

Doing it in style:

A global approach to finding value in equities

No single management style performs best in all market conditions – but there’s no doubt value-style investment has had a good run in recent years, as Simon Hoyle reports.

Cast your mind back to 1980. Australia’s Alan Jones was crowned Formula 1 World Champion, and Bjorn Borg and Jimmy Connors slugged it out for the No 1 slot in the men’s world tennis rankings. Richmond won the VFL grand final, and in NSW the Bulldogs won the rugby league premiership. *The Empire Strikes Back* and *Nine to Five* were among the top-grossing movies, while Blondie (*Call Me*) and Pink Floyd (*Another Brick In the Wall Part 2*) topped the Billboard charts.

At this time, pre-internet, it could take two or even three months for the annual report of a listed company in Europe to make it to the US. Today the transmission of information is as good as instantaneous, and Bernard Horn, principal and founder of the Boston-based fund manager Polaris Capital Management, says access to large volumes of good information, quickly, is critical to the efficient operation of a value manager whose value proposition is an ability to identify listed companies whose current share price is below the intrinsic value of the business.

Horn started out as a value manager in 1980. Then, the idea was relatively novel.

Today, Australian investors have the choice of a wide range of products built on a value-based approach to global equity investment, offered by fund managers ranging in size from boutiques to some of the country’s and the world’s largest institutions.

LONG-TERM PERSPECTIVE

But few have been in the game quite as long as Horn, whose perspective allows him to reflect on how the job of being a value manager has evolved over 35 years. In some ways, the approach is unchanged – the metrics and the valuation criteria used to pinpoint undervalued companies haven’t changed a great deal – but in other ways the job is almost unrecognisable.

“Because of the speed of the information flow in the 1980s – there was no DHL, there was no FedEx...and certainly no internet – value anomalies persisted for a very long time,” Horn says.

“There just wasn’t the general media scrutiny of what was going on around the world. Maybe you read an article about an international country every once in a while, but especially in the US it was very ethnocentric-focused; it was primarily ‘we’re the centre of the world and nothing else matters’.

“I would look at utilities in Spain on 13 per cent dividend yields, and it lasted for a few years.”

Horn established Polaris in 1995 and today, the firm has a database of 39,000 companies. In the blink of an eye it can analyse, compare and interpret the financial results of companies across the globe, helping it sift out the companies worth further investigation from those not worth spending the time on.

“Now we can screen that and use basically the same thought process and

same investment discipline, but do it in a much more automated fashion, with a ton of investment technology to bring to bear on the problem,” Horn says.

Late last year Polaris was added to the prestigious Macquarie Professional Series – named as Fund Distributor of the Year at the *Professional Planner* | Zenith fund Awards 2014.

BECAUSE OF THE SPEED OF THE INFORMATION FLOW IN THE 1980S – THERE WAS NO DHL, THERE WAS NO FEDEX...AND CERTAINLY NO INTERNET – VALUE ANOMALIES PERSISTED FOR A VERY LONG TIME

STYLE GUIDE

Value management differs from another major style category, namely “growth” (see Table 1: Growth vs value – a quick reference).

Data produced by the research firm Morningstar shows that large-cap Australian value managers have outperformed growth managers and managers who use a blend of styles in the one-, three-, and five-year periods ending December 31, 2014.

It might be tempting to conclude from this data that a value style is best in all market conditions; but the Morningstar chart shows value managers lagged behind growth managers, even if only slightly, for the 10 years to December 31, 2014.



Convictions that run deep. Opportunities that matter.

Macquarie

Macquarie Asia New Stars No1 . Fund
Macquarie Australian Small Companies Fund
Macquarie Diversified Fixed Interest Fund
Macquarie High Conviction Fund
Macquarie Income Opportunities Fund
Macquarie International
Infrastructure Securities Fund

Macquarie Professional Series

Analytic Global Managed Volatility Fund
Arrowstreet Global Equity Fund
IFP Global Franchise Fund
Polaris Global Equity Fund
Walter Scott Emerging Markets Fund
Walter Scott Global Equity Fund
Winton Global Alpha Fund

Macquarie Investment Management attracts teams globally with specialised asset management expertise and strong investment convictions that are dedicated to client performance and opportunity.

- World class investment strategies in equities, fixed income, infrastructure securities and alternatives
- Access Macquarie strategies as well as external investment managers through Macquarie Professional Series
- Australia's largest global asset manager with more than \$300b under management*
- Delivering insights and perspectives to advisers from our leading global investments experts.

For more information visit us at www.macquarie.com.au/mim

FORWARD thinking

*Measured by funds under management (as at 31 December 2014).

Important Notice: Macquarie Investment Management Limited ABN 66 002 867 003, AFSL 237492 is the issuer and responsible entity of the Funds. Investments in the Funds are not deposits with, or other liabilities of, Macquarie Bank Limited (MBL) or of any member of the Macquarie Group and are subject to investment risk, including possible delays in repayment and loss of income and principal invested. Neither MBL nor any other member of the Macquarie Group guarantees the performance of the Funds or the repayment of capital from the Funds or any particular rate of return. This is general information only and does not take account of investment objectives, financial situation or needs of any person. It should not be relied upon in determining whether to invest in a Fund. You should read the relevant product disclosure statement, available at macquarie.com.au/pds or by contacting us on 1800 814 523, before deciding to invest in a Fund.

Tim Murphy, director of manager research at Morningstar, says the research house does not favour one style over another, and he says there is “no house view on whether value is better than growth, or anything like that”.

“We wouldn’t say we expect value to outperform growth over a full cycle,” he says.

“There’s merit in a value style, and there’s merit in a growth style.”

Murphy says the key is that the managers remain true to label, and that they implement their style efficiently.

Morningstar runs what amounts to a “style check” on managers, by examining each of the equity holdings in the manager’s portfolio. It assesses them based on a range of accepted “value” criteria – including price-to-earnings ratio, price-to-sales and dividend yield – and a range of “growth” criteria as well, to ensure the implementation of the manager’s style is as it says it will be.

“Each individual stock gets a ‘style’ score and then for the funds we aggregate those individual stock style scores, weighted in the portfolio,” Murphy says.

“That is to assess what [a manager] is doing versus what they say they are doing. That’s how we look at style, as it pertains to equity managers.”

MORE OPPORTUNITIES OFFSHORE

Murphy says the distinction between value and growth managers in the Australian equity market is not as pronounced as the distinction between managers operating globally. He says that reflects the range of investment opportunities in the Australian market.

“There’s a much wider universe and opportunity set [globally],” he says.

“If you’ve got financials and resources

making up circa half your market...it’s hard to differentiate too much when that’s swallowing up your opportunity set.

“Whereas, if you’ve got a global opportunity set, there’s a much more diverse range of sectors and a diverse range of stocks, and it’s easier to differentiate.”

Polaris’s Horn says being able to scour the globe means a manager can find companies that are exploiting new and emerging markets and new technologies, which are not immediately fully appreciated by the broader market, and hence not fully reflected in the companies’ share prices.

“It continues to be a very mixed growth picture around the world,” Horn says.

“We talk to hundreds of companies a year. Whenever we talk to someone we say, ‘Hey, how’s business?’ and they tell us.

“We collect lots of data points and we assimilate those and we try to develop a view of where things are coming and going. The things that are working for us [right now] that have been generating the best returns in the portfolio relative to

the benchmark are the companies that are addressing in one way or another this mixed growth picture.

“There are areas in the world that are experiencing better growth – things like low-cost energy [producers].

“There’s a lot of deflationary aspects to what we’re seeing in markets, and to the degree we’re finding companies that are achieving deflation for their customers; it’s a real home-run for us, if we can find them and they’re undervalued.

“That’s why we’re out on the ground, travelling around the world, to pick up those data points that we can assimilate, so we can try to develop that view, so whenever we’re doing an analysis on a company we have to build those views into the expectations we have going forward, and eventually our cash-flow estimates.

“So we’re vary aware of [global growth prospects] but we’re not global macro-economic theme investors. That would be a really bad accusation for a bottom-up value manager.”

Chart 1: Style is timeless



Source: Morningstar

Table 1: Growth vs value – a quick reference

	GROWTH FUNDS	VALUE FUNDS
CHARACTERISTICS	Focus on companies with above-average rates of growth in earnings and sales. These stocks tend to have above-market price-to-earnings and price-to-sales ratios, as the rapidly growing sales and earnings justify a higher-than-average valuation.	Focus on companies with lower-than-average sales and earnings growth rates. Holdings generally feature stocks with lower price-to-earnings and price-to-book ratios. Stocks generally have higher dividend yields. Funds can potentially capitalise on turnaround situations.
RISKS	Growth may not always be realised. Price-to-earnings or price-to-book ratios may decline due to unforeseen events.	Market may have correctly priced underlying companies, in which case they may never realise their intrinsic value.

Source: Fidelity Investments