

WOLFGANG FICKUS

## WHEN THE GOING GETS TOUGH, THE TOUGH GET GOING

### QUALITY GROWTH VERSUS CYCLICAL GROWTH IN BOOM AND BUST



Wolfgang Fickus, CFA  
Member of the Investment Committee

Many fund managers would probably argue that the ‘super cycle’ (2002-2007) was a great period compared to the subsequent years that followed the global financial crisis, often referred to as the ‘low growth environment’ (2008 to-date).

If we take a look at open ended funds invested in European large caps, for example, 45% of portfolio managers outperformed their benchmark during the super cycle<sup>1</sup>, but by a small margin (average 1.37% p.a.) and by taking comparatively high market risk (average beta of 1.05)<sup>2</sup>. The percentage of outperforming openended funds significantly shrank during the ‘low growth environment’<sup>3</sup> to only 29%. Their outperformance was more significant (2.17% p.a.) and achieved with lower market risk (average beta of 0.97)<sup>4</sup>. This data suggests that it can be a rewarding strategy to outperform over a full boom and bust period by making the difference during the bust, especially when adjusting for risk.

Comgest’s European strategy has outperformed in this way over the 2003-2013 time period. Comgest Growth Europe, our large cap European fund, participated in the upswing of the ‘super cycle’, but generated strong relative performance in the ‘low growth environment’.

This pattern of outperformance mirrors our quality growth approach and its capacity to deliver earnings growth, that is less sensitive to the economic cycle. The autonomous growth path of quality growth companies<sup>5</sup>, which is generally driven by microeconomic success factors and megatrends, should allow them to grow earnings even when economic growth is weak or negative. This makes them resilient to economic downturns, mostly coinciding with equity bear markets. Quality growth companies also tend to participate in the earnings upside embedded in economic upswings, but less so than companies geared to the economic cycle.

The challenge is to adequately identify quality growth. As we will see later, this requires both bull and bear cycle experience. The challenge is particularly evident in a prolonged economic upswing. For example during the ‘super cycle’ of 2003-2007, many growth companies which

- 1 Performance measured from 1/1/2003 to 31/12/2007. Source: Morningstar.
- 2 Only 17% of the fund managers outperforming during the ‘super cycle’ also managed to outperform during the ‘low growth environment’.
- 3 Performance measured from 1/1/2008 to 31/12/2013. Source: Morningstar.
- 4 13% of open ended funds invested in European large caps outperformed both in the bull and the bear market.
- 5 At Comgest we define quality growth as growth, which is protected by a sustainable competitive advantage (i.e. brand, technology, scale). This competitive advantage must allow quality growth companies to earn a RoI in excess of its cost of capital and to grow its EPS by more than 10% p.a. with strong visibility in the long-term, which corresponds to our 5-year forecasting period at least. Strong cyclicality of a business model usually impacts the visibility of long-term earnings growth despite a strong and sustainable competitive advantage, which might exist. We avoid strong cyclicality in our portfolios. Certain sectors are prone to competitive advantages, which are short-lived, such as frequently in the consumer electronics industry. We try to avoid franchises in these sectors, if we estimate that the competitive advantage is not sustainable in the long-term.

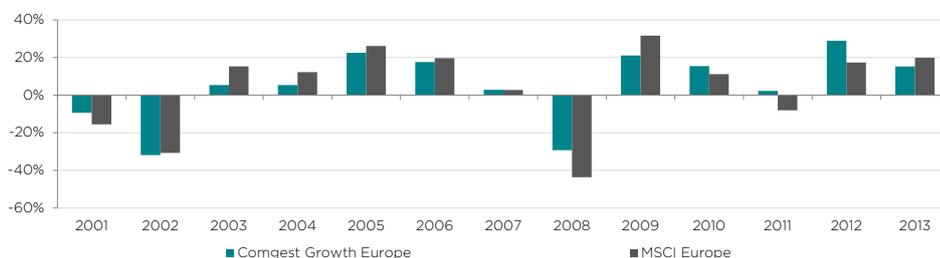
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initially appeared to be quality growth companies turned out to be cyclical growth companies, driven by what was an extraordinarily strong and long economic boom period. With a quality growth approach at Comgest, our analysis is not diverted by what we believe is – at best – difficult to forecast and – at worst – a random variable for portfolio management: the economic cycle.

Figure 1. Comgest Growth Europe: annual total return compared to MSCI Europe (net)



Source: Comgest

### A case study on quality growth in different economic cycles

We will now turn to an equity investment case study to demonstrate how quality growth works over a full bull and bear cycle in terms of earnings growth and investment performance. The case study will reveal how quality growth can be a winning strategy over a full economic cycle by outperforming during an economic downswing/stagnation period whilst typically lagging during the upswings (when more cyclically geared portfolios tend to do better).

For our case study we have selected the 2003-2007 ‘super cycle’ as well as the 2008-2013 ‘low growth environment’ period as two distinctly different macroeconomic backdrops to work with. As a reference, in 2007 real GDP growth rates were 14.2% in China, 9.8% in India, 6.1% in Brazil, 5.5% in South Africa, 3% in the Euro Area and 1.9% in the USA compared to 7.9%, 4.7%, 1.0%, 2.4%, -0.4% and 2.2% real GDP growth rates in 2012 for the same geographies.

Our case study follows three steps:

#### — 1<sup>st</sup> step:

By means of a Factset screening we analyse earnings growth for the MSCI Europe in both periods. We screen for companies, which reached their reported 5-year EPS high at the end of 2007 and were expected to grow EPS by more than 10% p.a. for each of the following two financial years (FY2008 and FY2009) at the end of 2007. The same screen is applied at the end of 2012 for all companies which reported their 5-year EPS high in FY2012 and which were expected to grow EPS by more than 10% for each of the following 2 financial years (FY2013 and FY2014) at the end of 2012<sup>6</sup>.

<sup>6</sup> The simplicity of the screening rule makes it easy to understand but vulnerable to criticism. The objective of the screening rule is to single out companies relative to their capacity to generate EPS growth over the long-term. We are aware that long-term EPS growth is an insufficient stand alone criterion to judge the quality of earnings growth. Growth itself does not create value. The objective of this paper, however, is to show (quality) earnings growth patterns in different economic cycles.

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We also apply this screen to the MSCI Emerging Markets, which represents our largest strategy by geography.

— 2<sup>nd</sup> step:

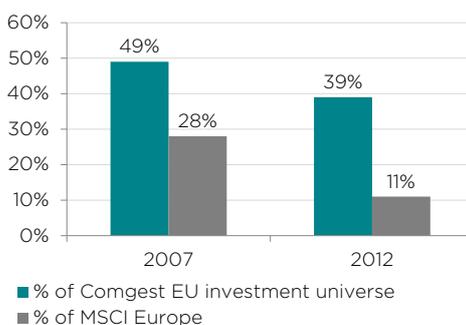
We analyse the overlap of the screening results with the Comgest investment universe for Europe. Given our investment process, companies which enter our investment universe fulfill Comgest quality growth criteria. Therefore, the % overlap between the screening result and our universe determines to what extent the two screens consist of quality growth companies beyond the purely quantitative aspects of the screening model above<sup>7</sup>. By combining step 1 and 2 we simplistically show the mechanism of quality growth in different cycle conditions. It is of utmost importance to understand that building a quality growth universe at Comgest is the most difficult part of this equation. It demands multi-year observation of a company including regular top-management meetings, results analysis, peer comparisons etc. Calculating a simple overlap therefore hides the core of our investment process, which is the topic of a separate analysis. We perform the same analysis for our Emerging Markets investment universe.

The 2007 screen will exhibit a low share of quality growth and a high share of cyclical earnings growth. The 2012 screen will exhibit a high share of quality growth and a low share of cyclical earnings growth.

— 3<sup>rd</sup> step:

We demonstrate how quality and cyclical earnings growth compare over a period combining the ‘super cycle’ and the ‘low growth environment’ in terms of fundamental and investment performance. For illustration purposes we extend this part of the analysis to the period pre and post the technology bubble during the year 2000. As a result we look at two subsequent boom and bust periods.

**Figure 2. Europe: scarcity of long-term earnings growth captured with Comgest quality growth approach**



(Screening criteria: % of companies with > 10% p.a. EPS growth for next 2 years meeting their 5-year EPS high at year-end indicated)

Source: Comgest

The most surprising result of our screening is the scarcity of companies in Europe delivering long-term earnings growth overall, if one agrees that a 7-year period of earnings growth is a long-term period (albeit not necessarily uninterrupted given the simplicity of our screening model). A less surprising result of our screening is that many more companies passed the screen at the end of the super cycle in 2007 compared to the end of 2012, when earnings growth was less abundant in a ‘low growth environment’. In numbers: 28% of the MSCI Europe constituents met the criteria in 2007 (122 stocks) versus a mere 11% in 2012 (46 stocks). Provided you share our conviction and experience that share price performance follows EPS performance over the long-term, identifying these companies compares to digging for gold.

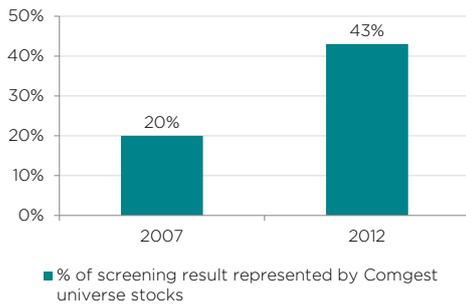
Does quality growth capture this rare long-term earnings growth in the market and how successful has it been in these very different economic set ups? To answer these questions we looked at the overlap of the above screens with the Comgest investment universe of quality growth

<sup>7</sup> This % overlap tends to understate quality growth in the screen: we are working with 8 investment professionals in Europe and therefore do not pretend to know every ‘quality growth’ company in the region. We permanently continue to enlarge our investment universe of quality growth companies.

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**Figure 3. Quality growth demonstrates superior better capture of earnings growth in period of economic stagnation or low growth**



(Comgest quality growth companies in Europe as % of 2007 & 2012 EPS growth screening result)

Source: Comgest

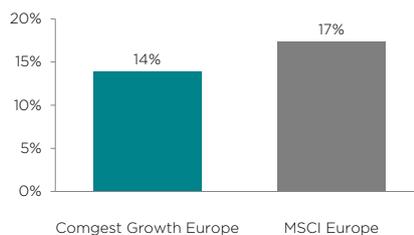
companies, which adds the necessary qualitative elements to the purely quantitative aspect of the EPS growth screen. The Comgest European investment universe currently counts 83 stocks. 51 of those are constituents of the MSCI Europe and hence fall into the scope of this screening. We refer to these 51 companies as the ‘relevant universe’.

Let us look at the results at first: 25 stocks of the ‘relevant universe’ passed the screen in 2007. That represents 20% of the total number of companies passing the screen (122 stocks) in that year and 49% of the ‘relevant universe’ of Comgest itself. In 2012, the number of stocks from the ‘relevant universe’ passing the screen decreases to 20, while the total number of MSCI Europe constituents passing the screen decreased substantially to 46 companies. Hence the Comgest relevant universe captures 43% of this small pool of long-term earnings growth in a weak economic environment. That represents close to 40% of Comgest’s ‘relevant universe’ itself<sup>8</sup>.

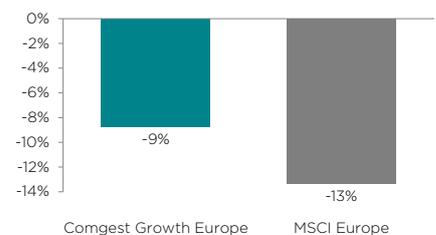
Indeed the relative capture of long-term earnings growth increases sharply from 2007 to 2012 jumping from 20% to 43%. That is the most important result of our screen. Our ‘relevant universe’ covers 12% of the MSCI Europe (51 universe stocks over 432 MSCI Europe constituents), but captures 43% of its longterm growth during the period of the ‘low growth environment’.

This has performance implications over a full economic cycle, assuming investment performance follows earnings growth. Quality growth strategies may well underperform in phases of economic boom, when their capture of earnings growth is comparatively low. This is because a large portion of earnings growth during this time is driven by a strong economic cycle and is therefore predominantly cyclical in nature. On the other hand, quality growth strategies may tend to outperform in phases of economic stagnation or decline, when they capture a dominant portion of earnings growth in the market. To the tune that equity bull markets coincide with boom periods and vice versa, the below table shows that our European large cap fund, Comgest Growth Europe, indeed outperformed in bear markets and vice versa.

**Figure 4.1. Bull markets**



**Figure 4.2. Bear markets**



Annualised performance since inception, as of 30 June 2014.

Source: Comgest

<sup>8</sup> In emerging markets (EM) the results are similar. 38% of our relevant EM universe pass the screen versus 30% in 2012. For the MSCI EM 30% and 14% pass the screen in both years, hence the index shows less resilience to the economic downturn and low growth environment of the past 5 years.

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**Figure 5. Quality earnings growth versus cyclical earnings growth over the long term**



(\*Dow Jones Cyclical Index next 12-months EPS versus Renaissance Europe C next 12-months EPS, EPS rebased to 100)

Source: Factset

There are a number of conclusions from our case study so far:

1. The majority of companies which demonstrate long-term EPS growth in harsh economic conditions, are quality growth companies.
2. A high proportion of companies that deliver long-term EPS growth in a boom cycle are in fact cyclical growth companies. Hence bull & bear market experience is required for differentiating properly between quality and cyclical growth<sup>9</sup>.
3. Quality growth companies generate long-term earnings growth in a manner which is relatively independent of economic cycle conditions. In our case study, circa 50% of Comgest's universe stocks passed the screen both in 2007 and 2012.

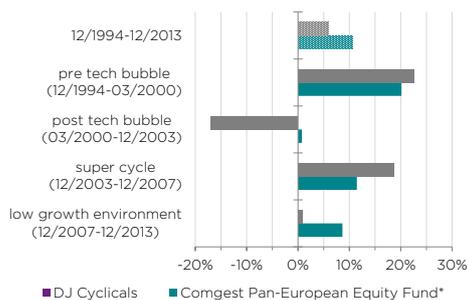
In a 3<sup>rd</sup> and last step we now analyse how a quality growth approach compares with a cyclically biased approach, in terms of fundamental and investment performance over two full economic cycles.

We start by comparing the next 12-months EPS of Comgest Growth Europe with the Dow Jones Cyclical index<sup>10</sup>. This is to compare the fundamental performance of our quality growth approach to a cyclically-biased index. We extend the comparison period to cover December 1994 to December 2013, as this period includes two subsequent periods of boom and bust, namely those surrounding the tech bubble, the super cycle and the low growth environment following the global financial crisis (GFC).

Tracing cyclical and quality earnings growth shows a significant outperformance of the Comgest Growth Europe fund over this 19-year period. Cyclical earnings, represented by the EPS of the Dow Jones Cyclical Index, demonstrate strong performance during economic boom periods as was the case in the run-up to the technology bubble as well as during the super cycle.

With the burst of the technology bubble as well as the outbreak of the global financial crisis, cyclical earnings literally collapsed, while quality growth earnings demonstrated remarkable resilience in both periods of significant economic decline or stagnation. It is worth highlighting that the Dow Jones Cyclical Index has never again reached its peak EPS of the year 2000 and has managed to only slightly exceed its level prior to the global financial crisis. Comgest Growth Europe's earnings outgrew the Dow Jones Cyclical Index substantially over two full periods of economic boom and bust between December 1994 and December 2013. It is the resilience of a portfolio in bear markets, which makes a tangible difference. Another way of visualising the regularity of the Comgest Growth Europe earnings profile versus the Dow Jones Cyclical Index is illustrated in Figure 6.

**Figure 6. Quality growth earnings outperform over the long term due to resilience in downturns**



(\*EPS CAGR of Renaissance Europe C versus DJ Cyclical Index in respective periods)

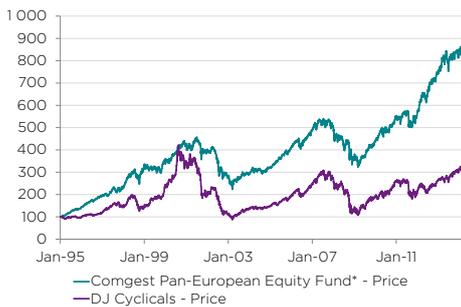
Source: Factset

9 Comgest fund managers have bull & bear market experience in applying our quality growth approach. For the European team the average industry experience is 16 years. For the Comgest emerging markets team the average industry experience is 13 years.  
 10 The Dow Jones Cyclical Index is a market capitalisation weighted index based on the STOXX 600 index. We build the index based on stocks in the following Factset sectors: Commodities, Airlines, Airfreight, Auto Parts, OEM, Automotive Aftermarket, Building Products, Chemicals, Containers & Packaging, Electrical Products & Appliances, Engineering & Construction, Home Furnishings, Homebuilding, Industrial Conglomerates, Industrial Machinery, Industrial Specialities, Marine Shipping, Miscellaneous Manufacturing, Motor Vehicles, Office Equipment, Pulp & Paper, Railroads, Recreational Products, Textiles, Tools & Hardware, Trucking, Trucks/Construction/Farm Machinery.

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**Figure 7. Quality growth earnings outperform over the long term**



(\*Dow Jones Cyclical Price versus Renaissance Europe C NAV, performance rebased to 100)

Source: Factset

Over two full economic cycles, the Comgest Growth Europe portfolio demonstrates superior earnings due to its resilience during the two bust periods post the technology bubble and following the GFC ('low growth environment' in the Figure 6 chart).

Assuming price performance follows fundamentals over the medium-term, prices should converge towards the underlying EPS. This convergence is one of our key convictions at Comgest and has been – in our view – the key driver for the substantial outperformance of the quality growth portfolio Comgest Growth Europe versus the Dow Jones Cyclical Index over two subsequent economic cycles.

Over the full period covering December 31, 1994 to December 31, 2013, an EPS CAGR of 11% translated into a price performance of 12% for the Comgest Growth Europe fund. The DJ Cyclical Index performed 6% p.a. on the basis of a 6% EPS CAGR. Hence, price and EPS performance have been fairly well aligned in both cases over this 19 year period.

The relative alignment over time between price and earnings should translate into some stability in terms of relative multiples between cyclical and quality growth over the long term. In fact, we observe a fairly recurring historical PE ratio premium of circa 40% for our European large cap fund versus the DJ STOXX 600 (in terms of forward PE multiples). In periods of economic decline or stagnation, this PE premium tends to contract as earnings for our European large cap product have been more resilient during the bear markets than share prices of our portfolio holdings, while earnings for cyclical companies plummeted stronger than their share prices (sometimes into negative or breakeven territory). Hence valuation effects have not been the driver for our strong relative performance over the long term but rather the superior earnings profile of our fund.

While this analysis has largely been based on a European equity fund case study, the same observation can be made with other Comgest funds, notably our emerging markets large cap product, Comgest Growth Emerging Markets. Price volatility of our funds tends to be below market price volatility due to the less volatile quality growth earnings profile. This is our benchmark for the future.

**Conclusion**

For investors it makes sense to have patience in equity investing and to focus on the micro strengths of companies instead of macro 'insights' of the market at large.

At Comgest, we base our investment decisions on a long-term view, by focusing on the few quality growth companies in our universe which have proven to grow, when cyclically geared portfolios tumble, as our case study highlights. Delivering solid performance when corporate earnings growth is scarce (or even negative) in a weak economic environment can generate tangible outperformance over a full economic cycle, especially compared to cyclically geared portfolios. Lagging the market when everybody is excited about a strong economic cycle has proven to be no obstacle to the long-term outperformance of our style

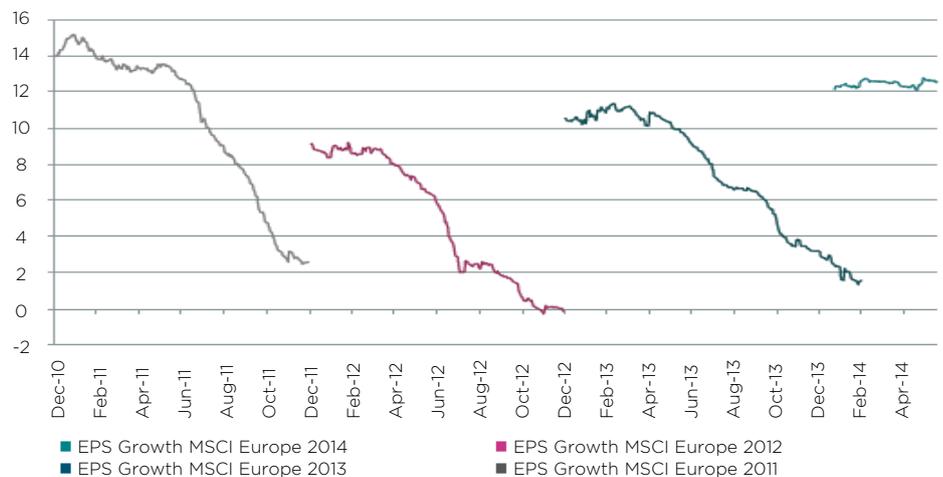
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versus cyclically geared portfolios, and indeed broader market benchmarks<sup>11</sup>.

Despite the concentration of the Comgest Growth Europe portfolio (typically 30-35 stocks), its 'quality growth' has been accompanied by a less volatile earnings pattern compared to the market and/or cyclically geared indices such as the DJ Cyclical Index. For long-term minded investors with an aversion to volatile equity strategies, Comgest's quality growth investment style may therefore be a particularly good solution. For investors who agree that forecasting the economic cycle is difficult and in any case, less reliable than forecasting corporate earnings trends for quality growth companies, we share the following chart with you. It shows the persistent disappointment European equity investors have witnessed over the past 4 years.

Figure 8. Damn, the cycle again



(MSCI Europe EPS growth in %)  
 Source: Factset

11 Comgest's Global, GEM and Asia ex Japan composites have outperformed their benchmarks by 5.6%, 6.2% and 4.9% p.a. respectively over the time period lasting from 31/12/1994 to 31/12/2013 in Euro.

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Member of the Investment Committee

Wolfgang Fickus is a graduate of the University of Cologne (Germany) with a degree in business administration (Diplom-Kaufmann) and studied at the London Business School. He also holds a CEMS Master's in international management and is a CFA® charterholder. Wolfgang began his career in 1995 at Paribas Asset Management Paris as a European-equity fund manager. In 2000, he moved to WestLB where he worked as an analyst for European technology stocks before becoming the Head of Mid- and Small Cap Research in 2005. Wolfgang joined Comgest in September 2012 and is a Member of the Investment Committee.

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