Persistent greatness

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Return on Invested Capital (ROIC) is one of the best measures to evaluate management's ability to allocate capital. In theory, ROIC will revert to the mean over time, and above- average ROIC should be reflected in the pricing of the stock. We see that some companies tend to have a consistently high ROIC that defies the financial laws of gravity. The ROIC of these companies remains consistently high. These stocks significantly outperform the market over time. What opportunities do these high-performing companies offer?

ROIC persistence

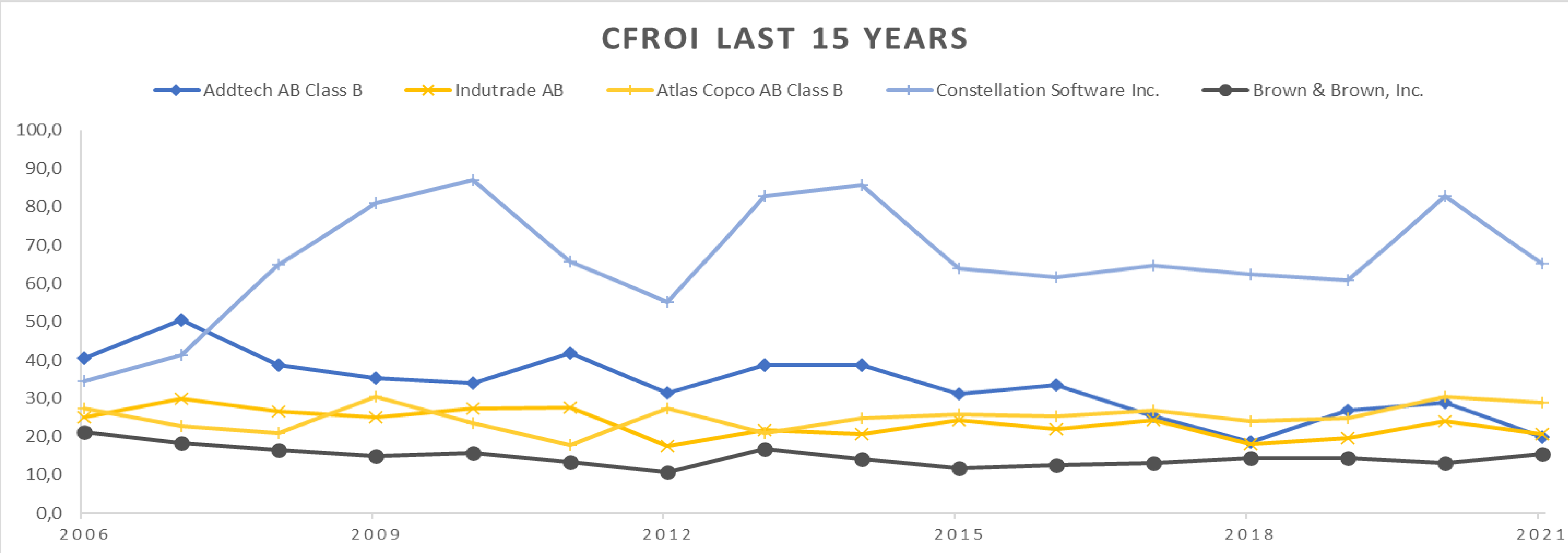
A study by Michael Mauboussin* (2007) on ROIC persistence found that 41% of the companies with the highest ROIC in 1997 were still among the companies with the highest ROIC nine years later. Similarly, 39% of the companies in the lowest ROIC quintile were still in the lowest quintile nine years later. If there were no persistence in ROIC, we would expect 20% of companies to be in each quintile in 2006, with an even distribution between quintiles. This implies that some quality companies perform well over time and that the reversal of the mean takes more than 9 years to catch up.

This study shows that companies are unlikely to rise from the worst quintile to the best quintile; in the study only 15% of companies have done so. Weak companies tend to remain weak. The companies that make the leap from weak to strong are the best performing stocks, but it is difficult to find these companies and they are much riskier than the companies that are already great companies. The key takeaway for us is that we should try to find companies that have the right ingredients in place to sustain high ROIC.

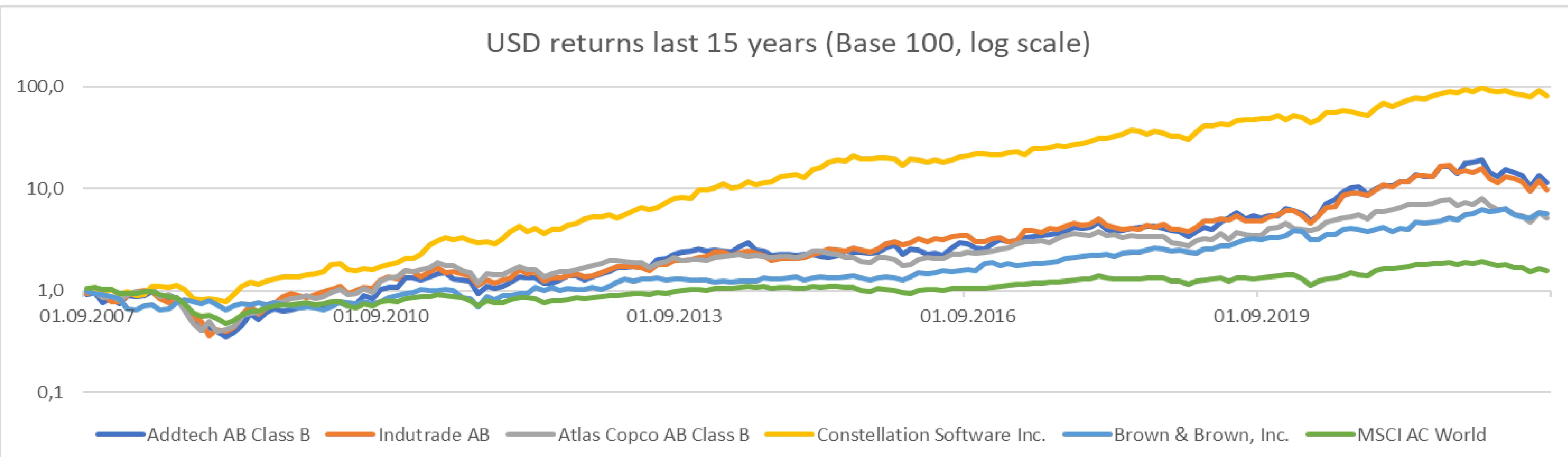
We prefer to look for the companies that are in the top quintile and that we believe will stay there because we believe our chances of finding them are greater and will give us a better risk-adjusted return over the long run. If you find a company that continues to deliver a top quartile ROIC you are likely to get good returns over the long term.

Historically great performing companies

Below are five examples of companies in our portfolios that have had a high CFROI (cash flow return on investment) over the past 15 years. We see them performing consistently over the entire period. One would expect the market to price that in at some point. However, we see that these companies have outperformed the market year after year.



The chart below shows that $1 invested in these companies in August 2007 is now worth 3-50 times what you would have received if you had invested in the MSCI AC World index when dividends are reinvested.



1 USD invested 31.08.2007	**31.08.2022**
Addtech AB Class B	11,4
Indutrade AB	9,7
Atlas Copco AB Class B	5,1
Constellation Software Inc.	80,4
Brown & Brown, Inc.	5,6
MSCI AC World	1,6

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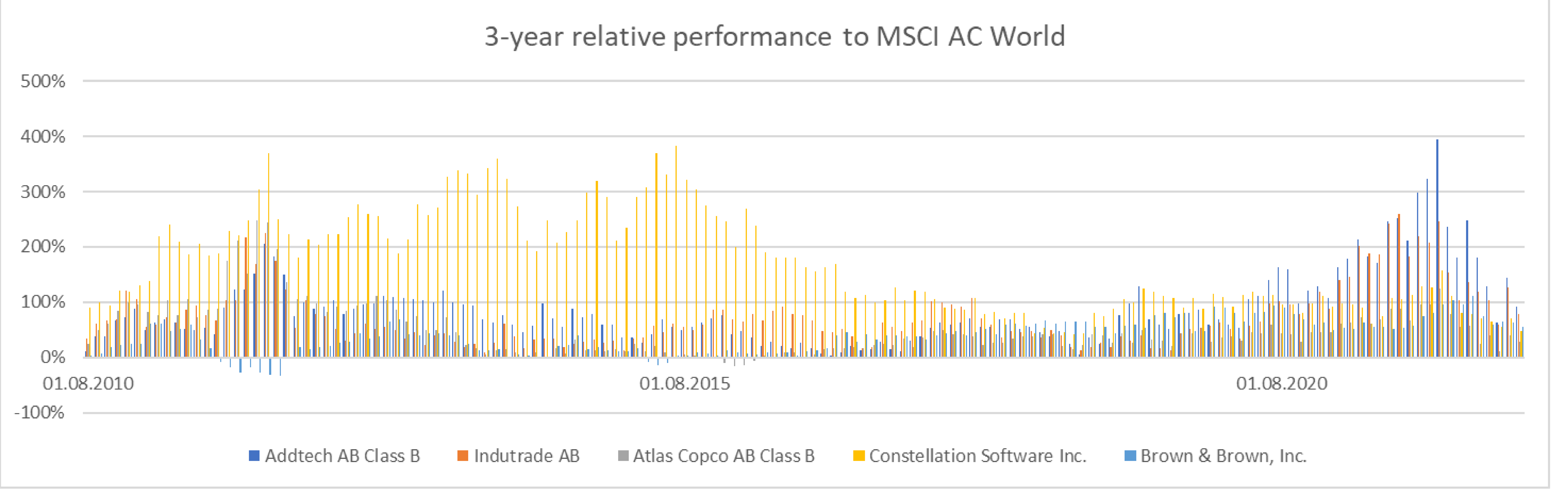
With a very short term time horizon of rolling 3 years, these companies outperform the MSCI AC World Index, suggesting that the market is constantly pricing in a rapid mean reversion. It is important to note that we invest with a much longer time horizon than 3 years, which makes these investments even more attractive in our eyes.



Characteristics of these companies

We believe the best way to find these companies is to look for companies that generate cash flow and are able to deploy the majority of their capital in acquisitions with a high return on capital over time. We look for great capital allocators. We prefer diversified companies so we do not have to rely on one product, one market or one customer to be successful. And we want to see a healthy balance sheet so they do not get into trouble in though times and can be as opportunistic as possible in weak markets.

When we find companies with these characteristics, we believe they will help us achieve good returns in the long term.

Resources

*"Death, taxes and reversion to the mean"(2007), Michael J. Mauboussin

"The Capital Reinvestment Strategy", William W. Priest, Steven D. Bleiberg, Michael A. Welhoelter

"The outsiders" (2012), William Thorndike

Return data from Factset.

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