Insights
Fundamental Growth and Core

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GARP Strategy Combines Both Growth and Value Aspects to Generate Alpha

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GARP is an evolved version of the value investing strategy that combines within it elements of growth as well. For instance, Warren Buffet, later in his career, expanded the concept of intrinsic value to include intangibles such as brand value, which gave a company its "moat". In the same vein, GARP relies on fundamental research on companies to identify those with quality business models that allow them to sustainably deliver future earnings growth, whilst being mindful of valuation levels.

In 1972, legendary investor Warren Buffet bought See's Candies, a Californian manufacturer and distributor of boxed chocolates. This marked a pivotal moment in Mr. Buffet's investment philosophy. Since striking out on his own in 1955, he had been practicing his mentor Benjamin Graham's investment approach — value investing. But value investors would likely have baulked at the decision to purchase See's Candies, which was at the time trading at 3x its net tangible assets.[1]

What had changed? Under the influence of Charlie Munger, his investment partner, Mr. Buffet was no longer occupied with purely cheap valuations based on current tangible assets but expanded the concept of value by considering future value generated by the intangible assets of a business. As far as See's Candies was concerned, Mr. Buffet foresaw that the business' powerful brand image would give it a long-term competitive advantage and pricing power to enable it to grow its pre-tax earnings.

Indeed, See's Candies' earnings grew from less than US$5 million at the time of its purchase to US$1.35 billion by 2007. As Mr. Buffett stated in his 1989 letter to shareholders: "it's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."[2]

We would describe Mr. Buffet's changed investment philosophy as growth at a reasonable price (GARP) — the purchase of quality companies with sustainable long-term growth prospects at a fair price. We believe that sustainable growth, if one does not overpay for it, should be a powerful source of return over the long term.

Value and Growth Investing

Value and growth are often considered as polar opposites in the context of equity investing. As a factor, value at its heart is about buying undervalued stocks based on their current asset base and earnings, which is reflected in metrics such as price to earnings, price to cash flow, price to sales, price to book and dividend yield, among others. Growth on the other hand is about buying companies with the potential for revenue and margin growth. A primary metric to screen for these companies could be past and projected growth rates in earnings per share (EPS).

For investors that take a bottom-up approach, systematically replicating factors might not fully capture the essence of either value or growth investing. If for value investing, fundamental factors tend to be backward looking, for growth, they tend to be forward looking, necessitating great levels of skill in identifying companies that have a potential for sustainable growth.

Benjamin Graham, often regarded as the "father of value investing", advocated an approach to investing that employs rigorous fundamental analyses to assess the intrinsic worth of a company by focusing on current asset base or earnings in isolation from the price of a security. Mr. Graham famously likened the market price of a company's stock to a bipolar business partner named 'Mr. Market', who offers to sell or buy company shares at wildly optimistic or pessimistic prices.

From this, it should be easy to describe the value investing strategy: buy the stock of a company from Mr. Market when its price is lower than its intrinsic value and sell the stock back when the price exceeds its intrinsic value. The need for a buffer between intrinsic value and price is famously known as the "margin of safety." Since the future price of a stock can never be fundamentally known, a margin of safety is necessary to absorb uncertainties in analyses.[3]

Growth investing on the other hand is undertaken based on expectations of future earnings growth that will in turn boost stock prices. This means one is valuing the long-term earnings potential of a company to estimate its true intrinsic value, which is underestimated when only its current assets are taken into account for analysis.

Intelligent investors, however, must be cautious in their approach: Mr. Graham himself ventured into growth investing later in his career, investing in insurance company GEICO at its infancy and holding it over a long time horizon to realize gains that exceeded his proceeds from many years of value investing.[4]

GARP as an Investment Strategy

GARP is an evolved version of value investing that combines within it elements of growth. For instance, Mr. Buffet took his mentor's teachings and expanded the concept of intrinsic value to include intangibles such as brand value, which gave a company its "moat"[5] that allowed it to continue to generate earnings growth that justified its higher valuation. Seen this way, GARP combines the best elements of both value and growth investing.

Growth and the Power of Compounding

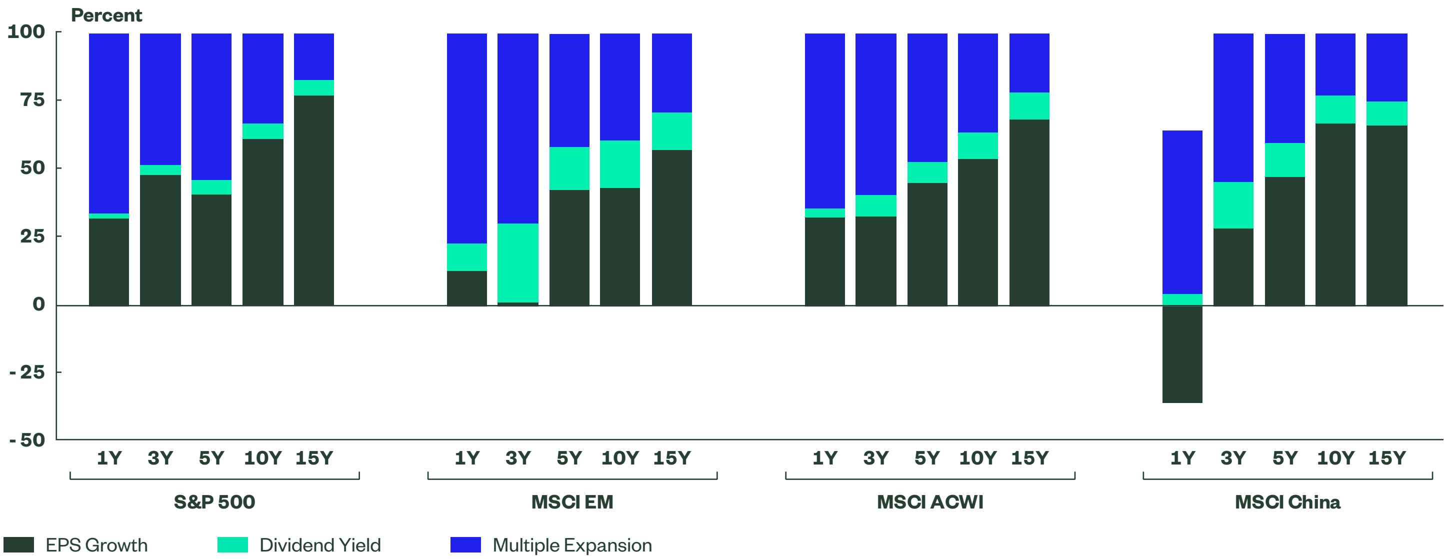
Let us examine each component of GARP in detail.

The 'G' in GARP refers to *sustainable* growth in earnings over the long term. Why is this important? Albert Einstein reportedly stated that compound interest is the eighth wonder of the world, but the power of compound growth is often significantly underestimated.

To demonstrate its power, we first decompose equity returns into dividend yield and price return, and then further decompose price return into changes in price to earnings and earnings growth. Over the short term, transient factors such as changes in multiples can dominate returns. Over the long term, however, compounded earnings growth leads to outperformance.

In Figure 1, we chart the contributions of these components to return over varying time horizons for the top quintile of four equity benchmark indices. We find that EPS growth is the most important driver of value creation for the top quintile performers of these indices over the long term. EPS grew in importance over time to between 57% and 77% of the total return.

Figure 1
Percentage Contributions of Various Components to Selected Index Returns



Source: FactSet, as at 31 December 2020.

Seen in this light, Mr. Buffet's famous buy-and-hold approach is as much traditional value investing as it is realizing the long-term growth potential in a portfolio.

Sustainable Growth Emanates From Quality

As Charlie Munger revealed in 1996, See's Candies was "the first high-quality business we ever bought."[6] At State Street Global Advisors, we believe sustainable growth emanates from quality, which is an attempt to quantify the health of a business. We start with a quantitative definition of 'quality'. Metrics to systematically screen for quality include high profitability (return on assets), low earnings volatility (EPS variability) and low leverage (debt/total assets).

Using return on assets alone as a proxy for quality and historical 3-year earnings growth as a proxy for growth, we disaggregate the S&P 500 Index into five quintiles and show the annualized return for each intersection (Figure 2).

Figure 2
S&P 500 Index Disaggregated into Five Quintiles

Total Annualized Returns	RoA Quintile 1	RoA Quintile 2	RoA Quintile 3	RoA Quintile 4	RoA Quintile 5	Total
3Y Earnings Growth Quintile 1	20.4	18.4	16.3	11.1	4.8	15.7
3Y Earnings Growth Quintile 2	17.3	16.0	12.4	12.4	10.2	15.8
3Y Earnings Growth Quintile 3	20.1	11.5	14.4	13.6	14.3	15.9
3Y Earnings Growth Quintile 4	11.3	10.5	9.5	10.6	4.0	9.4
3Y Earnings Growth Quintile 5	13.8	11.1	12.4	4.6	6.7	7.4
Total	**17.6**	**11.9**	**11.7**	**8.8**	**1.3**	**10.6**

Note: Returns from S&P 500 from 31 December 2009 to 31 December 2020; past performance is not a reliable indicator of future performance; index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Source: FactSet, as at 31 December 2020.

The results show that historically, investing in a portfolio that combined the highest quintiles of *both* factors (the intersection of the highest quintiles) outperformed investing only in the highest growth or highest quality quintile companies.

In our Fundamental Growth & Core team, we take a broader view of quality, beyond purely financial metrics. We focus on the quality of the business model (similar to moat) using tools such as Porter's Five Forces. Michael Porter stated that understanding competitive forces and their causes is key to revealing the nature of an industry's current profitability while providing a framework for anticipating and influencing competition (and profitability) over time.[7]

We believe this is what allows a company to sustain its competitive edge in the long run, which in turn is the foundation upon which the power of compounding can be realized.

Specifically, we ask questions such as:

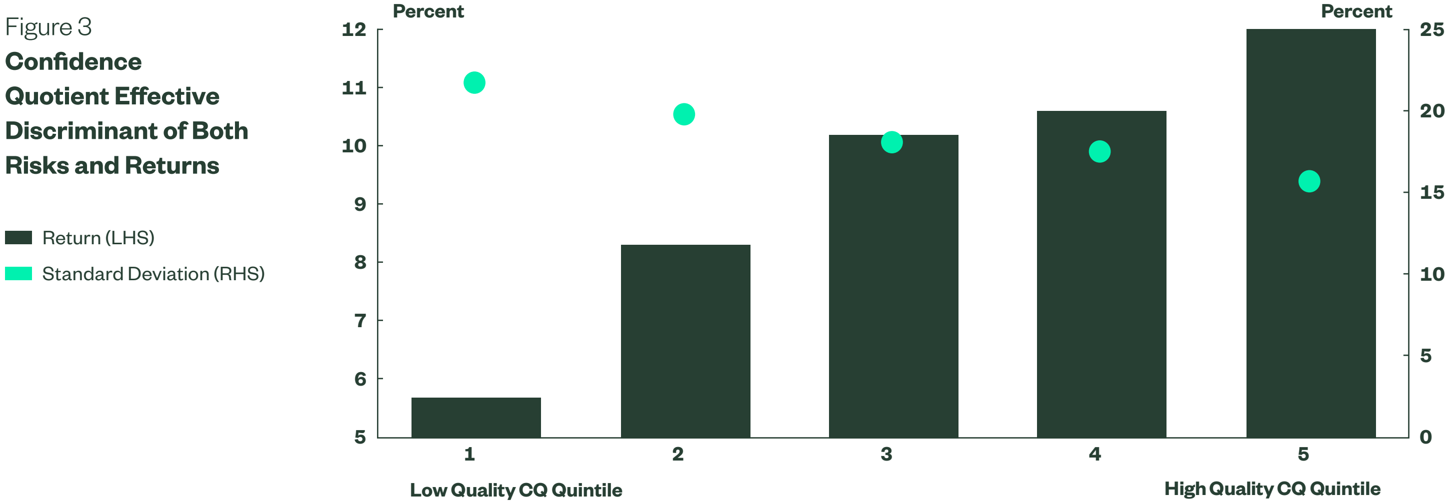
- Does a business have a sustainable competitive advantage and what is the source of that advantage?
- Is it an innovator that can shape and exploit secular trends?
- Is the management capable and trustworthy with a well-articulated strategy and the discipline to execute?
- Is corporate governance effective and transparent?
- Does the company conduct itself with high ideals in regard to environmental, social and governance concerns?

By going beyond what can be gleaned from accounting statements alone, we hope to distill the fundamental drivers that enable a business to continue to grow in the future.

We do not just stop there though. Our research team quantifies this qualitative information into a score that reflects our degree of confidence in a business. This proprietary score is known as the Confidence Quotient (CQ). We isolate quality through our **CQ framework** and through the process identify companies with durable business models that can typically grow earnings faster than the market rate, thereby becoming deserving of the 'Sustainable Growth' description.[8]

We believe higher CQ scores reflect a competitive advantage that is more likely to be sustained into the future. As evident in Figure 3, CQ has been a very effective discriminant of risk and return historically.

Figure 3
Confidence Quotient Effective Discriminant of Both Risks and Returns



Note: CQ is State Street Global Advisors' Fundamental Growth Team's proprietary measurement of quality based on indicators such as management, market position and transparency. Source: State Street Global Advisors, as at 31 December 2020.

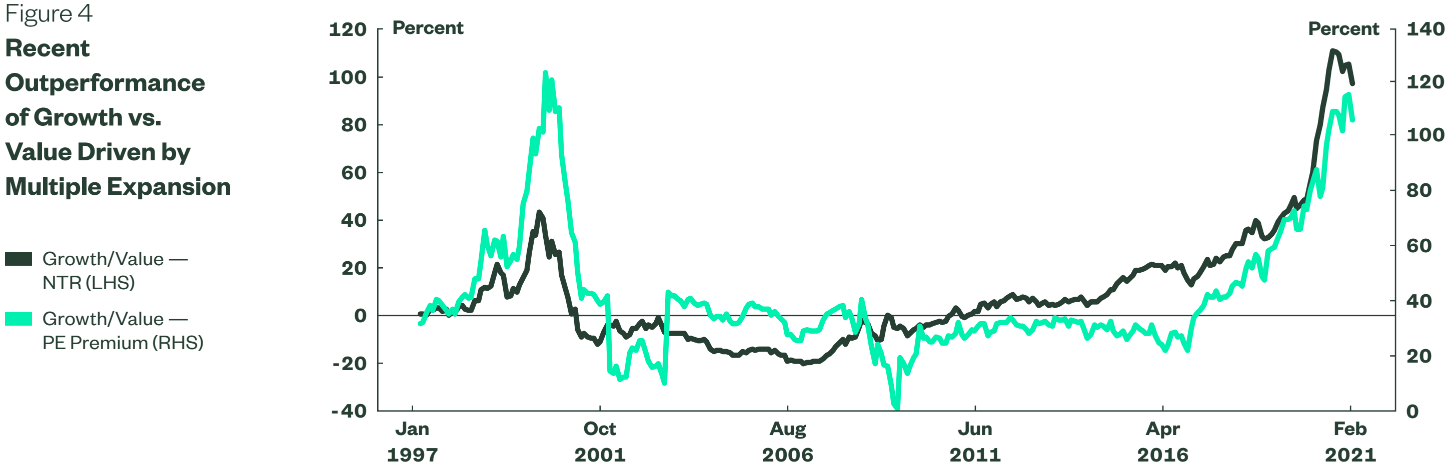
To Buy, or Not to Buy

Whilst our focus is on identifying companies with durable business models that can typically grow earnings faster than the market rate, we remain conscious of the valuation level we are paying to pick companies with sustainable growth models. This is the 'ARP' in GARP, which refers to 'at a reasonable price'.

Indeed, we could say that *quality at a reasonable price* is equally reflective of our investment philosophy. This is because there is a correlation between growth and quality in the way we define the CQ. We avoid low-quality names and through our "reasonable valuation" discipline, we also avoid pricey names that are typically defined by their "momentum growth" characteristics.

Figure 4 charts the movement of the MSCI Growth Index versus the MSCI Value Index. It also charts both the indices in terms of their respective price-to-earnings ratios over the long-term. The movements highlight the recent outperformance of the growth index relative to the value index. This outperformance was being driven by multiple expansion rather than earnings growth and — more worryingly for investors — this ratio has tended to mean revert over the longer term. In other words, valuation, or the price one pays, always matters *in the long run*.

Figure 4
Recent Outperformance of Growth vs. Value Driven by Multiple Expansion

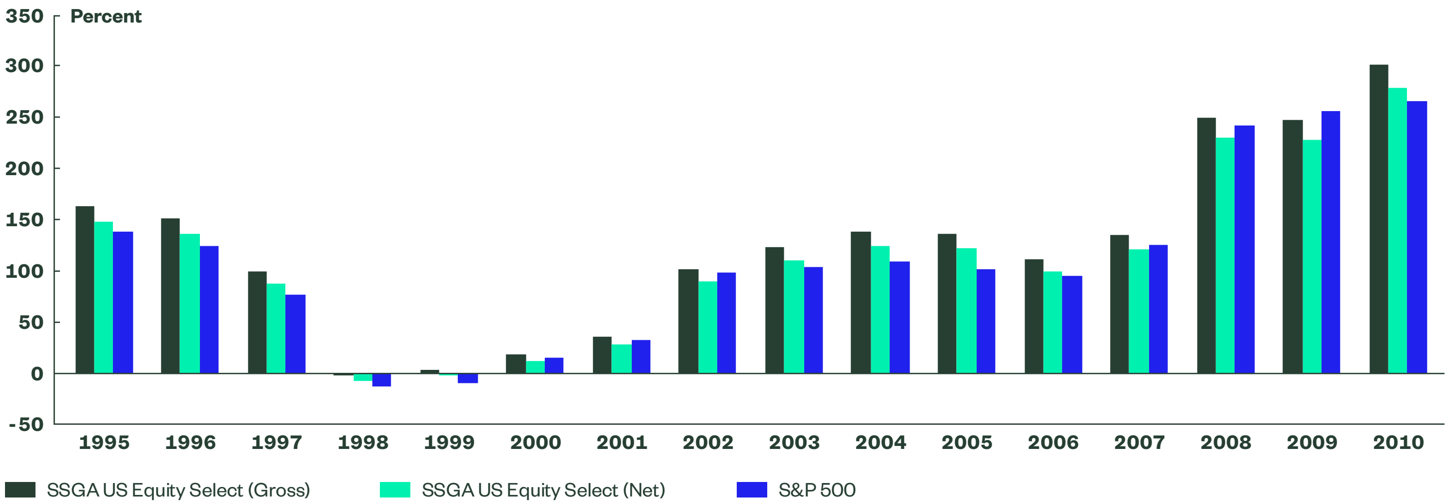


Note: Growth/Value — Net Total Return % = MSCI World Growth's cumulative outperformance over MSCI World Value starting end-January 1997, net of dividend withholding taxes; Growth/Value — P/E Premium = percentage premium of MSCI World Growth P/E over MSCI World Value P/E. Source: FactSet, as at 26 February 2021.

GARP Outperforms S&P 500 Regularly

Figure 5 highlights our longest running GARP strategy, the US Equity Select, which concentrates on mid- and large-cap companies domiciled in or trading in the United States. Starting from its inception in 1995, we show 10-year forward returns of the strategy per calendar year versus its S&P 500 benchmark. As is evident, the US Equity Select strategy outperformed its benchmark (S&P 500) through most of its history. This highlights GARP as an alpha-accretive strategy that complements a core index approach.

Figure 5
US Equity Select Strategy vs. S&P 500 Index



Note: SSGA US Equity Select composite annual gross returns and annual S&P 500 Index gross returns were used to calculate 10-year forward rolling total returns; composite net returns are also indicated; the performance shown is of a composite consisting of all discretionary accounts using this investment strategy; the above information is considered supplemental to the GIPS presentation for this composite, which can be found in the Appendix or was previously presented — a GIPS presentation is also available upon request; past performance is not a reliable indicator of future performance; performance returns for periods of less than one year are not annualized; the performance figures contained herein are provided on a gross and net of fees basis; gross of fees do not reflect and net of fees do reflect the deduction of advisory or other fees, which could reduce the return; some members of this composite may accrue administration fees; the performance includes the reinvestment of dividends and other corporate earnings and is calculated in US dollars. Source: FactSet, State Street Global Advisors, as at 31 December 2020.

Conclusion

Mr. Buffet himself had remarked in 1992 that both value and growth are joined at the hip and that growth is always a component in the calculation of value.[9] As described before, we call the investment philosophy that combines value and growth, GARP. It is an investment style that relies on rigorous fundamental research on companies to identify those with quality business models, which allow them to deliver sustainable future earnings growth, whilst being mindful of valuation levels.

State Street Global Advisors' proprietary CQ score captures the level of conviction we have in a company's sustainable growth advantage. Companies that have high CQ scores have historically outperformed, and our strategies based on this framework have consistently outperformed their benchmarks. We believe our high conviction research process will continue to be our long-term competitive advantage as well as a source of alpha for our clients.

Endnotes

1 Pricing a Box of Candy — Warren Buffett & See's. (September 18, 2013). Gurufocus.

2 Chairman's Letter to the Shareholders of Berkshire Hathaway Inc. (March 2, 1990). Berkshire Hathaway Inc.

3 Graham, B. (1985). The Intelligent Investor: A Book Of Practical Counsel. HarperCollins.

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5 Kim, T. (May 7, 2018). Warren Buffett Believes This is 'The Most Important Thing' to Find in a Business. CNBC.

6 Calvey, M. (August 21, 2012). Chuck Huggins, Former see's Candies CEO, Dies at 87. San Francisco Business Times.

7 Porter, M. E. (January, 2008). The Five Competitive Forces That Shape Strategy. Harvard Business Review.

8 Solecki, M. J. (April 26, 2021). Investing in Sustainable Growth: A Focus on Quality. State Street Global Advisors.

9 Chairman's Letter to the Shareholders of Berkshire Hathaway Inc. (March 1, 1993). Berkshire Hathaway Inc.

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