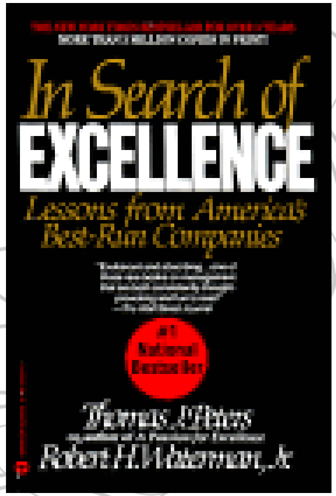
In Search of Excellence: The Investor's Viewpoint, Excellence Revisited

1987 and 1994, Michelle Clayman, Financial Analysts Journal



Tom Peters and Robert Waterman wrote the best seller, <u>In Search of Excellence: Lessons from America's Best-Run Corporations</u> in 1982. They identified 43 companies that were a blueprint for corporate excellence. Michelle Clayman, in a now similarly famous investment paper, studied the five year performance of stock portfolios made from these, and opposite "unexcellent" companies. The portfolio of excellent companies largely tracked the S&P500 market index, while the unexcellent companies outperformed by 12% pa. Clayman neatly illustrated the "value" phenomena – that is, good companies don't always make good investments. A diverse portfolio of out of favour, undervalued companies may be a better investment.

In her follow-up paper written five years later, <u>Excellence Revisited</u>, she again found good company performance tended to revert to the mean. However, she also showed the "value effect" can at times be absent. A long term perspective and diversification using different styles is critical.

Excellent companies …

Peters and Waterman identified 36 publicly traded "excellent companies" on the basis of out performance in six criteria, measured from 1961 to 1980

1. **Asset growth**
2. **Equity growth**
3. **Return on total capital**
4. **Return on equity**
5. **Return on sales**
6. **Market to book value**

Clayman formed an investment portfolio from the 29 of those companies that were still in existence after five years and for which accounting and financial data were available.

Excellent Companies	
Amoco	IBM
Avon Products	Intel
Boeing	Johnson & Johnson
Bristol Myers	Maytag
Caterpillar Tractor	McDonalds
Dana Corporation	3M
Data General	Merck
Delta Airlines	National Semiconductor
Dow Chemical	Procter & Gamble
DuPont	Raychem
Disney	Schlumberger
Eastman Kodak	Texas Instruments
Fluor	Walmart
K-Mart	Wang Labs
Hewlett Packard	

Common features of these companies were: bias for action, close relationships with customers, autonomy and entrepreneurship, productivity through people, hands on and value driven, stick to knitting, simple form, lean staff and "loose tight" properties

Unexcellent companies …

Clayman identified 39 publicly traded "unexcellent companies" which ranked in the bottom third of all of Peters and Waterman's criteria from 1976 to 1980

- From a starting list of 480 companies in the S&P index

These "in search of disaster" companies includes several steel, tire and textile firms. This list also includes companies that became well-known disasters

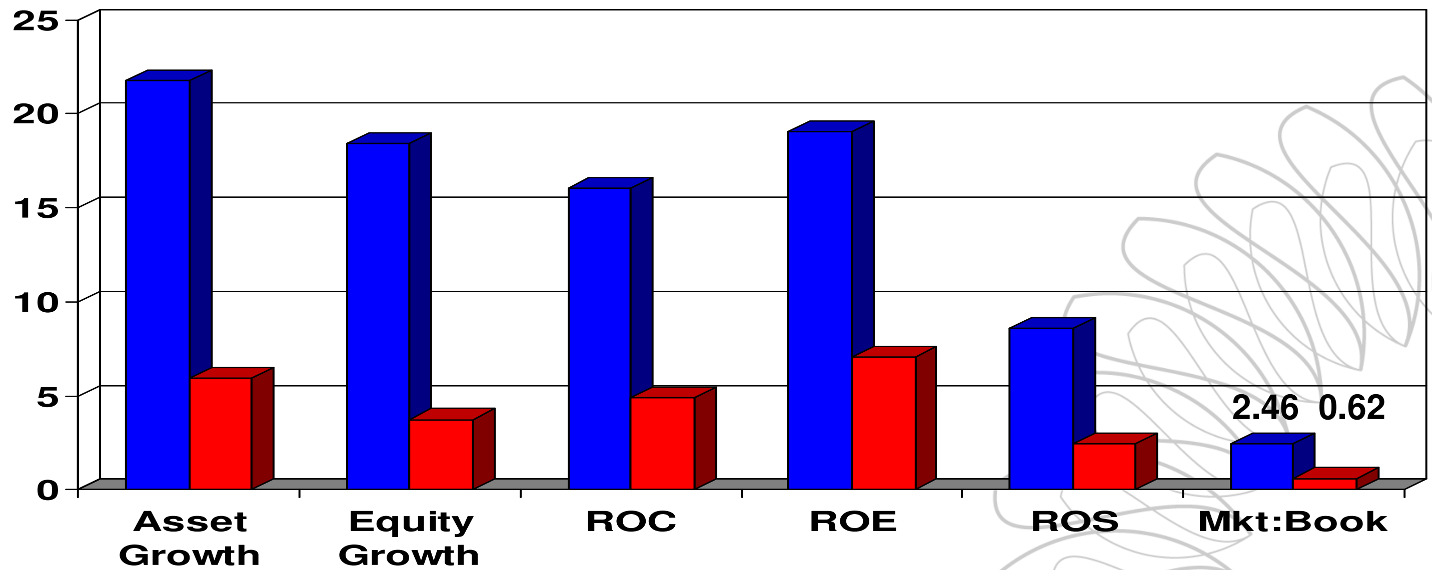
- eg. American Motors later bought by Chrysler

Un-excellent Companies	
American Motors	First Penna Corp
Macmillan Inc	Great Atlantic & PacificTea
Massey Ferguson	Firestone Tire & Rubber
Bethlehem Steel	Sherwin-Williams
Mohasco Corp	Singer
Interlake	Bemis
Hartmarx	Outboard Marine
Westinghouse Elec	West Point-Pepperell
Burlington Industries	Chicago Pneumatic Tool
U.S. Steel	B.F. Goodrich
J.P. Stevens	F.W. Woolworth
Hasbro	Goodyear Tire & Rubber
Associate Dry Goods	National Intergroup
Spring Industries	American Can
Brunswick	Allis-Chalmers
ITT	Federal Paper Board
Celanese	Kaufman & Broad
Owens-Illinois	Armco
FMC Corp	Williams
Pacific Lighting	

Key ratios of excellent and un-excellent companies

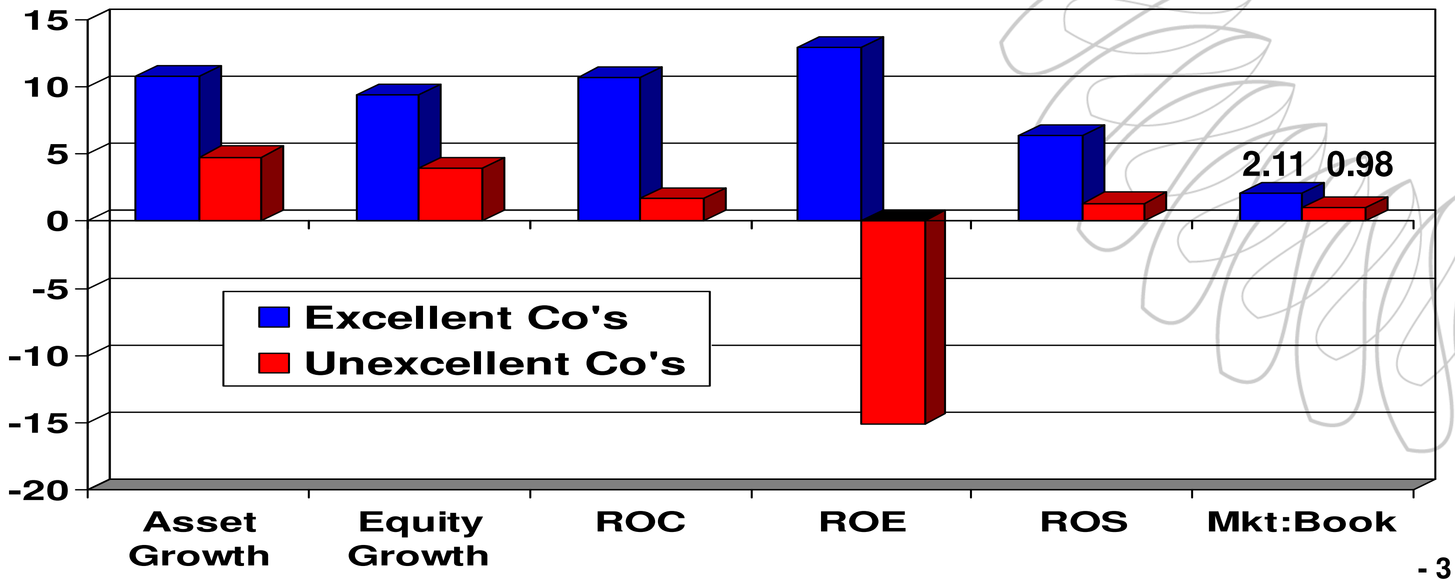
1976 - 1980

- Period used to select companies
- Excellent companies performed better



1981 - 1985

- Following period over which investment performance observed
- Greater reversion to mean for excellent companies
- Note changes in market:book ratio



Investment returns from the portfolio of <u>un</u>excellent companies outperformed those made up of excellent companies

Factor	Excellent	<u>Un</u>excellent
Investment Return (% pa over 5 yrs)	12.7%	24.4%
Standard Deviation (% pa)	17.7%	18.1%
Relative Return (% pa to S&P500)	+ 1.1%	+12.4 %
% of companies that outperformed index	38%	64%
Beta (market return component)	1.18	1.17
Alpha (non-market return) (%/month)	0.2%	1.0%

Explaining stock performance differences

"The good companies under-perform because the market overestimates their future growth and future return on equity and, as a result, accords the stocks overvalued price-to-book ratios [Market:Book here]; the converse is true of the poor companies"

"Over time, company results have a tendency to regress to the mean as underlying economic forces attract new entrants to attractive markets and encourage participants to leave low-return businesses. Because of this tendency, companies that have been good performers in the past may prove to be inferior investments, while poor companies frequently provide superior investment returns in the future"

A recent 2004 UK study reproduced this excellent company reversionary effect for a portfolio made up of *Britain's Most Admired Companies. The value effect was well described by professors Eugene Fama and Kenneth French in 1992**. Warren Buffet is considered a value investor. At Professional Wealth we employ a specialist institutional manager to provide our clients a low cost, low turnover exposure to value companies.**

*Agarwal, Brown, Taffler, Are Well Managed Companies Good Investments?, 2004 [using database covering top 250 UK companies]
**Fama, French, The cross section of expected stock returns, Journal of Finance, 1992

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