SMART MONEY

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Sleepy but well-run companies can deliver superhuman returns

When people think of investment home runs where an initial purchase goes up in value by 10 or more times, they tend to focus on famous venture capital deals, bold trades amplified by some sort of leverage, or well-timed bets on distressed assets that recover. Few would suggest that today's stock market was a ripe hunting ground for these sorts of once-in-a-lifetime opportunities.

Kevin Martelli, a value investor based in Switzerland, has conducted a study of "multi-bagger" stocks, which he defines as those that have risen in value by more than 10 times over the last 15 years. Mr Martelli, who runs a fund called Martek Partners, acknowledges that his study is backward-looking and an unscientific analysis that is hampered by the fact that only stock market winners are visible — while the losers that once looked like possible multi-baggers will not show up on any screen.

In spite of these limitations, his analysis holds some illuminating and counter-intuitive lessons for all types of investors, and challenges many of the most commonly held assumptions about what drives exceptional stock market returns over many years.

One of his most fascinating case studies is AutoZone, the US car parts retailer, whose shares rose by 24 times in value from 2000-13. This outstanding 27 per cent compounded annual return easily matches up with or beats the world's very best performing venture capital funds — yet it has been generated by a seemingly sleepy business in a low growth sector. How did this happen and what does it teach us?

Investor's study of 'multi-bagger' stocks reaches counter-intuitive conclusions

The first commonly held assumption about multi-bagger stocks is that they must experience hyper-growth in sales, and eventually profits, to drive the share price gains that lead to multiple returns on an initial investment. Finding these types of companies in the public markets, it is assumed, must require backing risky companies that could with luck become the next Amazon or Alphabet.

With AutoZone this was not the case. Mr Martelli counter-intuitively shows that strong sales growth is not always needed to drive exceptional stock market gains. In fact, during the period where AutoZone shares rose by 24 times in value, revenues grew at a compounded annual rate of just 6 per cent. Its store count rose by 5 per cent a year and average sales per store by just 1 per cent.

Another assumption made about public market multi-baggers could be that the outsized returns on investment are driven by the initial purchase price being made at an exceptionally low valuation. In the case of AutoZone, this was also not the case. In 2002, near the start of the company's 13-year journey to a 24-times share price appreciation, it was trading on a trailing multiple of earnings of 18 times. Not exactly screamingly cheap.

Quantitative investors who believe that returns can be boiled down into simple "factors" such as "quality" or "high dividends" could conclude that AutoZone's winning streak was down to some sort of mix of these characteristics. However, over this time, the company did not pay out dividends. It also did not screen particularly well on metrics used by "quality" ETF screens such as return on assets.

Over the same investment period, two of the large capitalisation US stocks regarded at the turn of the millennium as being quantitatively and qualitatively of the highest quality, General Electric and Coca-Cola, have made a loss of 57 per cent and a gain of 62 per cent, respectively. Both shares underperformed the S&P 500 over the period.

The conclusion Mr Martelli draws is that good capital allocation by management trumps growth. While AutoZone's sales only grew by 6 per cent from 2000-13, its earnings per share grew by 22 per cent. This was driven by operating margins increasing from 11 per cent to 19 per cent and the company using its substantial free cash flow to buy back 73 per cent of its outstanding shares.

This allowed the company to triple the single most important gauge of corporate management competence — return on invested capital or the amount of profit made for each dollar of capital invested by management.

Seemingly sleepy companies — when well managed — can deliver superhuman returns.

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