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The Haverford Trust Company

Joseph J. McLaughlin Jr., Chairman, Chief Executive Officer; Binney H.C. Wietlisbach, President; Henry B. Smith, Chief Investment Officer, Director; John H. Donaldson, CFA®, Vice President, Director of Fixed Income; Timothy A. Hoyle, CFA®, Vice President, Director of Research

“The Tortoise and the Hare’: Why does *Quality* work for long- term investors?”

By The Haverford Trust Company

Many people claim to be long-term investors and extol the virtues of compound interest and the extraordinary results it can produce given enough time.

At the same time, many investors are also keenly focused on the rate at which value is likely to compound over the next few years, while paying less attention to the length of time this growth is likely to persist. This is where *Quality* comes in. At Haverford, our hallmark, *Quality Investing*, focuses on “A”-rated equities that have delivered consistent earnings and dividend growth. We believe *Quality* is what gives a business the long runway to produce more desirable results for shareholders, given even a modest rate of compounding.

In our view, this lack of focus on the long term is what leads to the chronic undervaluation of high-quality companies and the opportunity for outperformance in their stocks. Think about the construction of most discounted cash flow (DCF) valuation models. Cash

flows are explicitly forecast with varying degrees of confidence over the next five to ten years. Thereafter, a “terminal” rate of growth is applied as an end cap. Typically, for the sake of conservatism, a terminal growth rate of 1 percent to 3 percent is applied. For most companies, this is an appropriately conservative approach, given the inherent difficulties of predicting the future.

But not all companies’ futures are equally difficult to predict. For a select group of companies with unique positioning in favorable industries, it is not unreasonable to forecast prosperity long past the traditional five- to ten-year window of the DCF model.

The impact of extended longevity can be profound.

For example, assume we are evaluating a company with \$100 in profits. What’s it worth? We would start by forecasting the cash flows, then discount them back to the present. Let’s assume we expect the cash flows to grow

6 percent annually for the next five years, then taper off to 2 percent thereafter. Given these assumptions, our company is worth \$1,507 with a 10 percent discount rate, or about 15x earnings.

But what if we expect our company’s excess profit growth to persist longer than five years? Instead of five years, if we forecast cash flows to grow 6 percent for the next 20 years, before tapering off to 2 percent, we calculate an intrinsic value of \$1,995, or approximately 20x earnings.

This result is not surprising, but what is more telling is the value of longevity over a rapid but brief growth rate. For example, our 20-year 6 percent grower is equivalent in value to a 20 percent grower that is only able to maintain that rate for three years. Considering the short time horizon of the investment community at large, it is not difficult to see why, given these two equivalent propositions, the tortoise tends to be undervalued relative to the hare. 🐢

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Seated, left to right:
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About The Haverford Trust Company

The Haverford Trust Company provides highly personalized investment management services based on our *Quality Investing* approach. Refined over three decades, Haverford's *Quality Investing* strategy is committed to maximizing returns while minimizing risk throughout the entire market cycle. Adhering to this consistent, successful investment philosophy since our inception in 1979, Haverford has enabled our client base and assets under management to continually grow. Today, assets under management or consultation exceed \$7.4 billion.* We take pride in the fact that we are privately owned and believe that independence gives us the flexibility to better serve our many clients, whether individual or institutional.

Assets Under Management
\$7.4 billion*

Minimum Fee for Initial Meeting
None required

Minimum Investable Assets
\$1 million

Largest Client Net Worth
\$250 million (firm)

Number of Team Members
75

Compensation Method **Asset-based fees**

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The Haverford Trust Company

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*Assets under management or consultation as of December 31, 2013.

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