What Makes Us Think and What We're Thinking About

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I received an interesting letter from an investor last year. In it he shared with us a quotation from a speech given by Fidelity's Peter Lynch . Here it is:

"McDonald's was up 10-fold after IPO but it was only in 18% of countries. Then it gets to 30% and the stock is up 30-fold. You have to know what innings you're in. There were more post offices in California than there were McDonald's restaurants. People missed the overseas potential too...Are you in the 3rd innings of a ball game that might last 20 years?"

Just to confirm the veracity and power of the anecdote I checked McDonald's share price history as far back as Bloomberg will go – which is 38 years (the actual IPO was 1965). On 31st October 1980 McDonald's traded at $1.1. As I write the stock stands at $178. The shares have a dividend yield at today's price of over 2.5%, suggesting that there has been a decent income return on top of that 161-fold capital gain - adding a cherry to the icing on the Big Mac bun.

Peter Lynch was famous for his tenacity in holding onto growing companies and thereby delivering "baggers" to his investors - shares that multiply many, many times over their initial purchase price. Now everyone, including Peter Lynch, knows that having the patience and fortitude to hang on to such winners is difficult. Not only do you have to hold for many, many years and that is challenging – intellectually and emotionally. In addition, the truth is it was only obvious in hindsight that McDonald's was going to become a 100-bagger and more. Every single trading day for 38 years someone could have offered a plausible reason to sell and probably did. What's more there was also plenty of extraneous market noise and volatility to unnerve you and shake you out of the stock.

But the even more difficult aspect of investing in the way Peter Lynch proposes – certainly most difficult for a professional investor who has to report regularly to smart clients – is how to justify the valuation on the way. For instance, by the start of 1990 McDonald's was now trading at over $8 – an 8-bagger since 1980. Historic earnings were $0.48, for a P/E of 18x. I imagine in early 1990 there was prolonged discussion in institutional investment meetings about what the right P/E should be for McDonald's and whether 18x wasn't a bit rich – especially for a stock that had already done so well.

Of course – with hindsight – we can now be sure that any debate about the valuation of McDonald's in 1990 was more or less irrelevant. It could have been valued on over 50x and even at that rating it would still have performed in line with the S&P 500 through to today. (The S&P rose 7.5x between 1990 and 2018 and McDonald's 22x – nearly 3x as much. Therefore McDonald's could have been nearly 3x more expensive in 1990 and still performed in line.) And any quibbling about the valuation that actually encouraged a sale of the stock was downright ruinous.

Yet we all know that the credibility of the investment professional who argues that such and such stock is overvalued on 18x is often higher than that of the investor who counters along the following lines. "I don't know what the right rating or price is for McDonald's today, I just think the business has a lot of growth ahead of it and that we should hang on and just ignore the valuation, except in extremis." To be honest that sounds a bit like me recently defending holding on to and still buying Diageo on 22x earnings (as, indeed, we continue to do). The sceptic appears to have exactitude on their side and the optimist sounds woolly. But exactitude is dangerous in investment, because the future is not amenable to exact forecasting. Moreover it is that which is not known (and, indeed, that which is essentially unknowable) that delivers the real long term value.

But here is a serious question – how do you find ways to justify hanging on to companies that have the potential to do what McDonald's has done? Or to do what we're sure Diageo will do over the next decade or two. We know we have to find ways to avoid being bounced out for arbitrary reasons. And often quibbles about valuation are arbitrary.

Now I'm in no way undermining the importance of company analysis and valuation disciplines for our approach. But let me suggest an additional and unrelated reason for hanging on:

Investments like McDonald's are not as rare as you might think. In fact there is a surprising number of them.

Enough, we submit, to base our investment approach on the principle of hanging on to a portfolio of promising companies. And waiting for very good things to happen for us and our clients.

This proposition is inspired by my reading last year of Christopher Mayer's exhilarating book "100 Baggers". I imagine every investor who reads it will have a similar reaction to mine. First thrilled; then resolved to - have some of that.

At the heart of Mayer's book is a list. It is a list of a lot of substantive US companies that have gone up at least 100-fold between 1962 and 2014. Think about that - these are the ones that turn $10,000 into $1.0m. And just to confirm they weren't speculative tiddlers - the median market cap for each at outset of Mayer's study was $500m. Meanwhile, the average time period for each of them to go up 100-fold was 26 years, that's around 19% per annum. Of course 26 years is a long time in investment, but it's not an impossibly long time is it? Or not impossibly long if you're enjoying 19% annualised returns on the way.

His list comprises 365 companies. That surprised me – it seems quite a lot. It appears it's not so unusual for shares in substantive companies to go up 100-fold. To put it into some kind of context, there are c3,600 quoted companies in the US today, give or take. So, although I acknowledge I'm not comparing like with like, we may conclude that, indeed, those 365 were and remain rare in the context of thousands of quoted companies - but perhaps not quite as rare as you might have thought.

Enough to make it at least not irrational to just carry on holding on to a decent company; because of the not trivial possibility that it might turn out over time to be not just a good investment, but an exceptional one.

Mayer's work encouraged me to review constituents of the UK stock market. I worked with the current FTSE 350, using Bloomberg as my data resource. What I looked to establish is how many of the current 350 biggest UK companies have delivered truly exceptional share price returns – preferably 100-bagged – over the period covered by Bloomberg, which reaches back to the mid 1980s. So, 30 years or more. Specifically I looked at trough to peak gains over that period, so it is the case that some of the examples I adduce below have fallen – more or less precipitously – from their peak share price. In addition, these are capital gains only – with no income included.

There are 12 companies in the current FTSE 100 and FTSE 250 which have at some stage delivered a 100-fold return to their investors – from a low to a peak. Let's list them. From the FTSE 100: Ashtead, Antofagasta, DCC (up 525 times!), Next, Randgold Resources and Sage. From the FTSE 250: Cairn Energy, Capita, Daejan Holdings, Domino's Pizza, JD Sports and Tullow Oil. I'm not saying that there is any coherence to this group or that one can draw from it any conclusions about likely future 100-baggers. I suppose the dozen do confirm that resource explorers that strike it lucky can deliver amazing returns; but good luck to you finding the next Randgold or Tullow – assuming you are even tempted to try. Meanwhile - Next, Domino's and JD Sport demonstrate the rewards available for correctly gauging and serving the tastes of the Great British Public.

My point about that dozen is this: that over 3% of the constituents of today's FTSE 350 have at one time or another gone up a hundredfold. (Although, I admit, they may not have started out in either the FTSE 100 or 250 as they set out on those gains.) Nonetheless, you have had a better than 1/30 chance that a random company, now a constituent of a reputable benchmark, has made a patient investor a very great deal of money. Already those odds are interesting and confirm Mayer's lesson that big winners abound.

Those odds get even more interesting if you're prepared to moderate your return aspirations. I looked next at those FTSE 350 companies that have gained between 50-100 times. There are another 12. Paddy Power from the FTSE 100; and BTG, CLS, Clarkson, Cranswick (up over 80-fold, not bad for a sausage maker), Dechra Pharmaceuticals, Diploma, Grainger, Rotork, St Modwen, Savills and Sirius Minerals from the FTSE 250.

The news gets better: as many as 65 companies increased between 20-50 times. And a further 82 have gone up at least 10-fold at some point since the mid-1980s. In total that means that 171 companies or nearly 50% of the current crop of 350 major quoted UK companies has at some point almost certainly met most peoples' hurdle for what constitutes a big

investment winner. That hurdle I take to be going up a minimum 10-fold. Remember – the annualised compound rate of return over 30 years for £1 to turn into £10 is 8%; £1-£20 is 10.5% pa; and £1-£50 is 13.9%pa. It may be relevant to note that the FTSE All-Share is up 7-fold over 30 years, for an annual compound of 6.7%, again ignoring dividends.

Below is a sample of some of the other major UK companies from the 350 that have turned out to be wonderful long term investments; up at least 10 times. I've picked the ones that reassure me, because I either own them, or might have done. If I'd been smarter or less fussy about entry points.

AG Barr, Associated British Foods, AVEVA, Brewin Dolphin, BAT, British Land, Bunzl, Burberry, Diageo, Euromoney, Greggs, Halma, Hargreaves Lansdown, ITV, Intermediate Capital, Johnson Matthey, Legal & General, LSE, Prudential, Rathbones, Reckitts, Renishaw, Schroders, Shaftesbury, Smith & Nephew, Spirax-Sarco, Standard Chartered Bank, Tesco, Travis Perkins, Unilever, Weir and Wetherspoons.

In fact, I'd say that in hindsight I'm a bit disappointed not to have delivered a few more 10-baggers for our clients over the last 20 years – given, as you can see, how relatively commonplace they are. I must get better at it.

If I do improve it will be because I have acknowledged and implemented some of the following wise words. These are taken from the book that inspired Christopher Mayer to write "100 Baggers". That book is the classic 1972 investment text – "100 to 1", by Thomas Phelps. Phelps was an old-hand stock broker – active in US markets since 1927. And what he learned over his career is encapsulated below:

"It would be hard to find a worse slogan than 'You'll never go bust taking a profit'. Every sale is a confession of error."

"Even if one knew what the stock market was going to do, it would be more profitable to forget it and concentrate on trying to find the right stock to buy."

"In Alice in Wonderland one had to run fast in order to stand still. In the stock market, the evidence suggests, one who buys right must stand still in order to run fast."

"The two reasons so few of us profit by 100-1 stocks are first that we do not try to do so and second that even when we are wise or lucky enough to buy one we do not hold on."

From Peter Lynch, via Christopher Mayer to these four great quotes from Thomas Phelps. Of course, none of this separately or combined amounts to a demonstration that a "buy and hold" investment approach is guaranteed to work and certainly not that our approach will work either.

But at least I hope these various anecdotes explain why we are so reluctant to sell anything. Why would you exit something that could go up another 50 times?

Nick Train, Portfolio Manager

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Source: Lindsell Train & Bloomberg

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