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focus

Investing in Quality: **Doing Nothing Can Be the Hardest Trade**

Owning great businesses over the long term has historically been one of the most reliable paths to wealth creation. This sounds simple. In reality, the challenges are both analytical — identifying quality in the first place — and psychological — sticking with it over time.

FORSYTH BARR

…it's easy to lose sight of what long-term investing is fundamentally about…

We live in an era of constant noise. In the short term, markets can whip up and down, driven by an endless stream of commentary, media hype (or panic), geopolitical shocks, shifting interest-rate expectations, or a thousand other distractions.

In that environment it's easy to lose sight of what long-term investing is fundamentally about: owning a share of a real business. Patient investors are rewarded not for predicting the next media headline, but by participating in the value those businesses create through growing earnings, reinvesting in new opportunities, and paying dividends over the long term.

Mind your Ps and Es

> *"In the short run the market acts as a voting machine. But in the long run it is a weighing machine."*
>
> ***Benjamin Graham, investing legend, 'father of value investing'***
>
> Graham's point was that in the short term stock prices behave like a popularity contest, but over longer horizons the market reflects what the underlying business is actually worth.

A Price-to-Earnings (P/E) ratio is a common way investors value a stock. Put simply, it shows how much you're paying for each dollar of a company's earnings per share (EPS). If a company earns $1 per share and its stock trades at $20, its P/E multiple is 20x.

P/E multiples vary widely across companies reflecting the market's view of the quality, reliability, and future growth of earnings.

Investors typically pay higher P/Es for businesses whose earnings are viewed as more dependable or expected to grow faster. For example, a fast-growing technology company may be valued on a high P/E because the market is pricing in the profits it expects the business to generate years into the future, not just what it earns today.

Lower P/Es, on the other hand, tend to apply to businesses with slower growth, more uncertain profits, heavier debt, greater competitive pressures, or industries facing disruption or regulatory risk.

A useful way to think about a share's valuation is:

Share price = P/E x EPS.

A share price can change for two broad reasons: (i) the P/E multiple investors are willing to pay rises or falls, or (ii) the company's earnings change.

In the short term, the P/E multiple is usually the dominant driver. The price is set by the market every day. Market sentiment, interest rate changes, economic fears, political shocks, or shifting narratives can move prices sharply — sometimes even if there's little change in the underlying business. A wave of enthusiasm around a new technology can push a stock's P/E materially higher (potentially to levels that look difficult to justify on underlying fundamentals). Conversely, a sudden bout of pessimism — triggered by a recession scare or an operational hiccup — can drag the P/E sharply lower even if the long-term earnings outlook is broadly intact.

Over the long term, however, earnings do the heavy lifting. Multiples can expand or contract, but it's difficult for a company to compound shareholder value over time unless earnings grow.

That's why experienced investors focus less on where the P/E might be next month or next quarter and more on the durability and growth trajectory of earnings over years.

Sticking with Quality

Core to our investment philosophy is owning high-quality companies — businesses with durable competitive advantages, attractive reinvestment opportunities, strong balance sheets, and capable management — which, over time, are positioned to grow earnings and/or deliver reliable income through dividends.

One reason 'quality' can matter is adaptability. Well-resourced companies with talented and aligned management teams often have more scope to respond when the world changes, whether that's an economic shock, a new technology, shifting regulation, or evolving consumer preferences. They can keep investing, pivot product development, or make disciplined acquisitions while weaker competitors are forced to retrench. Success is not guaranteed — even great businesses can be disrupted, but the odds of navigating change tend to be higher when a business starts from a position of strength.

Owning quality businesses, however, does not mean investors get a smooth ride. Even the best businesses experience sharp share price declines. There are many potential sources of short-term volatility: a company falling short of expected near-term earnings, a change in management, heightened regulatory risks, concern around a new competitor or technology, a broad market sell-off driven by economic fears, or a rotation out of one sector into another. None of these necessarily impair the long-term earnings trajectory of a high-quality company, yet all of them can drive share prices lower in the short term.

The key for investors is to have the discipline to look through the short-term noise, distinguish a temporary concern from a permanent deterioration, and remain focused on the long-term.

Case Studies in Patience

> *"The stock market is a device for transferring money from the impatient to the patient."*
>
> ***Warren Buffett, 'The Oracle of Omaha'***

History provides no shortage of examples where investors who stayed calm and held through material pullbacks benefited over the long term. Below we highlight several companies where the fortitude to hold or buy during turbulence delivered excellent returns over the long term.

Visa

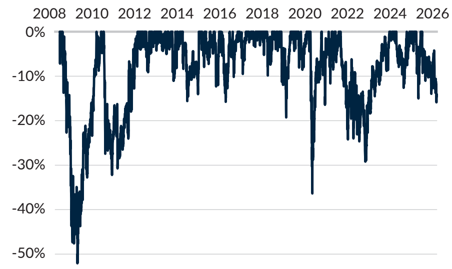
Visa operates one of the world's great capital-light businesses, collecting a small toll on the world's electronic payments. Yet Visa has still presented patient investors with moments of doubt.

Visa listed on the market in 2008. Soon after, the Global Financial Crisis hit, and the stock crashed by more than -50%. It had fully recovered by late 2009 only to fall by more than -30% in 2010 when US regulators capped fees on debit cards. When COVID hit and the global economy shut down the stock fell -36% in a matter of weeks. It fully recovered before falling again, down -29% in the 2022 bear market.

Regulatory threats around interchange fees periodically resurface as a concern; all up the stock has been down more than -10% off its peak 14 times since listing. Despite these bouts of volatility, Visa, leveraged to the secular shift from cash to digital payments, has delivered compounding returns of 20% per annum. Investors who bought Visa after it first listed and held to today have seen their investment increase 26-fold.

VISA SHARE PRICE DRAWDOWNS

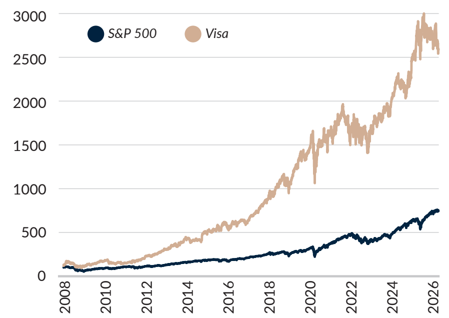
VS. PREVIOUS HIGH



Source: Datastream, Forsyth Barr analysis

TOTAL SHAREHOLDER RETURN:

VISA VS. S&P500



Source: Datastream, Forsyth Barr analysis

...Google controls some of the most valuable digital real estate on the internet...

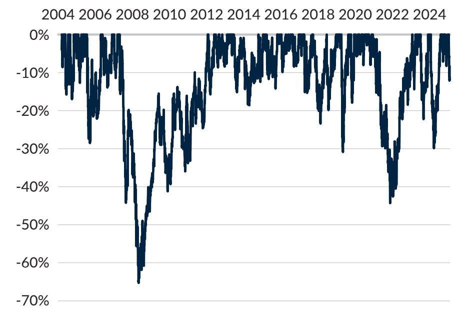
Alphabet (Google)

Alphabet's search engine Google controls some of the most valuable digital real estate on the internet. However, despite that dominant position and the secular tailwind of continued internet growth, Alphabet's share price has not been immune from large drawdowns along the way. Since listing, the stock has fallen -10% or more on 20 occasions, including seven by more than -20%.

Alphabet (then named Google) listed on the market in 2004. In 2006 it missed earnings expectations, and the stock was punished -29%. During the GFC it fell -65%. The recovery was bumpy, with periodic bouts of volatility due to European regulators questioning the company's dominance in search and levying multi-billion-dollar antitrust fines; the stock didn't recover back to its 2007 levels until 2012. During COVID the stock fell -31%. It fully recovered as digital advertising surged, only to fall -44% when the 2022 bear market coincided with the launch of ChatGPT and concerns around the potential AI disruption of the core Google search business.

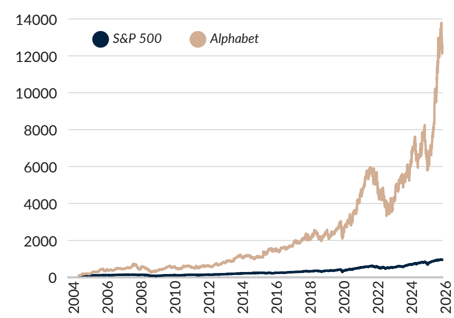
Concerns around its monopoly in search, data privacy regulation, and potential AI disruption have all periodically weighed on Alphabet's share price, but the secular shift of the world's advertising budgets from print and television to digital has helped Alphabet deliver compounding returns of roughly 25% per annum. Investors who bought Google on its first day of listing and held to today have seen their investment grow by approximately 125 times.

ALPHABET SHARE PRICE DRAWDOWNS VS. PREVIOUS HIGH



Source: Datastream, Forsyth Barr analysis

TOTAL SHAREHOLDER RETURN: ALPHABET VS. S&P500



Source: Datastream, Forsyth Barr analysis

…Mainfreight is one of New Zealand's great business success stories…

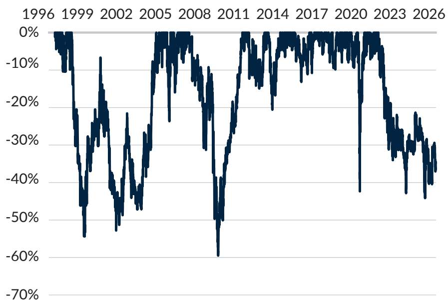
Mainfreight

Mainfreight is one of New Zealand's great business success stories — a freight and logistics company that has grown from its Auckland roots into a global operator with a passionate culture and a track record of outperforming peers across economic cycles.

The company, however, has not been immune to challenges. After listing in 1996, the early years were challenging; in 1998 the stock dropped -54% of its high. Earnings were hit by the Asian Financial Crisis, and a major Australian acquisition in 2000 initially fell well short of expectations. In the US, the CaroTrans business which Mainfreight acquired in 2001 saw activity drop sharply in the aftermath of 9/11. Later that decade, the stock was down -60% during the GFC.

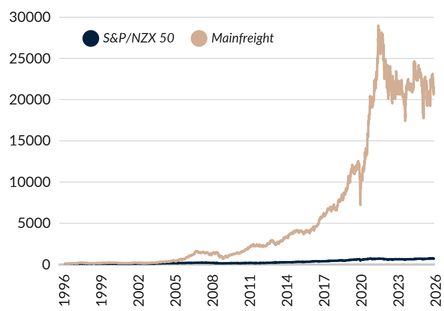
More recently, Mainfreight's stock price fell -42% during COVID, and today it sits -37% below its 2021 level. Pullbacks have been significant, and share price performance in recent years hasn't been stellar. However, those who've bought into the Mainfreight story — a decentralised structure, empowered staff, a focus on long-run returns on equity — have benefited as the company has compounded earnings and dividends at an impressive rate. Investors who bought Mainfreight on its first day of listing, reinvested the dividends, and held to today have earned a return of 20% per annum and seen their investment grow approximately 214 times.

MAINFREIGHT SHARE PRICE DRAWDOWNS VS. PREVIOUS HIGH



Source: Datastream, Forsyth Barr analysis

TOTAL SHAREHOLDER RETURN: MAINFREIGHT VS. S&P/NZX50



Source: Datastream, Forsyth Barr analysis

...consistently owning the highest quality companies...gives a portfolio the best chance to benefit...

The Hardest Part is Often Doing Nothing

In investing, when share prices are bouncing around, the most valuable thing you can do is often the hardest — sit still while your portfolio falls, resist the urge to act, trust the work that's been done.

Markets will always give you reasons to sell: an earnings miss, a macro scare, a regulatory risk, or a new competitive threat. The media will latch on and amplify each one, often intensifying the urge to act.

Sometimes those signals do warrant a reassessment, not because their price has fallen, but because the fundamentals of the business have changed.

The discipline lies in doing the work to tell the difference between a company whose long-term earnings outlook is genuinely impaired and an exceptional business which is temporarily mispriced by the market. No investor will get this right every time, however, in our opinion, consistently owning the highest-quality companies over the long term gives a portfolio the best chance to benefit from the compounding of earnings, dividends, and shareholder value.

If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

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