constituent components: growth, valuation multiple rerating and dividend yield.

As the saying goes, “Price is what you pay, and value is what you get”. In the short run, the stock market resembles a voter’s poll, where weak sentiment is reflected in a lowly valuation multiple. To the extent it is temporary, prospective returns are rosier, due to the rerating opportunity. Risk is lower too, as a cheap multiple offers a greater degree of downside protection, compared to one priced for perfection. When considering valuation, we monitor P/B and P/E (on mid-cycle margins) because earnings can be lumpy, whereas BVPS provides more of a ballast. Over time, stock markets behave more rationally - price and value ultimately converge.

Longer term, the quality of the underlying business matters more than the multiple, because shareholder value compounds, whereas derating gets averaged down over decades. For example, even if one bought Berkshire in 1995, at peak P/B of 2.3 times and suffered derating all the way back to 1.5 times as of the end of 2024, one would have still outperformed the S&P 500 over that stretch because Berkshire grew BVPS at 13% per annum, but the multiple derating eroded total returns by only 1.4% per annum over 30 years. However, had the multiple derated to 1.5 in 1996, then one would have suffered roughly 35% derating, that year.

Our P&C insurance holdings, both present and past (Progressive, Admiral, Arch and Chubb) exhibit a single common denominator. That is, a long run track record of shareholder value creation, which we think is repeatable, notwithstanding differences in geography, the lines of business, and so forth. We’ll only bite when it’s offering an attractive valuation to boot. In many ways underwriting is akin to investing; both try to handicap prospective returns



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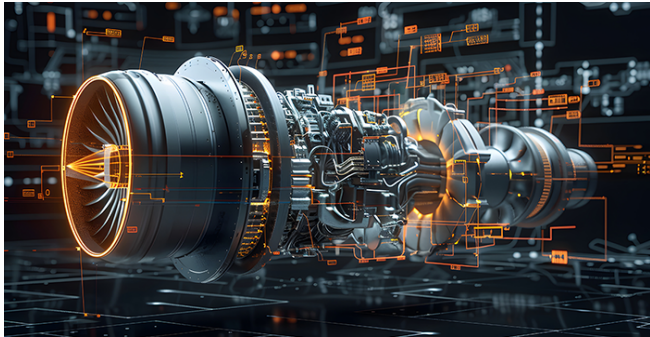
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