

A Professional Planner Infocus report, in partnership with ALLAN GRAY

The trick to contrarian investing is to have a firm, unshakeable belief in the unchangeable nature of the human psyche.

As the global economy struggles to find growth, investors scour markets for yield and valuations in some sectors balloon out, those who swim against the tide and look for opportunities in unloved places have an edge in a world overloaded with information.

At least, this is the view of contrarian investors Allan Gray Australia (AGA), whose Equity Fund looks for oversold stocks in industries that are uncomfortably out of favour.

"If you're willing to fish in the contrarian pool, you face less competition and that's an advantage" says Julian Morrison, National Key Account Manager at Allan Gray.

"That allows you to get into a position to have the strongest bargaining power and buy stocks at a steep, steep discount.

"But of course, there's a reason why there's no competition there, so the trick to pulling those investments off, is to have a level of patience uncommon in today's world," he says.

Negative news is the firm's currency, and while they never take a contrarian position to the broader market without cause, the team has spent years

watching market participants overreact severely to negative news.

"When the news is very positive, people tend to get overly enthusiastic and are willing to pay too high a price for a stock," says Morrison, pointing out that the firm steers clear of that.

"But if you have a situation where a stock is priced for a dreadful outcome, and it ends up being less bad than expected, that can be a great thing for us."

The determination to scoop up investments as they languish in uncomfortable times, be it a plunging oil price or an out-of-favour blue chip, gives contrarian investors opportunity to put into practice that most difficult of investor behaviours, patience.

BENEFITING FROM PASSIVE'S POPULARITY

Short term-ism has plagued active managers for decades. Contending with clients who demand immediate returns or are uncomfortable with waiting for a stock turnaround, active managers are often left hugging the index.

This short-termism is compounded by the rise of passive investing, a phenomenon spurred on by a long bull market. In recent years, trillions of dollars have poured into passive investment products, with demand for systematic and easily-replicated strategies offering low-fees and predictable performance.

Courtesy of the bull market, active managers have found it difficult to compete with these low-cost offerings, as they track the steadily rising index and provide their owners solid returns.

"The strong performance of shares during the last ten years causes people to think investing is easy, and they go low cost because the returns are easy," Morrison says.

"Active managers charging higher fees have to decide how far they are willing to deviate from the index, which is hard to do when people can't tolerate short-term underperformance and end up firing you as a manager."

As a result, the vast majority of active managers have chosen to deviate very little from the benchmark, for fear of provoking the short-term expectations of their clients.

Indeed, the average top ten holdings of the five largest Australian equity fund managers are all clustered in the same ten stocks, according to Morningstar data as at 30 June 2019, with the AGA Equity Fund on the other hand with no exposure to seven of the top ten stocks.

But AGA, which is privately owned and has developed deep relationships with their clients, can withstand this kind of deviation and has had no trouble attracting new money, despite their contrarian investment choices.

"Lots of people have realised, this large middle slice of active management means you're paying active fees but you're getting the benchmark or index performance," Morrison says.

"We've definitely benefited from people looking to outperform the index, though we've worked hard to explain the level of patience they need before they can see possible outsized returns."

THE PATIENCE FOR INTRINSIC VALUE

Rohan McPherson, director and senior adviser at FIRSTUNITY Wealth Management is no stranger to waiting for some of the AGA Equity Fund's investments to realise their true value.

"It can definitely get uncomfortable when the fund has underperformed for an extended period of time," McPherson, who has invested with Allan Gray for the last nine years, says.

"And they often hold some really unsexy stocks, but the name of the game is finding intrinsic value in a company, and I think if you're not stressed about something in your portfolio, you're not really diversified."

McPherson points to AMP as one such contrarian position. The beleaguered financial services company has suffered a severe public backlash following the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, which found it had charged clients for phantom financial advice.

"Most people would run a mile from this company, and the share price has copped a serious whack," McPherson says.

"But Allan Gray has looked carefully at the state of the business and has added to their holdings in the recent share issue, they really back their judgement."

In a world flattened by easy money and successful passive investment strategies, finding conviction in an unloved stock is a difficult manoeuvre.

The healthcare and energy sectors provide another way to think about contrarian investing. For the last decade, healthcare has been extremely popular with investors and is the strongest performing sector.

In contrast, the energy sector has become very unpopular and share prices have languished. These low prices have led Allan Gray to assess valuations are more attractive in the energy sector.

As energy prices tumbled, the profitability of companies throughout the sector suffered and the ability of the firms to add to their productive capacity became very difficult. The rationalisation of the industry sees many companies, generally those with inefficient processes and large debt loads, foreclose and a barrier for new supply rise.

"As investors, we won't face as much competition to buy these shares," Morrison says.

"In these situations, people who own the shares are eager sellers, and this means we have the bargaining power.

"We can't forecast how long the industry-challenge will last for, but as long as the commodity is still required by the world, we're happy to wait for them to rediscover their value."

In the world of investing, information is power. But as the real-time news and data flow into the homes of retail investors as well as across the desks of professionals, it is patience that ultimately offers upside for money-managers operating at the extreme end of active.

"Even if you have a piece of information that points to a positive development for an industry, let's say cannabis is becoming legal in various places and a market is opening up," explains Morrison.

"That information doesn't really help you much, because there are so many players and everyone has that information, they can't all succeed."

Rather, looking at negative news flows and pushing back on the innate human bias towards optimism gives real value investors an opportunity to apply a bottom-up, long-term approach.

"Operating at the extreme end of active management means we can take advantage of people's overreaction to bad news," Morrison says.

"And while some of the decisions we make definitely raise eyebrows, there's so much information in the world, and everyone has access to it, so patience is the one of the most reliable advantages you can have." ■

WORDS JESSICA SIER

NOW IS THE TIME TO BE A CONTRARIAN INVESTOR

FINDING CONVICTION IN AN UNLOVED STOCK IS A "DIFFICULT MANOUVER", ACCORDING TO JULIAN MORRISON FROM CONTRARIAN FUND MANAGER ALLAN GRAY, WHICH COUNTS AMP AMONG ITS ACTIVE POSITIONS.

