Fundamentally speaking: Duration outweighs valuation

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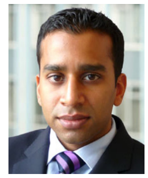
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Could it be that the most basic investment advice that you've received is misguided? "Buy low, sell high" appears a pretty obvious, surefire way to make money. But following this advice may actually lead to all sorts of judgment errors and easily forgotten transaction costs, as well as raising the question of what to do with the proceeds once you've timed the top of the market and claimed your prize.

Asking the wrong question

Most market commentary about a stock focuses on whether or not its price is cheap or expensive based on its price-to-earnings ratio (P/E)—the multiple of the current share price compared to the next year's estimated earnings per share. Commentators appear in the financial press to say a stock is "expensive" as it "trades on a high P/E".

Analysis of typical trading patterns suggests that most investors in emerging markets buy and sell stocks based on a one-year time horizon (see **Exhibit 1**).

EXHIBIT 1: HOLDING PERIOD OF MSCI EM EQUITY INDEX CONSTITUENTS

	Average market participant holding period
Itau*	7 months
Tencent	10 months
China Mobile	11 months
Naspers	13 months
Reliance Industries	14 months
Index Average	**13 months**

Source: Bloomberg. Data from 2010-2019. The securities above are shown for illustrative purposes only. Their inclusion should not be interpreted as a recommendation to buy or sell.

*Notes companies where the sum of ADR and Local shares have been used for purposes of calculation.

Such a short time horizon prioritises valuation multiples and ignores the key attraction of equities as an asset class: the opportunity they offer investors to identify assets that can compound their earnings over decades.

Focusing on near-term P/E multiples might seem a convenient shortcut to assessing valuation, but it's the wrong framework through which to assess the value of a long duration asset.

Equities, alone

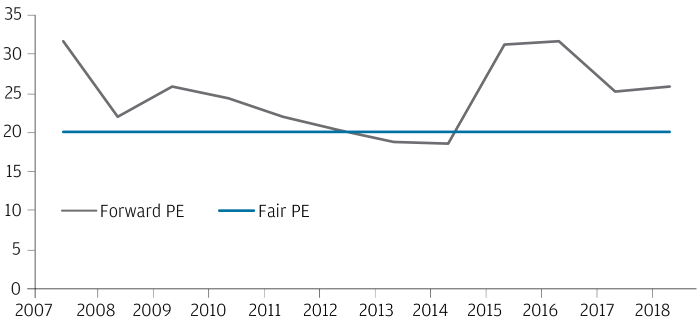
Equities, presuming they pay a dividend, are assets capable of producing cash flows in perpetuity. The fact that ownership can be forever and that coupons (dividends) can continue to grow over time make equities unique among all liquid financial instruments. It also means that it makes no sense to value equities solely on the basis of near-term earnings.

Take the example of HDFC Bank, an Indian private sector bank that we have held in our portfolios throughout the past decade. Our view has always been that a fair multiple for HDFC Bank, based on its profitability and growth outlook, would be about 20x its next 12-months' earnings.

J.P.Morgan Asset Management

No investor wants to buy a stock when it is expensive, so if our definition of cheap was that the stock had to be trading below 20x earnings, the only opportunity that we would have had to buy HDFC Bank in the last decade would have been during the 2014/15 taper tantrum (see **Exhibit 2**).

EXHIBIT 2: HDFC BANK FORWARD P/E

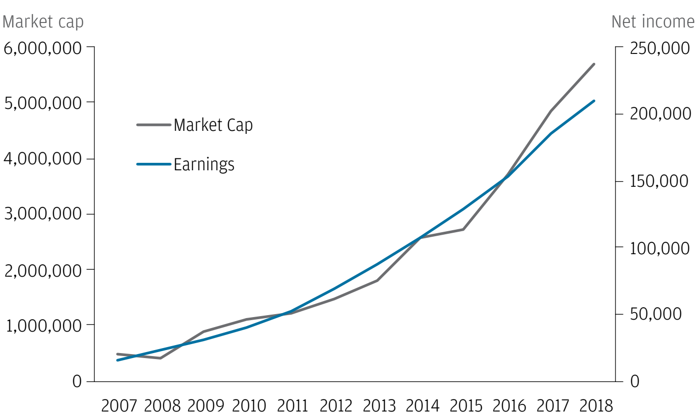


Source: Bloomberg. Data as of 2019

However, as we can see from the chart in **Exhibit 3**, deciding whether to buy HDFC Bank based on its P/E multiple may not have been the best indicator of long-term value.

The graph shows the earnings and market capitalisation of HDFC Bank over the last 10 years. Try to spot the 2013/14 wobble on this chart. It was just noise amid a steady onward progression of earnings growth. By the time the taper tantrum buying opportunity arose, the stock was already up four times from its 2007 starting point.

EXHIBIT 3: HDFC BANK MARKET CAP AND NET INCOME (MILLIONS OF INDIAN RUPEES, INR)



Source: Bloomberg. Data from 2007-2018.

On a one-year view the stock has continually looked expensive over the last decade. But valuing HDFC Bank based on its P/E multiple has consistently neglected the long-term value creation that has accrued from compound earnings growth. The longer HDFC Bank continued to grow its earnings, the more the decision to ignore the stock based on a high multiple at the start of the period looked like a bad one.

A focus on earnings

So what should a long-term equity investor be looking for?

For an investor with a time horizon of more than one year, valuation is determined not by the multiple on which a stock trades but by the earnings growth achieved by the business.

Exhibit 4 shows the drivers of total return from emerging market equities over time. In the long term, nothing but earnings and dividends matter. The compounding effect on earnings means that beyond five years the starting multiple has little impact on the return realised by the investor.

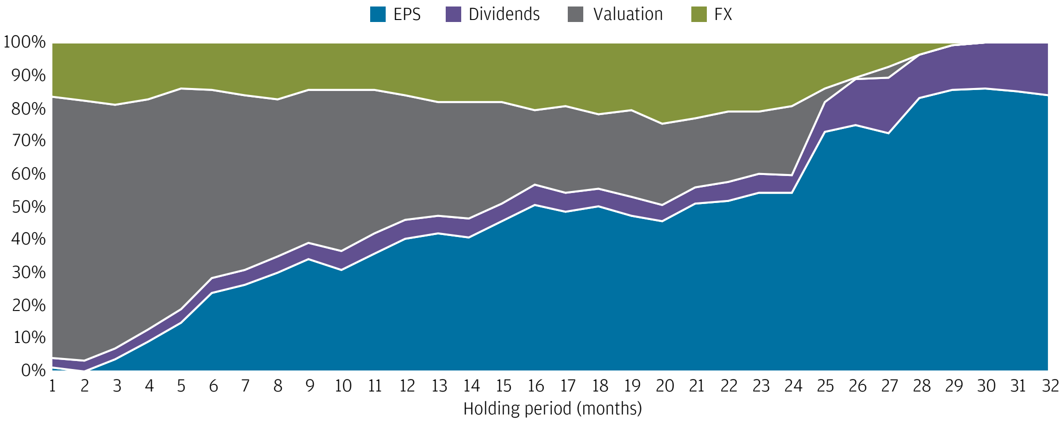
Successful long-term investing in equities requires a focus on the factors that make equities unique: infinite duration and compound dividend growth.

To have the greatest impact, investors should focus on earnings trajectory (and the confidence with which it can be predicted), and they should look for businesses with strong competitive advantages and moats, which can help to sustain earnings growth for longer periods of time. Crucially, investors should look to own these stocks for a long time, as long-term ownership ensures the unique benefits of equities are fully captured.

Successful long-term equity investing is therefore all about duration—both in terms of how long a stock can continue to grow its earnings and how long the investor can continue to hold the stock without being tempted to trade.

Because this differentiated holding period is likely to lead to differentiated investment outcomes over time, it makes sense for active investors to focus on identifying those assets where the dispersion of long-term returns are highest (see **Exhibit 5**).

EXHIBIT 4: BREAKDOWN OF EMERGING MARKET RETURNS OVER TIME

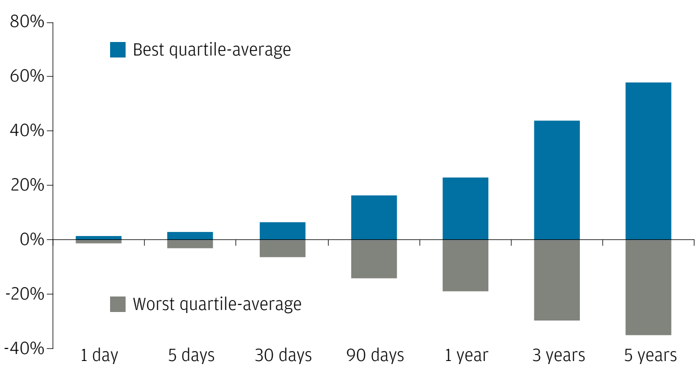


Average Return by Component Trailing 5 years

Earnings Growth	9.1%
Dividends	2.7%
Currency	-0.8%
Valuations	-1.5%
MSCI EM	10.0%

Source: J.P. Morgan Asset Management, MSCI. Chart as of March 2017 based on data from MSCI for the period between 1994 and 2017. Past performance is not necessarily a reliable indicator for current and future performance. Average return by component trailing five years, average of quarterly MSCI data from March 1998 to March 2019.

EXHIBIT 5: RETURN DISPERSION GROWS WITH TIME



Source: Bloomberg. Data from 2011-2019, MSCI Emerging Markets.

As an investment team, our long-term focus is reflected in the average length of ownership we are able to report for many of our holdings (see **Exhibit 6**). Each of these stocks have, at times, traded at multiples that could be considered above fair value, but we have stuck with them and enjoyed the far greater benefits of compound earnings growth over time.

Conclusion

Benjamin Graham, the intellectual godfather of the investment industry, said: “In the short term the market is a voting machine but in the long run it is a weighing machine”.

The true value of a business is defined not by its near-term P/E multiple but by its earnings trajectory over the long run. Many of today’s investors lack the patience to allow the true value of equities to emerge, preferring to try and game the voting machine.

Our work supports the view that long-term investors are in a strong position to take advantage of the unique compound earnings growth opportunity presented by the best equities in their investable universe.

EXHIBIT 6: HOLDING PERIODS AND EPS GROWTH FOR CORE HOLDINGS

Company	Continuously held since	JPM holding period (years)	Average market participant holding period (in months trailing 36 months average)	EPS growth over period (USD)	MSCI EM EPS Growth over JPM holding period
Wal-Mart De Mexico	1994	24	16	9%	6%
Samsung Electronics	1996	22	20	28%	5%
Housing Development Finance Corp	1998	20	27	17%	9%
Taiwan Semiconductor Manufacturing Corp*	1998	20	18	16%	8%
President Chain Store Corp	2001	17	22	11%	8%
Unilever Indonesia	2001	17	31	13%	8%
Bank Rakyat Indonesia	2003	15	24	13%	7%
Banco Itau*	2004	14	7	9%	4%
Lojas Renner	2006	12	10	15%	3%
Infosys*	2007	11	3	10%	1%
AIA Group Ltd	2010	8	26	16%	0%
Capitec	2011	7	17	12%	-1%

Source: Bloomberg, Factset, J.P. Morgan Asset Management. JPM Holding Period covers funds managed by the Focused investment team within the Emerging Markets and Asia Pacific team. Data for columns 2 and 3 based on the JPMorgan Emerging Markets Investment Trust plc. For calculation purposes, EPS growth calculated using USD-based fiscal earnings over the year the stock was purchased. All data from start of fiscal year to latest available for December 2018. The securities above are shown for illustrative purposes only. Their inclusion should not be interpreted as a recommendation to buy or sell.

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