The Rondure Approach to Quality Investing

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Our bedrock philosophy at Rondure Global Advisors is that high-quality companies, bought at reasonable prices, have the potential to outperform the broader market over time.

We consider ourselves value investors, but not in the sense of buying distressed or dodgy securities (as the term often connotes in our industry). To us, buying securities with a long-term margin of safety is the essence of value investing. If Benjamin Graham's notion is true that "price is what you pay and value is what you get," then paying a fair price for a wonderful business is just as much "value investing" as paying a low price for a dubious one.[i]

What we look for are companies we call Quality Compounders. What are Quality Compounders? Companies with 1) high returns on capital, 2) stable free cash flow, 3) strong balance sheets, and 4) compelling competitive advantages.[ii] The first three of these attributes can be assessed retroactively looking at a company's financial performance. It's the last one—a company's competitive advantages—that requires a forward-looking evaluation of its ability to continue compounding capital well into the future.

Quality Compounders are companies to whom we feel comfortable entrusting our clients' capital, confident that they can do extraordinary things with it, with no need for micro-managing by us!

Why Quality?

Why buy and hold high-quality stocks? Simply put, because they have been shown to offer better long-term risk-adjusted returns than the broader market. In short, quality has generated strong and consistent abnormal returns, as a host of academic research has confirmed in recent years.[iii]

That pattern has held true notwithstanding competing ways of defining corporate quality, whether in terms of high profitability, high earnings quality, limited maintenance expenditure needs, or low beta/low volatility.[iv] Moreover, it has been shown to exist

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across geographies, market capitalizations, and time periods, thus reducing the likelihood of data mining accounting for the finding. Instead, the data suggest an anomaly that persists but varies in strength over time.[v]

The implication is that investors tend to overpay for risky or poor quality stocks. Perhaps it is due to a belief that exciting stocks are more likely to offer outsized returns, an assumption that inflection points in intrinsic value are easier to identify than they actually are, or the allure of finding the next rocket-ship-to-the-moon. Whatever the reason, remember that lottery tickets continue to sell and casinos continue to fill up, despite the negative expected return they offer their clientele!

This insight hearkens back to Benjamin Graham's *Intelligent Investor*, where he argued that equity investors should "apply a set of standards to each [stock] purchase, to make sure that he obtains (1) a minimum of quality in the past performance and current financial position of the company, and also (2) a minimum of quantity in terms of earnings and assets per dollar of price."[vi]

It was Graham's insistence of establishing minimum quality criteria (a fact that is underappreciated by most investors today, who regard him only as the father of deep value investing) that paved the way for his most well-known disciple, Warren Buffett, to elevate this approach years later. Thanks in part to Charlie Munger's influence, Buffett later advised: "Forget what you know about buying fair businesses at wonderful prices. Instead, buy wonderful businesses at fair prices… Charlie and I are simply not smart enough to get great results by adroitly buying and selling portions of far-from-great businesses."[vii]

These investors intuited what a host of empirical research has come to validate: Consistently highly profitable companies with low debt have historically generated higher returns than their peers, even controlling for the fact that they have generally been more expensive than other stocks.[viii]

What Makes a Quality Company?

From a quantitative standpoint, a quality company meets three criteria:

- **High return on capital** as measured by gross margin, return on assets, and return on capital employed
- **Stable free cash flow** defined as low return volatility, consistent cash flow growth, cash flow in excess of net income, and consistent dividend growth
- **Strong balance sheet** defined by little-to-no debt (or where debt, minimal cash flow cyclicality) and limited need for external financing to fund organic growth or the return of capital to shareholders

These criteria lead to portfolio companies with a demonstrated capacity for generating profits in a wide variety of economic environments. Yet they also have cash backstop to weather dry spells. Their degree of survivability, or staying power, insulates equity holders against the permanent loss of capital, the primary definition of risk in our view. Their exceptionally steady earnings growth facilitates long-term capital appreciation and return of capital, greatly mitigating the duration and intensity of downside price volatility. Such companies often have a low market beta (a measure of volatility).

Figure 1 breaks down these financial metrics in more detail.

Figure 1: Financial Hallmarks of Quality Compounders

Strong Balance Sheets	Stable Free Cash Flow	High Returns on Capital
∞ Net Cash Balance Sheets ∞ Non-Cyclical or Cyclicals without Debt ∞ Non-Debt-Accruing to Facilitate Dividend Growth or Share Buybacks	∞ Positive Free Cash Flow Growth ∞ Cash Flow / Net Income > 1 ∞ Consistent Dividend Growth ∞ Consistent Earnings Per Share (EPS) Growth	∞ Attractive Returns on Invested Capital (ROIC) ∞ Attractive Non-Cash Returns on Assets (NCROA) ∞ High Gross Margins

High Return on Capital

Quality Compounders make use of what's available to them, whether in terms of assets or invested capital, to hopefully generate returns in excess of their cost of capital. The very finest companies can do so even as their scale grows very large—in fact, some of the finest compounding machines increase in their ability to generate cash returns as they age.

Our experience has taught us—and the empirical data bear this out—that certain special companies enjoy rare competitive advantages that allow them to redeploy their free cash flow at attractive rates of return over many years. Economic theory would argue that these advantages should be whittled away quickly, as new competitors come along and customers go elsewhere. But the reality is that a fortunate few companies can resist this reversion to the mean, allowing them to earn high returns on capital long than the market often thinks possible.

Stable Free Cash Flow

Quality Compounders are marked by steady core profitability. That trait can enable steadily growing earnings, which in turn can facilitate long-term capital appreciation and the return of capital via dividends and buybacks, which tends to lessen the duration and intensity of downturns in their share prices.

When a company can put internally generated capital to work at high rates of return over many years, the task for its shareholders, as part owners, becomes to patiently allow it to reap the rewards of this fortunate situation over many years. No need to constantly trade it as it moves up and down, which reduces brokerage costs. Likewise no need to incessantly worry over its solvency. Its competitive position allows us to sleep well at night.

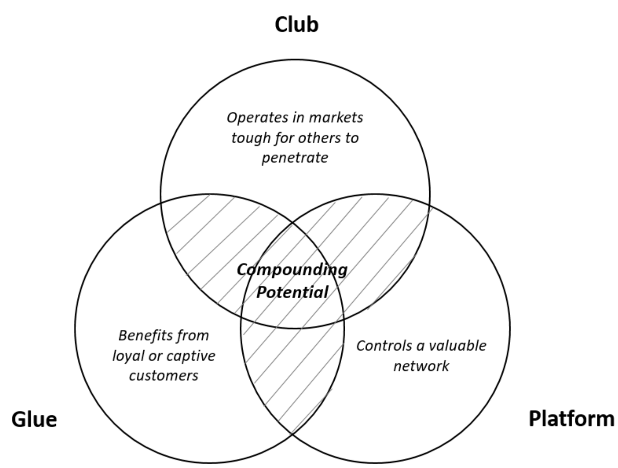
Strong Balance Sheet

Even the most elite companies require an all-weather balance sheet if they are going to compound shareholder capital over many years. All companies, no matter how wide their competitive moat, will face dry spells, make strategic mistakes, or commit operational errors from time to time. Maintaining low financial leverage prevents that scenario from turning into a catastrophe for their equity holders.

The Club, Glue, Platform Framework: How We Identify Compounding Potential

As fundamental active managers, our research process extends beyond quantitative screening in an attempt to determine which of today's quality companies are most likely to generate compounding returns for equity holders in the future.

Figure 2. Club, Glue, and Platform Businesses



We seek out business models with strong Club, Glue and/or Platform (CGP) elements. These companies dominate markets that are tough for others to penetrate (high Club score), benefit from loyal or captive customers (high Glue score), or control a valuable network (high Platform score). Compounding companies always score well in at least 2 of these 3 areas (see Figure 2). These exceptional characteristics help them to transcend the forces of competitive equilibrium and avoid a negative reversion to the mean in their return metrics.

Why We Think Quality Matters

Our aim at Rondure Global is to deliver clients excellent long-term compounded returns and mitigate loss of capital from large drawdowns. We think that owning companies with exceptional profitability, strong balance sheets, and wide competitive moats is the best way to accomplish that. As we see it, holding companies of this profile raises the odds of outsized long-term returns without the downside risks of owning lesser-quality firms. It's a relatively simple way to approach the market—which is partly why we think it works—if applied in a disciplined way over many years. Everything we do at Rondure in terms of our research and investment process is designed to work toward that goal.

Margin of safety refers to any conservative allowance used by value investors in effort to protect their capital and portfolios from downside risk.

Free cash flow is the cash flow remaining after accounting for cash used to support operations and maintain its assets.

Beta is the measure of volatility of a stock compared to general market risk.

Intrinsic Value is the calculated or perceived value of a company based on fundamental analysis, which typically involves the valuation of the company's cash flows.

Earnings Per Share (EPS) Growth is a company's net income divided by its total outstanding shares.

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[i] We are indebted to Robert Novy-Marx for this formulation. See his paper, "Quality Investing," Working Paper available at rnm.simon.rochester.edu, p1. The quote that "price is what you pay and value is what you get" is attributed to Warren Buffett, who in turn attributed it to Benjamin Graham.
[ii] This formulation is derived from the pioneering early work of Jeremy Grantham on quality equity investing (see "The Case for Quality—The Danger of Junk", *GMO White Paper*, March 2004). Although many other ways of parsing and defining quality have been offered in the years since, we still think this one best captures our idea of investment quality.
[iii] Amenc et al. "The Dimensions of Quality Investing: High Profitability and Low Investment Smart Factor Indices," Scientific Beta: An EDHEC-Risk Institute Venture. Mar. 2015.
[iv] A useful comparative table of quality definitions can be found in Norges Bank Investment Management, "The Quality Factor," *Discussion Note 03/2015*, p. 6.
[v] Cliff Asness et al. "Quality Minus Junk." *AQR Working Paper*. Oct. 2013.
[vi] Benjamin Graham, *The Intelligent Investor*, 1965. See the section "Stock Selection for the Defensive Investor."
[vii] Buffett would later recall: "Charlie's most important architectural feat was the design of today's Berkshire." It was his "blueprint" that lead to the "wonderful businesses at fair prices" insight. "Charlie made me focus on the merits of a great business with tremendously growing earnings power." Glen Arnold, *The Financial Times Guide to Value Investing*, 2009, and Charles T. Munger and David Clark, *The Tao of Charlie Munger*, 2017.
[viii] Eugene F. Fama and Kenneth R. French, "A Five-Factor Asset Pricing Model (Sep. 2014)," Fama-Miller Working Paper.

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