PARNASSUS FUNDS®

Quality Stocks at a Discount: Relative Value in Action

11.27.2023

By Billy Hwan, Portfolio Manager;

Krishna Chintalapalli, Portfolio Manager

Despite strong results over the past year, value stocks have been pushed out of the spotlight as stock investors focused more on tech-driven growth. At Parnassus, we've found that uncertain and volatile markets like the one we face entering 2024 can provide unique opportunities for our approach to value investing—identifying relative value through temporary mispricings in quality stocks. We have worked to position the Value Equity portfolio so that we manage to navigate a range of potential market outcomes in 2024.

How do we define relative value? Unlike deep value, which looks for the cheapest stocks based on valuation multiples, relative value is less likely to be vulnerable to value traps. And unlike traditional value, which seeks out stocks trading below their intrinsic value based on discounted cash flows, relative value offers more flexibility in considering quality companies as investments for their business resilience. By contrast, the Parnassus Value Equity strategy focuses on value rather than purely on valuation. We perform a detailed analysis to identify businesses trading at a valuation discount to their peers or their own historical performance—discounts that in our assessment are temporary in nature. This approach opens us up to investments in higher-quality companies that may be trading, during a short but opportunistic

window, below their true value.

We pursue stocks that may seem expensive based purely on multiples and yet are attractive relative to the quality of the underlying businesses and their potential to compound value over time. We consider contrarian investments alongside quality compounders trading at discounts, selecting approximately 35–45 companies that we think are temporarily out of favor and have the potential to grow.

The companies we select for our Value Equity portfolio are generally large cap, high-quality businesses that are well positioned to navigate short-term market or economic challenges, emerging stronger from them and rewarding patient investors. These companies typically have entrenched competitive positions, profitable business models, seasoned management teams and sustainable business practices.

Price discipline is a key part of our strategy, requiring a temperament that prevents emotion from clouding judgment. We are less interested in debates around company quality, focusing instead on any mispricing caused by cyclical downturns or short-term controversies. And because our research goes in depth to evaluate macroeconomic context, industry dynamics and secular trends, we aim to identify companies that can outperform when the overall sector is down.

Like any investment approach, relative value tends to perform better in some markets than others. Given our focus, we typically do well when quality companies do well. Conditions that could favor our Value Equity strategy include recessions and their subsequent recovery, as well as moderating/higher interest rate environments. First, in a recession or even a milder economic downturn, businesses that are poised to be resilient, such as the large cap quality names we seek for our portfolios, are most likely to hold up and increase value coming out of a recession. The uncertainty around the current soft-landing scenario has generated volatility, and we are optimistic that it favors the style of stock picking we are best suited for.

Second, when interest rates are moderating, value can outperform. In these conditions, where credit is tightening and rates have increased, borrowing costs have also increased, making it more expensive for companies to use debt to fund aggressive growth plans. The companies we select typically have very low debt, which gives them a competitive edge.

Conversely, our relative strategy may not meet performance expectations during other market conditions, such as when interest rates are low or lowering, when lower-quality companies are favored or when rising inflation causes commodities such as gas and oil to rise. Notably, value investing, in general, faced challenges generated by a decade of low interest rates following the Great Recession, which helped growth stocks advance because of the low cost of capital to propel business expansion. Additionally, Parnassus Funds don't invest in companies that derive significant revenues from the extraction, exploration, production or refining of fossil fuels. When energy or utilities are performing strongly, our value strategy will be negatively impacted by the lack of exposure to those sectors.

Three stocks we think represent our relative value approach in action include Comcast, Progressive and FedEx.

Comcast (CMCSA) is a wide-moat business with some attributes of a traditional value company. The stock trades at seven times enterprise value to earnings before income taxes, depreciation and amortization (EBITDA). We see this as an attractive value relative to its stock price and multiple history. What's more, it is currently benefiting from a 4% annual increase in subscription costs, as well as pricing power with its roughly 30 million broadband subscribers, many of whom are contributing to an increase in the usage of broadband data, which has a higher revenue per user. This trend can translate over time into higher profitability and dividends.

Progressive (PGR) is an insurance company that we review as a quality compounder because of a pricing discount. But it's also been a strong performer historically because of its innovation. The company gained market share as it lowered prices during the pandemic even as competitors scaled back—a move that's now allowing it to raise premiums when others are cutting them due to inflation. In our view, the company should be economically resilient because consumers will

be less likely to cut insurance policies from their spending since many types of policies are legally mandated.

FedEx (FDX), a logistics, transportation and business services company, represents a compelling transformation story. It was one of the beneficiaries of the pandemic e-commerce boom, and it has weathered the post-pandemic correction well. The company is implementing new initiatives to improve efficiency and profitability, such as Network 2.0, a logistical upgrade to improve delivery efficiency, and its DRIVE program, which targets $4 billion in annual cost reductions. The stock is trading at 12 times its forward price-earnings ratio, which we believe doesn't reflect its potential for a recovery in shipping demand.

Our Value Equity portfolio is focused on high standards for the companies we select, as well as the uncertainty of the environment they operate in. This dynamic can present investment opportunities that are challenging to find and act on, but we not only see more of these opportunities ahead, we are confident in relying on our firm's nearly 40 years of experience in researching value stocks for the financial insight to tap into these opportunities.

Principles and Performance_Quality Stocks at a Discount_Relative Value in Action.pdf

Download
View
Email

EBITDA *is short for earnings before interest, taxes, depreciation and amortization. It is one of the most widely used measures of a company's financial health and ability to generate cash.*

Forward P/E *is a valuation metric that uses earnings forecasts to calculate the ratio of the share price to projected earnings per share.*

Mutual fund investing involves risk, and loss of principal is possible. There are no guarantees any investment strategy, including a socially responsible (ESG) investment strategy, will be successful in any market environment. Stock markets can be volatile, and stock values fluctuate in response to the asset levels of individual companies and in response to general U.S. and international market and economic conditions. The Fund invests in small and/or mid cap companies, which are generally riskier than larger companies, and the Fund's share price may be more volatile than funds that invest in larger companies.