

CORPORATE EXCELLENCE INSIGHTS

Hérens Quality AM is a specialized provider of systematic Quality Investment Solutions and one of the few providers of Quality equity investment strategies worldwide. Corporate Excellence Insight is our monthly publication that includes a brief update on markets and our thoughts about major trends that are impacting the investment management industry.

MARKET UPDATE: STRONG EARNING UPDATES

February saw positive performance in stock markets driven by resilient economic data and strong earnings reports, particularly in the US where the S&P 500 gained 5.3% for the month. The majority of S&P 500 firms exceeded analysts' earnings forecasts, with economic indicators such as the US composite Purchasing Managers' Index showing continued expansion and job additions in January.

76%

SOME 76% OF S&P 500 COMPANIES HAVE SURPRISED TO UPSIDE

Results for the final quarter of 2023 signaled continued corporate strength despite the angst. Balance sheets held up, Big Tech darlings powered on and operating margins were steady as companies slashed costs.

\$80bn

OPENAI COMPLETES DEAL THAT VALUES THE COMPANY AT \$80 BILLION

OpenAI has completed a deal that values the San Francisco artificial intelligence company at \$80 billion or more, nearly tripling its valuation in less than 10 months. OpenAI is now one of the world's most valuable tech start-ups, behind ByteDance and SpaceX.

0.2%

GERMANY SLASHES ITS 2024 GROWTH OUTLOOK

German Cabinet has approved an economic forecast revising growth down to 0.2% this year — well below a previous forecast of 1.3%. Unstable economic environment and historically low global trade growth is a challenge for an export nation like Germany,

MONTHLY TOPIC: ADDRESSING VALUATION

Supported by improved earnings outlook, as well as reduced macro uncertainty amid evidence that inflation has not become entrenched, valuation of the equity market has expanded recently. Valuation of Quality has followed suit after suffering disproportionately in 2022. However, experience of the last two years is a vivid highlight that changes in valuation multiples can cause volatility of returns in the short horizon, but consistently predicting such swings is a futile endeavor. Over the long-run, however, fundamentals trump the short-term noise, leading to outperformance of Quality, despite its above-average valuation.

As proponents of 'Quality at Attractive Valuation' approach, it might come across as counterintuitive that Quality portfolios typically command a premium compared to the market. However, it is rare to see a company with solid fundamentals, durable competitive advantages and sustainable earnings power trading at a discount to the market.

Our assessment of what constitutes an attractive valuation is a comprehensive process that goes far beyond comparison of multiples. Equally important for us is to understand how the multiple looks in the context of the business model, compared to companies of similar quality, and taking into accounts company's growth outlook and its sustainability.

[Read full Article on Page 2](#)

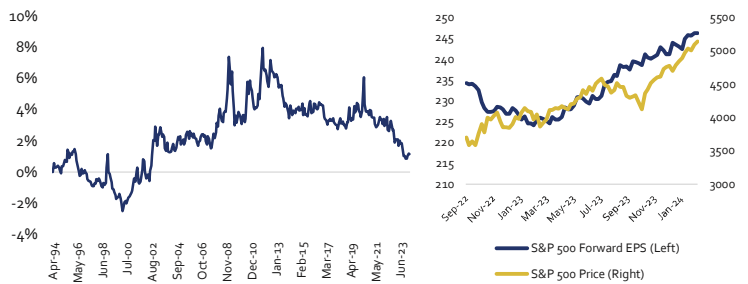


Why 'attractively valued' is not the same as 'cheap'

Has the market rallied beyond reason?

After a stellar 2023 for equity returns, some investors might feel uneasy about what to expect this year. A factor often cited as a sign of froth in equities is the spread between S&P 500 earnings yield and 10-year treasury yield, which has recently hit the lowest in years (Fig. 1), on surface suggesting that equities are overheated. However, one should also consider that the Fed guided for three cuts in 2024 – a fact which the rally of 2023 has been reflecting all along, together with improvement in earnings expectations.

Figure 1: spread between S&P 500 earnings yield and 10-year treasury yield (left); S&P 500 price and earnings expectations (right); as of 29/02/2024



Source: Hérens Quality AM, Refinitiv

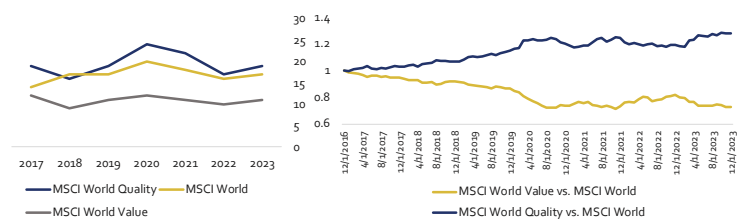
On earnings front, we are already seeing signs of destocking cycle ending and of recovery emerging in sectors that suffered in 2023, such as semiconductors and manufacturing. Easing inflationary pressures are also now acting as a tailwind for many businesses in the form of lower commodity prices and transportation costs (although developments in the Middle East may jeopardize that).

Altogether, we believe the equity market's valuation reflects improved earnings outlook, as well as reduced macro uncertainty amid evidence that inflation has not become entrenched.

The valuation aspect of Quality

For Quality, 2023 was also a strong year with solid outperformance, while valuation of Quality has expanded after suffering disproportionately in 2022 (Fig. 2). But does it mean that now is a bad entry point into Quality?

Figure 2: Forward P/E (left); price return of Quality and Value vs. MSCI World (right), as of 29/02/2024



Source: Hérens Quality AM, Refinitiv

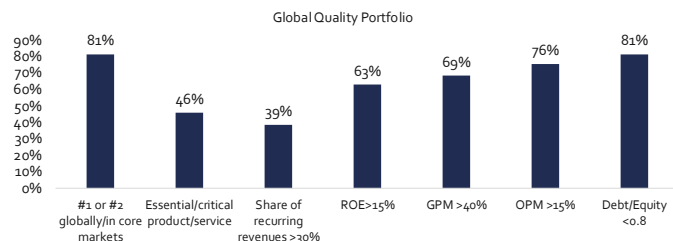
Experience of the last two years is a vivid highlight that changes in valuation multiples can cause volatility of returns in the short horizon, but consistently predicting such swings is a futile endeavor. Over the long-run, however, fundamentals trump the short-term noise, leading to outperformance of Quality (Fig.2), despite its above-average valuation. The valuation aspect of Quality is something our clients, rightfully, challenge from time to time. Indeed, as proponents of 'Quality at Attractive Valuation' approach, it might come across as counterintuitive that Quality portfolios typically command a premium compared to the market. However, if 'Quality at Attractive Valuation' was about buying companies with solid fundamentals, durable competitive advantages and sustainable earnings power at a discount to the market – we, unfortunately, would not have many companies to invest in. While bargains within quality sometimes pop up (just look at Meta's 11 P/E in October 2022), we typically have to accept that companies we buy will not be optically cheap.

Quality deserves a premium

So what is it about Quality that leads to this phenomenon? It is not just about EPS growth. While we take growth into account when assessing valuation, for us, however,

EPS growth does not have to necessarily be high – even more important is the question of whether it is sustainable and can at least meet the market's expectations. This is why even Quality companies with rather modest growth profiles, especially in Consumer Staples (e.g., Costco) and Health Care (e.g., Agilent) sectors can command demanding premiums, as uncertainty about their growth outlooks is lower. Of course, characteristics of the business model also lead to differences in valuation. As Fig.3 shows, Quality companies are, in addition to being superior fundamentally, 1) market leaders with strong economic moats; 2) have high share of recurring revenue; 3) provide mission-critical products or services – all of which are factors that contribute to sustainability of their earnings power. Such companies rarely trade at a discount to the market – and it is not a bad thing.

Figure 3: Quality characteristics; as of 31/12/2023



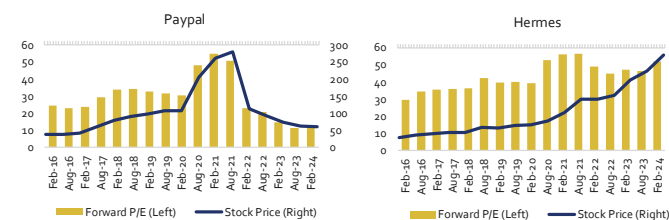
Source: Hérens Quality AM

The story behind the multiples

On the contrary, valuation should reflect the strength of a business model: when the story looks good, but the market is not buying it – suspicion should be raised, as it might be a signal of trouble ahead. An example is PayPal, which trades at 11 forward P/E – a bargain for a leader in payments with excellent balance sheet, right? At one point, we, too, fell for this trap, as we held the Company believing the risk-reward is compelling. However, in a price-taking industry that is being rapidly commoditized, the terminal value of the business, the biggest chunk of valuation, is under question. At the other end, some companies always look expensive, such as luxury giant Hermès, which trades at P/E of 45. Even though Hermès is not a high-growth business, the market puts high value on timeless quality and appeal of Company's products, along with resilience of its business model, which has been proven over more than two centuries.

Such business model differences are crucial to analyze in order to judge whether valuation is fair.

Figure 4: Forward P/E multiples and stock price growth of PayPal and Hermès; as of 29/02/2024



Source: Hérens Quality AM, Refinitiv

Qualitative analysis in the context of valuation

Valuation is as much art as it is science, and there is no ultimate cheat sheet to approach the topic. However, disciplined assessment of valuation is just as important as evaluation of fundamental quality. Therefore, our assessment of what constitutes an attractive valuation is a comprehensive process that starts with analysis of a range of multiples (P/E is only the tip of an iceberg), but goes far beyond that. Equally important for us is to understand how the multiple looks in the context of the business model, compared to companies of similar quality, and taking into accounts company's growth outlook and its sustainability.