Author interview:

Lawrence A Cunningham

Introduction

Much has been said and written, not least in the last 6-12 months, about value vs growth as investment styles. We hear much less about a third style of investing which could be labelled 'quality investing'. In the 2015 book with the same name, Professor Lawrence A Cunningham - together with AKO Capital portfolio managers Torkell Eide and Patrick Hargreaves - describes the philosophy behind this school of investing. The authors also lay out a great 'toolbox' of what they call 'building blocks' and 'patterns' for how to identify great businesses, where the patterns can almost be thought of as analogous to Charlie Munger's 'mental models' as applied to investing. The book also goes through a few dos and don'ts when implementing the quality investing philosophy. What really brings all of it to life is the long list of case studies of great businesses and how these fit the different patterns described. It sounds like, with a bit of luck, we can anticipate a follow-up to the book in one form or another, as Cunningham says he is working on another major project.

My attempt to summarise the quality investing approach would be as follows:

1) Stocks follow earnings (over time) - but this requires a long-term vision
2) There is a subset of companies whose value creation and sustainable earnings growth is well in excess of the market
3) We can identify some of these companies before the event using certain 'mental models' (or 'patterns' as they are referred to in '*Quality Investing*')
4) The valuation premium for these businesses is frequently insufficient, which enables us to earn excess returns

Lawrence is probably best known for his work on corporate governance generally and Berkshire Hathaway and Warren Buffett specifically. More recently he has also spent significant amounts of time on the Quality Shareholders Initiative, which studies the impact of shareholders on a company and its performance. AKO Capital is a London-based long-short fund focused on European listed companies where the emphasis is on finding high quality compounders to own for the long term. AKO's founder, Nicolai Tangen, has gone on to run the Norwegian sovereign wealth fund.

IBTB sat down with Professor Cunningham to discuss a range of topics including how to define quality investing, risks involved in the approach, what enables shares of these companies to outperform over time and much more. My takeaway is that, while the principles of quality investing may be timeless, the implementation needs to change and adapt over time. A healthy measure of paranoia is just as central to quality investing as it is to any other approach.

A definition of quality investing

While value vs growth is a popular debate among equity investors, we hear much less about how quality investing relates to these other styles. I asked Lawrence for his definition.

'In plenty of contexts, they overlap…the mindset is still hunting for value' but overlaid with a willingness to pay up for true quality. He describes the approach as a real hybrid between growth and value. In the book, the authors say the following: 'In our view, three characteristics indicate quality. These are strong, predictable cash generation; sustainably high returns on capital; and attractive growth opportunities'. It is this ability to reinvest cash flows at high returns that seems key to so many successful proponents of the

quality approach. Effectively, the rest of the book details various drivers of the returns and growth necessary for long-term quality compounding.

I also took the opportunity to ask Professor Cunningham about the notion that quality investing seems to be a search for opportunities that are 'hiding in plain sight.' But short-term performance will rarely stand out either on the downside (e.g. vs high beta/low quality in a downturn) or on the upside (e.g. vs cyclicals in a rapid recovery) i.e. never truly out of- or in fashion. I put it to Lawrence that the 'algorithm' for these businesses often seems to be 'middle of the road' with MSD to HSD organic growth and HSD to low-teens EPS growth.

'The quality investing framework we describe is a long-term orientation and so the goal is steady, sustained earnings and returns on invested capital that compound so that wealth just accumulates as years go by…you're not shooting the lights out but nor are you shooting yourself in the foot a lot'.

The authors of *'Quality Investing'* express this as follows: 'Successful quality investing, therefore, sometimes requires avoiding the temptation of apparently exciting investment discoveries. It means accepting the relative dullness of analyzing what is often in plain view'.

An enduring approach

With just over 5 years having passed since the book was first published, I asked whether there are any changes or amendments he would make.

'I do think it has withstood the test of time overall…It draws on a classical tradition so I think it will have legs for many years to come'. However, he also says that like any piece of work it is not complete; one area that would deserve more attention today would be the quality of the shareholder base and dual class share structures etc. There is a wealth of resources on these topics on the George Washington University Law School website (Professor Cunningham is Director of the Center for Law, Economics and Finance at GW): https://www.law.gwu.edu/c-leaf-initiatives. You can also visit Professor Cunningham's companion site, Quality Shareholders Group at https://qualityshareholdersgroup.com/

Is quality getting crowded?

I asked Professor Cunningham whether, in his view, the quality end of the spectrum is getting crowded and whether this in itself could invalidate the approach by 'arbitraging' away excess profits. The background to my question is that increasing numbers of institutional investors, some of which have a high profile such as Howard Marks and Mohnish Pabrai, seem to be migrating towards a quality focus.

Lawrence's view is that, even if that was the case, these investors are creating value for society at large by attempting to price these businesses based on their long-term outlook. However, he also believes that smart investors can still find opportunities in this arena by thinking about factors that are not yet fully appreciated by the market (which he describes as 'hunting for those undiscovered or underappreciated features of excellence'); examples of this would include the quality of the shareholder base and the culture of a business. 'If the cohort has arbitraged away the basic toolbox of the Quality Investing book, I would say investigate the quality of the shareholder base, the internal culture of the firm and additional tools in the kit to probe enduring outperformance'.

Is quality investing just asking a different question?

One critique I hear when it comes to quality investing is that it doesn't solve the investment puzzle; it simply gives us other questions to answer such as 'how can we identify these great businesses before the event?'. This may be especially valid if, as many investors do, you believe corporate lifespans have compressed and that disruption of technologies and business models is rife. I therefore asked Professor Cunningham about his views on this challenge.

He says that *'Quality Investing'* was about 'laying out a framework of pattern recognition basically that takes up the old idea of competitive advantage, what Warren Buffett calls a moat…and we tried to delineate a number of additional moats or features that help a company sustain its advantage'. One such example is what the authors call a 'friendly middleman' which is effectively a salesperson dressed as an expert e.g. a dentist or an optometrist. Companies that benefit from this feature would include Geberit and EssilorLuxottica (both the subject of case studies in the book). Lawrence also emphasises that the authors looked for combinations of these patterns that practically make a business 'impenetrable' (this seems somewhat analogous to Charlie Munger's idea of a 'Lollapalooza').

The 'patterns' include features such as recurring revenue, toll roads, pricing power and corporate culture. For all of these patterns there are various components (e.g. long-term thinking and family ownership in the case of corporate culture). *'Quality Investing'* provides a great toolbox of these to use when trying to identify great businesses. A checklist for identifying these businesses can include questions around whether a company has unique brands (that enable pricing power), whether a company is a dominant innovator in its industry (e.g. as measured through share of total industry R&D spend) or whether a company is a reliable gainer of market share in its industry.

Is it more difficult to identify these moats now than in the past, I asked Professor Cunningham? 'It's fine to know how thick a moat is…What's probably more important is the direction' says Professor Cunningham i.e. whether it is getting wider or narrower. This sounds similar to Buffett's emphasis to his managers on widening their moats, Mohnish Pabrai's search for businesses that are 'getting better', Tom Gayner aiming to be 'directionally right', and WCM's "moat trajectory." Effectively, quality investing according to this interpretation becomes a hunt for businesses where the combination of moats is becoming more impenetrable with time.

Why is the quality premium insufficient?

One of the principles/assumptions underlying quality investing (and expressed in the book) is that 'stocks follow earnings'. However, if there really is a way of identifying great businesses with a good strike rate one might ask why the market systematically undervalues these companies (one of the key subjects of chapter four of the book). Is it down to institutional factors like short time horizons, an excessive belief in mean reversion or accounting rules that have failed to keep up with the changing nature of many businesses?

Professor Cunningham believes all these play a part. In fact, in '*Quality Investing'* the authors state that 'The risk of overpayment is also offset by a general tendency of stock markets to under-price quality companies…Explanations for this phenomenon include market incentives skewed to the short term, a pervasive presumption of mean reversion that does not automatically apply to well-positioned companies, and an under-appreciation of earnings upside for quality companies'.

Downside protection

Is quality investing closely related to downside protection?

'Yes, I think that downside capture is a rationale for a focus of this sort' says Lawrence. He also says that given that market downturns inevitably happen from time to time, 'being prepared for it is not a bad idea'. A quality investing approach is a great way to integrate this type of thinking into your process.

Where to find quality

Our discussion touched on where to find quality businesses in terms of sectors, geographies and market caps.

'I think in theory this sort of business should appear in any sector, in any geography, in any time in history'. The reason for focusing on European companies in '*Quality Investing'* was AKO's focus on this part of the world. While the make-up of the moats might vary, great businesses can be found almost anywhere in the world. Professor Cunningham also thinks it is a viable strategy to try and find these great businesses young.

Where to find quality investors

We finished our conversation with Professor Cunningham listing a few names of quality investors that he likes to follow. In the UK, these include Baillie Gifford who are focused on quality and long-term performance, as well as Findlay Park and Fundsmith (see our review of Terry Smith's 'Investing for growth' http://www.investingbythebooks.com/book-reviews-chronologically/2021/1/14/smith-terry-investing-for-growth?rq=Terry%20smith). In the US, examples would include Berkshire Hathaway, Brandes as well as Epoch and WCM. For a further list of quality shareholders in Cunningham's network, visit his website: https://qualityshareholdersgroup.com/our-network.

IBTB would also like to mention names like Ensemble Capital, who feature in a previous interview (http://www.investingbythebooks.com/columns/2019/10/2/interview-with-arif-karim-of-ensemble-capital), Lindsell Train and Gardner Russo & Gardner. Nick Train at Lindsell Train is interesting as an example of someone who pays little (although some) attention to valuation while Tom Russo is famous for having focused on consumer goods throughout his career (although he has also added holdings in a few other industries more recently). These are all good places to look for further insights for those interested in quality investing.