

Most Valuable Brands Fully Valued

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We seek to invest in undervalued companies with durable competitive advantages, clear growth prospects and positive industry dynamics. We pay close attention to companies with leading brands and loyal customers (think Apple, Nike) as these companies typically generate high returns on capital and strong free cash flows. On the flip side, we're wary of companies with brands exhibiting declining consumer interest (think Under Armour, Ralph Lauren), even if shares look inexpensive. Turning around a challenged brand is a Herculean effort, requiring significant investments in marketing, product development and supply chain management.

For the last seven years, business magazine *Forbes* has produced a [list of the world's 100 most valuable brands](#). In our view, most of the leading brands

are now fully valued. One way to look at a company's valuation is to examine the implied long-term growth rate embedded in its current share price. This approach reverses the normal valuation approach. Fair value is set as the current share price. Then, with the discount rate and the one-year-out analysts' average earnings per share estimate as known inputs, we solve for the growth rate. The result can be compared to historical growth expectations and the outlook for the company going forward. If implied growth is higher than historical levels then that might be a sign the stock is overvalued. Low expectations might identify an opportunity where the market's expectations are out of touch.

Chart 1 plots the historical implied long-term growth baked into *Forbes'* top 15 most valuable brands at each quarter

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end between Dec 31, 2005 and July 31, 2017. We made two adjustments to the group. Facebook, the fourth ranked brand, was removed because it went public in the latter part of the period. And we eliminated non-U.S. domiciled companies for a cleaner U.S.-only comparison. Toyota, Samsung and Daimler were replaced with the next U.S. domiciled companies on the list: Nike, Oracle and Verizon.

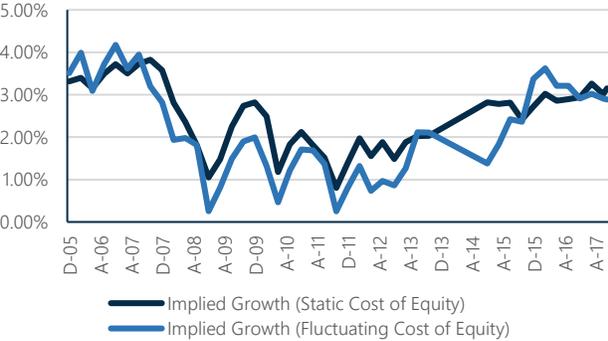
We present two implied growth calculation methodologies: one with the cost of equity set at a static 9% and one with the cost of equity fluctuating as the stock betas and the risk-free rate change quarter-to-quarter. Chart 2 compares the four higher-growth tech stocks—Apple, Google, Microsoft and Amazon—against the other 11 companies within the top 15 brands list. Implied growth for both groups is near pre-Great Recession levels.

Great brands, great companies. But with growth expectations now close to the levels recorded at the previous

economic cycle peak, we do not see any inherent margin of safety. It appears that only significant margin expansion or upward shift of long-term growth expectations would drive shares materially higher—neither of which we foresee. Current net margins for the group are already 7% higher than the last cyclical peak and global GDP growth appears to be stalled at under 3%. Because of their full valuations we do not currently own any of the companies with the top 15 brands.

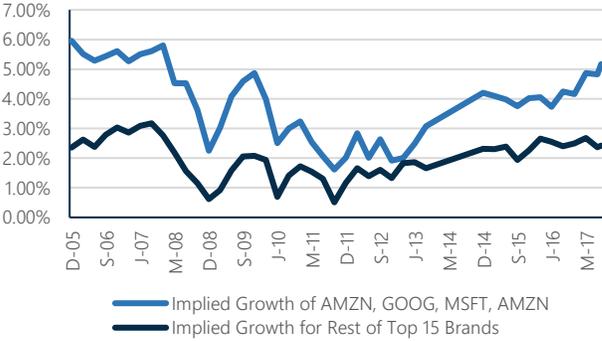
With a combined market cap of just over \$4 trillion, these top 15 brands represent roughly 20% of the total market capitalization of the S&P 500 Index. Passive investors need to be aware of the full valuations of the underlying stocks within their Index ETFs (implying sub-par potential returns and/or vulnerability to declines from fair value). By digging a bit deeper though—albeit good values are scarce—one can still find attractive opportunities.

Chart 1. Implied Growth for Top 15 Most Valuable U.S. Brands December 31, 2005 to July 31, 2017



Source: FactSet, Trapeze Asset Management Inc.

Chart 2. Implied Growth for AAPL, GOOG, MSFT, AMZN vs. Rest of Top 15 Most Valuable U.S. Brands December 31, 2005 to July 31, 2017



Source: FactSet, Trapeze Asset Management Inc.

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