How to Use the "Davis Double Play": Making Money in Durable Businesses

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The book "The Davis Dynasty" talks about 3 generations of Davis family investors. The one that interests us here is the first generation: "Shelby Davis". Shelby Davis made a fortune investing – on margin – in insurance stocks. That fortune really came from a "triple play" of returns – each working with the next in a multiplicative rather than an additive way – that led him to compound his money at more than 20% a year for many decades. Davis focused on insurers – businesses unlikely to become obsolete – that were growing and had a low P/E ratio. Not growing too fast. And not stocks with too low a P/E ratio. But, stocks where the growth was high enough to give him some return just from growth and where the P/E ratio expansion could be high enough to give him some return from that too. He also used leverage. A lot of it. I won't be discussing that part of his returns here. But, obviously, it was a big part of it. If you buy – as he did – about half the shares you own on margin, you'll amplify your returns (good or bad). Margin loans are a pretty cheap source of debt. However, they're also a pretty high risk source of debt, because of the constant risk of calls for more collateral. The book – "The Davis Dynasty" – goes into some, but not a lot, of detail on how he managed this. There were probably a couple times in his career when declines in his stock portfolio would've made the risk of being completely wiped out due to margin a serious possibility. Without the constant use of margin borrowing, his results wouldn't have been nearly as good. So, I'll focus on just "The Davis Double Play" here and leave the risks of turning it into a triple play (by using margin) a subject others can address. I don't buy on margin. And I wouldn't have anything intelligent to say about how to do it safely.

But, I do buy stocks that are growing EPS and that have a low P/E ratio. So, let's talk about how that can work for you. First, you would need to identify a stock that is likely to grow earnings per share over the next 10 years. Davis owned his winners for far, far longer than 10 years. He owned some losers and other stocks for less than 10 years too. I pretty much always own stocks for less than 10 years. But, as I said in a recent podcast, I go into stocks on the assumption I'll own them for 10 years. So, looking 10 years out is the standard approach for me.

I'll start with Andrew's favorite stock to talk about: Computer Services (CSVI). We bought Computer Services when it had a P/E of around 16 or so. For our purposes here, I'm going to assume a P/E of 15. The reality with this one is a bit more complex. Corporate taxes had been cut and this hadn't yet cycled through a full year of the company's results. And then the company isn't really followed by analysts. But, it does grow earnings just about every year. So, the forward P/E should be lower than the trailing P/E.

Compared to other stocks, it probably had a P/E of 15 or so. Peers traded at 25 times earnings or higher. I thought the stock was a good enough business that it deserved to trade at 25 times earnings. Putting aside the tax cut, EPS had grown about 6% a year at Computer Services. In the long ago past, it had grown much faster. But, since the financial crisis – Computer Services serves mainly smaller banks – its rate of EPS growth had slowed to like 6%. I'll use assumptions of a P/E of 15 and an expected EPS growth rate of 6% here. The company was retaining a bit less than half its earnings. In other words, the dividend payout ratio was about 50%. If a buyer had assumed the stock's price was 15 times the earnings of the first year reflecting the tax cut fully, then a buyer would also have expected a dividend yield of about 3%. Now, let's imagine you bought the stock at 15 times earnings and a 3% dividend yield (again, this stuff is normalized for the year ahead – the law had already been changed, so it wasn't speculative but it also wasn't yet in the trailing numbers). Assume also that the buyer of the stock – like me – really did believe the stock's P/E multiple should one day expand from 15 to 25. That part is speculative. But, 10 years is a long time. In my experience, if you're right about the future and quality of the business – you'll be right about the stock's multiple AT SOME POINT in the next 10 years. You can't know what the multiple will be at any particular point. But, if you're right that you're buying a really high quality business and holding it for 10 years, then you'll be right that you'll get the chance at some point in the next 10 years to sell at a P/E of 25 (or whatever your assumption is). This doesn't work so well over short periods of time. Betting on a multiple expansion over more like 3 years instead of 10 years is a lot more speculative and a lot more of an exercise in playing pure luck.

So, what kind of returns could you get in a stock that: 1) Didn't pay out THAT high of a dividend (maybe a 3% yield looking forward a year, lower at the time you'd be buying), 2) Didn't have a P/E ratio THAT low (15 times earnings is a "normal" price for an "average" public company), and 3) Wouldn't grow THAT fast (6% annual EPS growth is about in line or ever so slightly better than the long-term average for big stocks). Basically, this stock would've looked fairly priced to a lot of people. The dividend yield was fine. No one would say it was low. But, it wasn't particularly high either. The P/E might be low for a high quality business. But, a value investor would consider a P/E of 15 a normal level. In other words, the P/E would be seen as pretty much a neutral factor here. And then growth of 6% a year is interesting. This one probably should've been seen as more valuable than a lot of people might have seen it. On the one hand, EPS growth of 6% a year would never attract growth investors. On the other hand, any EPS growth much above 5% a year that happens basically every year out into infinity (or, at least a period that seems as long as infinity for someone's investment horizon) is adding a good deal of value. Computer Services had a good return on equity (20-25% every year, basically). One way of checking this is that if you assume EPS growth of around 6% a year while also assuming a dividend yield in the neighborhood of 3% a year – that's your "normal" market level of a 9% a year return right there. You don't need multiple expansion. You can just make 9% a year by holding the stock indefinitely. So, it's the multiple expansion that gets you any market beating return. This lowers the bar a lot. With deeper value stocks, the multiple expansion sometimes makes up most of the return (not just most of the return in excess of the market). There are even some stocks where EPS is falling. So, the multiple expansion has to make up all the return plus offset what otherwise would be a bit of a decline.

In a "Davis Double Play" like Computer Services – it's possible to make a lot in terms of annualized return from the multiple expansion, because you are getting all of your required return to match the market simply from earnings growth and dividends.

How much can the multiple expansion add? Well, going from a P/E of 15 to 25 would add different amounts to your compound annual growth rates depending on how long it took for the expansion to happen. Here is the contribution to your CAGR over various 1-10 year periods.

10-year holding period: 5%

5-years: 11%

3-years: 19%

1-year: 67%

This is what I meant in a recent podcast when I said "Plan for 10% portfolio turnover. Hope for 100% portfolio turnover." A 10-year holding period in Computer Services might have gotten you returns as high as like 15% a year. It depends on quite a lot of factors we don't yet know the answers to. Would the dividend payout ratio be that high in the future, would EPS growth be more like 5%, 6%, or 7%? And would the P/E multiple end up exactly at 25 when you sold? But, if we just assume 6% annual EPS growth, a 3% dividend yield, and then an additional 5% return from the P/E multiple expansion – you'd be at around a 14% annual return. That's good over 10 years. Great for holding one stock the whole time. But, more frequent stock flipping where you buy a cheap stock and hold it for 3 years and sell it and buy another and repeat might be as effective as just holding CSVI for 10 years given our assumptions. That's less true over 5 years. Returns in that case would be 20% a year total. That's tough for even a smart, frequent stock flipper to beat in just pure value stocks. Over 3 years (and certainly 1 year) I think the "Davis Double Play" approach is going to clearly win out. We're talking returns in pretty much the 30% to 75% a year range over times as short as 1-3 years. Buffett only did about 30% a year annualized in his partnership days. There are investors – especially in bull markets – who consistently top 30% a year for a while. But, it rarely lasts all that long. Any approach that could give you 30% type returns if all goes especially well and more like 15% returns if thing work out as planned is a strong strategy.

At Focused Compounding, we got lucky with the timing of when CSVI's multiple expanded. So, we got more like the very high returns you see over the super short time periods. But, that was just luck. It could've taken 3-5 years instead of 1-3 years to play out. In theory, it could've taken 10 years. So, that's always what you want to prepare for. Let the speed of how quickly a P/E multiple expands be the surprise that drives market beating returns in your portfolio. Only count on it happening over a long time like 10 full years.

The "Davis Double Play" sounds safer than it really is. I think it's a safe approach if applied to the right kind of stocks – Warren Buffett type stocks. Here, we talked about the dividend yield, EPS growth rate, and exit P/E multiple as if they were separate factors. They're basically the same factor. How quickly and consistently is the business compounding its earning power? The exit multiple you sell at will be a P/E that reflects how the market views the likely consistency of future EPS growth. The dividend will probably track EPS growth over time. So, it's that constant year-over-year EPS growth and the expectation it'll keep happening far into the future that drives all your returns. When you buy something like Computer Services – you're really betting on just that one factor. Consistent compounding of EPS well into the future. You're putting all your chips on that one assumption.

It's not an accident that Shelby Davis focused his "Davis Double Play" approach on insurers. Insurers go out of business if poorly run. They don't become obsolete like tech companies can. These are basic businesses. Things like insurers, banks, advertising agencies, ad supported media, consumer brands, etc. is where Buffett has made close to 100% of his big money. He's bought other things. But, except for some railroads and utilities – which are also plenty durable – he has not put much money into anything that quickly and easily becomes obsolete. Now, he couldn't foresee the decline of newspapers around 2000 when buying a newspaper around 1980. No one can see that far off into the future. But, we can tell he was trying to avoid buying into a situation like that. When he knew there was a real risk to a company's durability – he got out.

Extremely durable companies are the only ones where the Davis Double Play will be safe enough to use over and over again. Losses in this approach should be really low if you avoid stocks that might not be durable enough to remain consistent compounders 10 years from now.

You'll also need to insist on a couple other factors. One – you'll always need some growth. Value investors need to remember that 6% growth at a good ROE adds a lot of value versus no growth. And growth investors will hate this other caveat. To give yourself enough time to benefit from multiple expansion, you can't buy stocks with high multiples. The approach I laid out worked well with Computer Services at 15 times earnings (and would've worked even better at a P/E of 10 – but, chances to buy a stock like that at a P/E of 10 outside of a market wide panic are nearly nil). But, it wouldn't work if you started with a P/E of 25. To get the same benefit as going from a P/E of 10 to 15 or 15 to 25 you'd need a stock's P/E multiple to expand from 25 to 40 (if you bought in at 25). Basically, this tells you to look for stocks trading at a P/E multiple of 10, be willing to buy the right stocks at a P/E multiple of 15, be willing to hold stocks even at a P/E multiple of 25. But, don't start your search for good growth stocks at P/E multiples as high as 25. It will work with the Starbucks and Microsofts and Southwest Airlines and Wal-Marts and so on of the world. Companies that grow fast for a very, very long time. But, you can't get a Davis Double Play at P/E multiples over 25. You need to start in the teens or lower. Above that, you're employing a pure growth stock strategy where you'll actually need growth to offset multiple contraction. It's like having something a little less than even a "single play". Instead: look for good enough growth with a low enough P/E and plan to hold for the long-term, but hope to get a chance to sell in the short-term.