Limitations of Investment Metrics, Part 2

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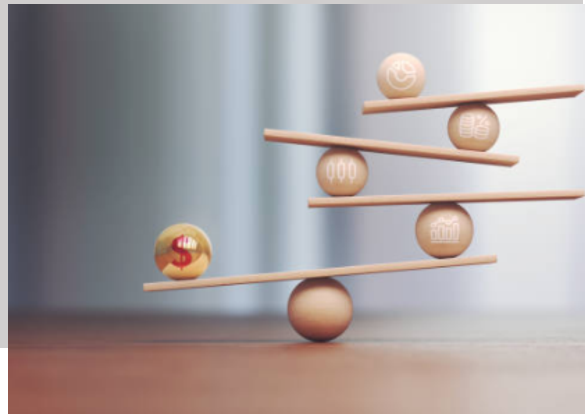
When existing tools don't work, sometimes you have to make your own tool.



We left off from our first article in this two-parter having concluded that there isn't, and won't be, a one-size-fits-all investment return metric. All of the metrics previously discussed—MOIC, NPV, CAGR, and IRR—each have their own unique benefits and limitations, and are useful in some set of situations. The core issue is that the fundamental capacity the metrics are trying to measure, "how well has this investment performed," is dependent on what an investor believes to be valuable.

Time to return, total return size, and volatility of return can lead to differences of judgment on the success of an investment, and therefore to different preferred metrics for measuring success.

Even with the wide variety of metrics available for measuring return, there are still some scenarios that seem underserved. As an example, we introduced the situation of a family-owned apple orchard, purchased relatively cheaply 40 years ago, that has followed early successes with a long stretch of break-even performance at best. How do we construct a metric with recency bias, instead of with bias to the date of investment?

Meanwhile, Back at the Orchard

We like to think of "current performance" as a balance between two concepts: value generation, or the ability of the asset to create economic value; and captive capital, or the total capital the owner has tied up in the asset.

> In this way, the ratio of value generation to captive capital allows an owner to look at the current return from the asset, and a basis for determining the opportunity cost of investing that same capital elsewhere.

Value generation is fairly self-explanatory, and there are several metrics we might choose from in order to best represent that concept. Captive capital, on the other hand, is a bit more theoretical—it's not "invested capital," which can be described as cash outlay at the outset of the investment, or "book value of equity," or other metrics that have some connection to the price and structure of the transaction. Instead, it's a representation of the capital *today* that the owner has locked up in the deal, or the cash (before transaction costs and taxes) the owner could get out of a sale (and therefore capital that could be invested elsewhere if it were to be freed up). In this way, the ratio of value generation to captive capital allows an owner to look at the current return from the asset, and a basis for determining the opportunity cost of investing that same capital elsewhere.

Of course, we'd need to select some specific measurable characteristics, instead of theoretical concepts, in order for this to be useful to our friends on the orchard. To strip out the effect of land appreciation (for the sake of argument, let's say appreciation is noisy and it helps us to remove it in this case), we could measure value generation by actual cash distributions.

For more volatile distributions, we might average over a three- or five-year period to find an "average annual cash distribution," but for more stable businesses we would likely just use the cash distributions over the trailing twelve-month period.

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For captive capital, we would want to use the market value of owner's equity. Yes, of course we realize that's not a line item on the balance sheet—but though it can be difficult to ascertain, it is the value that represents the capital the owner could free from the business (again, before taking out taxes and transaction costs). The math of this is easier to envision with publicly-traded assets, as anyone can look up a market-clearing price in seconds, but the opacity in pricing illiquid assets doesn't make the concept any less true for private markets. It is primarily this opacity, and the cost to overcome it, that keeps lots of business owners from periodically updating their understanding of how the market views the value of their business.

There are a few ways to skin that particular cat. Generally, professionals who are actively involved in transactions should have (or access to those who have) a general sense of how interested parties would value a business.

While the only real way to get the market to speak for a particular asset is to take it through a sale process, which isn't feasible to do annually as a "market check," having indirect data points should at least be enough to develop a ballpark range. Private equity firms already do this—they typically "mark" the equity value of their investments on a quarterly or annual basis, depending on the requirements of their limited partners. It can be time-consuming, and there's considerable judgment involved, but the outcome is a consistently refreshed understanding of market value.

We can combine these two concepts and call this bespoke metric a "current yield on market value of equity," and for the real estate investors in the crowd, this looks a lot like some of the yield metrics you use to evaluate steady-state mature holdings.

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Or for corporate finance fans of ROIC or ROE, this is the same idea, just updating equity to reflect the market's value of equity instead of book value.

As with other metrics, this has strengths and limitations. Its greatest strength is that it is current—it retains no holdover artifacts from the transaction event, and only depends on the actual value creation of the operating business.

Its weakness is that it is useful for relative comparisons (such as comparing multiple portfolio companies, or comparing an investment against average returns from an asset class), but meaningless as an absolute measure.

Said differently, after much calculation, the orchard owners find their CYMVE to be about 4%. Is that...good? Bad? It's neither, but it might be informative for them to think of the typical annual return from investing capital in US equity index funds to be in the 7-8% range, which is probably both lower-effort and less risky.

There's one more avenue of thought to explore to best help this family, but it requires a bit of existential investigation. Hold your groans, this will be relevant, I promise. The soul-searching question is:

Does Return Matter?

We care about return because it's a quantitative record of performance. But practically speaking, any investor is looking to answer two fundamental questions.

First: "When we made this investment, we agreed to a price and structure because we had a view on what the future would hold. Were we right? If not, did we learn anything that would impact how we would treat future investment opportunities?"

This is valuable information for any repeat investor. It is valuable for internal purposes, as it creates a feedback loop that informs better investment decisions in the future, as well as for external purposes, as it creates a language for sharing results—

useful in fundraising, as any private equity professional who has answered questions about "track record" can confirm. But it doesn't help us much with the second fundamental question, the one our orchard owners find to be more pressing: "now what?"

Every asset has a market value, and every day an owner chooses to hold an asset rather than sell it, that owner is implicitly choosing to buy that asset at its market value. Return, unfortunately, doesn't tell us anything about the quality of that choice. However we choose to measure it, return is an entirely backward-looking concept, and we all know that past performance is not necessarily an indicator of future results.

Return metrics mostly answer the question of "how did we do," and if applied creatively as we have in this article, the question of "how are we doing." But there's no return metric for answering the question of "how are we *going* to do," and that's arguably the most important question for any asset owner to answer.

If Not Return, Then What Should We Be Tracking?

If an owner can always arm himself with the market value of an asset, and his own independent value of the asset, he needs no other metrics to fully inform a hold or sell decision. The framework for making that decision is simple, if not easy: if the value of the asset is greater to someone else than it is to the current owner—by enough of an extra margin to outweigh the "tax wedge" and the time, effort, and monetary costs of a transaction—then it makes sense to sell it.

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The simplicity of the decision framework is undone by the difficulty of supporting it with any level of precision. To put it plainly, these numbers are hard to get.

Luckily, we have some suggestions. (Don't we always.) We've already described above how to use networks of professionals to periodically track market value of a business, so all we need is an old-fashioned internal valuation. The mechanics of this are pretty simple—using a multi-year forecast in order to inform a discounted cash flow analysis—and investors already do this as part of the investment process. All we're advocating is that you *keep doing it*. There's rarely a need to go through this exercise more than once a year, and annually typically is a logical cadence that aligns with existing budgeting or management planning processes.

As a note, the "extra margin" is tricky and subjective. You might expect a group of investment bankers to argue for all the reasons a transaction should occur; on the contrary, there are lots of steady businesses that, but for changes in the personal lives and estate planning of the ownership, should never be sold. It takes a special set of market circumstances to create enough of a difference in judgment on value between the market and the owner to overcome the inertia and barriers against a sale.

So Return Kind Of Matters?

Of course it does. Return, if measured by popularized metrics or by bespoke ones crafted for a particular purpose, gives an investor the ability to keep score, and that's important for a whole host of internal and external reasons. But many investors use that score as a way to make forward-looking choices about what to hold and what to sell, and we think return metrics provide an inappropriate picture for the decision-making most investors face with long-held assets. The truth is that sometimes there's just no replacement for good, old-fashioned, multi-year cash flow forecasting. (You can let out those groans now.)

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