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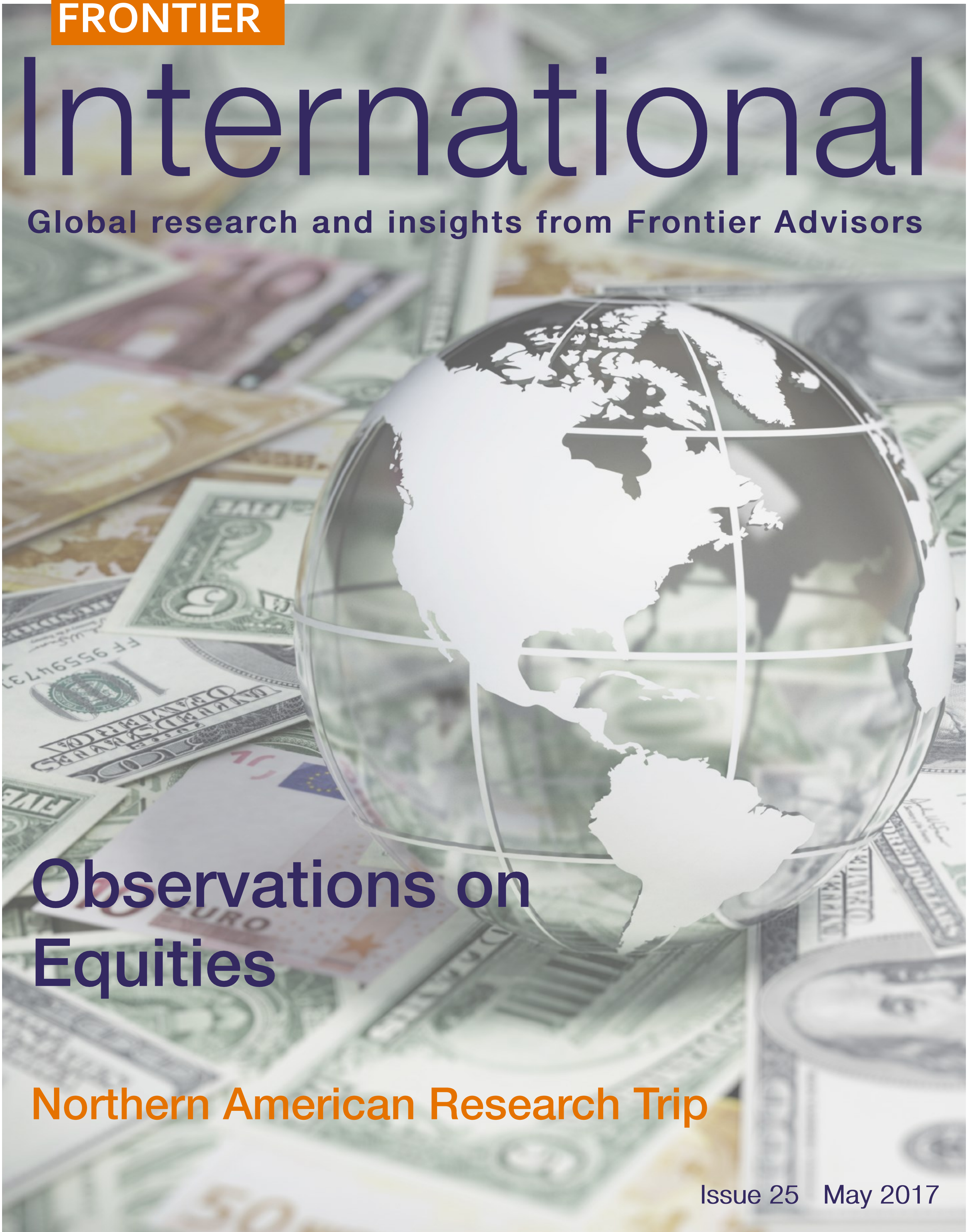

Observations on Equities

Northern American Research Trip

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Frontier regularly conducts international research trips to observe and understand more about international trends, and to meet and evaluate first hand a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high level assessment on the key areas and observations unearthed during this recent research venture. We would be pleased to meet with you in person to provide further detail on these observations.

AUTHOR

Fraser Murray

Fraser Murray is Director of Research at Frontier. In this capacity, Fraser leads the Research Program within Frontier and is the Head of Equities.

Fraser joined Frontier in 2012 and is well known and highly regarded within the investment and funds management communities having previously worked at Ibbotson Associates/Intech Investments for nearly 15 years where he held a variety of roles including five years as Head of Manager Research and five years as Head of Equities and Property. Fraser started his asset consulting career at Towers Perrin in 1994 as a Research Associate in its Melbourne and London offices.

Fraser holds a Bachelor of Commerce with Honours from the University of Melbourne and a Graduate Diploma of Applied Finance and Investments from Finsia, and is a Fellow of Finsia.

AUTHOR

Nathan Bode

Nathan Bode is a Senior Consultant at Frontier having joined the firm as a Consultant in 2012 from Standard & Poor's. His responsibilities at Frontier include providing consulting support to clients, and involvement with both investment and manager research.

Nathan worked for five years within Standard & Poor's Fund Services division and prior that spent four years at Westpac Banking Corporation, where he worked as a Middle Markets Credit Associate, and also in Property Finance as an Assistant Relationship Manager.

Nathan holds a Bachelor of Commerce (Finance Major) and Bachelor of Arts (Chinese Major) from Monash University, and a Diploma of Financial Services (Financial Planning).

Background

Members of Frontier's equities team recently visited global and emerging market equity managers over a two-week period, mostly in the US, but also in Canada. We met with a broad spectrum of managers, including managers across investment styles (value/growth/GARP).

Meeting an eclectic group of managers gave us the opportunity to compare and contrast different views on the equity market reversal of the past year – where value outperformed growth and where cyclicals outperformed defensives. It also gave us the opportunity to compare and contrast how managers within their respective style groups have positioned their portfolios, and what this has meant for performance.

This is particularly relevant for the value manager cohort, where we have observed an increasing dispersion of approaches and a large dispersion of returns. This is the focus of our paper.

Why is this topic relevant?

Within the value manager peer group, performance has been extremely diverse. For example, over the 12 months to 31 March 2017, our best-performing Buy/Neutral Plus rated value manager outperformed the MSCI All Country World Index by 10.8%. This compares with our worst performing Buy/Neutral Plus rated value manager which underperformed the same index by 6.6%. That represents a massive performance differential of 17.4% for two managers which prima facie have similar approaches. From close examination of the differences in approach, Frontier can actually see logical reasons why this differential has existed (i.e. the underperformer in question has actually stayed true to its style and is not considered to have deviated from its stated approach).

We think these results, more than anything else, reflect the broad interpretations of value style investing – something that has evolved over time given value approaches were more similar 10-15 years ago. While there are some common expectations for what a value manager should look like, fund characteristics vary markedly depending on the manager in question. This, and the recent dispersion in performance, reinforces the importance of understanding manager characteristics beyond headline style.

What types of value managers exist and what types of value managers did we meet with?

No two managers are created equal, and the same can be said for types of value managers. Commonly-used definitions for value investing, and types of value investing (e.g. intrinsic value, absolute value, relative value, deep value), are often tossed around. These terms can be confusing and we find they are interpreted differently from one person to the next.

For the purpose of this paper, we crudely divide the universe into the following: moderate value managers (where value metrics may only be barely evident) and deep value managers (where value metrics are highly evident). Dividing the universe this way has its own limitations. For example, there are considerable variations within these two classifications, and some managers will own both deep value opportunities and those without strong value characteristics. That being said, we think the delineation between deep value and moderate value is clearer than other value classifications, and it is our preferred approach.

The key distinction between deep and moderate value managers is the universe for consideration. Deep value managers typically confine themselves to stocks with cheap stock price metrics (price/earnings, price/book, etc.) and dismiss the rest of the universe as not representing value. Moderate value managers may include these deep value opportunities but they are also likely to include many other stocks that they deem to be of good value when considering their earnings growth and quality characteristics. Naturally enough, moderate value managers can (and do) have diluted value characteristics.

We met with a broad spectrum of both types of value manager, including managers that display characteristics of both.

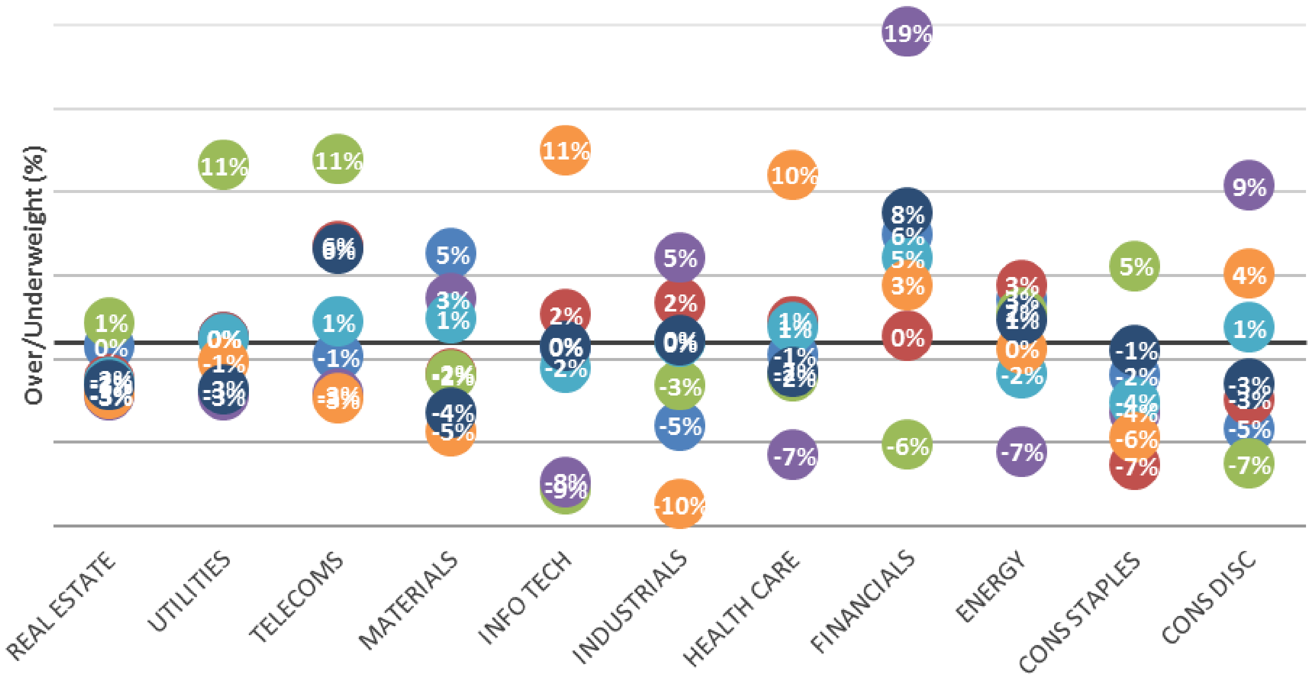
How are these different types of value managers positioned?

Within the value manager cohort, we have found a large dispersion in the types of countries, sectors and stocks managers have been drawn to. The chart below illustrates this by showing the range of sector weights, relative to their respective benchmarks, for some of the value managers we met with, as at 31 March 2017.

With regards to deep value managers, a company may be attractively valued because of issues specific to its own operations that have depressed its share price or because it is in an out-of-favour industry. For these managers, many of the deep value opportunities have been within the more cyclical areas (that's generally the case, but it has been even more so than usual). Examples include stocks in Europe, Brazil and Russia, as well as Energy, Materials, Industrials and Financials sectors.

For the moderate value managers we met with, the sector allocations we observed weren't necessary in line with what one might expect from a value manager (especially a deep value manager). For example, one moderate value manager we met with had a zero allocation to Materials, and underweight to Energy, and significant overweights to the Health Care and Information Technology sectors. These overweight sectors are not in the value domain as classically defined.

Chart 1: Range of manager sector active weights as at 31 March 2017



While we still think there is a place for deep value managers, we have observed that many of the modern value managers are a “progressive” form of moderate value manager. We define “progressive” moderate value managers as those which have a heightened focus on understanding a company’s earnings potential. For these managers, it is not enough to simply buy stocks that are viewed as cheap purely on stock-price ratios, as deep value managers do, and the focus on mispriced growth (at the industry level, company level and even within specific segments of a company) is elevated. We view this as the main reason for the differentiated positioning between the two value manager groups.

This type of varied thinking is most notable in a sector like Information Technology where mean reversion seems less likely to occur versus other sectors. We consider this a sector to be prone to the deep value trap as many of the segments of Information Technology seem “winner takes all” rather than having the economics being shared across many of the industry participants. We think an approach of investing in out-of-favour, underperforming Information Technology companies poses a heightened risk of investing in companies in secular rather than cyclical decline, and this is an area where deep value managers have at times being caught off-guard. The modern value manager seems more attuned to this.

What has this meant for performance?

The eclectic mix of value managers has created significantly different performance profiles within the value peer group. Realistically, it has made measuring a value manager according to a value peer group or with reference to a value index to be a meaningless exercise that is more likely to lead to misleading conclusions than to be a beneficial exercise.

Generally speaking, we found those moderate value managers we met with have delivered stronger relative returns over the medium-to-long-term. We attribute this to the managers' heightened focus on a company's quality and growth prospects. This has helped protect these products from significant underperformance in the years leading up to 2016, where traditional quality and growth segments (e.g. Consumer Staples, Information Technology and Health Care sectors) performed extremely well.

In contrast, having performed poorly for a number of years, most deep value managers considerably outperformed their benchmarks and peers in 2016; with the turnaround mainly attributable to their overweight to deeply out-of-favour, cyclical sectors and stocks. This includes Financials, Industrials, Energy and Materials stocks.

We expected these deep value managers, with their greater emphasis on low stock-price multiples and cyclical sectors, to perform strongly in the recent environment – and they did. Similarly, the more moderate value managers were not as leveraged to the value recovery, but had also been holding up more effectively in the prior period when value was out-of-favour.

The last words…

This reinforces the importance of looking past the style box to truly understand how a strategy is run and what kind of performance investors should expect. How a manager defines value will determine what their portfolio looks like and, ultimately, how the fund performs. We think that value as a style has become highly fragmented and, in many cases, tossing around this term to describe managers is less meaningful than ever.