GLOBAL LONG-TERM UNCONSTRAINED

Monthly Market Update

MARTIN CURRIE
A Franklin Templeton Company

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Valuation discipline is critical

The importance of anticipating normalising interest rates (or why some valuation gurus take the wrong approach)

Executive Summary

- Valuation discipline is critical at all stages of the macroeconomic cycle, but even more so at this stage of uncertain monetary policies
- Our valuation tools ensure we aim to put a fair value on companies based on long term assumptions rather than what the market might be willing to pay over the next 12 months
- This long-term valuation approach moves away from the tendency for market short-termism, as seen from the shrinking holding periods over time
- Investors should ensure long term valuation tools anticipate normalising interest rates, which is critical during periods of very low interest rates
- Forecasting long term interest rates is an important difference to using market rates, which is what some valuation experts advocate
- Investors should project corporate cash flows until businesses become mature, reverting to terminal growth assumptions beyond that
- Our disciplined valuation approach makes us confident that we have not overpaid for businesses that we hold in our strategies.

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Valuation discipline and the importance of anticipating normalising rates

In this month's market insights, we zoom in on an important aspect of investing, which is core to our investment process: valuation discipline. Valuation discipline is important at any point in time for investors, but we would argue that it is even more critical at this stage in the economic cycle, as uncertainties around monetary policies and their impact on the economy abound.

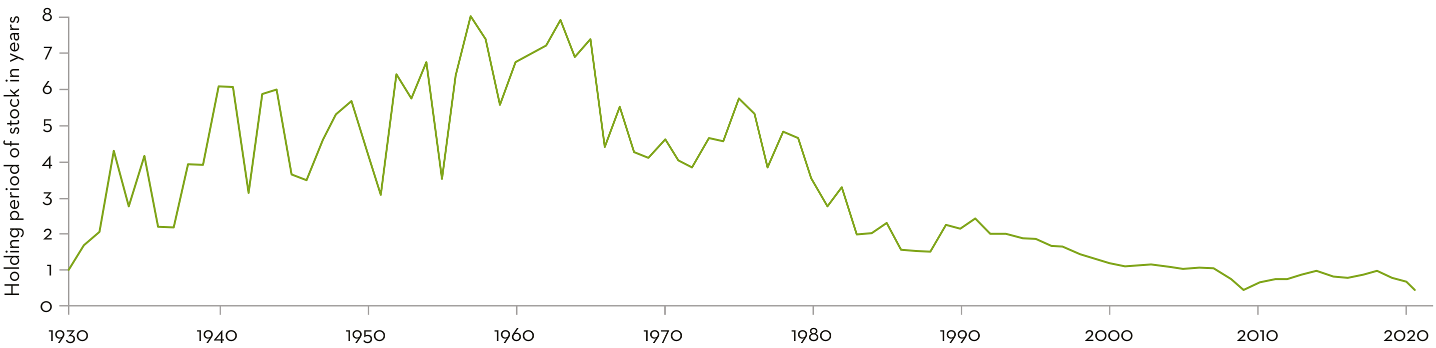
We have a structured valuation approach, which gives us that discipline. We have price targets on all stocks we invest in and the ones that are on our bench. These targets are constantly updated and calculated based on a combination of valuation tools: Discounted Cash Flow (DCF), which accounts for 50%, Economic Value-Add (EVA) 25%, and target multiples 25%.

On target multiples, we focus on year 5 multiples, rather than 12 months forward, so that we move away from shorter term considerations, and away from what the market might be willing to pay for a business nearer term, instead focusing on the longer term.

On Economic Value Add, we capture the spread companies generate between the Return on Invested Capital (ROIC) and Weighted Average Cost of Capital (WACC). This valuation measure ensures it properly captures companies that create value for shareholders through significant positive spreads – we find that the market has a tendency to undervalue companies' compounding value-creating characteristics, due to its short-term focus.

In fact, the market has gradually become more short term over time, as can be seen from the chart below, focusing on the S&P500. It plots the average holding period for mutual funds, which has gone from c.six-eight years back in the 1950's to 1970's, to below 10 months in the past five years, and even to closer to 6 months as holding period in the past year.

Average holding period for S&P 500 mutual funds, 1930 - 2020



Source: NYSE, Refinitiv. Note: holding periods measured by value of stocks divided by turnover.

> Valuation discipline is critical at all stages of the macroeconomic cycle, but even more so at this stage.

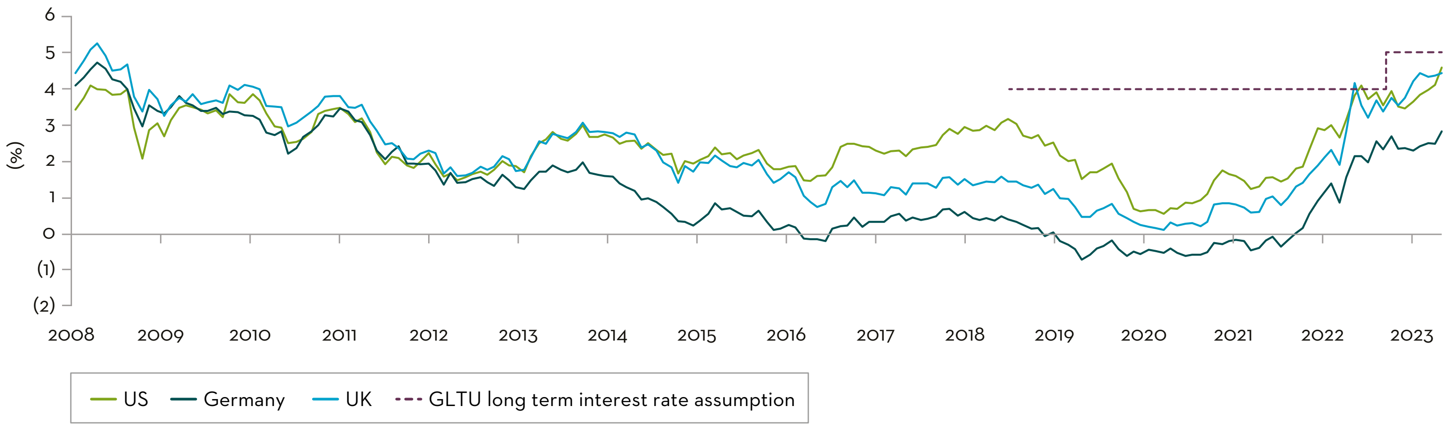
For our DCF analysis, which constitutes 50% of our price target assessment, we want to highlight a few aspects. Firstly, we forecast companies over a period of 20 years. The reason for this is that we want to capture companies through their life cycle, all the way to their maturing stage. We believe that the maturing phase of a company is typically between 10-20 years. Some companies will be able to sustain superior growth and returns for longer than others, so a 20 years forecast period permits us to have flexibility in our assumptions about timeline to maturity.

Our terminal assumptions beyond year 20 are for a growth to perpetuity of 2.5% – this could be deemed as conservative by some, but it is worth emphasising that we are looking here at growth to perpetuity beyond year 20.

Discount rates – the importance of anticipating normalising monetary policies

In our view it is important to anticipate normalising interest rates. in determining the discount rate we use in our DCF calculation. In fact we changed our approach in June 2018, instead of using a spot interest rate, we shifted our inputs into a long-term assumption where we thought rates would go. This was critical to do so when sovereign bond rates were at zero or negative, in many regions 18-24 months ago. When we made this structural change in 2018, we took the view that long-term interest rates would normalise at a 4% level. As of September 2022 we further increased our long term interest rate assumption to 5.0%, as we detail in the next section.

Global 10 year bond yields, 2008 - 2023



Source: FactSet, 31 October 2023.

> Valuation approach based on long term valuation tools ensures we put a fair value on companies based on long term assumptions rather than what the market might be willing to pay over the next 12 months.

Reasons for shifting our long-term interest rate assumption to 5% in September 2022

Based on the belief that in the long-term inflation would up creep up to 3% (rather than the 2% we previously assumed), we increased our long-term interest rate assumption to 5% in September 2022.

Our view of a stickier and longer lasting inflation is based on four aspects:

- **Wage inflation bringing second round inflation pressure:** persistent wage inflation could turn inflation from being frictional to being structural (see our inflation report from October 2022 for details)
- **Deglobalisation (near-shoring, on-shoring and friendly neighbour-shoring):** leading to reflation trends
- **Technological fragmentation:** leading to diseconomies of scale in key industries, bringing in further inflationary pressures
- **Energy transition:** the shift towards greener and alternative energy sources is likely to be inflationary, given the magnitude of investments needed

Our approach of using long-term interest assumptions instead of spot long term rates, to anticipate normalising interest rate policies, is different from what valuation experts advocate in their books.

We believe that one of the major drawbacks of using spot interest rate assumptions in valuation tools, as advocated by valuation gurus, is that one ends up valuing companies based on whichever interest rate expectations prevail at the time. When investors value companies when rates are close to zero or negative using spot rates, it risks overestimating fair value assessments. It also means that once the monetary policy regime shifts towards rising rates, the fair value of a company reduces rapidly, as higher updated rates assumptions feed into the valuation models.

Our approach of inputting a long-term rate, based on the assumption of normalising interest rates, means that our fair value estimates are stable, and not prone to major variation as rates fluctuate. We end up with putting a fair value on the businesses that we analyse, using long-term valuation tools and assumptions. This is instead of capturing shorter term market gyrations of long term interest rates expectations.

All in all, the above helps explain the reasons why we shifted to a 5% interest rate assumption in September 2022, and the importance of anticipating normalising interest rates in valuation tools, rather than using spot interest rates.

> Investors should ensure long term valuation tools anticipate normalising interest rates, which is critical during periods of very low interest rates.

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