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The Total Shareholder Return Trifecta

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A trifecta is an outcome where three things are achieved. This term is most typically associated with betting on horseracing, in which case the wager is to pick the first, second, and third-place finishers in a given race. Not entirely different, at Crawford we are investing to achieve an investment trifecta by selecting stocks that provide our investors with all three components of total investment return: fundamental business progress or growth, dividend yield, and valuation improvement. Each of these components is incorporated into our proprietary Total Shareholder Return (TSR) algorithm.

First, a quick review of our TSR framework and how we utilize this at Crawford. The TSR formalizes each component of expected return, and we use this methodology to define and evaluate our internal return expectations for the companies in which we invest or consider for investment. Outlining our formal set of expectations around each component of investment return is something we find well worth scrutinizing and continually tracking. This framework functions particularly well for the more consistent and predictable dividend-paying companies we focus on at Crawford, thus enhancing our overall likelihood of investment success.

We believe the TSR convention enables more effective comparison and evaluation of cross-sector investment opportunities when different members of the analyst team are arriving at conclusions on companies under their coverage. This mitigates biases and leads to effective decision-making at the individual security level, but is also effective at the portfolio level where it can inform expectations about overall levels of expected return. Companies often share their “growth algorithm” with investors, yet we are the only firm we are aware

of that formally incorporates this into our process, maintains and adjusts company-specific expectations on at least a quarterly basis, and embraces a stock rating system that focuses on the main components of TSR.

Many firms utilize price targets, which are essentially analyst projections of a security's future price, typically in the next 12 or 18 months. We believe that our TSR framework is superior to this industry convention for several key reasons:

1. Our TSR algorithm includes dividend yield, and price targets do not.
2. Price targets are typically revised and changed frequently whereas our TSR framework is focused on more durable company attributes and employs a longer-term investment horizon.
3. TSR better aligns with what we believe investors should think about when owning a company, and it helps accomplish a winning trifecta.

If we know how a trifecta is achieved in horseracing, how does it occur in investing with Crawford? First, each company pays a dividend, so figuring out the beginning yield is simple. This is always positive, and a result of our focus on owning companies that exhibit Dividend Integrity is that the dividend typically grows over time. Of course, the rising dividend is a byproduct of a consistent business that produces a growing stream of free cash flow, possesses strong earnings, and has solid business health. This satisfies the second component of the trifecta, fundamental improvement, which is often the most meaningful contributor to the TSR. Thus, fundamental improvement receives the blue ribbon above. Lastly, as fundamentals improve, the third and final component of the trifecta is satisfied as the valuation most typically expands or improves. Below we will examine each component in greater detail.

Dividend Yield: For over 42 years, we have been using the dividend as a window into quality at Crawford. Not only are dividends an excellent indicator of quality, but they are a meaningful component of total investment return. The future cash flows from dividend payments contribute to the intrinsic value of a stock, and dividend increases can have a significant impact on the value of a stock over time. When all of the attractive attributes of dividends are considered, among the most favorable is the fact that the income component of total investment return is always positive.

Fundamental Improvement: After using the dividend as an initial indicator of quality, we attempt to uncover high-quality businesses with strong and consistent fundamentals and potential for further improvement through our fundamental, bottom-up research process. However, we prefer to invest in these companies when risk/reward is positively skewed, which often occurs when short-term business conditions deteriorate or other market considerations pressure valuation.

Valuation Expansion: We look for stocks that have a catalyst for reversion to the mean in valuation. When we invest in companies with the potential for fundamental improvement, and particularly when we do so during a short-term disruption that impairs valuation, enhanced multiples of earnings and cash flows often accrue to patient investors.

The TSR Trifecta

To borrow a couple more gambling analogies, we hedge our bets by focusing on high-quality companies with low embedded expectations. That is, we do not invest in “long shots.” Long shots have high payoffs but also have high volatility and a low likelihood of success. We also hedge our bets by diversifying investment portfolios. We do this through investing across sectors and the market capitalization spectrum. Furthermore, we use a version of the Kelly criterion strategy which some gamblers may be familiar with. Our version of this at Crawford includes building portfolios by variably weighting position sizes. Simply, we hold larger position sizes in companies with stronger TSR prospects where we have higher conviction. And finally, we achieve some positive return from the dividend of each investment made. We believe ours is a winning strategy, and we intend to continue to maintain our long-held philosophy to create successful outcomes for our investors.

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