How to lose money investing in 'Buffett inevitables'

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"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price," wrote Warren Buffett of Berkshire Hathaway in a letter to shareholders in 1989.

Over the past several years, many prominent Indian value investors have repeatedly quoted and taken this Buffett saying to heart. Currently, many of them even seem to be doing quite well. However, the party will crash sooner or later. The sheer financial mathematics of the situation dictates that.

In brief, the logic goes that certain types of companies have a business model which works through thick and thin of the economy, i.e. through the recessions and the high growth phases. They seem to have what is called an "economic moat" and a sustainable competitive advantage. These companies were called "moat companies" or "inevitables" by Buffett.

According to Indian Buffettologists, some of the typical "Buffett inevitables" in India are: Nestle India Ltd, HDFC Ltd, Page Industries Ltd, Procter and Gamble Hygiene and Health Care Ltd, Hindustan Unilever Ltd, ITC Ltd, Tata Consultancy Services Ltd, HDFC Bank Ltd, Titan Co. Ltd, Jubilant Foodworks Ltd, Asian Paints Ltd, Gillette India Ltd, Castrol India Ltd, and others.

The prominent Indian "value investors" say that these companies can be safely bought at a "fair price" since their business model is so strong that even at a "fair price" they are going to deliver returns better than the market returns.

The next step is where the battle is lost. The "fair price" can range from a price-earnings (P-E) ratio of 30 to 60 or even higher in their opinion. One can easily look up the trailing P-E ratios for the above mentioned companies to confirm this.

The chief characteristic that is touted is that these companies are growing their earnings at the rate of 20%-plus. This is, of course, due to internal factors such as continuous capital investments through retained earnings with high profitability and external market demand for their products and services.

It should be kept in mind that there are very few companies in any economy that can grow at more than 20% per year for more than a decade.

Consider a company growing at 25% per annum. If it continues growing at this rate for the next five years, its earnings would be three times larger and over the next 10 years it would be about nine times larger.

So, these are great businesses. What is a fair price for these businesses?

Currently, such companies that have been growing at the rate of 20%-plus are available at P-E ratios ranging between 30 and 60. Is this justifiable?

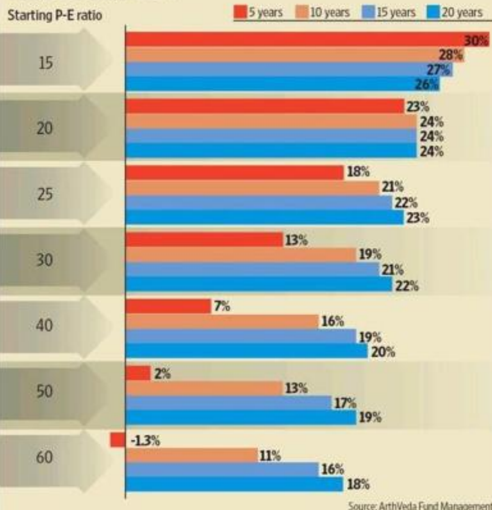
Let's see what kind of returns can be expected if we buy a company at various P-E ratios. For this, we will consider that the company is growing at 25% for the next several years and then it slows down and its multiple gets de-rated to the market's average P-E multiple of 18.4. If a company is bought at the P-E ratio of 60 and is held for five years, during which its earnings grow at the rate of 25% per year and at the end it sells for 18.4 times its fifth year earnings, it will deliver a return of -1% compounded.

A company bought at a P-E ratio of 50 with other conditions being the same will deliver 2% compounded returns over the five years.

The table gives the returns for holding for 5, 10, 15 and 20 years for various P-E ratios with similar conditions, i.e. sold at 18.4 P-E multiple after the holding period.

THE REAL TEST

Returns for different holding periods for various price-earnings (P-E) ratios with similar conditions. It is assumed that the company is growing at 25% for next several years. Then it slows down and its multiple gets de-rated to the market's average P-E multiple of 18.4.



One things is obvious, that even after 20 years of growth rates of 25% per year, one is unlikely to get a 20% return on their investments if they pay more than 40 P-E.

It is very obvious that if one pays at or above this, then over the next five years, one is looking at single-digit returns below fixed deposit returns. This, of course, assumes that the company continues to perform earnings growth at 25% per annum over that period. Any drop in that will produce still lower returns.

At a P-E of 30, the returns are below market growth rates of 16-18%. If there is any drop in the growth rates, say, the company grows at 20% per annum instead of 25%, the returns drop to 9%.

At a P-E ratio of 25, the returns are nearly the same as the markets if all goes well and company grows at 25%. If the growth rate drops to 20%, the returns drop to 13%.

At a P-E ratio of 20, one is going to get higher than market returns if all goes well and market returns of around 18% if the growth rates drop to 20%.

Real money is made when one buys such a company at a P-E ratio of 15. Then one is looking at 30% compounded returns if all goes well and 25% compounded returns if the growth rate drops to 20%. Even if the growth rate drops to 15%, one is looking at a compounded return of 20%. Now that is an investment with a margin of safety and can be called true value investing!

There is safety in terms of the future growth rates as well as the future P-E multiples while generating returns that are significantly in excess of the market returns, i.e. true alpha.

This fad of "paying up" for a wonderful business brings back memories of the "Nifty Fifty" companies of 1960s US stock market. Many of these companies were "moat companies". However, they lost huge money for investors, and only those who held for more than 25 years earned returns close to what the S&P 500 gave or 8-11% per annum. Anyone who lost patience (or faith) in between would have lost a huge chunk of their wealth.

The current crop of prominent "half-Buffettologists" of India is probably making the same mistake. The future returns are not going to look similar to the past returns for them. Their strategy has half the elements of Buffett's—the "economic moats"—but the the other more important half of discount to conservatively estimated intrinsic value and a margin of safety is missing. The strategy is better described as growth-at-any-price or momentum investing of both varieties, versus price momentum and earnings momentum. Compounding this with a "concentration" strategy is a direct path to disaster.

Buffett would say that the only "inevitable" about this is that it will fail!

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