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Multiple ways to win (and lose)

We recently took the decision to sell Quest Diagnostics (DGX), having purchased it for our clients in February 2016. While the return, including dividends, over the period of 75%, and 46% outperformance of the index, are clearly positives, it perhaps, just as importantly, provides an illustration of the thinking that underpins our investment philosophy and processes.

Before we make an investment in a company, we need to believe that it is trading at a discount to our assessment of its intrinsic value. While we are sceptical of the conviction that many market participants seek to obtain and portray through very specific valuation metrics and models, we would necessarily accept that something is required to approximate what that intrinsic value is, both in an absolute and relative sense.

To this end, and unless there is a specific reason otherwise, we typically determine what return we can roughly expect over our typical investment horizon of 4 to 5 years. This will include an expectation for earnings, multiple expansion or contraction and cash distributions (e.g. dividends). Generally speaking, it is either the earnings and/or multiple components that contribute the majority of a total expected return.

Our initial expectation for DGX included a broadly equal contribution from earnings and multiple expansion. In respect of the latter, we believed that once some of the transient issues impacting DGX at the time had passed, it would be capable of supporting a multiple of 15x – what we deemed to be fair on the basis of fundamentals and history. In fact, in just a little over 15 months DGX's multiple increased to 19x, a gain of over 50%, while earnings largely tracked our expectations.

The fact that our assessment of intrinsic value and total return assumes that any change in multiple does not manifest for 4 to 5 years obviously underestimates the potential return of a stock should it happen much sooner, as in the case of DGX. It is a conservative approach and ensures that we only invest in stocks which offer an attractive total return, even if any expected change in multiple only comes much further down the line.

Multiples are a reflection of both fundamentals and market sentiment, the latter of which can be fleeting and fast moving. Until now we have only talked about increases in multiples, but multiples can clearly decrease as well, and, just as with increases, potentially considerably in a short space of time. You can be right with earnings, but if you get the multiple wrong it may well not matter. That's why when we buy stocks, or review our existing holdings, we pay a lot of attention to multiples and how much downside there is if the fundamentals fall below our expectations, but perhaps, if not more importantly, if market sentiment changes for the worse. One of the principal tenets of our investment philosophy is to seek to avoid permanent losses of capital. It can take a lot of earnings growth to grow out of a big multiple contraction.

As it relates to DGX, having seen its multiple rapidly increase to 19x, we cannot dismiss the possibility of sentiment reversing. We certainly struggle to see how it could meaningfully increase from here. If the former happened in a short-space of time it could lead to a significant loss of capital that would take some considerable time to recover.

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