The London Company

Does a Strong Balance Sheet Provide Downside Protection?

An analysis of the risk-mitigating effects of balance sheet strength in various down-markets scenarios.

Balance Sheet Strength & Downside Protection

Setting the Stage

At The London Company, our goal is to outperform the broader market with less volatility over full market cycles. Our investment process is designed to limit the downside in each holding and we recognize that losing less in down markets is one way to outperform over time.

While every step of our investment process is intended to mitigate risk, we believe a strong balance sheet is a key element of downside protection for a company, especially during troubled times. Companies with greater financial flexibility can weather an economic downturn and invest in the business for future growth. Key to balance sheet flexibility is maintaining a relatively low debt level while generating consistent cash flow. We recognize that a conservative amount of debt can be advantageous while too much debt can be problematic.

Our Test Composite

With that in mind, we decided to review how shares of companies with strong balance sheets have performed during downdrafts in the broader stock market. Market downturns often tie in with economic recessions, but there are more frequent material market declines than recessions. Various events can spook the market including actions from central banks, commodity spikes, geopolitical events, terrorist attacks, as well as a slowdown in any number of economic variables.

Using data from Investment Metrics, we reviewed stock price data beginning in 1990 to 2021. We reviewed monthly data and examined any period where stocks declined 20% or more over at least a three month period. The goal was to see how companies with strong balance sheets performed in those periods.

Our universe was the top 3000 stocks based on market capitalization. It is similar to the Russell 3000 Index, but not exactly the same.

To test balance sheet strength, we focused on three key metrics:

- The **current ratio** (current assets/current liabilities) is a measure of short term liquidity.
- The **interest coverage ratio** (EBIT/interest expense) is a measure of financial strength and how much flexibility a company has to cover its debt service costs.
- The **debt/equity ratio** (debt/equity using book value of equity) is another measure of financial strength. Keep in mind, this uses book value of equity, which can penalize companies that repurchase shares over time. The accounting rules require a company to reduce equity for any share repurchase. This is different from how we view debt/capital as part of our balance sheet optimization process, but that is a separate topic for another day.

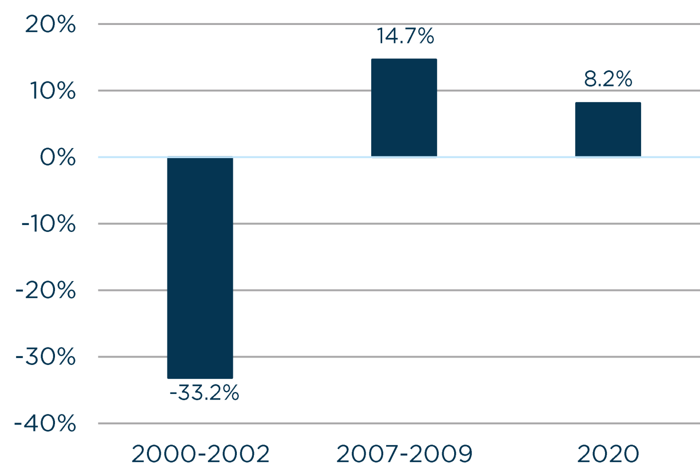
To test each balance sheet variable, we looked at how the top 25% of stocks in each bucket traded. For current ratio and interest coverage, we looked at the companies with the highest scores (showing strength), while we looked at the lowest 25% for debt/equity (less debt).

We reviewed the results of the three metrics and also created a composite equally weighted across the three metrics. Each company received a score for each metric and then a combined score. The companies with a combined score in the top quartile make up the composite.

Going back to 1990, there were three periods when the market declined at least 20% over three months or more. In the three periods under review, the test composite of three factors outperformed in two of the downturns, providing solid evidence that balance sheet strength matters in a downturn.

Here is a review of the relative performance of the composite vs. the sample universe in each of the three periods. The chart shows the percentage difference in relative performance for the composite vs. the sample universe (top 3000 stocks by market cap).

Relative Performance of Test Composite[1]
1990-2021



There were two periods where balance sheet strength led to material outperformance. Those periods included the Great Recession (10/31/2007- 2/28/2009) and the 'Great Lockdown' due to COVID-19 (12/31/2019-3/31/2020). The one major outlier on the negative side makes it clear that a strong balance sheet may not protect shares that are trading at excessive valuations. Following the tech bubble in the late 1990s, many of the companies with the strongest balance sheets were in the Information Technology sector. Tech stocks didn't hold up well largely due to the excessive valuations at the time and slowing assumptions for future growth in tech spending.

[1]Source: Investment Metrics
Past performance should not be taken as a guarantee of future results.

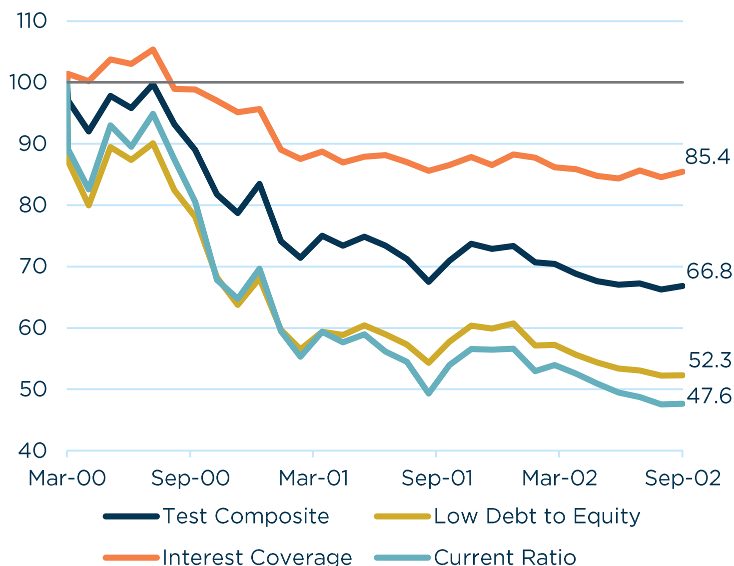
Performance of Factors & Composite

The next section reviews how the individual balance sheet factors as well as the composite performed in the three downturns mentioned above. The charts show relative performance. A score of 100 means that group of stocks performed in line with the benchmark over the period. Anything over 100 represents outperformance, while anything under 100 represents underperformance.

Post Tech Bubble

This was a long downdraft driven by excessive valuations for the market, especially technology stocks. The US experienced a recession in 2001 and an act of terrorism on 9/11/2001. Information Technology stocks were pricing in exorbitant growth expectations leading up to Y2K. Information Technology spending levels quickly declined post the beginning of the year 2000 and stocks suffered. The sample universe declined 45.3%. Balance sheet strength was actually a negative during that period largely because tech stocks had strong balance sheets, but very high valuations. Nothing can provide downside protection when stocks are trading at over 50x earnings and growth slows. All three metrics and the composite significantly underperformed the sample universe.

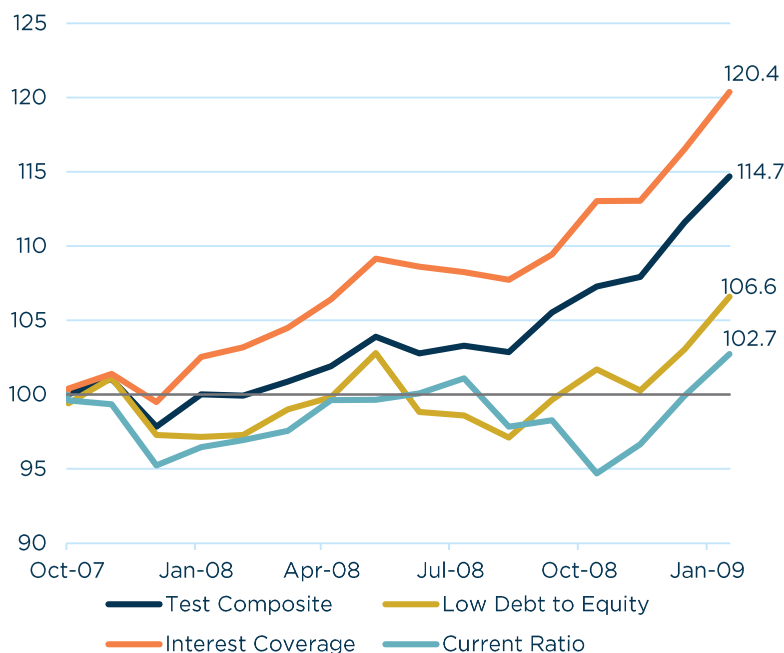
Post Tech Bubble (Mar 2000 - Sep 2002)[1]



The Great Recession

This was another long downdraft that was triggered by the bursting of the housing bubble and the impact on the banking system. Most economists view this as the second worst recession in US history. Banks and consumers were forced to de-lever and it took years to dig out of this difficult period. The sample universe declined 50.3%. Balance sheet strength mattered and all three balance sheet strength metrics and the composite outperformed.

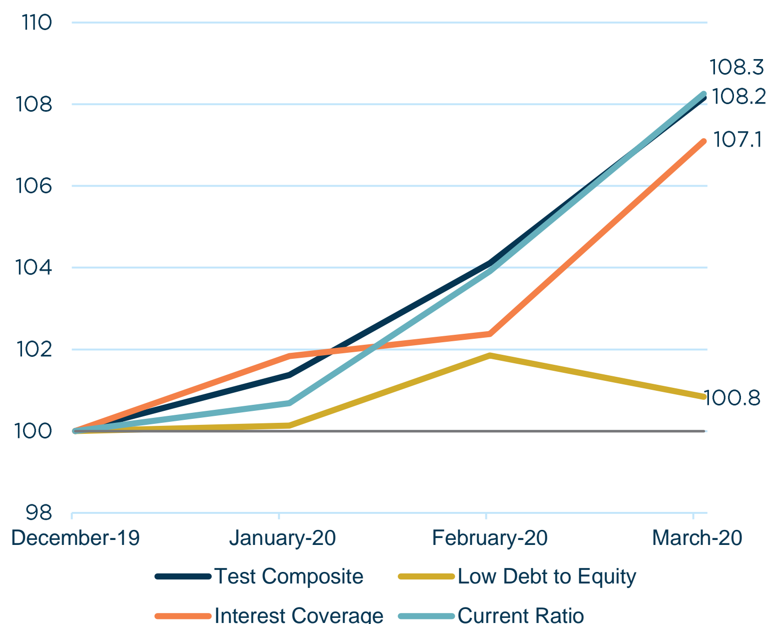
Great Recession (Oct 2007 - Feb 2009)[2]



The Great Lockdown

After a strong 2019 driven by a dovish pivot by the US Federal Reserve, investors were surprised by the coronavirus in early 2020. The virus started in China and quickly spread around the world leading to a global pandemic. In response to the virus, the US government mandated most businesses shut-down for a number of weeks, leading to a recession. The sample universe declined 21.3% during the three month period. Companies with strong balance sheets outperformed the broader market.

Great Lockdown (Dec 2019-Mar 2020)[3]



[1, 2 & 3] Source: Investment Metrics.
Past performance should not be taken as a guarantee of future results.

We have demonstrated that balance sheet strength matters in downturns except when valuations are excessive. Fortunately, our investment process at The London Company incorporates valuation discipline using our Balance Sheet Optimization (BSO) process. BSO is how we estimate intrinsic value of a company. The goal of BSO is to build the investment thesis around the strength of what exists and the flexibility a strong balance sheet affords management. Importantly, we make conservative assumptions around future growth expectations, which will often keep us from buying more expensive stocks. That valuation discipline allowed London Company portfolios to outperform in all three significant downturns under review.

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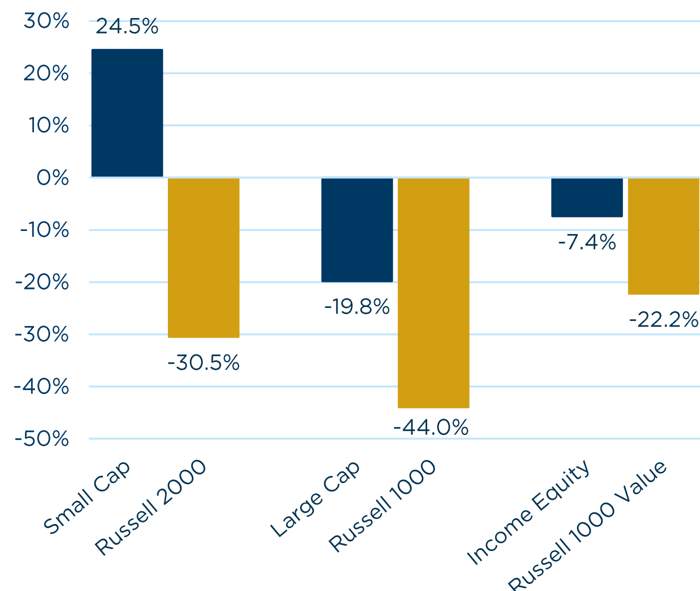
Performance of London Company portfolios during the three significant downdrafts:

The charts below highlight the performance of London Company portfolios in each of the three time periods. During the first two periods, we managed three portfolios (Small Cap, Large Cap, and Income Equity). In the third period, we also managed a Small-Mid cap portfolio and Mid Cap portfolio.

Post-Tech Bubble

As we discussed earlier, stocks were very expensive as we entered year 2000. The most expensive stocks at the time were in the Information Technology sector. Those same stocks also happened to have strong balance sheets. However, the balance sheet strength was not enough to offset the excessive valuations. London Company portfolios had limited tech exposure at the time due to our valuation discipline. Therefore, relative performance for all three London Company portfolio was very strong. The chart below shows actual performance over the 30 month period.

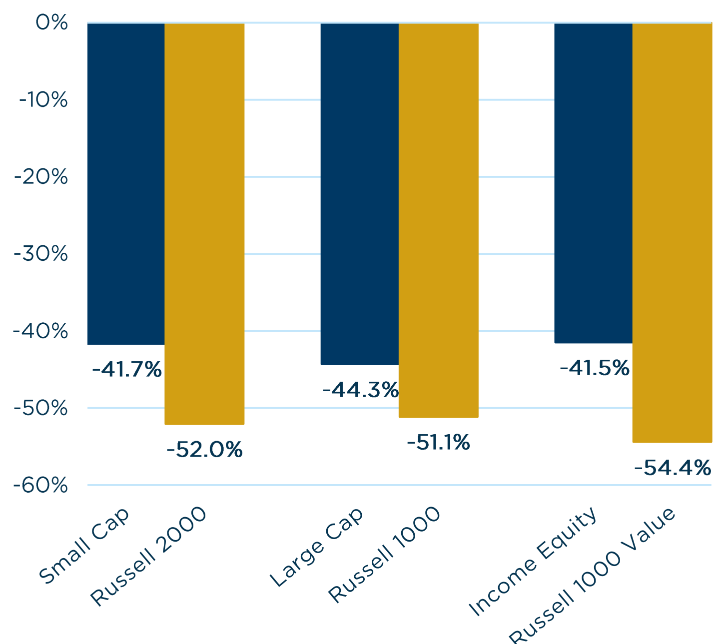
Post-Tech Bubble (Mar 2000 – Sep 2002)[1]



Great Recession

Following a multi-year rally beginning in late 2002 and extending into 2007, stocks fell significantly through the Great Recession. All asset classes were hurt during a period where the housing market crashed, banks struggled, and unemployment spiked. Each London Company portfolio outperformed its respective benchmark during this difficult 16 month period.

Great Recession (Oct 2007 – Feb 2009)[2]

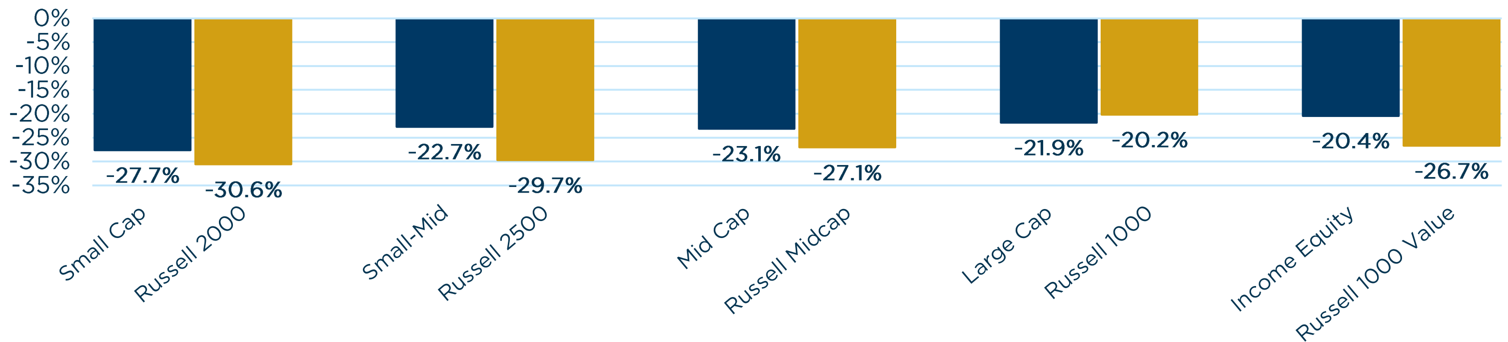


Great Lockdown

Following the longest economic expansion in US history, stocks fell in early 2020 as a global pandemic hit. As we are writing this report, we are still dealing with COVID 19. Fortunately, the US Federal Reserve and the US Government were active with monetary and fiscal stimulus to strengthen the economy and maintain the proper functioning of markets during this difficult time. Stocks traded off for three months before beginning to rally in April.

[1 & 2] Source: eVestment. Composite data reflects net performance.
Past performance should not be taken as a guarantee of future results.

Great Lockdown (Dec 2019 – Mar 2020)[1]



Four of the five London Company portfolios outperformed their respective benchmarks during this brief downturn. The only portfolio to lag its benchmark was the Large Cap portfolio. Its benchmark, the Russell 1000, had greater exposure to growth factors which held up well. The Russell 1000 Index was also driven by a few large companies that made up almost 20% of the index.

Conclusion

We believe balance sheet strength matters, especially in times of greater volatility and downdrafts in the market. Balance sheet strength can't protect against excessive valuation though. In our study, we reviewed any period of at least three months when the broader market declined by at least 20%. Companies with balance sheet flexibility held up better in two of the three downdrafts. The exception was the period following the excessive valuations of the tech bubble.

The London Company portfolios protected well in each market downdraft. The combination of sustainably high returns on capital, balance sheet strength, and consistent cash flow led to London Company portfolios outperforming their benchmarks across the market cap spectrum in each period of weakness.

Our investment process at The London Company incorporates a valuation discipline that has helped our portfolios outperform their respective benchmarks in recent downturns.

[1] Source: eVestment. Composite data reflects net performance.
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Balance Sheet Strength & Downside Protection

Annualized Returns
As of 9/30/2021

	QTD	YTD	1YR	3YR	5YR	10YR	ITD (6/30/1994)
Large Cap Gross	-1.7%	13.2%	23.9%	10.9%	14.1%	14.3%	11.8%
Large Cap Net	-1.8%	12.8%	23.4%	10.5%	13.6%	13.8%	11.2%
Russell 1000	0.2%	15.2%	31.0%	16.4%	17.1%	16.8%	11.0%

	QTD	YTD	1YR	3YR	5YR	10YR	ITD (12/31/1999)
Income Equity Gross	-2.3%	11.9%	20.5%	12.0%	12.7%	14.1%	9.6%
Income Equity Net	-2.4%	11.6%	20.0%	11.6%	12.2%	13.6%	9.0%
Russell 1000 Value	-0.8%	16.1%	35.0%	10.1%	10.9%	13.5%	7.3%

	QTD	YTD	1YR	3YR	5YR	10YR	ITD (3/31/2012)
Mid Cap Gross	-2.1%	7.4%	22.7%	14.1%	15.7%	-	14.3%
Mid Cap Net	-2.2%	7.1%	22.3%	13.7%	15.3%	-	13.8%
Russell Midcap	-0.9%	15.2%	38.1%	14.2%	14.4%	15.5%	13.5%

	QTD	YTD	1YR	3YR	5YR	10YR	ITD (3/31/2009)
SMID Cap Gross	-1.6%	10.2%	28.4%	13.6%	13.6%	14.1%	16.6%
SMID Cap Net	-1.8%	9.6%	27.4%	12.8%	12.8%	13.3%	15.8%
Russell 2500	-2.7%	13.8%	45.0%	12.5%	14.3%	15.3%	16.5%

	QTD	YTD	1YR	3YR	5YR	10YR	ITD (9/30/1999)
Small Cap Gross	0.6%	11.3%	40.9%	10.0%	10.9%	12.2%	12.9%
Small Cap Net	0.4%	10.7%	39.9%	9.2%	10.1%	11.4%	12.4%
Russell 2000	-4.4%	12.4%	47.7%	10.5%	13.5%	14.6%	9.2%

Disclosure Notes

The London Company was founded in 1994 in Richmond, Virginia and provides equity portfolio management services to pension, profit-sharing, foundation, corporate, investment companies, and individual investors. The firm, which is majority employee-owned, is an independent, autonomous investment management organization. The London Company of Virginia is a registered investment advisor. Registration does not imply a certain level of skill or training. More information about the advisor, including its investment strategies, fees and objectives are more fully described in the firm's Form ADV Part 2, which is available upon request by calling 804.775.0317, or can be found by visiting www.TLCadvisory.com.

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Investment Metrics – Market Factor Methodology

To calculate the relative return of any single factor, analysis starts by creating a single factor portfolio. To create the single factor portfolio, equity securities in the selected region are sorted in descending order according to a single equity factor (eg. Book to Price). At the beginning of a calendar month, securities are selected for the single factor portfolio by starting at the top of this sorted list and accumulating securities until the aggregate market cap of the single factor portfolio equals 50% of the total region market cap. This effectively provides a "top half" of the market by the single factor (eg. the cheapest stocks according to Book-to-Price).* The set of securities are held until the end of the calendar month. The one month performance of that single factor portfolio is then measured versus the entire market. The same construction process is performed each month, and the consecutive monthly returns are appropriately linked together to provide cumulative factor performance measures across different time frames. This process is repeated using each of the different factors and the results are aggregated together. Applying the consistent process across factors allows relative comparisons of the outperformance or underperformance of the various factors within a single region.

For more information about Investment Metrics' methodology or factor definitions, please contact The London Company's Marketing & Client Service team at 804.775.0317 or info@TLCAdvisory.com.

* Market Cap = Top 70% of Market

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