

Growth at a Reasonable Price: A Forgotten Asset Class?

The Case for GARP Investing: Summary & Key Points

- As documented extensively in our research, many “[growth stocks](#)” have soared due to a misplaced focus on the growth rate of **revenues** without any focus on earnings
- The myopic focus on sales growth left an entire asset class of stocks with high **earnings growth** at reasonable valuations behind, and these stocks look uncommonly appealing today, in our view
- After two years of struggling, recent results from our GARP stock screener and its associated model portfolio have been stunning, and we believe it may continue to offer terrific risk and return trade-offs
- Recent outsized GARP results should persist when compared to core indexes, in our view
- Our GARP investment strategy reconciles the debate around the merits of growth and value investing by offering investors the best of both worlds in one concentrated portfolio of stocks

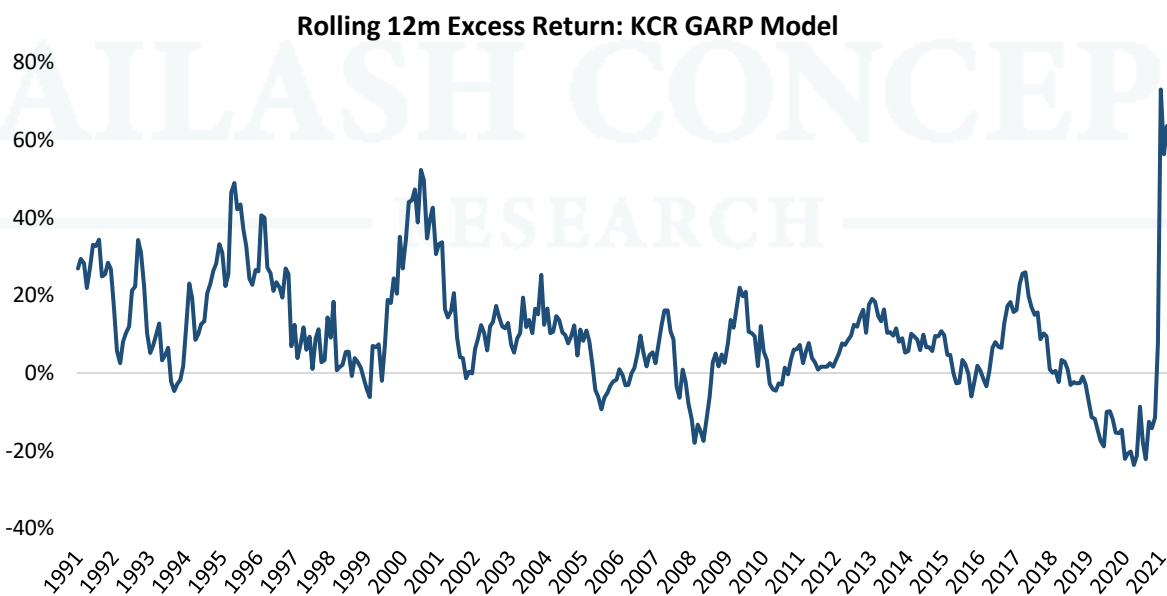
The chart below shows the rolling 12-month excess returns of our GARP Model vs. its benchmark. As one of the first products built by the team, it has been in live production since 2011. We explained the methodology that underpins the model in our piece [The Siren Song of Growth - Why Investors Willfully Set Sail for the Rocks](#).

In that piece we explained how to improve security selection among stocks with earnings growth rates well above the market. The model portfolios built by the associated ranking tool are highly concentrated.

Since its inception, the product has put up significant excess returns. For almost seven straight years, the model offered GARP investors a reliable source of alpha. That came to a screeching halt when the growth bubble took off in 2017. From April of 2017 - February of 2020, the model took a ruthless beating as investors crowded into [high-priced, low-quality companies](#) that often featured [abysmal fundamentals](#).

You can see that recent results have been stunning. The rest of this paper explains why we believe this is only the beginning of what will be a long run for fundamentally sound growth stocks.

Fig. 1: After a Difficult Couple of Years, Investors Have Rediscovered Growth at a Reasonable Price



Source: Kailash Capital, LLC; Data from 4/30/1989 – 12/31/2021

Asset Allocation: “Did I Miss the Rotation to High Quality?”

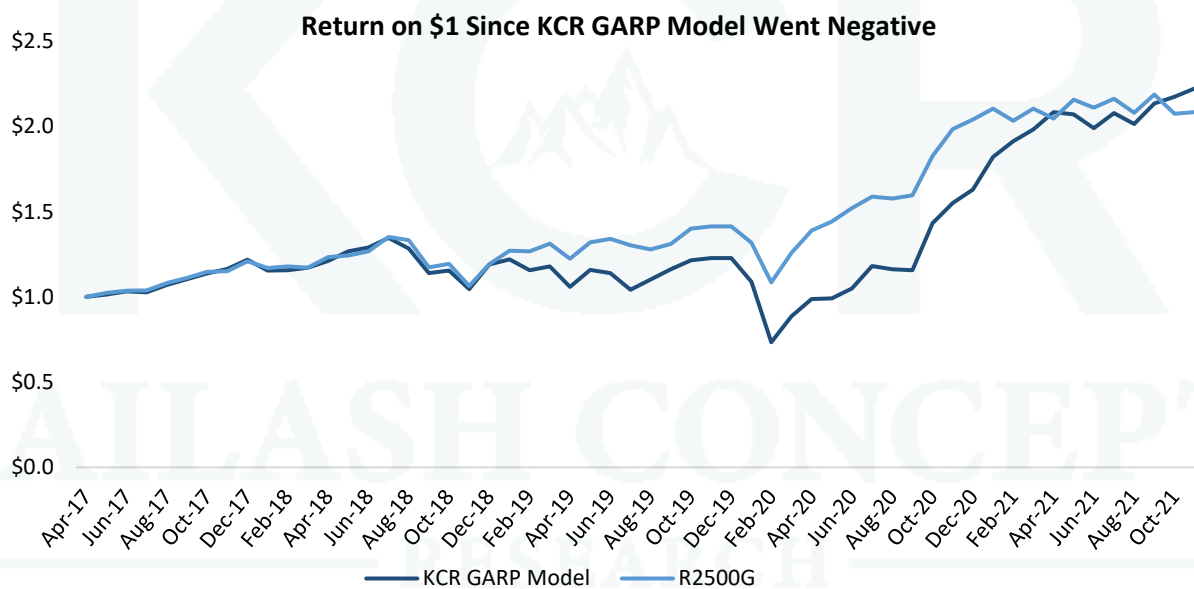
KCR gets this question a lot. Speculative [glamour stocks](#) have taken a fearsome beating. Many investors with gray hairs are scarred by the post-2017 period. Characterized by negative nominal and real rates, accelerating [monetary debauchery](#) by central banks, and [furious trading](#) of speculative shares, it is easy to think that the most minor shift towards a semblance of normalcy is “the end.”

The KCR team will write about this in more detail shortly, but Fig. 2 below should help provide some perspective. In the first chart we showed that from April 2017 to February 2020, our GARP model fell behind before racing 60% ahead of the index in the last 12 months. That 60% outperformance is the type of number that gets people, including ourselves, to think “we missed it.”

The chart below shows the returns of our GARP model through today. All that 60% excess return in the above chart did was get the model back to breakeven!! The KCR research team is highly confident that this model will resume its long-term tendency to generate excess returns.

While nobody can predict the future (much less the Fed!) we believe this is simple but powerful evidence that the trend towards favoring mispriced growth has just begun.

Fig. 2: Since April 2017, KCRs GARP Model is In-line with the R2500G Despite Recent Outperformance



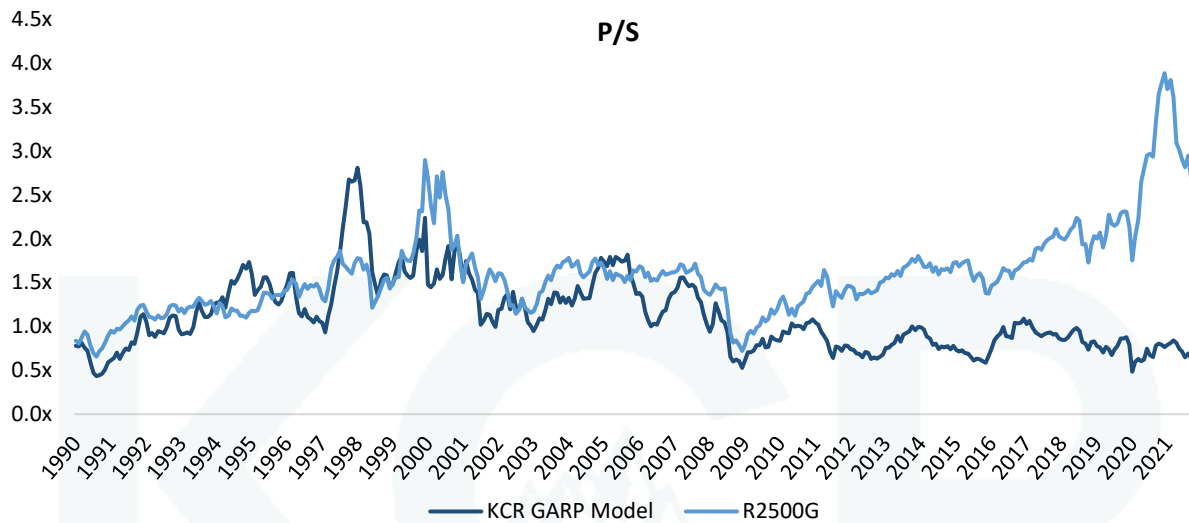
Source: Kailash Capital, LLC; Data from 4/30/1989 – 12/31/2021

GARP Research and Security Selection: The Case for Engaging in a GARP Strategy

Figure 3 below shows the price to sales (P/S) ratio of the Russell 2500 Growth Index and our GARP portfolio. Not only does it speak for itself, but it also speaks to the idea that nobody has missed anything. Our portfolio has almost NEVER been cheaper than today, and the index valuation is STILL in line with the dot.com peak.

In fact, it has probably NEVER been a better time to be a GARP investor, in our view.

Fig. 3: KCR’s GARP Model is at Record Cheapness While the R2500G is Coming Off Record Highs

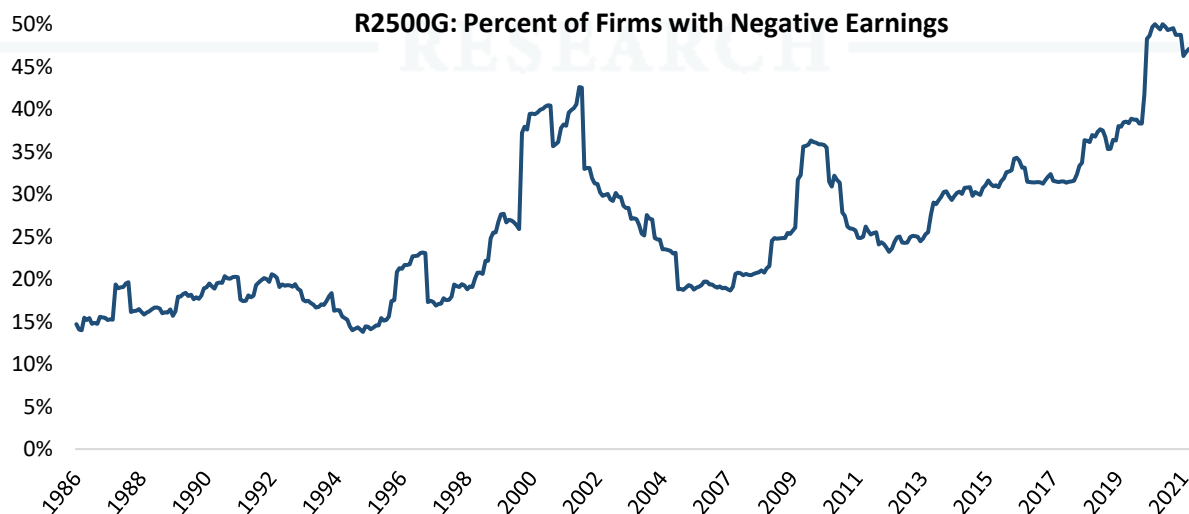


Source: Kailash Capital, LLC; Data from 4/30/1989 – 12/31/2021

Let’s Define Security Selection: The Case for GARP-in-a-Chart

Figure 4 is a chart we built for a long-time client.¹ This speaks to the disaster of not just speculation but also indexing. Remember, growth at a reasonable price stocks have the novel feature of **earning money**. In today’s market, **half the growth index fails this simple metric**.

Fig. 4: Half of All Stocks in the R2500G Lose Money



Source: Kailash Capital, LLC; Data from 3/31/1986 – 12/31/2021

¹ Hat tip to Paul G - thank you!!

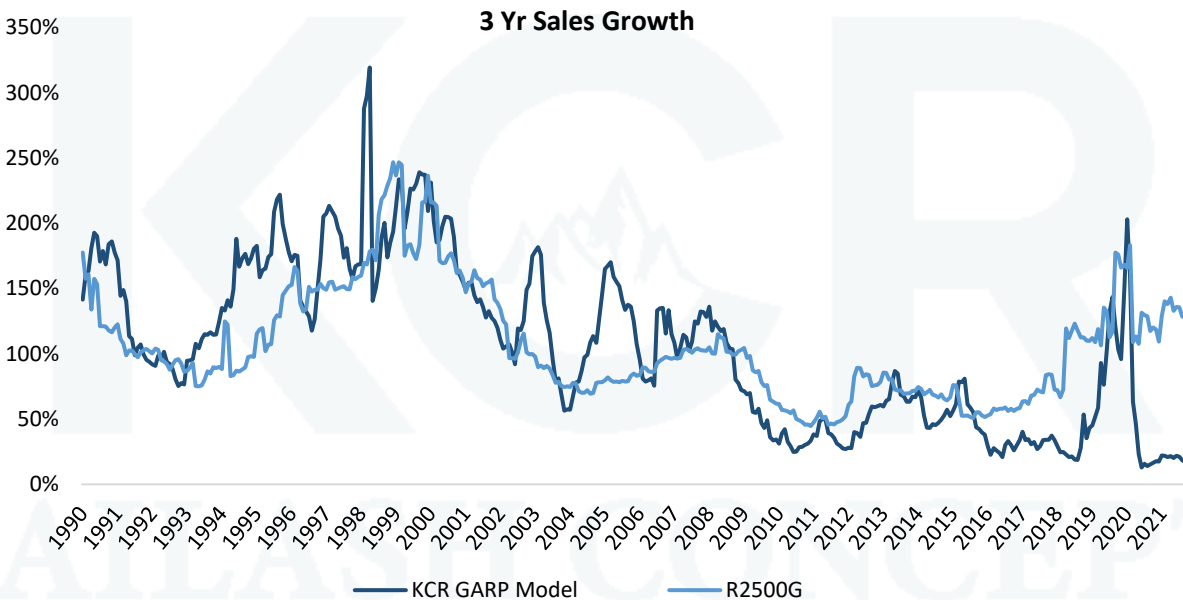
How to Price GARP Stocks in a World Without Reason

In our initiation piece on GARP investing back in 2012, we explained in detail that simple PEG ratios do not work. Having seen in Fig. 4 above that nearly half the stocks in the index lose money, we are here to suggest that **any** method of earnings-based metric may beat the index over the next few years.

As always, we want to be transparent about what the trade-offs of our Model are vs. the Index. Figure 5 below shows the trailing 3-year sales growth of the R2500G and our GARP portfolio. You can see that the index's top-line has doubled over the last three years while our portfolio companies have only grown sales ~20%.

So, if you want stocks with earnings and a positive return on equity - both mandatory features of our model - you will forfeit some top-line growth. KCR does not hesitate in this regard: we would always prefer stocks with slower-growing profits than firms that lose money to grow top-line faster. **As we have explained in our piece [panning Carvana](#)², not everyone can be the next Amazon.**

Fig. 5: KCR's GARP Model Has More Modest Revenue Growth than the R2500G Index



Source: Kailash Capital, LLC; Data from 4/30/1989 – 12/31/2021

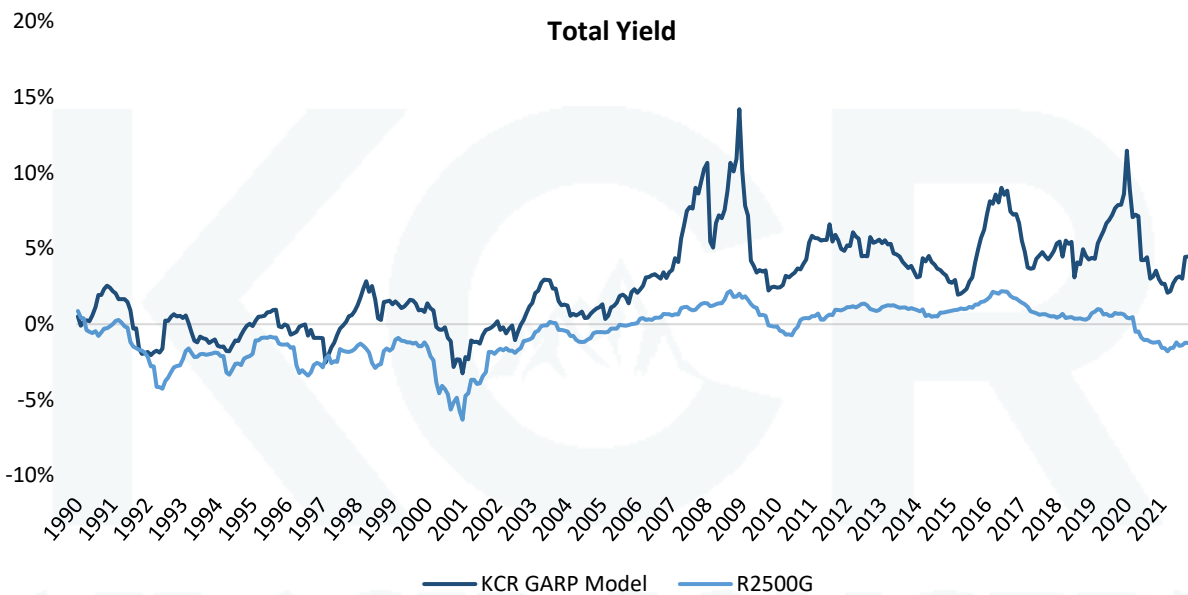
² NOTE: that was a brutal ride as the stock rose 80% post publication.... but we would note that as we have attested since our founding in 2010, economic gravity ALWAYS returns and Carvana is now down -30% absolute since publication and lagging the Russell 1000 and Russell 2500 Growth Indexes by nearly 65%.

GARP Investing with Income = WINNING

When approaching growth investing, KCR does **not** place any explicit loading on dividends or income. To the degree the stocks in our portfolio offer these features, we view that as a “kicker.” In our research making a case for [Staples](#) and [high-quality dividend stocks](#) we offered readers possible solutions to the yield famine so eloquently explained by *Grant’s Interest Rate Observer* in their piece “[Prescient Jay Powell](#).”

Looking at Fig. 6 below, we are happy to report that our portfolio of mispriced growth stocks offers investors total yields **higher** than junk bonds. In our piece on [Debt to EBITDA ratios](#), we marveled at the reckless lending in High Yield. **KCR believes that long-term investors will be better served owning a high-quality portfolio of stocks that pays you to own them as they compound their earnings rather than a collection of covenant-lite bonds backed by weak borrowers.**

Fig. 6: KCR GARP Model Delivers Nearly 5% Total Yield vs. Dilution from the Index



Source: Kailash Capital, LLC; Data from 4/30/1989 – 12/31/2021

Before we move to the final page, KCR would like to make sure our readers notice that people buying R2500 Growth Index funds are getting screwed paying low management fees for that index fund but are inadvertently being charged 1.3% to subsidize the stocks in it. Dilution is a real expense to investors.

Conclusion: Fundamental Facts

The table below compares the fundamentals of the KCR GARP portfolio to the R2500G. Here are the facts:

- KCR GARP: large FCFs at low valuations with healthy Total Yields and sustainable growth rates
- The R2500G demands investors pay extraordinary prices to own companies which dilute them by being net issuers of equity (Total Yield, -1.3%) in return for wholly unsustainable sales growth
- **No matter if you ascribe to the KCR process or another one, the index metrics indicate it has rarely been a better time to be a GARP investor than today**

Fig. 7: Fundamentals – KCR GARP Portfolio vs. R2500G

	FCF/EV	P/S	EV/Sales	P/E	Fwd P/E	P/B	ROE	EBITDA Margins	Total Yield	ROA	3 Yr Sales Growth
KCR GARP Portfolio	7.2%	0.6x	1.0x	11.2x	8.7x	2.0x	21.4%	18.9%	4.5%	6.6%	17.3%
R2500G	1.3%	2.7x	3.3x	127.1x	40.2x	6.3x	6.4%	-145.5%	-1.3%	1.0%	111.7%

Source: Kailash Capital, LLC; Data from 12/31/2021

Please see below for the KCR GARP Model constituents.

Exhibit 1: GARP Model Portfolio – January 2022, Current Picks in Bold

Portfolio Weight	Ticker	Company Name	Market Cap (\$m)	Portfolio Weight	Ticker	Company Name	Market Cap (\$m)
8.1%	TPH	TRI POINTE HOMES INC	3,134	1.8%	VOYA	VOYA FINANCIAL INC	7,455
7.6%	AXL	AMERICAN AXLE & MFG HOLDINGS	1,065	1.7%	CC	CHEMOURS CO	5,492
6.3%	TOL	TOLL BROTHERS INC	8,695	1.7%	CCS	CENTURY COMMUNITIES INC	2,761
5.8%	SIG	SIGNET JEWELERS LTD	4,578	1.7%	RL	RALPH LAUREN CORP	8,760
5.3%	CAR	AVIS BUDGET GROUP INC	12,048	1.6%	IFS	INTERCORP FINANCIAL SVCS INC	3,045
5.1%	ARCB	ARCBEST CORP	3,064	1.5%	BBBY	BED BATH & BEYOND INC	1,473
3.7%	MTH	MERITAGE HOMES CORP	4,584	1.5%	STNG	SCORPIO TANKERS INC	748
3.7%	TMHC	TAYLOR MORRISON HOME CORP	4,296	1.5%	FL	FOOT LOCKER INC	4,410
3.3%	TDC	TERADATA CORP	4,604	1.3%	MTOR	MERITOR INC	1,737
3.2%	OC	OWENS CORNING	9,195	1.3%	MAN	MANPOWERGROUP	5,279
3.1%	JELD	JELD-WEN HOLDING INC	2,415	1.1%	FLWS	1-800-FLOWERS.COM	1,522
3.1%	FBP	FIRST BANCORP P R	2,846	0.9%	HEES	H&E EQUIPMENT SERVICES INC	1,600
2.9%	HOG	HARLEY-DAVIDSON INC	5,800	0.9%	GTN	GRAY TELEVISION INC	1,932
2.6%	IGT	INTL GAME TECHNOLOGY PLC	5,932	0.9%	RLGY	REALOGY HOLDINGS CORP	1,960
2.4%	CTRN	CITI TRENDS INC	814	0.7%	CRI	CARTER'S INC	4,347
2.3%	CNR	CORNERSTONE BULDNG BRNDS INC	2,201	0.7%	TEX	TEREX CORP	3,041
2.3%	ATEN	A10 NETWORKS INC	1,285	0.7%	ENR	ENERGIZER HOLDINGS INC	2,681
2.2%	Y	ALLEGHANY CORP	9,179	0.7%	SSP	EW SCRIPPS -CL A	1,597
1.8%	SBH	SALLY BEAUTY HOLDINGS INC	2,084	0.7%	WWE	WORLD WRESTLING ENTMT INC	3,741
1.8%	PPC	PILGRIM'S PRIDE CORP	6,872	0.6%	COMM	COMMSCOPE HOLDING CO INC	2,255

Source: Kailash Capital, LLC; Data from 12/31/2021

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