VIDEO - Broken Compounders: An Inferior Asset Class

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Background: Every once in a while, a previously well-regarded, darling stock has a shocking pullback. Three years ago, our favorite personal bank First Republic blew up. This past year, universally held United Healthcare (UNH) and previously well-regarded Fiserv (FISV) have strongly retreated. We thought it would make sense to look for compounders that materially break and see if there were any rules of thumb to apply about catching the "falling knife" or continuing to avoid it. We define "Broken Compounder" as Top 900 US stocks (Mid-Cap. or larger) excluding Biotechnology stocks where blow-ups are common, that were up more than 100% in 5 years with 5-year annualized Sharpe ratio of above 0.5 followed by a beta-adjusted drawdown of more than 30% in 1-month. We excluded periods of market selloff in 2000, 2008 and 2020 to focus on idiosyncratic breaks. This gives us 520 total "Broken Compounders" to evaluate over the last 20 years. In 2025, we have seen the third most Broken Compounders, after the Financial Crisis and COVID.

Attributes: About 80% of the Broken Compounders are mid-cap and growth stocks. Only 12 of the stocks we define as Broken Compounders are mega-caps, including UnitedHealthcare (UNH) and Oracle (ORCL) in 2025. There are plenty of high-quality broken compounders, with about the same number of top- and bottom-half quality over the last 20 years.

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Obviously, the highest percentage of Broken Compounders is going to come from the sector with the most compounders, and Technology, Consumer Discretionary, and Healthcare are the three sectors with the most stocks.

Valuation prior to breaking: We looked at the valuation of stocks that ultimately became Broken Compounders, right before they "broke" by comparing their price-to-forward earnings to their industry-group median. In some sectors, like Technology, Industrials, and Consumer Staples, the premiums were substantial. In others, like Healthcare, valuation compression was less of a cause than fundamental changes. In aggregate, however, nearly 40% of all Broken Compounders were in the most expensive quintile of the market on price-to-forward earnings.

In general, avoid Broken Compounders after the "break": From the original period of 'breaking", the subsequent industry-relative return is quite weak over the following 12 months, implying Broken Compounders are an inferior asset class. On average, one-week dead-cat bounces should be sold for large- and mid-caps, whereas mega-cap broken compounders tend to stabilize 6-months later, though admittedly the sample size is only 12 occurrences in the last twenty years.

Substance over style: Style doesn't seem to matter for subsequent returns for Broken Compounders. Value compounders perform the worst following being broken. However, the highest-quality stocks tend to stabilize following the 21-day period we defined, whereas lower quality stocks continue to lag.

Rules for Broken Compounders: After a compounder breaks, we analyzed attributes of subsequent winners and losers. Avoiding those with the highest forecasted EPS growth seems prudent, as they underperform their industry average by a further 950bps on average over the next three months. Finding companies with high return on tangible equity growth can be a good idea, but avoiding those with weak return on tangible growth is crucial. The poorest ROTE growth quintile of Broken Compounders goes on to lag its industry by an additional 14% over the next 3 months.

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