
Momentum Matters for Value Investors

Momentum is a dirty word in the value investing world. Buy cheap stocks and they eventually go up is the mantra.

Put aside the fact stock price momentum is a factor that has enabled people like [Cliff Asness to make money](#). (Historically, at least. Now that everyone knows about it, it is likely to be a lot less profitable). I'm going to argue that momentum is not just a factor that contributes to share price performance. It is also something that needs to be factored into a company's valuation.

Heresy, yes, but here goes.

Value investors tend to think mean reversion is one of the fundamental rules of the universe. Ben Graham starts the value investing bible, *Security Analysis*, with a Horace quote that sums it up: "Many shall be restored that are now fallen, many shall fall that are now in honor".

That has historically been true of a lot of asset-heavy businesses. Low returns and poor profit lead to less investment and less competition, which in turn causes prices to rise and profits to improve. Often to a level that attracts new investment and the circle starts again. Anyone invested in the mining sector over the past decade has seen this cycle play out in full.

Human versus physical capital

It's a mental model that works for quite a few sectors. But the numbers are dwindling. More and more listed companies don't have significant tangible assets. They have people. And people are not like machines - their productivity can vary dramatically depending on the environment they are in.

Whereas a successful asset-heavy business finds it hard to fend off competition, in human-heavy businesses, success can breed success.

I've recently been researching a UK-listed company called **Softcat**. It's an IT services company that serves small and medium businesses in the UK. From a small catalogue business in the 1990s, it has grown to become the UK's second largest operator in its space and recently reported more than £1bn in annual revenue for the first time. That has been achieved without one acquisition.

What interests me most is Softcat's kooky remuneration arrangements. The IPO document states that "Account managers receive relatively low base salary and then a percentage commission on gross profit earned on their sales, which is uncapped". They go on to brag that "attrition rates are high (approximately 50%) during the first two years of employment".

High attrition rates (and low pay) in the early years leads to self selection. But those who are successful do very well: "account managers with five years or more of experience generated ... average earnings (excluding base salary) of approximately £145,000."

Just like Flight Centre

It reminds me a lot of **Flight Centre**. The industries share similar dynamics—healthy overall growth but low barriers to entry. And Softcat does all of the cultish stuff that Flight Centre does, like boozy trips for the most successful sales people. I'm not sure if they still do this but in a fairly recent interview, Softcat's founder said the staff used to decide who was promoted and who wasn't:

“We had democratically elected managers decided by an annual vote. Even my position was up for election. We also voted on people's pay rises every year. We gave everyone three data points: what salary the person is currently on; what salary they think they should be on; and what salary their manager thinks they should be on.”

It's out there stuff. And in my experience, structures like this can fail spectacularly. But once they have momentum, they can be outrageously successful.

Why momentum matters

The analytical point is that, especially in services businesses, don't underestimate how important momentum is. People businesses are horrendously difficult to turn around if in decline. Staff redundancies lead to bad culture and lower productivity, which inevitably leads to more redundancies and the loss of the best contributors to competitors.

And when they are profitable and growing, they can attract the best people, offer the best perks and secure further growth.

It's one of the reasons I'm excited about **Enero's** latest result. This marketing services company has been a death spiral for most of the past decade. Over the past 18 months, through lots of hard work, tough decisions and some luck, Managing Director Matt Melhuish managed to right the ship. For the first half of this financial year, the company posted 15% organic revenue growth and total revenue growth of 33%.

Obviously that helps our valuation. But, more importantly, it shows the company finally has some momentum. And I doubt there is an industry where it is more important than marketing services.

I met with the CEO and senior management of Hotwire communications on a recent trip through San Francisco. This tech PR business is the largest and most important in Enero's stable of marketing agencies. The staff - mostly young females - were still buzzing about a recent all-company “bootcamp”. It looks less like a bootcamp and more like a party to me.

But these are the perks that are essential for attracting talented young staff. And you simply can't do it when you are shrinking and cutting costs.

Granted, there are a wide range of views at Forager about how sustainable Enero's growth is. One half year doesn't a track record make. One thing I am sure of, though, is that a little momentum helps.

