The Holy Grail of Investing

Aflac. Kansas City Southern. Altria Group. Franklin Resources. Southwest Airlines. TJX Companies. Nucor. Monster Beverage.

All these companies are in different industries, from cigarettes to airlines to insurance and retailing. They have different market caps ranging from a few billion to hundreds of billions of dollars. So what do these companies have in common?

They all belong to a club that can be called the “100 bagger club.” That is, the stocks of all these companies have returned at least $100 for every $1 invested. Put another way, an original $10,000 investment in any of them would have turned into at least $1,000,000.

Finding 100-Baggers

In his new book, *100 Baggers: Stocks That Return 100-to-1 and How To Find Them*, Christopher Mayer analyzes the key characteristics of 100-baggers and tries to find patterns in selecting these compounding machines. Mayer became inspired about the concept of 100-baggers after reading a book called *100 to 1 in the Stock Market* by Thomas Phelps. In that book, long out-of-print but recently re-published, Phelps provides a study of 100-baggers from 1932 to 1971. Mayer picks up the study where Phelps left off and created a database of every 100-bagger from 1962 to 2014. He looked for stocks that had a market cap greater than $50 million, in today’s dollars, prior to their hundredfold climb.

In all, Mayer found 365 companies that became 100-baggers. This population seemed to favor no particular industry: retailers, food processors, insurance companies, tech firms, and many other kind of businesses all made the list. The median initial sales figures for all the companies was about $170 million, and the median market cap was about $500 million.

So what were the essential characteristics of these companies? What should we be looking for in potential 100-baggers? Mayer identified three important traits.

Return on Invested Capital

The most essential component behind a 100-bagger is the company’s ability to earn high returns on their base of capital. Mayer states that looking at companies with high returns on equity (ROE)—at least 20 percent—is a good starting point. In addition to ROE, one has to think about the ability of the company to reinvest those returns. To reach 100-baggerdom, a company needs to have the ability to reinvest cash at that high rate for many years to come—the longer the better.

Lots of Growth and Lots of Time

Essentially, a 100-bagger is the product of growth and time. Almost all of the businesses in the study were much bigger businesses at the end than when they began. You want to find businesses that can grow their sales and earnings per share by having lots of room to expand.

And when you find a good grower, you have to give it time. The fastest stock to become a 100-bagger took just five years to get there, but that was an extreme outlier. Normally, it takes between 20 and 30 years, with the average time being 26 years.

When talking about growth, it is also prudent to talk about valuation. While it is important to not pay exorbitant prices for growth stocks, it is also imperative to not be too stingy. As the famous investor Peter Lynch has said, a 20 percent grower selling at 20 times earnings (meaning the stock has a P/E of 20) is a much better buy than a 10 percent grower selling at 10 times earnings (P/E of 10). Let's look at some numbers to illustrate this point.

	Company A (20% grower)	Company B (10 % grower)
Base Year	$ 1.00	$ 1.00
Year 1	$ 1.20	$ 1.10
Year 2	$ 1.44	$ 1.21
Year 3	$ 1.73	$ 1.33
Year 4	$ 2.07	$ 1.46
Year 5	$ 2.49	$ 1.61
Year 6	$ 2.99	$ 1.77
Year 7	$ 3.58	$ 1.95
Year 8	$ 4.30	$ 2.14
Year 9	$ 5.16	$ 2.36
Year 10	$ 6.19	$ 2.59

While both companies start with earnings per share of $1, at the end of the tenth year Company A earns almost two and a half times as much as Company B. If both stocks retain their original P/E ratios, Company A will be trading at $123.80 in year 10, while company B will be trading at $25.90. That's a 6-bagger versus a mere double. Even if Company A's P/E fell to Company B's level of 10 by the end of the tenth year, it would still have produced a better return than Company B since $61.90 is more than triple the original outlay of $20.00.

Owner-Operators

While it is not required, Mayer states that it is preferred to search for good management teams when searching for 100-baggers. These managers should be "owner-operators," meaning they should own a lot of stock in their own companies so that they have "skin in the game." Look for owner-operators that treat shareholders as partners and have a history of allocating capital

smartly. They should understand that capital allocation is the CEO's most important job, and that it is cash flow that determines value.

Overcoming a Big Hurdle

Let's say you've found a company that has the makings of a future 100-bagger managed by a young, shareholder-friendly CEO. What is one of the biggest hurdles to making 100 times your money? The biggest hurdle is you—you and your emotions.

Consider the case of Apple. From its IPO in 1980 through 2012, the stock was a 225-bagger. But—and this is a big "but"—those who held on for the entire ride had to suffer through a peak-to-trough drop of 80 percent. Twice. There were also several 40 percent drops along the way. Netflix, which has been a 60-bagger since 2002, has lost 25 percent of its stock market value in a single day…on four different occasions! One day it fell a full 41 percent, and there was a four-month stretch in which it lost 80 percent. Does any of us honestly have the stomach to be able to hold onto a stock that has such wild price gyrations?

The urge to let go of a "loser"—or to grab a quick gain—is very strong. That is why Mayer advocates using a "coffee-can portfolio." The coffee can idea began with Robert Kirby, who first wrote about it in 1984 in ***The Journal of Portfolio Management.*** "The coffee can portfolio concept harkens back to the Old West, when people put their valuable possessions in a coffee can and kept it under the mattress," he wrote.

The idea is that you find the best stocks and then you don't touch them for at least 10 years. You incur basically no costs with such a portfolio and, most importantly, you keep your emotions from working against you.

Conclusion

Investing in 100-baggers is the dream of every investor. Finding just one should be enough to provide a comfortable retirement for most anyone. In his book, Christopher Mayer does a great job in showing what it takes for a company to return 100-to-1. The next 100-bagger is out there waiting to be found and, with enough time, discipline, and a little luck, a studious investor should be able to find it.

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