MFS® White Paper

May 2019

Intrinsic Value Investing at MFS

Introduction

- Modern finance often associates value investing with low-multiple investing.
- However, value, unlike price, is hard to measure.
- We consider ourselves to be value investors, but don't believe that value is best captured by focusing on low multiples.

In this white paper, we define how the MFS Intrinsic Value investment team thinks about value, and that is, simply put, as intrinsic value. We also discuss why and how value links with our investment philosophy, and also the risks associated with what has come to be understood as value investing.

What do we mean by intrinsic value?

Albert Einstein is often quoted as saying that "everything should be made as simple as possible, but no simpler." Modern finance often fails to achieve this balance, either making things needlessly complicated or over-simplifying them.

It has done this, we believe, with value investing. Because value is hard to define, modern finance has come to characterize it as the simplest available proxy: current multiples of earnings, or book. The lower the multiple, the logic goes, the higher the likelihood that the value is greater than the price paid. This simple logic is hard to resist.

At the root of our investment philosophy, however, lies the conviction that not all earnings are created equal. We believe that a qualitative understanding of the numbers is often more important than the actual numbers themselves. Our experience tells us that modern finance has characterized value investing far too simplistically.

Therefore, when we think of value, rather than relying on current or short-term earnings as a proxy, we focus instead on a more durable, reliable and less volatile notion of value that we refer to as intrinsic value.

How do we assess intrinsic value?

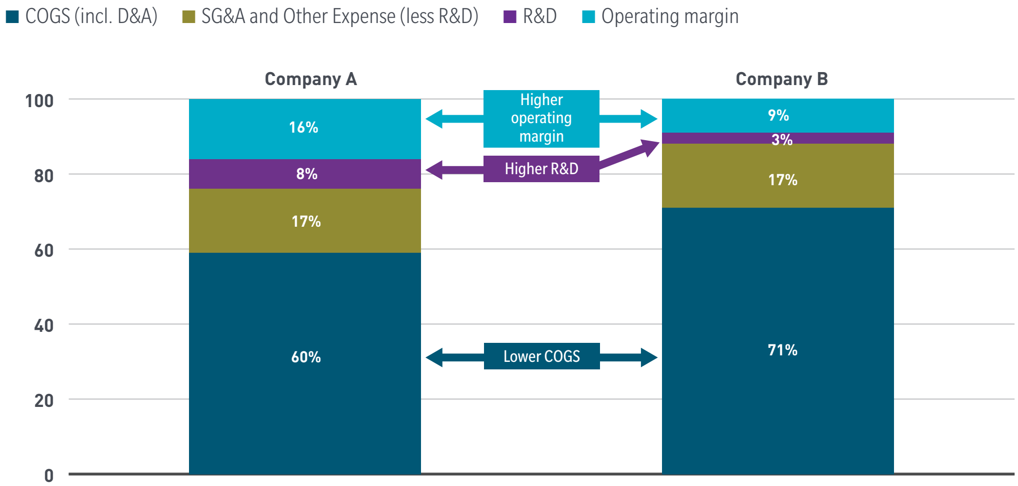
In our view, intrinsic value cannot easily be measured using metrics such as current earnings or cash flows at face value. Our approach is to develop a comprehensive understanding of how those cash flows are generated in the first place. Accordingly, we try to think as broadly as possible in order to recognize the main influencing factors underpinning those cash flows.

The valuation of most publicly traded companies is ultimately determined by their future years' cash flows. The long-term sustainability of returns on capital, which will drive those cash flows, is therefore key. In turn, two factors drive the sustainability of returns over the long term: 1) the nature of the business and 2) the way in which it is managed. Therefore, we spend most of our time and energy evaluating these two factors for every company under consideration.

1. Understand the nature of the business

We believe that differentiation and sustainable competitive advantages are foundational for long-term cash flow resilience. Therefore, we set out to find companies that are differentiated, i.e., that have something unique. This uniqueness almost always forms the basis of a company's key competitive advantage and makes it difficult for rivals to compete on the basis of price alone. While it may seem obvious, we believe that this essential corporate attribute is often overlooked by the market, representing a source of opportunity for us. For example, consider two chemicals companies and their simplified profit and loss statement (P&L) shown in Exhibit 1.

Exhibit 1: Key cost and income ratio to sales for two chemical companies

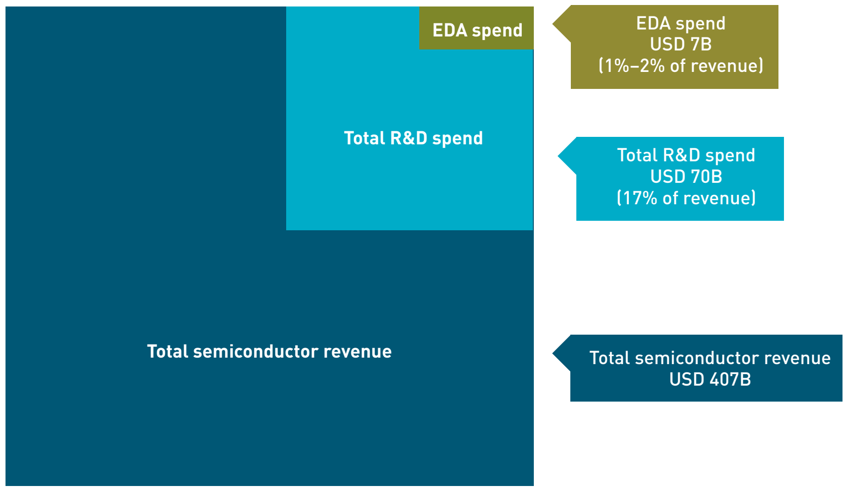


COGS: cost of good sold; **R&D:** research & development; **SG&A:** selling general & administrative; R&D research & development.

Both companies are classified as operating in the chemicals sector; however, they produce quite different products, serving different customers. Company A is a specialized chemical company which creates unique flavors and fragrances for its customers' products. Exhibit 1 shows that Company A achieves a higher operating profit margin, and it does so while investing considerably more in R&D costs as a percent of sales which is key to sustaining its differentiation and thus its competitive position.

We also look to invest in companies who have pricing power. One example of where we look for this is in those products or services that represent a small cost to companies' end-customers but are mission-critical to them. In aggregate, these types of products and services are subject to less price pressure from customers and therefore tend to benefit from better-than-average pricing power over the long term. Exhibit 2 provides an example from the semiconductor industry, where electronic design automation (EDA) tools are mission-critical and yet relatively cheap, approximately 1% to 2% of 2017 semiconductor revenue, or 10% of 2017 semiconductor research and development spending.

Exhibit 2: Semiconductor global sales compared with spending on R&D and EDA[1]



Source: 2017 SIA data and MFS estimates.
[1] R&D: research and development, EDA: electronic design automation

2. Understand the way the business is managed

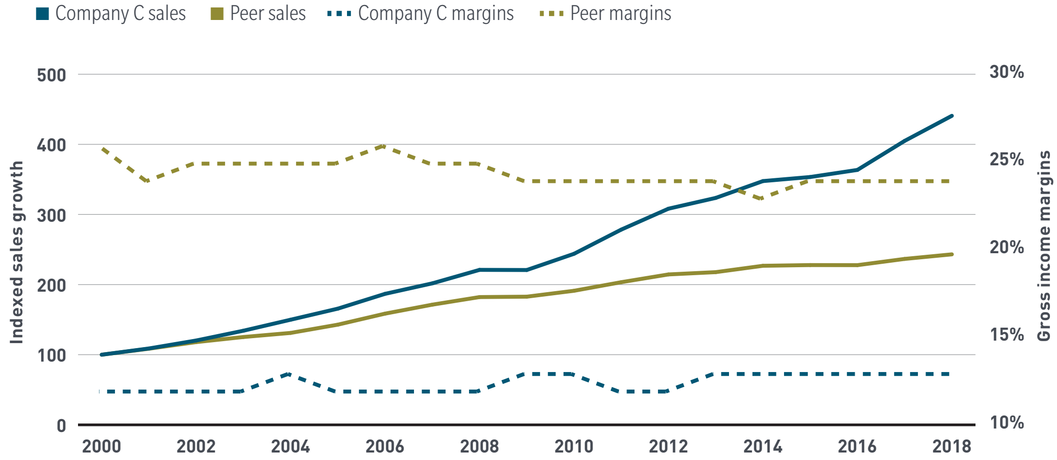
We also deliberately look to invest in companies with a good management team and corporate culture that clearly understand the key drivers of long-term success.

We seek out management teams whose actions are oriented toward maintaining, or ideally, expanding their key competitive advantages. This approach is generally associated with current and historical high levels of investment in the key areas upholding that differentiation, which, depending on the nature of the business, may relate to sales and marketing, research and development or, less frequently, capital expenditures. Our belief is that companies will create future value long term by maintaining and investing in their key drivers of success.

We are wary of companies that, through the differentiation of their services, take a short-term approach to earnings growth and engage in the price gouging of their customers.

Consider Company C, a large global retailer organized as a wholesale club. Its primary mission is to maximize value to the customer. Aided by the company's ever increasing scale, management pursues the goal of passing on the benefits of cost savings to customers through recurring price reductions. Not surprisingly, as depicted in exhibit 3, gross margins are well below the margins of a peer group of traditional big box retailers. Company C's strategy has produced a fiercely loyal customer base that has sustained steady growth and strong returns over the past 20 years, despite the advent of Amazon and the rapid pace of digital disruption in the retail sector.

Exhibit 3: Sales growth (LHS) and gross profit margins (RHS), Company C vs. peer group



"Peer" figures shown above are a simple average of figures reported by three traditional big box retailers. Sales figures are based on calendar year figures reported as of December each year, and used to grow an index level rebased to 100 at the start of the analysis.

Why do we focus on cash flows and long-term enterprise value instead of other measures?

We actively focus on cash flows at the expense of accounting-derived metrics such as earnings or book. Our rationale is that cash flows, not accounting earnings, ultimately pay the bills and future dividends. Accounting earnings can often provide a very distorted picture of the true economics of a business. Furthermore, cash flows are not as easily manipulated by management teams, although in some instances this is a definite risk. Exhibit 4 illustrates how earnings can deviate from cash flows.

Exhibit 4: Accounting earnings can be poor indicators of cash flow generation

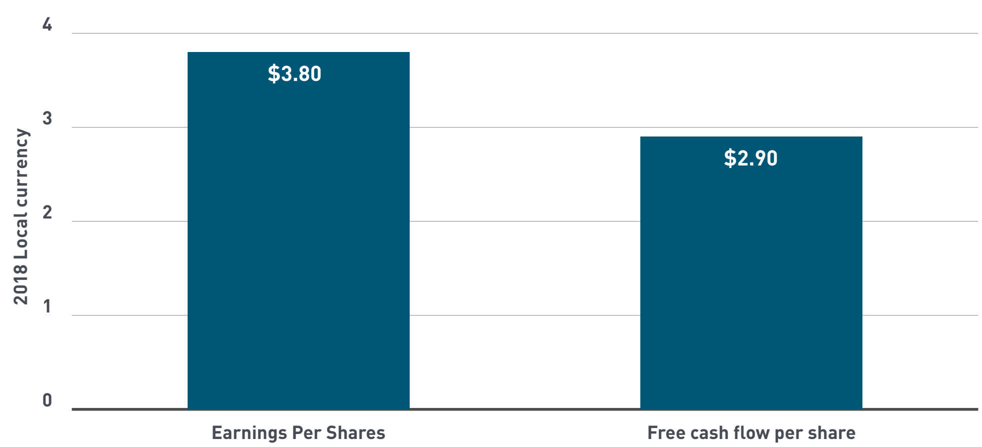


Exhibit 4 illustrates the differences in earnings and free cash flow for Company D, an oil major, which is a proxy for the challenges faced by the whole sector. Accounting earnings are calculated by assuming a level of depreciation (accounting measure) that has typically been lower than the capital expenditure (cash spend) required to try and maintain a similar level of production.

We often find that management teams are incentivized by, and therefore closely manage, earnings figures. Focusing on cash can help shift attention away from the false sense of security that can come from overly exact reported earnings — and the multiples derived thereof — and toward the many non-quantitative yet critical factors that we refer to in this paper.

Challenges of low-multiple investing

Overly focusing on low price-earnings, price-to-book or high-dividend yields as key valuation criteria can lead one down a potentially dangerous path for two key reasons:

- **They ignore the sustainability of returns.** The higher and more sustainable returns are, all else equal, the higher the earnings multiple or price-to-book a given company should trade on. Rates of return drive a company's ability to reinvest and therefore long-term cash flow generation and potential dividends.
- **They ignore the risks.** Because these valuation yardsticks fundamentally neglect balance-sheet leverage — indebtedness, pensions or leasing intensity for example — they fail to capture the intrinsic underlying volatility of, and risk to, earnings, book value and dividends.

We believe this is a particular concern currently, as technological and business model changes are happening at an unprecedented rate, and in an environment where system wide balance-sheet leverage is at record highs globally.

How do we define risk in the context of intrinsic value?

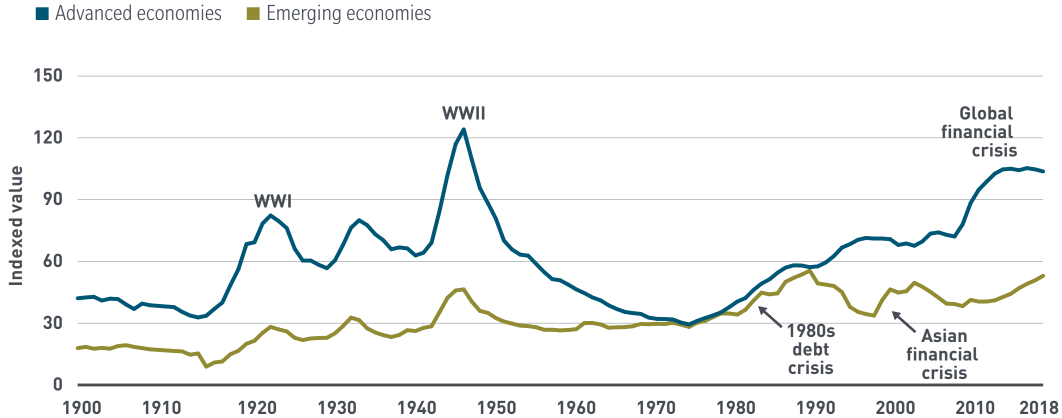
For us, a focus on intrinsic value means a relentless focus on risk. We define risk as the permanent destruction of capital. We discuss some of the most important factors that can cause this below. However, as when assessing opportunity, we consider a much wider array of factors and their interaction. The four areas of risk that seem to be broadly applicable are disintermediation potential, exogenous risks, macroeconomic bubbles and endogenous risks.

We are particularly wary of companies that are at risk of disintermediation. This is because many of the characteristics that we look for and like, as well as the cash flows that depend on them, can be rendered worthless. Technological progress is advancing as fast as it ever has, affecting and changing the way business is conducted in many sectors of the economy and changing how consumers behave. The risk of disintermediation is a crucial and increasingly important consideration.

We also seek to avoid businesses whose cash flow profiles can change relatively quickly because of factors outside of a company's control. Particularly at risk are companies operating under unstable political regimes, in jurisdictions with weak legal recourse or in regulated sectors or companies that depend on the level of prices of globally traded and fungible commodities.

Likewise, although we do not attempt to forecast macroeconomic variables, we actively endeavor to minimize exposure to areas of the world where there exists strong evidence of macroeconomic bubbles — bubbles that, if they burst, can transform the operating landscape. One example of this is lack of direct exposure in our intrinsic value portfolios to areas related to fixed asset formation in the Chinese economy. Another is our avoidance, to a significant degree, of credit exposure, since the global economy has never been as financially indebted as it is today. Exhibit 5 provides an indication of average government debt relative to GDP since 1900.

Exhibit 5: Average government debt relative to GDP



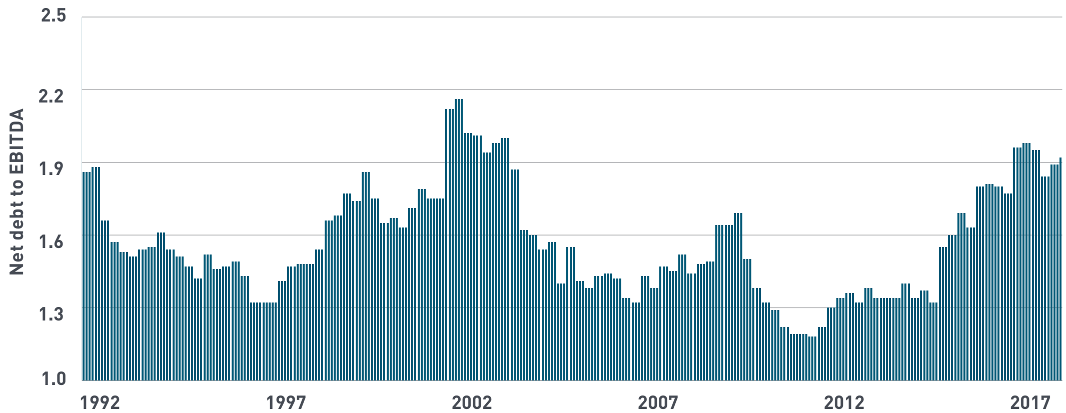
Source: IMF Fiscal Monitor April 2018 (data from 1900 to 30 April 2018). Average is calculated using GDP at purchasing power parity. Advanced Economies: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong SAR, Ireland, Italy, Japan, Korea, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Taiwan Province of China, United Kingdom and United States. Emerging Economies: Argentina, Brazil, Bulgaria, Chile, China, Colombia, Egypt, Hungary, India, Indonesia, Iran, Jordan, Kazakhstan, Kenya, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Romania, Russia, South Africa, Sri Lanka, Thailand, Turkey, Ukraine, Uruguay, Venezuela.

The risks listed so far are external in nature: Any of them can greatly impair or affect a company's ability to generate cash flows. But, unfortunately, companies often create risk for themselves. In this respect we seek to avoid companies that are run for short-term profit maximization, a behavior which compromises their long-term competitive advantages and their sustainable cash flows. While present-day financial markets are heavily influenced by a focus on short-term share price performance, we aim to protect our clients from the downside risks related to this short-term mentality.

As mentioned previously, we seek to avoid investing in companies that price their products and services aggressively relative to the ultimate value of those products and services. Companies typically do this to enhance their short-term sales and earnings, but in doing so they open the door to the future competitive disruption of their businesses. Because the type of companies that we seek to invest in — those having differentiated products and services — are often in a position to engage in this type of behavior, we take as much care as possible to avoid this kind of risk.

We also actively avoid leverage. Although we sometimes compromise with operating leverage (assuming certain criteria are met), we have a much lower threshold of tolerance toward financial leverage. Financial indebtedness is a direct threat both to a company's ability to invest sustainably and to the ultimate worth of its equity. Exhibit 6 shows how corporate leverage is reaching previous cycle peaks.

Exhibit 6: US investment grade corporate net debt relative to EBITDA



Source: Morgan Stanley Research, Bloomberg Finance LP, FTSE Fixed Income LLC., as of 30 June 2018, most recent data available. **EBITDA:** earnings before income, taxes, depreciation and amortization.

Putting it all together

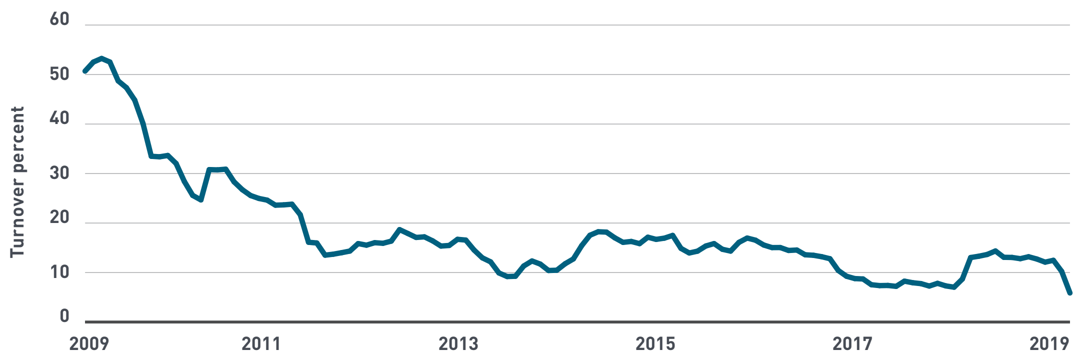
As a result of all these considerations, we believe that relying on the current level of earnings or cash flows can be a very misleading proxy for value. Alternatively, developing a comprehensive understanding of how those cash flows are generated is often more important than the actual level of cash flows.

Our preferred valuation metric — although not the only one we use — entails comparing companies' enterprise values with the cash flows they generate. Because of the factors mentioned above, we try to better understand the sustainability and context of the cash flows by qualitatively analyzing them. We then appraise these cash flows in relation to the entire enterprise value of companies (equity and liabilities, not just their market cap). This attention to a company's liabilities is crucial, for not too infrequently equity participants forget that they are at the end of a long line of suitors with claims on the company's future earnings. Generally, the rights of employees, pension plans members, bondholders and lenders, leasing landlords, litigation counterparties and tax authorities are all placed above the rights of equity holders. We also make valuation cross-checks. Enterprise value-to-sales (EV/sales), for example, is useful for highlighting businesses that invest too little or too much and as a result, earn too little or too much. We also ask this question: Is the total enterprise value materially too big or too small for the value that a given business is generating?

To put our investment philosophy into practice, there is one key prerequisite: an unyielding focus on the very long-term. Intrinsic value is about long-term sustainable value, and for this reason it necessitates a long-term mindset. With ever-shorter time frames plaguing the investment industry, we consider this a key differentiating feature of our investment approach.

Exhibit 7 shows the 12-month rolling turnover of the MFS International Intrinsic Value Strategy (an equity strategy co-managed by Ben Stone and Pablo de la Mata) over the past 10 years, averaging around 15% per annum.

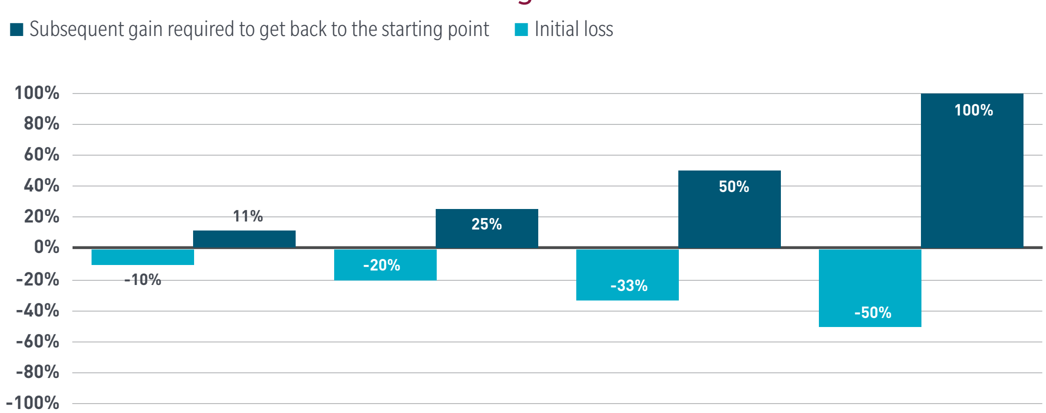
Exhibit 7: MFS International Intrinsic Value Equity strategy*, 12-month rolling turnover over past 10 years



Source: Monthly data as of 30 April 2009 to 31 March 2019. Portfolio turnover is calculated as the: (Lesser of Purchase or Sales)/Average Market Value of the Date Range. *Based on an alternative representative account for the MFS International Intrinsic Value Equity strategy. Prior to 1 June 2019 the strategy was named MFS International Value Equity strategy.

Lastly, there is one tenet that underlies everything we do and which ties the various aspects of our investment philosophy together: Rather than focus on the upside and what can go right, we focus on the downside and what can go wrong. An essential pillar of our investment philosophy is that to do well we must first avoid doing badly. We seek to avoid large mistakes such as the permanent destruction of capital in order to support the investment objectives and goals of our clients. Exhibit 8 portrays a stylized example of the significance to a portfolio of downside risk management and minimizing negative returns.

Exhibit 8: Focus on downside risk management



Note: Stylized example of initial loss and subsequent gain needed to recoup loss; for illustrative purposes only.

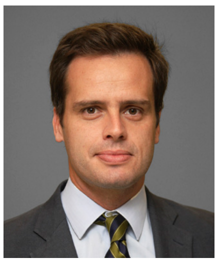
Our ultimate aim is to generate excess risk-adjusted returns over full market cycles. Taking the long-term view can entail tolerating periods of underperformance over shorter time frames. But we believe that a relentless focus on long-term sustainability, along with careful consideration of what can go wrong, offers the best approach for achieving our key investment objectives.

Conclusion

In conclusion, we believe that overly focusing on low-multiple investing, although simple to understand, is an unreliable way of identifying real long-term value opportunities.

By contrast, we believe a relentless focus on intrinsic value can help preserve clients' capital and generate attractive risk-adjusted returns over the long run.

Authors



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