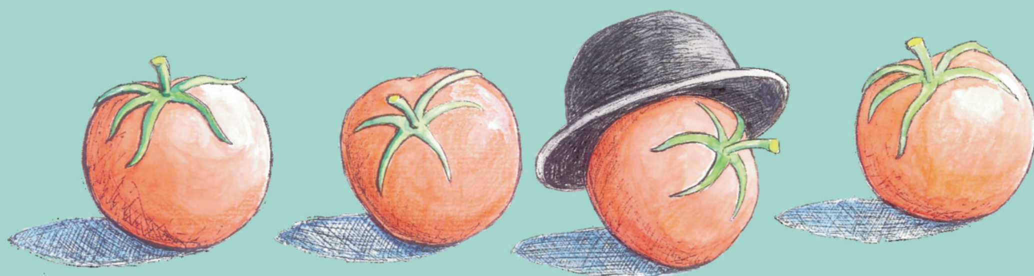
"You Say Tomayto..."

Contrarian Investing in Bitesize Pieces



Alastair Mundy

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Sample

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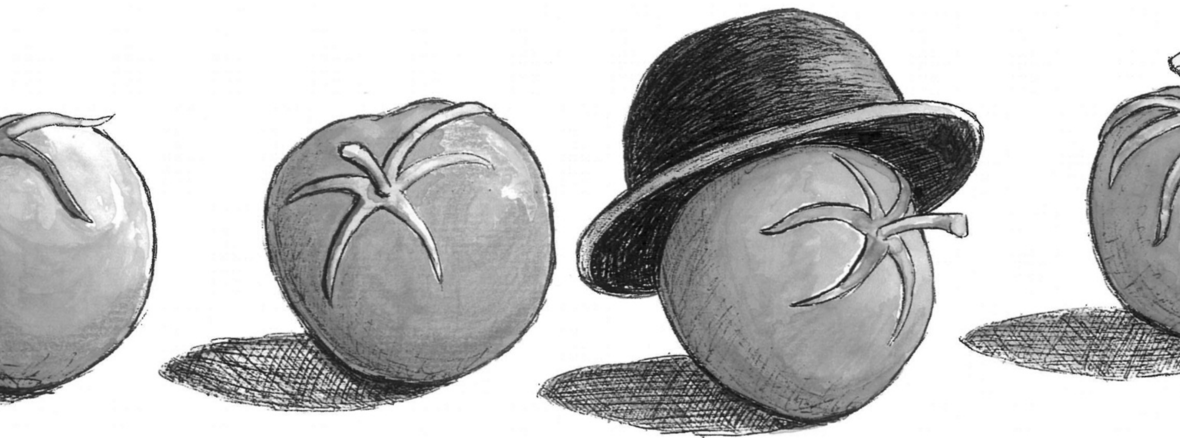

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This project would not have been possible without the help of my colleague, Holly Fox. In a moment of insanity Holly offered to make sense of the chaos generated by four years of monthly commentaries. Through a charming combination of suggestion and light requests she persuaded me to rewrite some poorly written parts and clarify others. She also corrected my worst grammatical errors and most embarrassing spelling mistakes. Holly now tells me that, as with 'proper books', I have to accept the blame for any remaining howlers.

Cartoonist Rob Townsend added much with his wonderful cartoons and excruciatingly corny sense of humour. I have almost forgiven him for playing at the wrong tennis club.

It would also be remiss of me to not mention the merry band of contrarian investors I work with: Jo Slater, Peter Lowery, David Lynch, Celia Duncan, Mark Wynne-Jones, Steve Woolley, Leo Liao, Mike du Plessis, and Alessandro Dicorrado. From what I have seen, most contrarian investors are miserable, grumpy, glass half-empty people and it is my privilege to have found nine of them. Investing can at times be a lonely business and working with such loyal, talented, and humble colleagues helps put the fun into fund management. Investing clients' money is a serious business, but it helps not taking yourself too seriously.

The long-suffering and lovely Mrs Mundy (aka Louise) deserves much praise for not just tolerating me for so long, but also encouraging me to turn a random thought into a real plan. She has even stopped moaning about my book mountain. And of course the three little 'doodies', Joel, Max, and Leah, earn credit for making their Dad realise there are far more important things in life than how far the Unilever share price has moved in the last 24 hours.

Many thanks also to my Mum and Dad for their support and love. They appreciated the importance of a decent education, but avoided drumming it into my sister and me. Instead they communicated it in a more subtle way, which has doubtless paid far greater dividends.

A number of friends read various drafts and made some useful suggestions; I found Toni Richards' and Amber Wyatt's feedback particularly helpful. My sister Julia reverted to type and marked her draft with extraordinary diligence and enthusiasm – I now know how it feels to be one of her students. I am also indebted to Suzanne Tull and Myles Hunt at Harriman House, whose expertise transformed my book from a simple draft into a professional publication.

Finally, I am grateful for the support of all my colleagues at Investec Asset Management, who have helped with this project and who are part of the work environment that encourages my investment process. They have allowed me to write about what I believe is relevant, rather than asking that I copy the style of our competitors. I unreservedly apologise to the marketing department for the many rude things I appear to have written about them over the last four years.

About the Author

Alastair Mundy grew up in East London convinced he would be the first British Wimbledon Men's Singles Champion since Fred Perry. For reasons best known to him, he studied Actuarial Science at City University, London, but after battling his way through the course decided actuarial work was far too boring. Alastair's first job in the real world was a brief stint analysing British government debt (gilts), which drove him to find a position as an equity analyst. He currently works at Investec Asset Management, where he has headed the Contrarian Equity Team for ten years. He is married with three children and remains committed to mastering his second serve.

"It's been bought by a
contrarian investor."

Introduction

It is a particularly self-indulgent act of a fund manager to publish a collection of his monthly commentaries and I am in no position to defend my actions with much substance or fervour. However, feedback received over the years from regular readers suggests that my monthly thoughts are considered more digestible than the standard fare of the investment industry. Investment is not a dry subject and I believe the technical jargon commonly found in some industry publications is employed primarily to persuade the reader of the author's intellectual superiority.

Commentary writing can be a blight on fund managers' lives, somewhere between monthly compliance meetings and completing training logs. Our marketing departments constantly urge us to review the prior month and then offer a forecast for the coming ones. Rather than conform resentfully, I write on topics I find interesting, stimulating, or even puzzling. I dare say when my marketing department notices I have strayed, I will be hung upside down by my toenails and instructed to correct my ways.

This collection of notes should not be read as a 'How To' guide of contrarian investing; it is instead intended as a base from which to explore the complex, broad, and fascinating subjects of investment analysis and fund management. Most of the areas considered have been researched in much greater depth by experts. Often I have simply raised one or two of their most relevant or revealing thoughts. I hope to encourage fellow investors to think less about why GlaxoSmithKline rose by 0.5% last month, and more about the factors most likely to determine its price in five years' time.

The merits of contrarian investing are documented in a number of ways over the following pages. Although I'm sure my wife

considers my bloody-mindedness and stubbornness as being perfect qualifications for a contrarian investor, the approach is a little different than she assumes. Yes, it requires one to act against the crowd. However, it is futile to do so without good reason. A naïve contrarian investor pops into a pub looking for a fight and is delighted if his first opponent is Lennox Lewis. A more seasoned contrarian looks to fight only little old ladies and small children. But, looking for the right opponent in my local pub in Upminster is far from straightforward – little old ladies can sometimes be veteran jujitsu champions – and detecting the easier battles in the stock market is similarly challenging. At first blush, many stocks are optically attractive and other appealing stocks may initially look like dogs.

There is no trustworthy shortcut (that we have found anyway) to separate the dogs from the delightful. The long cut is the implementation of much hard work. Not hard work as in coalmining or ten hour days on a building site, but hard work as in understanding a company's business model, why other investors hate it, what positive factors they might have missed, how its balance sheet and cash flow interact, and whether its valuation is sufficiently attractive. None of that is rocket science (although my colleagues who actually conduct the analysis may disagree), but that does not make it easy. The bull arguments are often well hidden and can only be discovered through meticulous work, a sceptical mindset, and deep thought.

Contrarian investing offers fruitful rewards to an investor, but can sometimes prove a tortuous approach. The technology bubble of the late 1990s was little fun and the mining bubble a few years ago did nothing for my blood pressure. At such times, the crowd, convinced that recent events have changed the world forever, rationalises new investment paradigms. Perfectly good stocks are sold to fund the new, new thing. However, it is during these tough periods that, providing they don't lose their jobs, the real contrarians

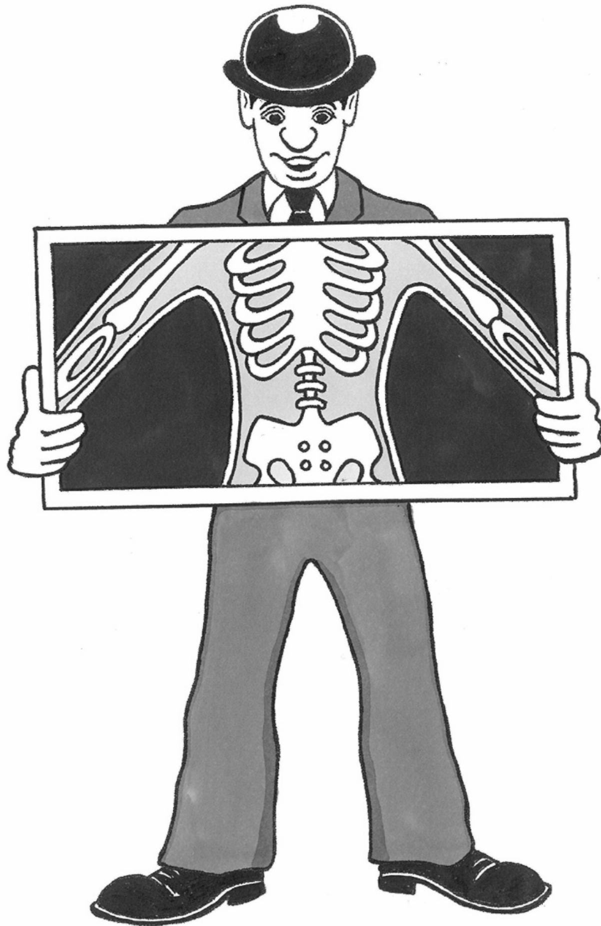
can distinguish themselves from their impostors and load up with great ideas for the next investment cycle. Eventually, the market realises the new paradigm is the emperor with no clothes and normal service is resumed.

Alastair Mundy

1.

You Say Tomayto

Beneath the Skin of Contrarian Investing



You say tomayto

I was once encouraged by a colleague to be less open when discussing our contrarian investment process. He was concerned that I would let the cat out of the bag and successfully convert a plethora of non-believers to our ways. I couldn't blame his motivation for the suggested vow of silence; he clearly recognised that we were one-trick ponies and worried that if our behaviour was copied by other investors, any competitive advantage would soon be arbitraged away, requiring us to put a hoof in the air and admit defeat.

> "It is not easy implementing a contrarian strategy"

Whilst undoubtedly over-rating my evangelical skills, I thought he also missed some vital points that suggested contrarian investing would remain a minority sport. It is not easy implementing a contrarian strategy. Many investors are uncomfortable acting against the crowd and even if they 'know' it is the correct course of action, will still strive to avoid it. Eminent economist John Maynard Keynes was spot on when he commented that "worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally".

However, as important is the consideration that, because none of us can accurately forecast the future, our competitors might be correct in opposing our investment opinions. We model ourselves as historians, rather than all-knowing astrologers, spending a significant amount of time piecing together the past and trying to ascertain whether published accounts are accurate records of what occurred. We make no promises about the future. It is purely guesswork – albeit educated guesswork.

This guesswork determines that we assess a series of facts and make a judgement on how they will shape the future. But our conclusions are just one view. For example, we may feel a company's executive remuneration scheme over-rewards the recipients for good

results while avoiding penalties for failure. However, other investors may believe that the structure ensures management and shareholders are perfectly aligned and incentivises management successfully. Likewise, some may regard a company that keeps its capital expenditure similar to its depreciation as an efficient capital allocator, but others may believe it is under-investing in the business. Investors might believe a poorly managed company can be shaken up or be on the slippery slope to bankruptcy or that a company generating a high return on capital exhibits high barriers to entry or excessive and unsustainable returns. There is a yin to every yang, a Morecambe to every Wise, and a 'tomayto' to every 'tomahto'.[1]

In its simplest form, one could argue that this difference of views is a 50/50 bet; no different to tossing a coin. However, the wager we make is more complex because in stock market analysis there are a number of outcomes with different probabilities of occurrence and a variety of pay-offs. We search for those stocks with an attractive pay-off if the outcome is as we expect, but that will inflict a relatively small loss if we are wrong.

Of course, the most important reason why my evangelising should be of limited concern is that more erudite and articulate investors and academics than me have tried and failed. There have been numerous books and academic studies published on the merits of contrarian and value investing, but despite this, the majority still wish to practise alternative investment religions.

I think it is safe to ignore my colleague's pleas. We are left with the bizarre ambition that we wish to persuade our clients that our contrarian principles have some merit, whilst simultaneously hoping that our competitors remain convinced that we are clueless.

December 2011

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[1] Although the nature of our investment style dictates that we sometimes feel lonely, the presence of investors with opposing views suits us well as it provides the liquidity after which we hanker. These investors sell to us when we are buying and buy from us when we are selling. (Annoyingly, our analysis suggests that both sets of investors make good money from us, at least in the short term.) It is a much greater challenge to invest and disinvest when running with the herd.

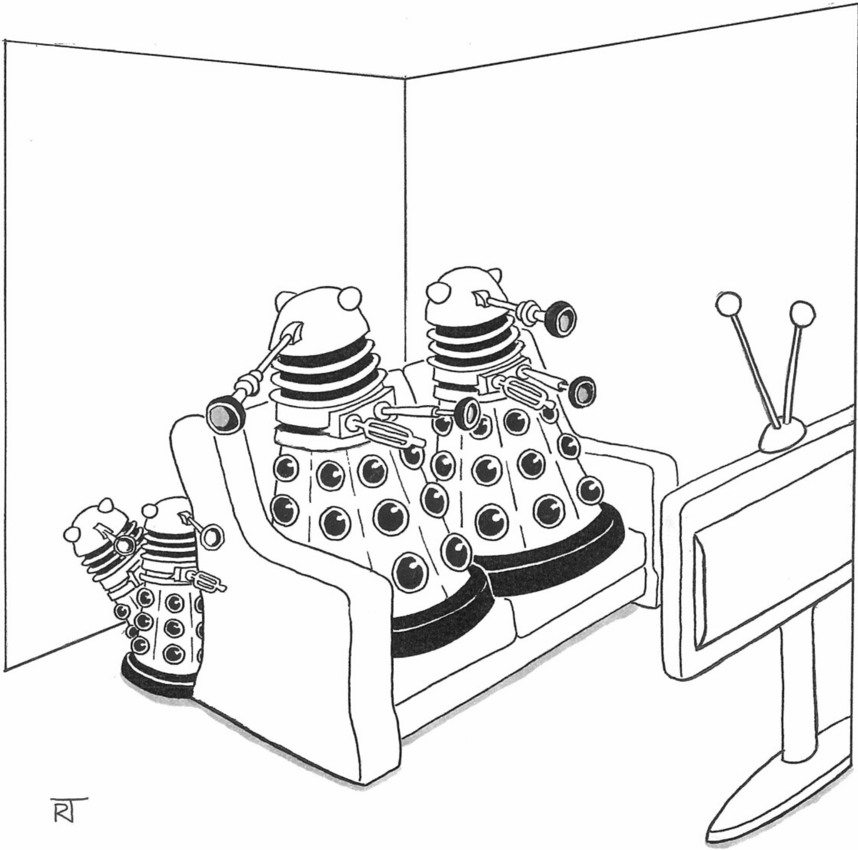
Too scared to watch?

I was recently asked to prepare a presentation that contained a case study of a stock within the portfolio. Obviously, I was tempted to showcase a brilliant investment that illustrated foresight, a clear and perceptive mind and a fantastic talent in timing, but frankly I couldn't see the point. Every investor should, after all, be able to dig up a couple of examples of some good stock picks. At best, they probably reflect a decent mixture of luck and skill, but with clever use of hindsight a presenter can persuade an audience that skill was the major contributor.

This exercise of reliving past glories in front of an audience is particularly futile for an investor in out-of-favour stocks. It is rather like, as a kid, watching an episode of *Doctor Who*[2] for a second time. You know the plot, you know that really nasty things never happen to the Doctor, and therefore you don't need to hide behind the sofa. But remember how scared you were the first time? Our vital job when presenting, is to recreate the conditions at the time of purchase, not at the time of sale, and typically we find it difficult to explain or even remember quite how uncomfortable we felt. Without those emotions the story lacks meaning.

Any investment argument we make can be separated into two lists: one with the positive motives for buying a stock and the second with some good motives for passing. A falling share price supports those investors who energetically espouse the negatives. Although at these moments we do our best to remain calm and deal with facts alone, the decision never involves just black or white; usually we are

[2] Long-running British TV science-fiction series featuring the eponymous Time Lord. Doctor Who explores the universe in his time machine-spacecraft, thwarting the evil plans of countless extra-terrestrials. His arch-adversaries, the cyborg Daleks, plot world domination and the extermination of all non-Dalek life. Being virtually impenetrable to most weapons and equipped with a death ray that can kill anything, the Daleks have the innate ability to scare small children witless; this is despite having what appears to be a sink plunger welded to their heads (see cartoon).



"You can come out now, kids ...
`Doctor Who`'s finished."

offered slightly different shades of grey and it is tough to act rationally. We are only human and our confidence may be knocked after buying the shares at a higher level or having heard a particularly strong counter-argument.

"It is tough to act rationally"

To simulate the feelings when buying a deeply unloved stock, I generally encourage an audience to imagine eating alone in a restaurant. For most of us it is a deeply unpleasant experience. We can start by reading the menu and wine list and checking our mobiles, but when these distractions have passed it is hard to relax. All around us happy groups of people are wining, dining, talking, and laughing. Every now and again, we catch someone's eye and they give us a look of what can only be read as pity. After all, no one would choose to eat alone. We assume they see us as sad, lonely, and friendless. This experience is repeated a number of times as we scan the restaurant and, when the food finally arrives, our heart is pumping and we will eat a lot faster than other diners, before inevitably leaving our table first and with great relief. (Standing up at a football match in the home end and applauding the referee for giving a 50/50 decision to the away team will probably elicit similar feelings, but is probably more dangerous than is necessary to appreciate the merits of contrarian investing.)

Of course, just experiencing these feelings associated with acting alone doesn't guarantee success. Often the consensus is correct (Brazil being favourites to win the World Cup doesn't guarantee their failure), or sometimes the risks are simply not worth taking because the rewards aren't sufficiently attractive. We regard the nausea, increased blood pressure and general sense of unease as being necessary, but definitely not sufficient conditions to make many of our investments. To the mix must also be added hard work and diligent analysis.

May 2010

Portfolio concentration – separating the good from the great

Clients and potential clients often request a breakdown of our performance by individual stock, i.e. an attribution analysis. It would, obviously, be great to provide a list containing only successful stock picks. However, performance is not like that. Historically, we have found that even those stocks we have purchased that have performed well over longer periods have had variable short-term returns. Add to this list our losers and it is clear that we will always generate a mixture of positive and negative returns. In fact, over the long term, virtually all investors can point to a spread of a few very good ideas, a greater number of decent picks, a fair number of poor ones, and one or two howlers.

> "If you can tell a good investment from a bad one, you can also distinguish a great one from a good one"

If this is the case, shouldn't we just invest in our really great ideas and avoid the rest? I have changed my beliefs on this over the years. I previously thought that at purchase it was too hard to distinguish the best ideas from the rest and that significant diversification was a necessity. However, I have now converted to successful value investor Seth Klarman's view: "If you can tell a good investment from a bad one, you can also distinguish a great one from a good one". The stumbling block to implementing a great ideas strategy, however, is that we simply cannot always find sufficient stars to fill a portfolio to allow our clients to sleep comfortably at night.

For example, when we purchased our last pieces of Travis Perkins and Signet Jewelers (after several attempts at higher prices) we were reasonably confident, on a probability-weighted basis, that we were buying some very cheap shares. At the time, however, the market in general, and these stocks in particular, were distressed. Opportunities like this occur rarely. If we held only stocks where we could match that level of confidence, our portfolio would be either highly liquid or one with few stocks. Portfolios with those characteristics would rarely be permitted under most clients' mandates and, even if possible, would typically display such high volatility that few investors would have the stomach for the journey. While Klarman warns that it is vital not to confuse volatility with risk, I would imagine most clients are not so forgiving.

Some fund managers are comfortable with this strategy. Warren Buffett has always run a fairly tight portfolio and his business partner Charlie Munger at times has had what most would consider an absurdly tight portfolio. However, even Munger cannot escape from the problem of skewed attribution: "If you took our top fifteen decisions out, we'd have a pretty average record".[3]

Interestingly, a reasonable amount of academic research supports the strategy of investing only in one's best ideas. For example, Cohen, Polk, and Silli[4] found:

> The stock that active managers display the most conviction towards ex-ante, outperforms the market, as well as the other stocks in those managers' portfolios, by approximately one to four percent per quarter depending on the benchmark employed ... The other stocks managers hold do not exhibit significant outperformance. This leads

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[3] Munger, Charles T., *Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger* (Donning Company Publishers, 2005).

[4] Cohen, Randolph B., Christopher K. Polk, and Bernhard Silli, *Best Ideas* (Social Science Research Network, 2009).

> us to two conclusions. First, the US stock market does not appear to be efficiently priced ... Second, the organization of the money management industry appears to make it optimal for managers to introduce stocks into their portfolio that are not outperformers. We argue that investors would benefit if managers held more concentrated portfolios.

Given our remit of managing a fund that must always be at least 80% invested in UK equities, how can we best use these findings? To reduce the risk of buying underperformers, we believe it is vital to hold cash when we have insufficient ideas to maintain a fully invested portfolio, and to reduce volatility, we are content to build some 'index-aware' positions. The world's great investors may sneer at this strategy and others may accuse us of index hugging, but we believe it is very important to reduce volatility to a level with which our clients are comfortable.

February 2010

The risks of structural decline – a requiem to fondue sets

Catching falling knives was a reasonably fruitless activity in 2011. In fact, several of the worst market performers in 2010 were poor once again last year. As contrarian investors, we must question whether anything has changed to adversely affect our style of investing in out-of-favour shares. Is contrarian investing heading the same way as boy bands, Curly Wurlys,[5] fondue sets, and shaggy perms?

In our view, some rules of engagement have changed significantly. The first is the influence of the economic and financial backdrop. Company turnarounds are most straightforward when economic conditions are sound; there is simply more turnover within an industry to share between the various protagonists. In weaker times, the battle for turnover is intense and the weaker players struggle to recover their poise. As turnarounds require the support and patience of banks, they are even tougher if financing opportunities are scarce. To take one example, Dixons Retail has refurbished its UK stores (Currys and PC World) and re-trained its historically unenthusiastic staff, but the debt burden it carries has hampered this process. Despite most independent commentators reacting positively to the changes at Dixons Retail, its market share has continued to fall as competitor intensity (from Amazon, John Lewis, and superstores) has increased in a declining market.

The second noteworthy change is technological. It is interesting that even forecasts of technological progress made by the most fervent analysts in the late 1990s technology boom were insufficiently bullish. Technology has subsequently developed

[5] A Cadbury creation dating from the 1970s – a tasty but oddly-shaped chocolate-caramel lattice. The bars were once very popular, but now account for less than 0.1% of the company's sales in Britain.

"Is contrarian investing heading the same way as boy bands, Curly Wurlys, fondue sets, and shaggy perms?"

extraordinarily quickly and, in the process, has destroyed a number of business models that had endured for decades. For example, regional newspapers (an area where as investors we continue to embarrass ourselves) appear to have lost their monopolies in recruitment and classified advertising to online competitors. Now that we can surf the net to find houses for sale and pubs that need chefs, it is unlikely that former glories such as these will be revived.

Each generation probably believes that the changes it experiences are more meaningful and wider-reaching than others. But the effect that technological progress has had on companies in retailing, media (and even technology) industries in particular, suggests this claim currently has some credibility.

So how should a contrarian investor respond if conditions are less propitious? We have always warned against catching *all* falling knives and stress the importance of detailed balance sheet analysis of every potential investment. Without long-term financing, a weakly capitalised company must recover quickly. We prefer to, where possible, minimise our balance sheet concerns so that the companies we own have sufficient time to manufacture a turnaround.

In addition to a sound balance sheet – and importantly we demand it is sound across a number of future scenarios – there are other indicators that we believe help to improve our hit rate when we purchase out-of-favour stocks.

The quantum of companies' operational underperformance can vary across industries. In some industries, particularly those in which companies have established brands, market shares are reasonably stable and declines can be relatively slow. However, in others,

particularly those more fashion related or commoditised, market shares are more volatile – and once lost are much harder to regain.[6]

This volatility of market share often arises in industries that have few barriers to entry, thus allowing 'brands' to grow very quickly. It is, for example, interesting to see how quickly aggregators (such as Confused.com and CompareTheMarket.com) have rapidly built brands and won large market shares in the motor insurance market. Similarly, supermarkets have built substantial market shares in many non-food related products over the last decade. To make matters worse, they have been comfortable selling products as loss leaders, thus dragging down overall industry profitability as price competition bites.

It is also revealing to consider barriers to exit. If it is too expensive for a company to leave an industry (because of, for example, onerous lease payments), it may be forced to remain in the market and thus reduce the returns for other profitable competitors.

Few of these considerations are clear-cut. Industry dynamics can change, even following stability over several decades, and share prices can move quickly to discount a new era. As a rule of thumb, we now prefer to search for underperforming companies in industries where market shares move slowly and reasonable barriers to entry exist, and we are ever more diligent in our balance sheet analysis.

January 2012

[6] As an incurable romantic, I was appalled last season to see my son and his mates use cricket bats made by Adidas and Nike (heavens above, is nothing sacred?). These manufacturers have muscled their way into a market previously monopolised by the nostalgia-inducing names of, amongst others, Duncan Fearnley, Gray Nicholls, and Stuart Surridge.

"We've got another one who's tried catching falling knives!"

Mean reversion – whatever goes up probably comes down

There has been much talk of bond bubbles recently and some commentators have tied their colours firmly to the mast. Nassim Taleb, the author of *Fooled by Randomness*, was quoted in the *Financial Times* recommending that every single human being ought to bet against US Treasuries as it was a 'no brainer'.[7]

It is interesting that there is far less chatter highlighting the bubble-like characteristics of profit margins (profits as a percentage of sales). After all, many companies in the US and Europe are currently generating high margins. Historically, this has proved a mean-reverting series (for the non-mathematicians, 'whatever goes up goes back down'), although strangely enough, it is quite hard to find many strategists discussing this possibility. Instead, individual companies are typically lauded for generating higher margins as, to many, it indicates organisations in rude health.

Margins are high for a number of reasons. Low interest rates and tax rates have contributed and cost-cutting, be it on labour or more general costs, has clearly had a major influence. In the short term it is likely costs will be tightly controlled, especially as management are generally highly incentivised to reach their targets. There may be individual hiccups along the way (is there a correlation between penny-pinching on health and safety and the incidence of oil spills?), but the rule of thumb seems to be: keep cutting until the pips squeak – and then cut some more.

Another contributor to margin accretion, although not always highlighted by official statistics, must be price inflation. There is no doubt that my Marks & Spencer's socks and pants are not as long-lasting as they were twenty years ago (and I have no reason to believe

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[7] Davis, Jonathan, 'Beware the ending of a bond epic', *Financial Times*, 5 September, 2010.

I wear them harder). Has a reduction in prices accompanied a reduction in quality? Well, they are lower priced, but I'm not convinced they are low enough to justify the reduction in quality. While the plural of anecdote is not data, it is not just clothes providing a lower quality to price ratio. Furniture, toys, and a variety of household goods all seem to have significantly shorter life expectancies. It would be fascinating to see some research in this area.

"Individual companies are typically lauded for generating higher margins as, to many, it indicates organisations in rude health"

Both cost-cutting and subtle price inflation can continue for some time. Of course, a company's cost-cutting eats into other companies' revenues and consumers' jobs, while price inflation erodes all consumers' disposable incomes. This may be a story of gradual movements rather than step changes, but we are certainly not betting on a new paradigm of structurally higher margins.

August 2010

Tesco – every little helps margins revert

One issue that has concerned us for some time is the high level of operating margins generated by a number of listed companies in the UK stock market. Indeed, several companies are producing their highest ever margins and most are much closer to their peak than their trough. Our belief in mean reversion drives our scepticism that companies can continue to achieve such high levels of returns. Clients questioning this belief typically challenge us to explore the reasons for margin erosion. One possible reason is increased competition and Tesco's woes provide an interesting case study in this regard.

Tesco's profit warning on 12 January 2012 was a surprise to the market (as evidenced by the 16% fall in share price on the day). Tesco's top brass had encouraged investors to regard the company as a master of its destiny – a company sufficiently large to set the rules in the UK food retailing sector and manage its domestic business to produce an operating margin consistently around 6%.

Tesco's market-leading margin had been generated historically by passing on its huge buying power over suppliers on to customers in lower prices, consequently encouraging growth in shoppers and therefore turnover. In its glory days, Tesco's virtuous circle of lower prices and high volumes discouraged competitive reaction from smaller competitors.

The theory – and for a time, the practice – was fine, but something evidently went wrong. Perhaps Tesco started to milk UK profitability to feed its international ambitions or maybe management's over-confidence handed other food retailers the opportunity to catch up. Whatever the reason, and despite the huge amount of capital expenditure that Tesco has recently committed to the UK, Morrisons, Sainsbury's, and Asda have eroded its market share.

In a desperate attempt to maintain its margins Tesco started pulling other levers. For example, according to Oriel Securities, over the last five years the amount of square foot per member of staff in the UK has risen by 24%. (This is not a perfect statistic to use given the confusion created by the high growth in recent years of labour-intensive Tesco Expresses and labour-light non-food space, but there is little doubt that the trend is correct.) Whilst a short-term positive for profitability, this has affected service levels and resulted in longer checkout queues and emptier shelves. Also, Tesco's reputation for low prices has been damaged and customer perceptions in some surveys suggest that Tesco is now considered the least competitive of the big four. Interestingly enough, on price check surveys Tesco is more competitive than its customers believe. It might be that Tesco ensures the prices of the least surveyed goods are the most uncompetitive, or it may simply suggest that it is finding it difficult to convince its customers that its prices really are competitive. Either way the company has a problem.

Under its new chief executive Philip Clarke, Tesco immediately responded with a significant increase in staffing and other costs. It is unclear what the longer-term impact of Tesco's profits warning will be on the food retailing sector, but the immediate impact is a reduction in margins of the market leader. A company generating supernormal margins has been reined in by a combination of its customers and its competition. Tesco (which we are currently analysing in detail – we will share our conclusions at a later date) may be the 'canary in the coalmine'[8] or simply a one-off. The stock market is betting on the latter and remains sanguine about the strength of corporate profitability. If this assumption is incorrect, the lower equity market volatility of the last few months may well prove short-lived.

April 2012

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[8] It used to be common practice that coal miners carried caged canaries with them; if poisonous gases were present in the tunnels, the canary would show symptoms before the miner, acting as an early-warning system.

Risk management – dinner party do's and don'ts

The asset management industry has grown substantially over the last twenty years, and some pockets have expanded phenomenally. Areas such as compliance, hedge funds, and marketing have grown faster than any sane forecaster would have predicted. The benefits each of these has brought to clients are questionable, but for another day. However, the growth of risk management from cottage industry to behemoth is worthy of discussion.

Perhaps this is the most straightforward growth story. After all, who wouldn't wish to assess risk more carefully if provided with the opportunity? Once clever software packages allowed asset managers, and just as importantly their clients, to assess if risk was under control, it was impossible to put the cat back in the bag. 'Shall we do less risk analysis' is an unlikely vote-winner for a pension fund trustee or city professional whose greatest fear is probably an outsized legal claim against them for negligence.

This would be well and good if this thorough analysis of portfolios, their vulnerabilities and sensitivities was actually beneficial. Sadly, it is not. I will not defend that statement with any deep intellectual insight, but merely point out that an extraordinary global financial crisis struck when risk analysis budgets were at all-time highs. (The absurd counter-argument from risk experts is that we should imagine how much worse it could have been if their superb modelling hadn't been used.)

The main snag with all the risk packages is that they assume previous combinations of circumstances will repeat. So, if a company's share price has always jiggled around a lot, it always will, or if stock A and stock B have always moved together then, likewise, they always will. While I am aware of the importance of history, this does smack of constantly fighting the last war.

Although I have little respect for the modern methods of measuring risk, I wholeheartedly accept the need for risk management. My preference is to approach it with a greater degree of common sense. Over the years, I have often compared portfolio management to hosting a dinner party.[9] No seasoned host would invite just the six or eight funniest friends they have: convention dictates their friends' less amusing partners must be invited too – probably a good thing as funny people are not always the best listeners. And even funny people ultimately run out of jokes, leaving a vacuum to be filled with a random football trivia question or philosophical puzzle. And when that doesn't work, there is always a place for 'Where are you going on holiday this year?' (Mrs Mundy's party piece). The most successful parties and series of parties therefore need a good mix of invitees. And portfolios are no different: a number of stocks bought at a variety of times for a host of reasons can bring great strength to a portfolio.

Admittedly, that does read like the *Janet and John*[10] guide to portfolio risk management, but it is not always necessary to make a simple subject complex (unless you are a consultant charging ridiculous fees). Of course, the analogy can be taken further. There are some 'friends' who you should never invite to a dinner party and there are also some stocks or assets that should never be in a portfolio. Inevitably the absolute turn-off is excessive valuation.

Some clients might use performance as a shortcut to assess portfolio risk. After all, a fund manager who consistently outperforms his peers must, in their eyes, be doing something right.

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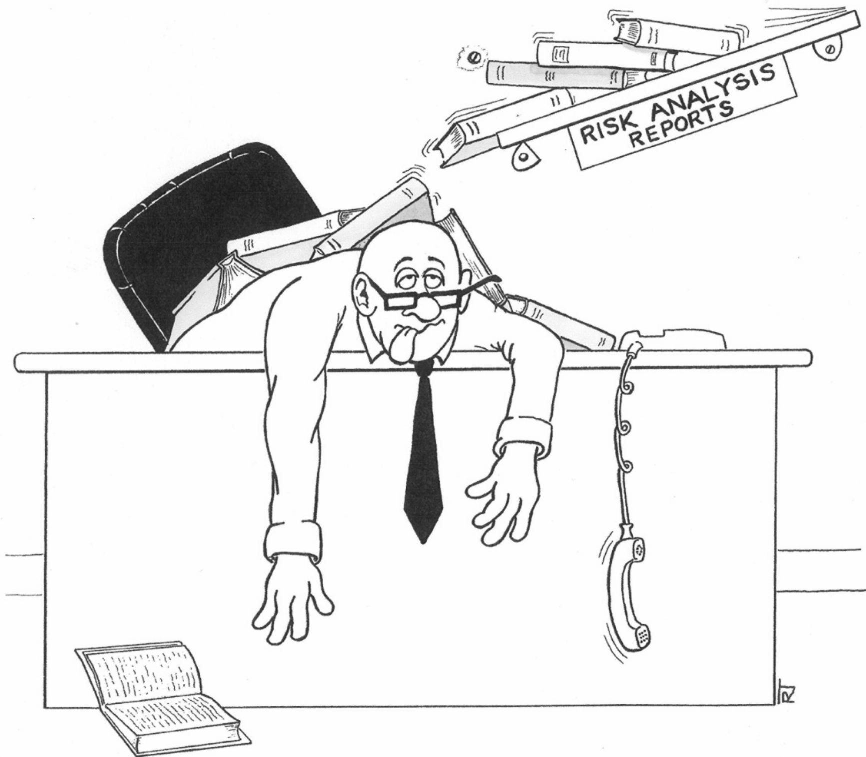
[9] Coming from Essex I have never even been invited to a dinner party, let alone hosted one, so please indulge me here.

[10] A series of learn-to-read books used in UK primary schools from the 1950s to 1970s featuring two siblings from an unashamedly middle-class family.

> "A number of stocks bought at a variety of times for a host of reasons can bring great strength to a portfolio"

Unfortunately, the best fund managers over medium-term periods have sometimes proved particularly dangerous custodians of clients' money. It is almost as though these managers have convinced themselves they can control absolutely anyone at their parties and have therefore taken to creating increasingly bizarre guest lists. Eventually, the party goes horribly wrong.

February 2012


RISK ANALYSIS
REPORTS

Stretching the analogy

Some common feedback we currently receive is that many potential stock market participants would prefer to wait until 'things are less uncertain' before committing extra funds to equity markets. In an ideal world, this is a perfect strategy. However, stock markets rarely behave in an ideal way. 'Less uncertainty' usually equates to a mixture of better economic news, better corporate results, confidence that the worst of the large negative surprises are behind us, and a greater flow of cash into equities. Unfortunately, when these factors can finally be ticked off a checklist, we will probably be closer to the top of the market than the bottom.

So, rather than waiting for less uncertainty, the equity investor looking to maximise his returns would probably benefit more if he dealt only in periods of **great** uncertainty. Conditions might become even more uncertain (i.e. worse) and prices fall further, but providing he was buying well below fair value it would not be a long-term problem.

"Stock markets rarely behave in an ideal way"

Our stock purchases are analogous to pulling an elastic band. It is never clear how far the elastic band will stretch, but ultimately it will do one of two things: bounce back, or break. Imagine the elastic band can be pulled back a total of *x* notches, but that no-one knows what *x* is. Someone playing this game will be rewarded the longer he waits for it to bounce back, **provided** he does finally bet on it bouncing back. The only way he doesn't win is if the elastic band breaks. On the other hand, he definitely **cannot** win if he never bets on the elastic band bouncing back. And obviously he will win far less (and possibly even lose), if he waits for the elastic band to bounce back before placing his bet.

Taking the game a bit further, it makes no sense for the player to make bets on when the elastic band bounces back if he knows that

a large number of bands actually break and that the money he makes on those bouncing back will not cancel out the losers. While this tortuous analogy has been 'stretched' to its limit, it is very useful in explaining our strategy so far in 2008.

i. We know we have to deal in uncertain times. Whenever all participants are certain and bullish, markets are typically expensive and ready to fall.

ii. We have a number of elastic bands (stocks) in case some do break (fall significantly).

iii. We are happy to buy stocks provided they have already stretched significantly from their fair value.

iv. If they stretch even further we are happy buying more, providing that we still believe they will bounce back.

v. We won't keep betting more and more on a bounce-back. We will sometimes simply maintain our position.

vi. If we lose confidence in the bounce-back, or worry that a break has become more likely, or can find other stocks where we believe the odds of a bounce-back/break are more attractive, we are happy switching.

vii. The stocks most attractive to us are those that offer significant gains from a bounce-back combined with the lowest probability of a break.

August 2008

Navel gazing

At the end of every calendar year most investors seem happy to share their hopes and fears for the year ahead. Several of them are also content to provide forecasts for market levels. We have always emphasised that there is little science and even less accuracy in this process. Commonly, these forecasts are accompanied with specific timings ('tough first half, but better second half') as if the primary question is simply not exacting enough. We do not participate in such competitions as firstly, we know we would likely be wrong and, secondly, we don't really understand the market's obsession with calendar year returns.

The time saved avoiding this exercise has allowed us to conduct some 'navel gazing' on our investment process. Two areas we have been considering are patience and low portfolio activity; many of the best investors over a number of decades share these characteristics.

Patience is a fascinating subject. As contrarian investors, we are often guilty of buying and selling too early. While neither of these are sins in themselves – after all when asked how he had become so rich, Baron Jacob Rothschild commented, "I made my fortune while selling always a little too early" – we think we could improve our process by not always buying so early. The institutional imperative that demands continual outperformance probably increases one's desire to deal, as does the extraordinary amount of (useless) information to which everyone has access. The ability to wait patiently for only the best ideas is not easily gained, but pays great rewards. Baron Philippe de Rothschild (clearly from a family that both invested well and were eminently quotable) once exclaimed that the time to buy was "when there is blood in the streets".

Some clients wonder if our emphasis on patience and low turnover (on average we hold our stocks for three years, compared to an industry average of between six and nine months) is justified

"The ability to wait patiently for only the best ideas is not easily gained, but pays great rewards"

given the speed at which markets move in the modern era. While this is a relevant question, this 'speed' should not be confused with 'distance'. For example, equity markets have taken nine years ('distance') to de-rate to their current levels from their valuation peak, despite some intermittent bouts of extreme volatility ('speed'). This is true for stocks too: think about the steady decline and de-rating of formerly successful companies such as ITV and Rentokil – more a grind than a collapse.

The successful application of patience is difficult (thankfully, otherwise we would be unemployed), but we continue trying to learn from our and others' mistakes. Sitting on our hands waiting for the right time to act and then avoiding selling too early are just some of our New Year's resolutions.

December 2008

Contrarian investing – cycling through the haze

When shares are falling, many investors wait for a catalyst or at least some 'increased visibility' before buying. This virtually ensures they will miss the bottom. If they are reluctant to change their sometimes entrenched views, they may also miss a significant amount of the initial burst of performance from the lows. We believe it is essential to capture this early part of the performance cycle, and with no-one waving a flag at the bottom, an investor must purchase early. This demands that investors must buy into a story that by definition is considered increasingly unattractive.

Not surprisingly, the investor acting in this way is deemed to have lost the plot. John Maynard Keynes summed it up elegantly:

> "For it is the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy."

> "Investors must buy into a story that by definition is considered increasingly unattractive"

In preference to fine-tuning both our share purchases and profit expectations for a company, we instead assess the average level of profits the company can achieve over the medium term. To borrow from Keynes once again, it is more important for this forecast to be "approximately right rather than precisely wrong". An average stock market rating typically accompanies the attainment of an average level of profits, so if we can buy the company's shares at a meaningful discount to the product of these numbers then sizeable profits can

be generated.

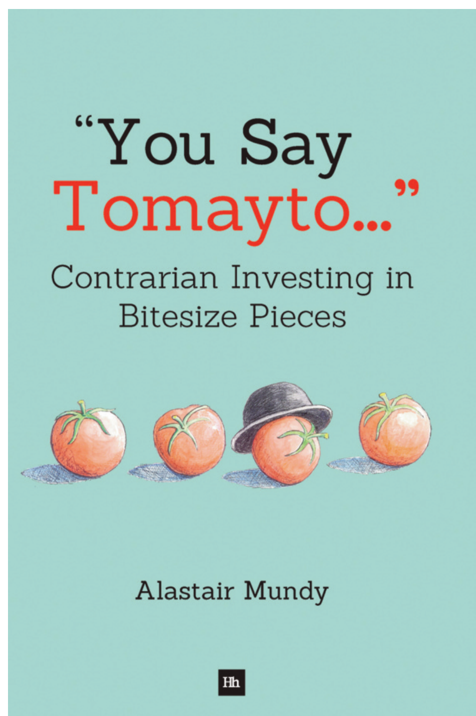
Of course, this won't always work. The company's future average level of profitability may be much lower than history suggests, or a company's existing capital structure may restrict the expected level of profits. However, providing this approach works on average, the relevance of each individual stock attaining its expected level of profitability is reduced. When we perform this exercise we are certainly not refuting the likelihood of a downturn or denying the possibility that a downturn may be quite deep; we are simply taking a longer-term view instead.

March 2008

You Say Tomayto

Contrarian Investing in Bitesize Pieces

Alastair Mundy



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