European Capital Partners

Friday Morning Coffee

Nr. 39 – Message from Mr. Hindsight: Investors are bad at forecasting growth

As value investors we have nothing against companies wanting to expand their businesses and show solid earnings growth. On the contrary, **growth is good and important for every healthy business**. If a company can make investments yielding a return far higher than the cost of making the investment, we prefer the company to reinvest all their earnings back into the business as it maximises value creation over time. If a company has run dry of interesting investment opportunities but still run a nice cash-generating business, we prefer the company to pay us a high dividend and leave the all-important investment decision to us. If the company does not generate more cash it needs to run the business, we do not invest in the company.

However, as value investors, we find it **extremely difficult to estimate future earnings growth correctly.** That is why we want to err on the conservative side when it comes to estimating the future growth potential of a business and give little weight to the growth part of the business in our estimated fair value computations. This raises the question whether our investment approach is too conservative and whether other investors are more accurate than we are at forecasting growth correctly. That would indeed give these investors a competitive advantage enabling them to pay higher valuation multiples for a company and still make good investment returns without being disappointed by a lower growth rate than initially expected.

Research analysts from different broker houses make their forecasts available to us, but how good are they in forecasting the long-term earnings growth of a company? In order to get a better impression, we looked at the largest European companies in the large cap DJ Stoxx 600. With 2012 as our base year we collected for each company data for earnings growth 5 years prior to 2012, estimated earnings growth from 2012 to 2017, and the realized earnings growth in 2012-2017 period. **The result of this little (non exhaustive) study shall give us a hint about the difficulty in making predictions about future.**

The following note gives the opinion of the Investment team at the time of the publication. Please refer to important notice at the end of the document.

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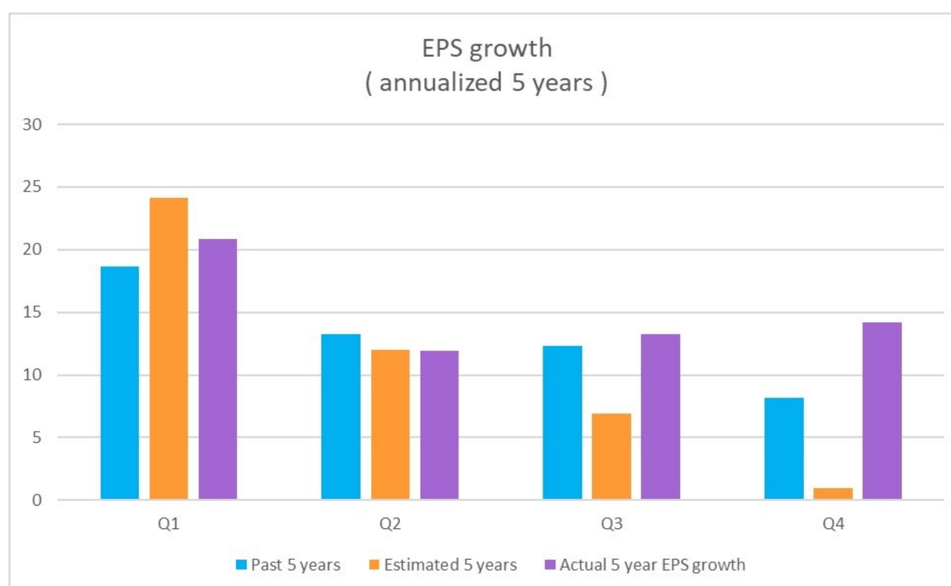

Source: Bloomberg, ECP

I draw several conclusions from this analysis:

1) Analysts have a costly tendency to exaggerate both the good and the bad as they tend to be over-optimistic (Q1) and over-pessimistic (Q4).

2) The historical growth rate of a company appears to be a much better guide for its future than the analyst estimates.

3) There is mean reversion, to the extent that growth rates of the 4 quartiles normalize over time to the median European company.

As value investors, we are not trying to forecast growth rates. On the contrary we try to exploit over-pessimism in the stock market on certain companies. So I suspect, we would find investment opportunities in the 4th quartile. Once reality kicks in on a longer-term horizon, earnings growth turns out to be higher than everyone expected and was closer to what these companies have realized in the past. That reality will ultimately be reflected in the stock price and make the return for the value investor.

I wish you a great weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
January 11th, 2019

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