

Morningstar Investment Management Adviser Roadshow



Join the Conversation

#MIMAR

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Investment Management group, Morningstar

Finding Investment Opportunities in an Uncertain
Investing World

Agenda

- ▶ **Valuation-driven investing**
- ▶ Why we need to be contrarian investors
- ▶ Investment opportunity set
- ▶ Current investment opportunities
- ▶ Where have we been and how are we investing?
- ▶ Key takeaways and questions

How value is determined

“

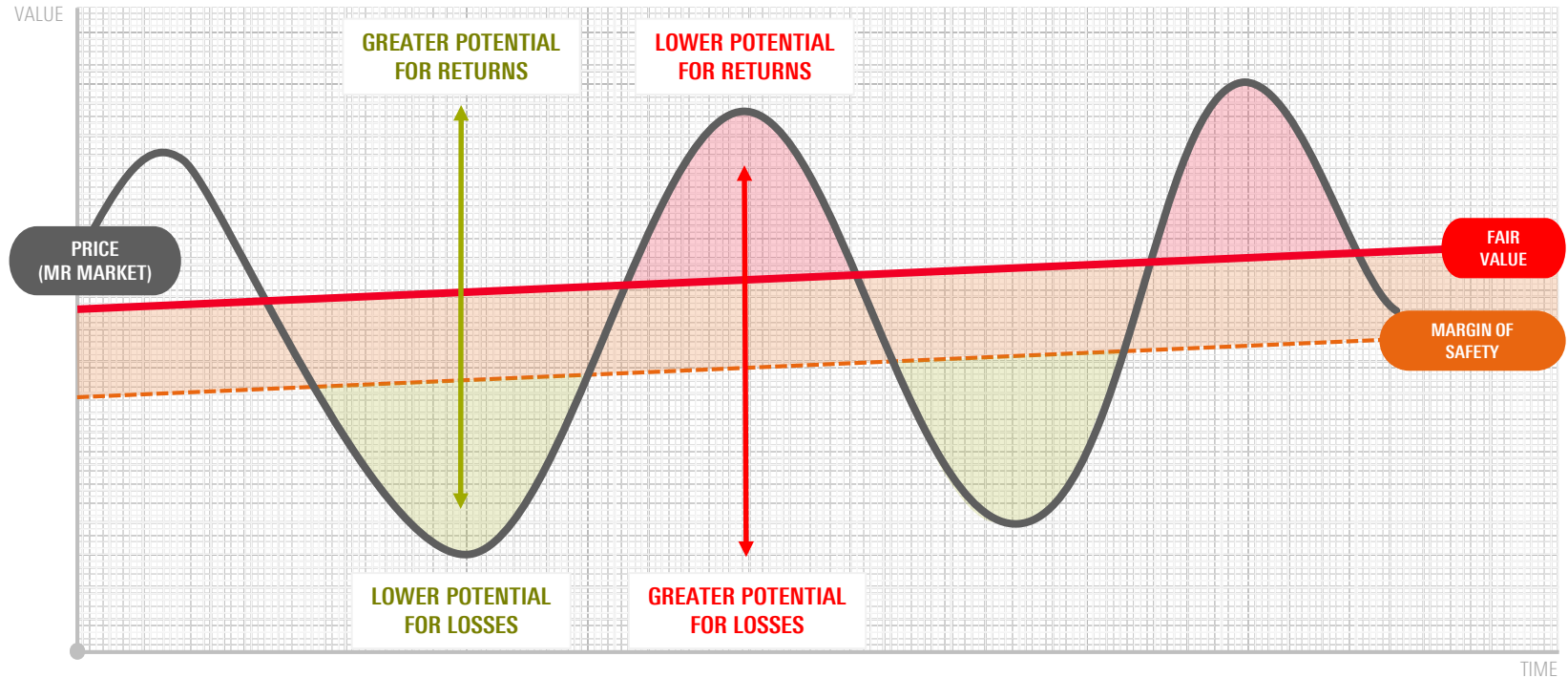
In the Theory of Investment Value, written over 50 years ago, John Burr Williams set forth the equation for value, which we condense here:

*The **value** of any **stock, bond, or business today** is determined by the cash inflows and outflows — discounted at an appropriate interest rate — that can be expected to occur during the remaining life of the asset.*

”

Warren Buffett, Berkshire Hathaway's 1992 Annual Report

Price to fair value drives returns and losses







Source: Morningstar. For illustrative purposes only.

Valuation and average returns



Source: DataStream, Bloomberg, FactSet & Morningstar Investment Management as at 31/12/2017. For illustrative purposes only.

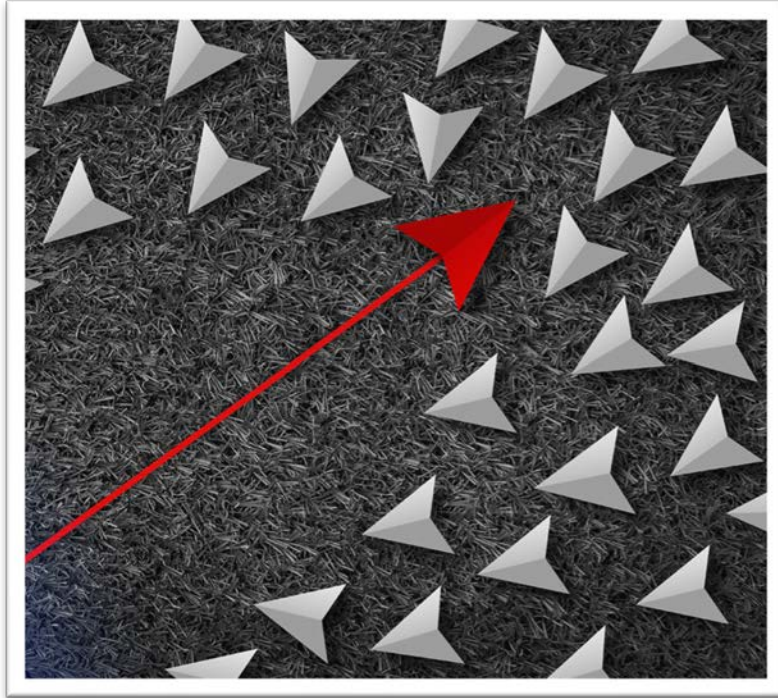
Our valuation framework for asset classes, regions & sectors

VALUATION-IMPLIED RETURN		=	CASH FLOW YIELD	+	CASH FLOW GROWTH	+	CHANGE IN VALUATION
EQUITY			Dividends Buybacks		FCF Growth Earnings Growth		Price/Fair Value P/CF, P/E
PROPERTY			Distributions		FCF Growth Earnings Growth		P/E, P/CF, P/FFO
BONDS			Coupons Interest		Defaults		Yield Spread
CURRENCY			Interest Rate Differential		Inflation		Real FX Rate

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What it means to be a contrarian



"The central principle of investment is to go contrary to the general opinion, on the grounds that if everyone is agreed about its merit, the investment is inevitably too dear and therefore unattractive."

**John Maynard Keynes,
Letter to Jasper Ridley, 1944**

Two theories – key contrasting arguments

Efficient Market Theory

- ▶ Investors are assumed to be rational and hence value securities rationally
- ▶ Irrational investor trades are random and cancel each other out
- ▶ Irrational trades not cancelling out are met by rational arbitrageurs

Behavioural Finance Theory

- ▶ Investors regularly violate rational postulates, with biased decisions and preferences
- ▶ Investors don't deviate from rationality randomly, most deviate the same way
- ▶ In contrast to efficient markets theory, real-world arbitrage is risky and limited

Warren Buffett's folksy rhyme to the rescue

Warren Buffett outlined this well in in his 1988 letter to Berkshire Hathaway shareholders:

"...Amazingly, EMT was embraced not only by academics, but by many investment professionals and corporate managers as well. Observing correctly that the market was frequently efficient, they went on to conclude incorrectly that it was always efficient. The difference between these propositions is night and day..."

Source: Inefficient Markets: An Introduction to Behavioural Finance Andrei Shleifer

The Jellybean Experiment

Wisdom of the crowd

- ▶ Jack Treynor's jelly bean experiment
- ▶ Michael Mauboussin (2007) –
73 Columbia Business School students:
 - ▶ Guesses: 250 – 4,100
 - ▶ Average error: 700 (62%)
 - ▶ Actual number: 1,116
 - ▶ Average guess: 1,151 – just 3% off



Source: Mauboussin, M.J and Page S

Wisdom of the collective

According to the Diversity Prediction Theorem:

Collective error =

Individual error (ability of the individual) *minus*
Prediction diversity (difference of individuals)

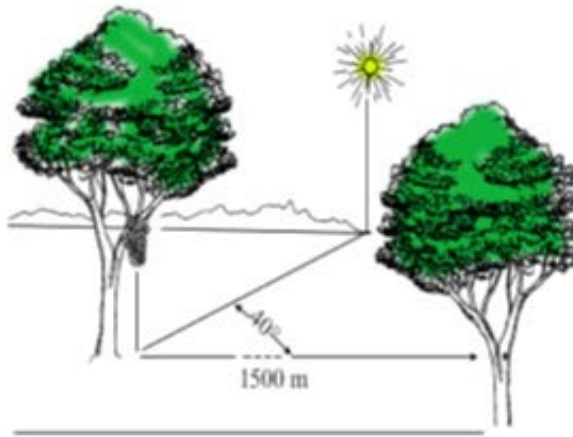
Collective wisdom
breaks down when:

Insufficient diversity causes individual errors to correlate

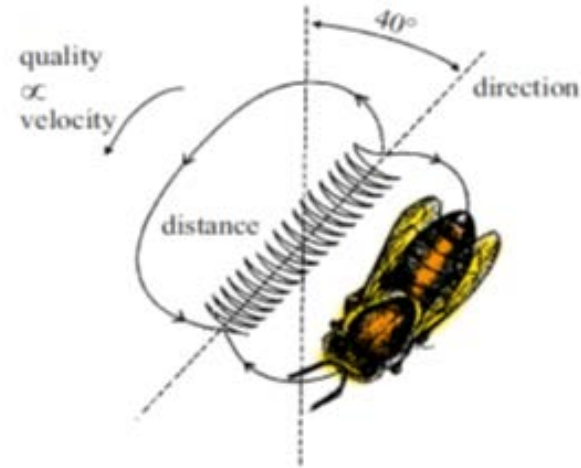
Bees use collective intelligence to select new hive sites

Interdependence and independence

Possible hive site



Waggle dance



Waggle dance is used to indicate potential bee hive sites. Each scouting bee makes an **independent evaluation** - and the new hive is only established once a **quorum is reached**.

Source: Collective Intelligence in social insects, NR Franks / Modified from an illustration of nectar foraging by honeybees in Seeley (1985)

Music downloads and social influence on decisions

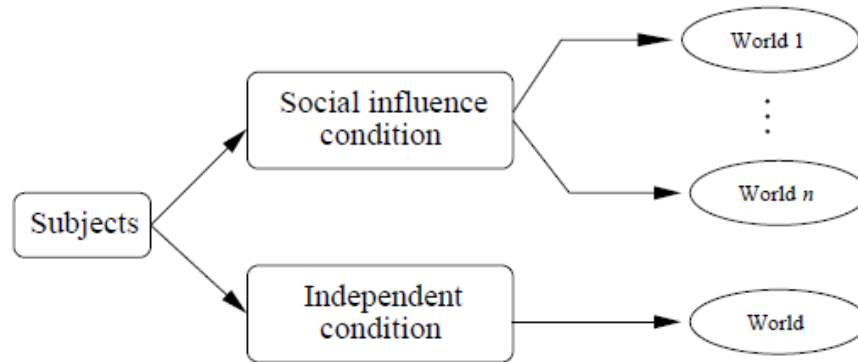
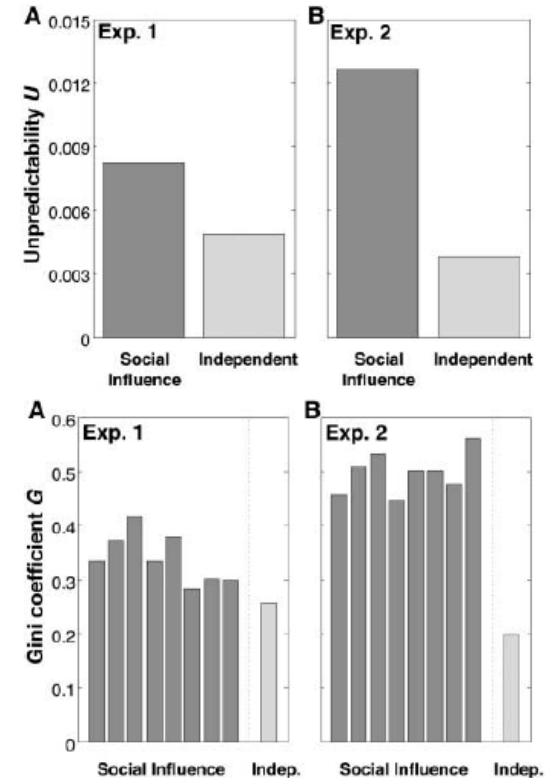


Figure S1: Schematic of the experimental design.

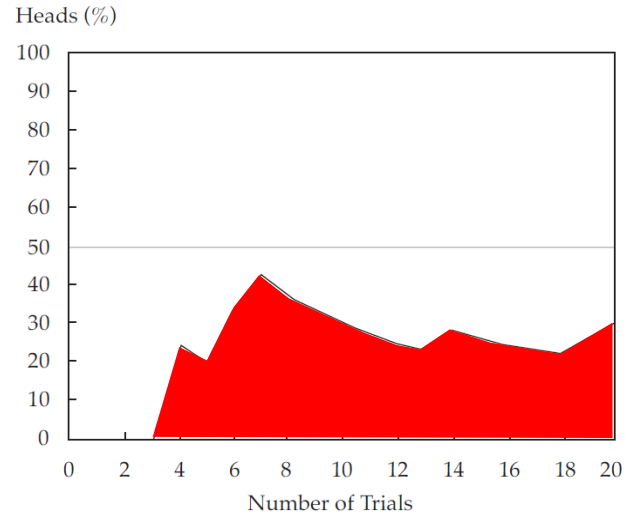


Source: Experimental Study of Inequality and Unpredictability in an Artificial Cultural Market, M. J. Salganik, P. S. Dodds and D. J. Watts. Science 2016

Illustrating noise versus signal

Short-term oriented observers may see the first 20 coin tosses and conclude that it is a “tails-biased coin”.....

20 Trials



Source: Mauboussin

Illustrating noise versus signal

Short-term oriented observers may see the first 20 coin tosses and conclude that it is a “tails-biased coin”.....

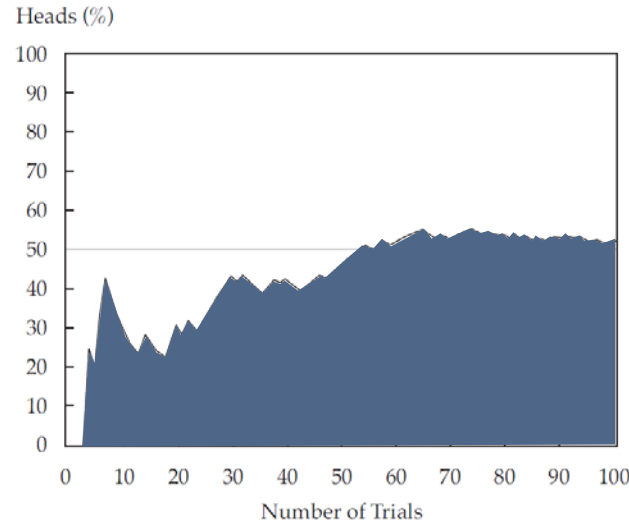


Source: Mauboussin

Illustrating noise versus signal


Short-term oriented observers may see the first 20 coin tosses and conclude that it is a “tails-biased coin”.....

100 Trials



Source: Mauboussin

Loss of difference and narrowing breadth



**Well functioning markets have
diverse participants**

Independent participants e.g.
value/growth, short-term/long-
term, institutional/retail,
fundamental/technical

Loss of difference and narrowing breadth

Well functioning markets have diverse participants

Independent participants e.g. value/growth, short-term/long-term, institutional/retail, fundamental/technical

A breakdown of diversity leads to fewer investor types

Remaining investors follow similar strategies, more correlated

Loss of difference and narrowing breadth

Well functioning markets have diverse participants

Independent participants e.g. value/growth, short-term/long-term, institutional/retail, fundamental/technical

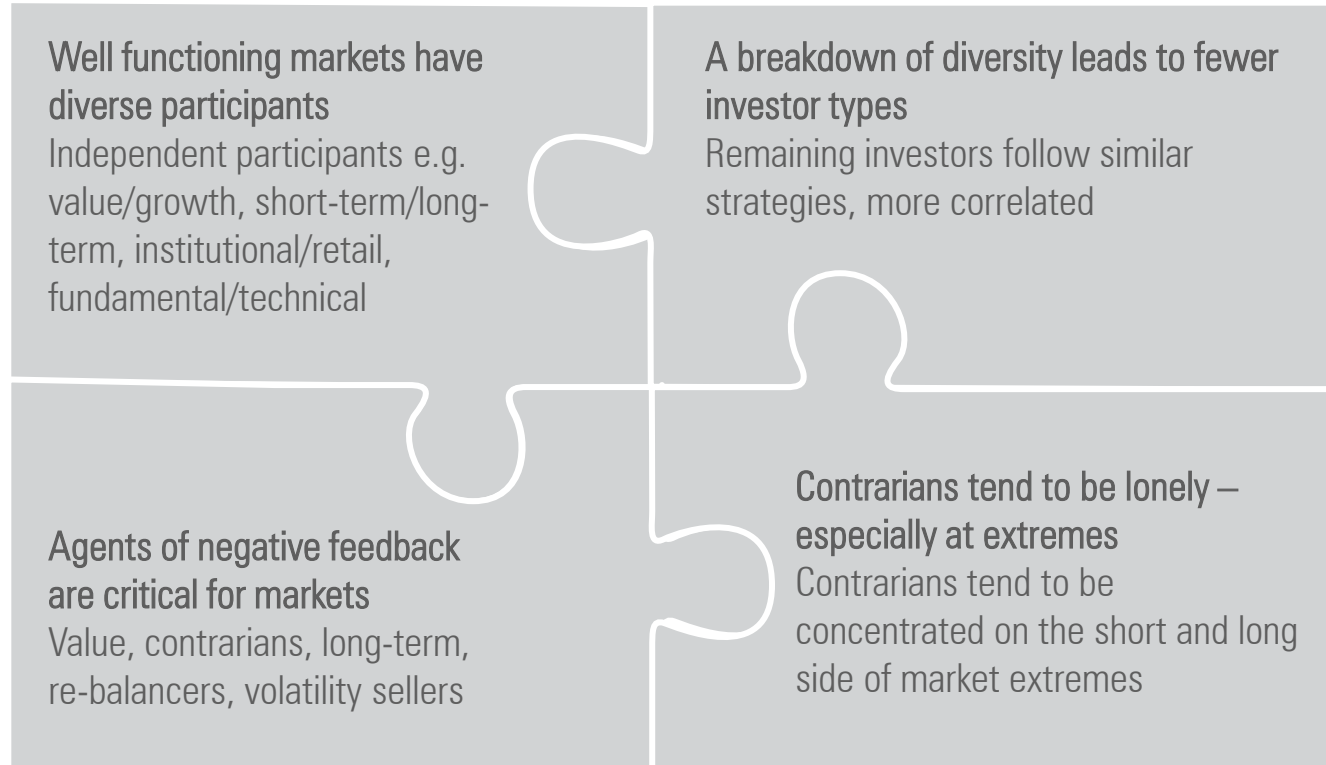
A breakdown of diversity leads to fewer investor types

Remaining investors follow similar strategies, more correlated


Contrarians tend to be lonely – especially at extremes

Contrarians tend to be concentrated on the short and long side of market extremes

Loss of difference and narrowing breadth



Contrarian investors checklist

- 
- ☐ Are most investors underweight and is ownership concentrated in more contrarian investors?
 - ☐ Are earnings expectations low relative to history and other assets?
 - ☐ Is sentiment negative as gauged by investor surveys?
 - ☐ Is trading volume or turnover low?
 - ☐ Is realised and implied volatility high and rising?
 - ☐ Are there low valuation ratios relative to history and similar assets?

Critical condition – buying dollar bills for 50 cents



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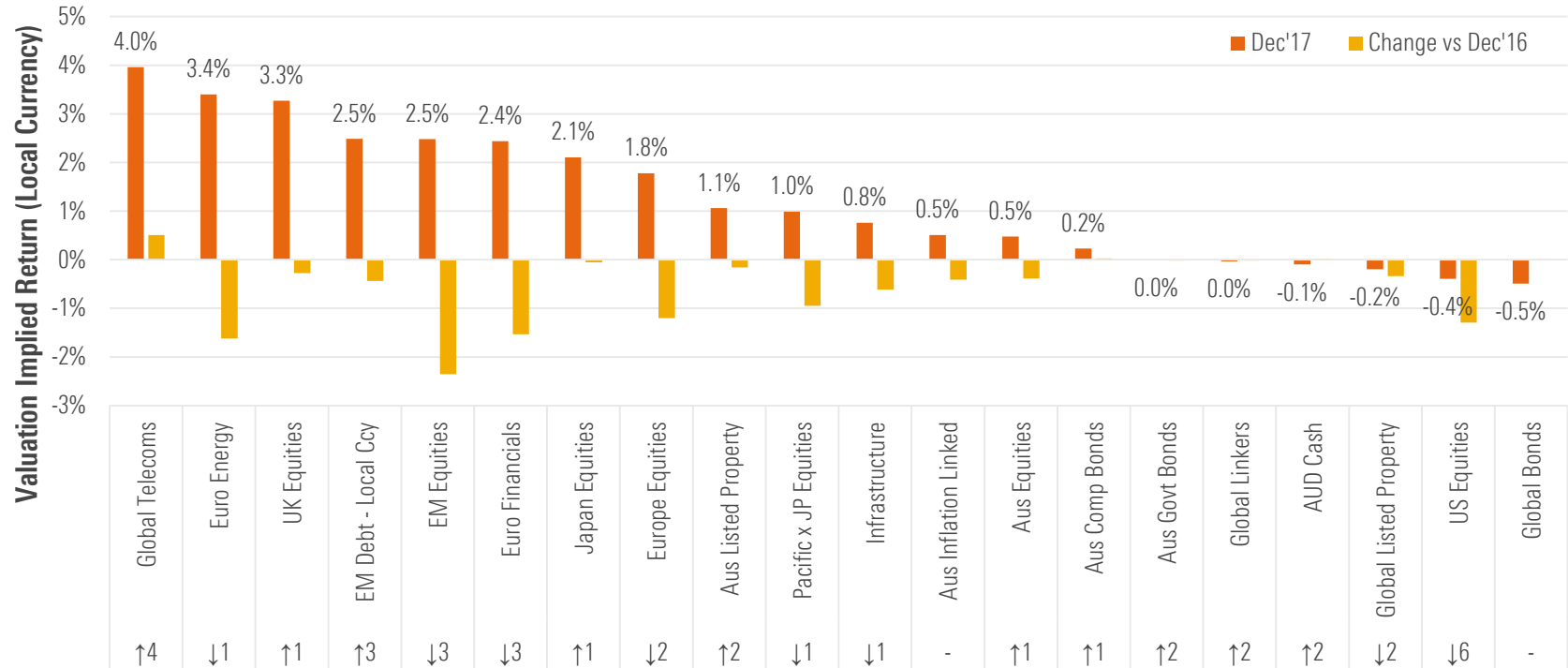
“Value investing, today as in the era of Graham and Dodd, is the practice of purchasing securities or assets for less than they are worth—the proverbial dollar for 50 cents. Investing in bargain-priced securities provides a “margin of safety”—room for error, imprecision, bad luck, or the vicissitudes of the economy and stock market.”

Seth Klarman – Introduction to the 6th edition of
Security Analysis, Graham and Dodd

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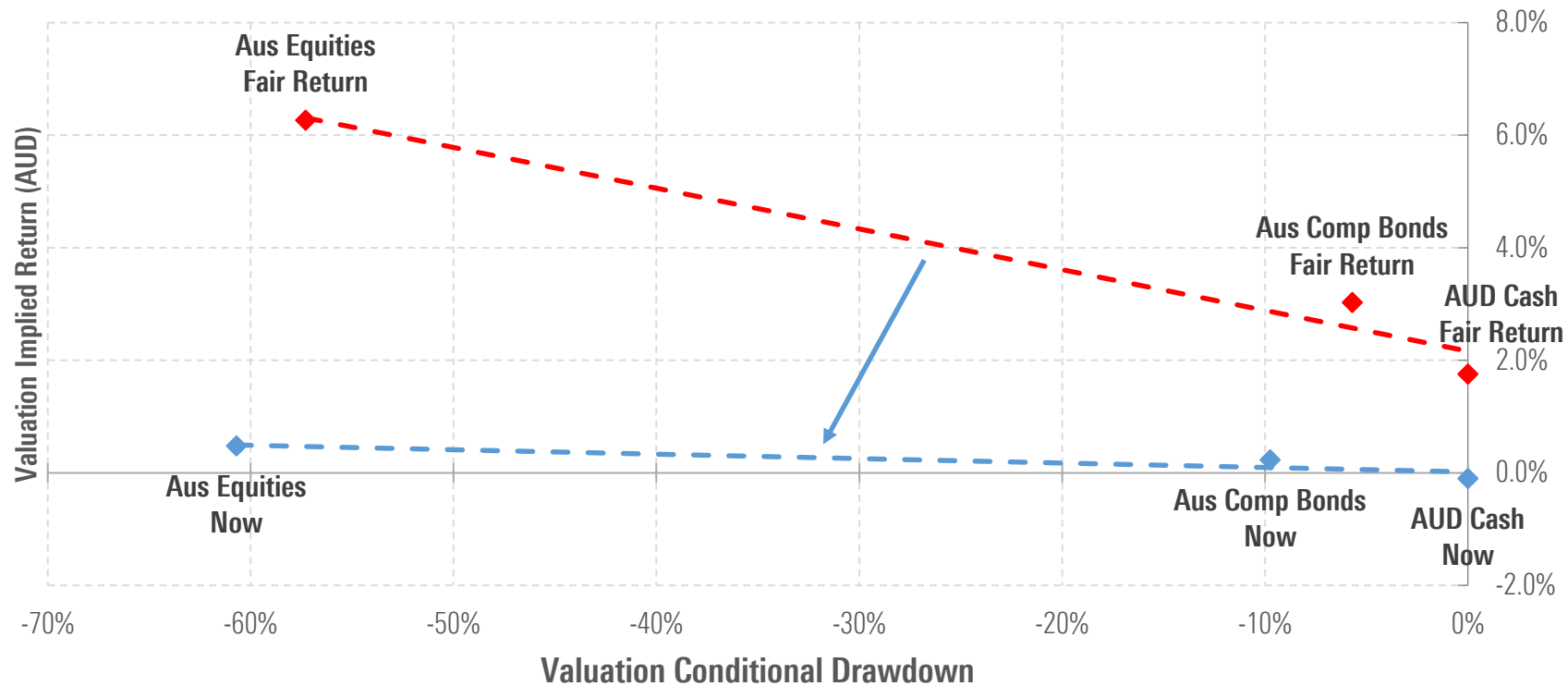
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Current valuation-implied return opportunity set



Source: Morningstar, data as of 31/12/2017

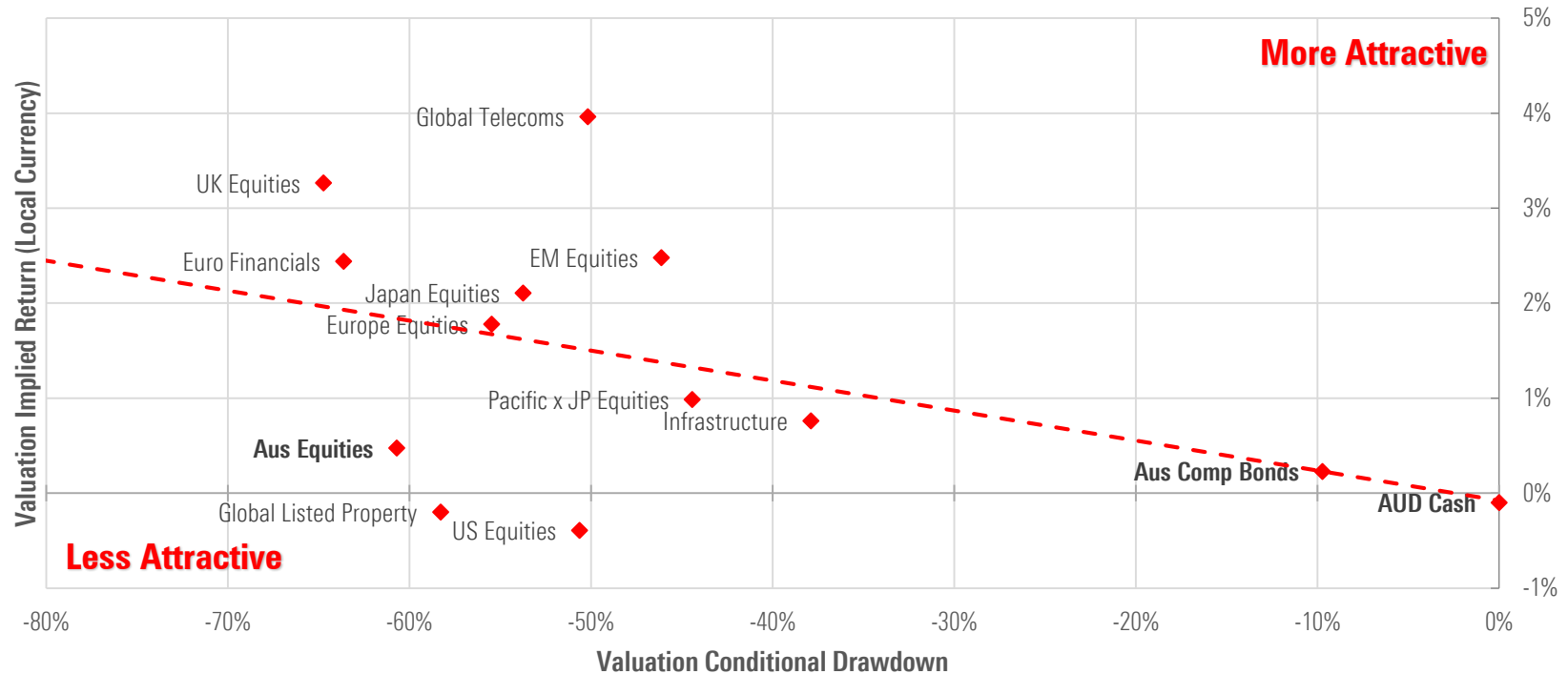
Asset allocation in a low return world



Source: Morningstar Investment Management Estimates. For illustrative purposes only.

Finding opportunities in equities

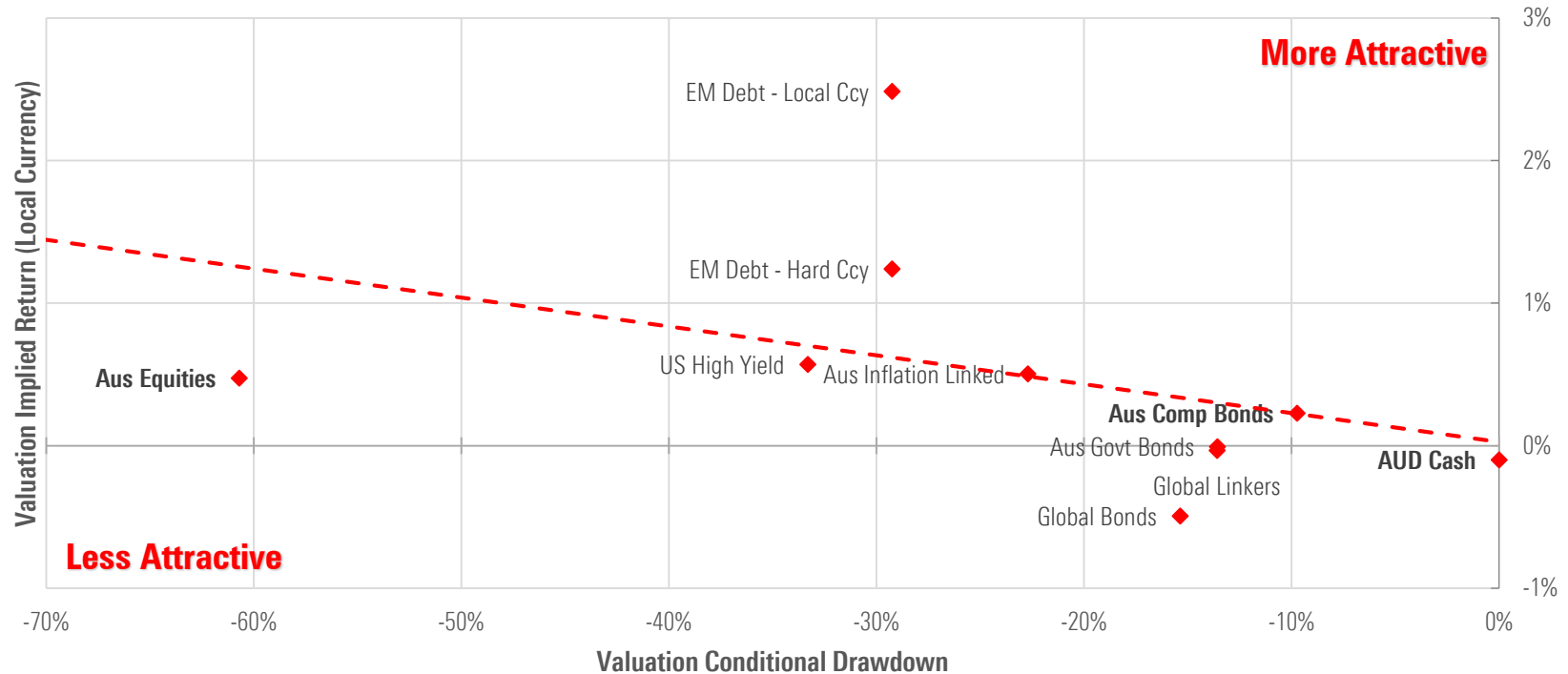
Equities vs Key Australian Assets



Source: Morningstar Investment Management Estimates. For illustrative purposes only.

Finding opportunities in fixed income

Fixed Income vs Key Australian Assets

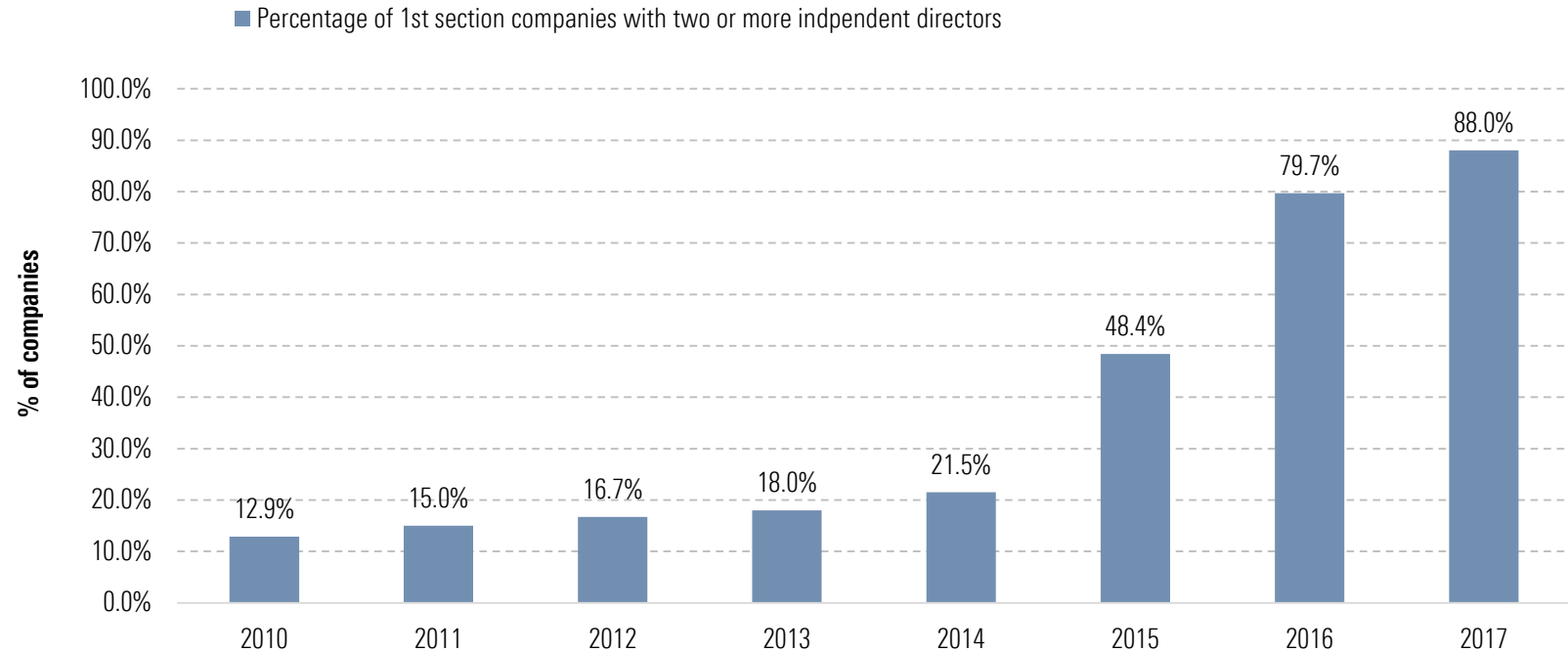


Source: Morningstar Investment Management Estimates. For illustrative purposes only.

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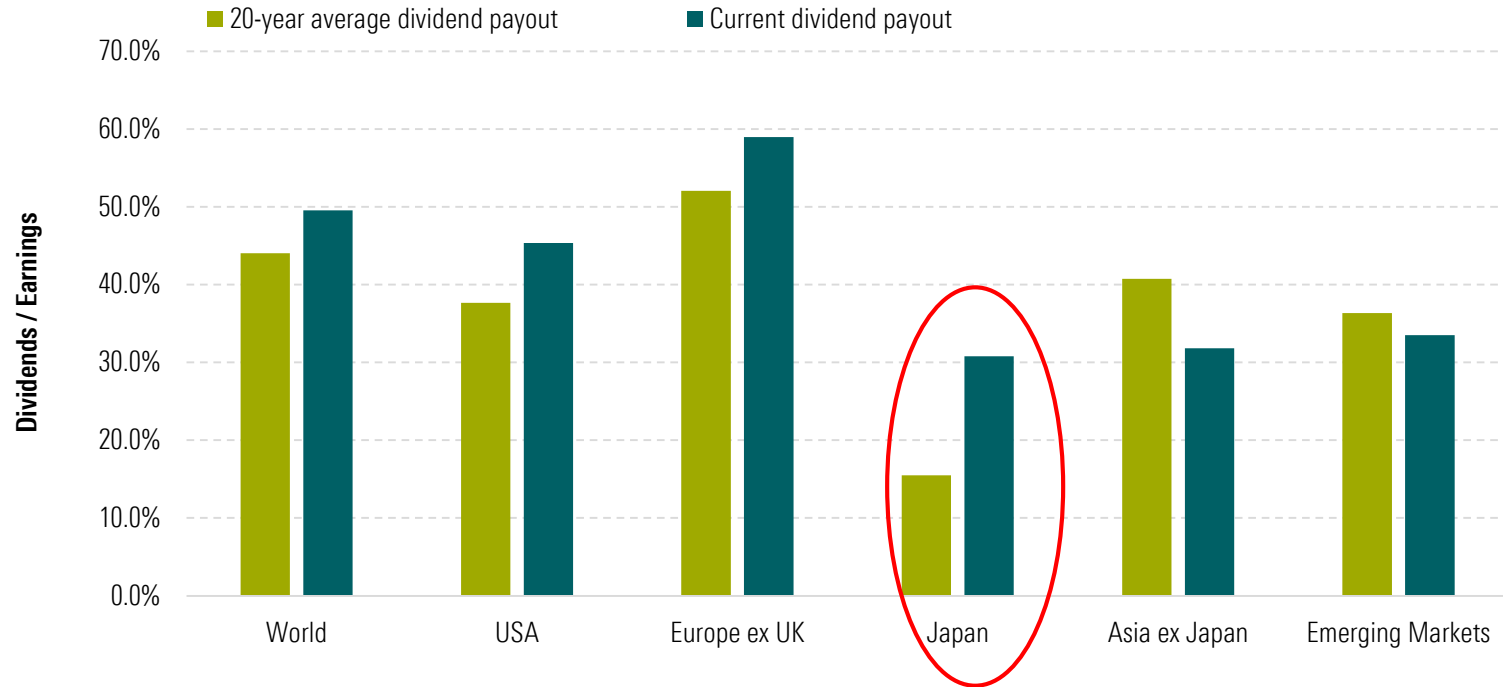
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Japanese companies are showing improved corporate governance



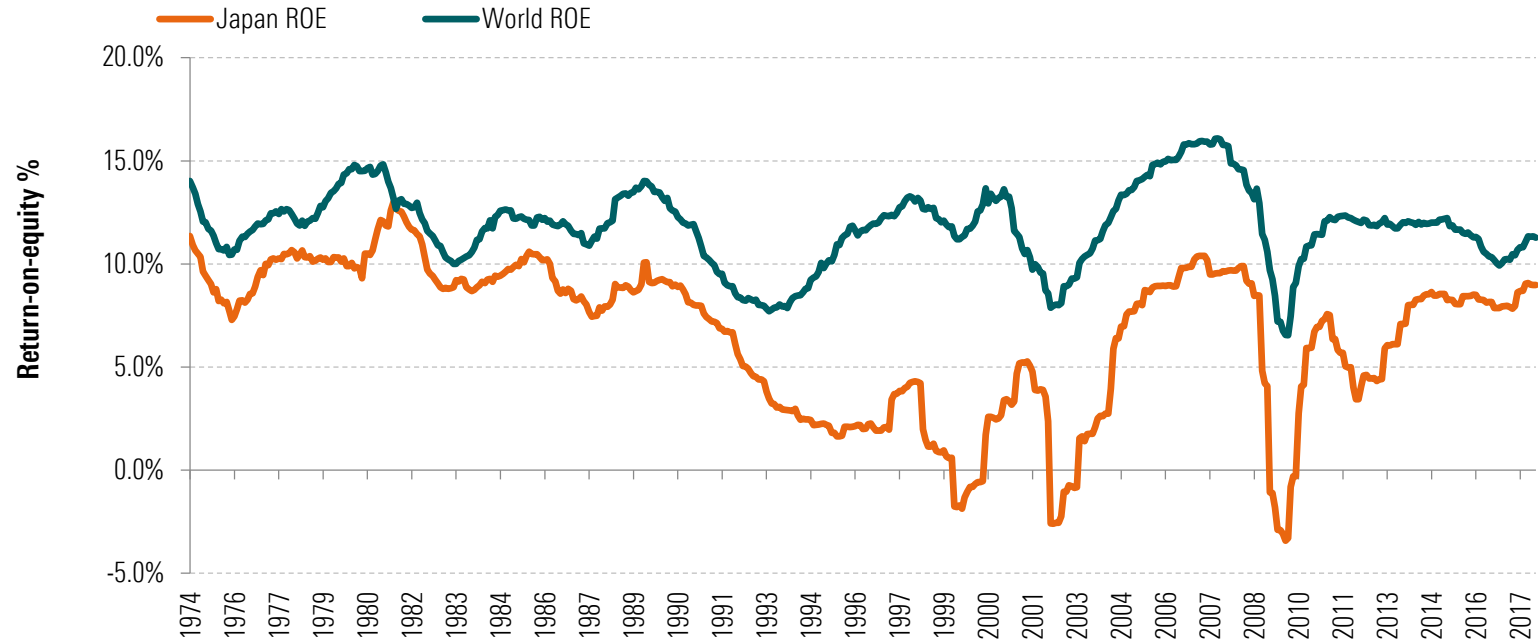
Source: JPX Tokyo Stock Exchange

Japanese dividend payout ratios have also increased ...



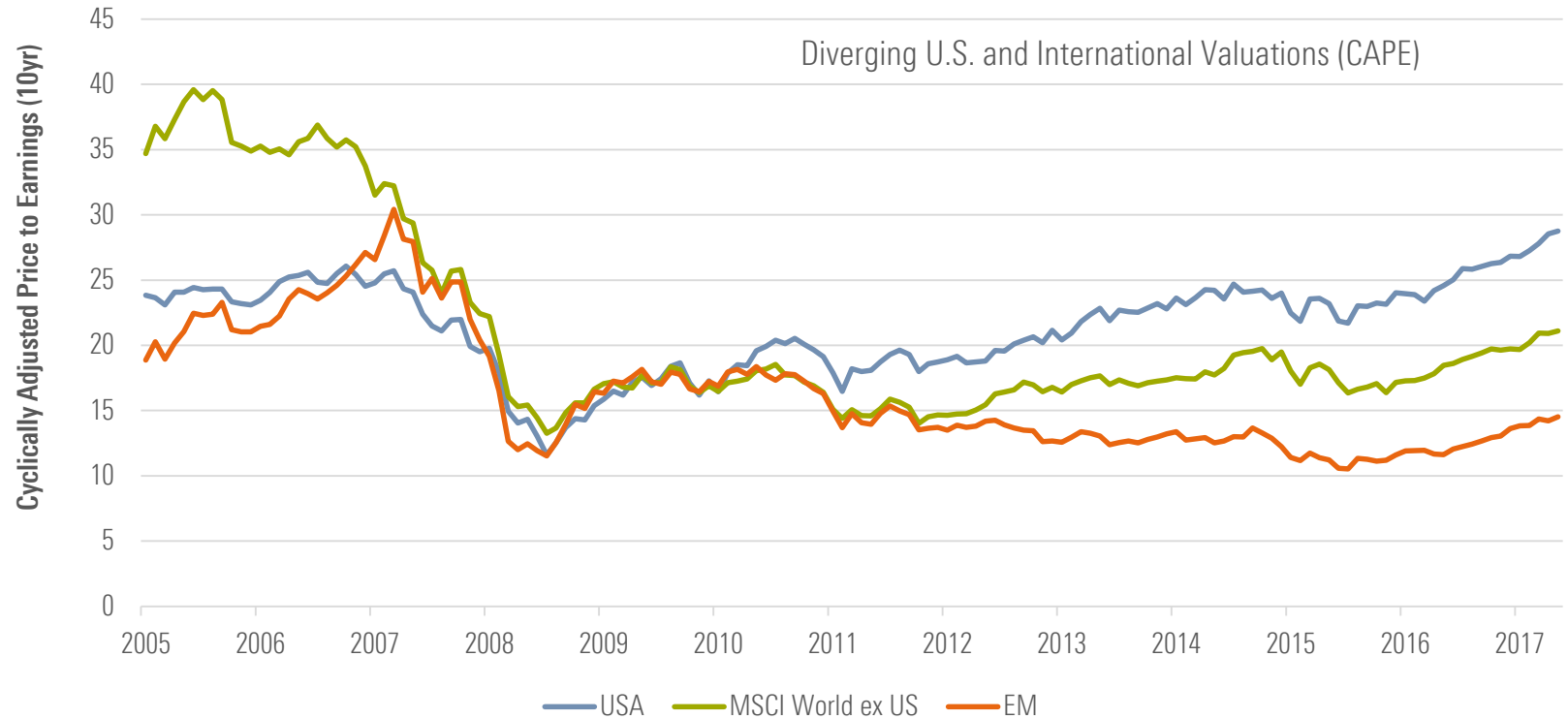
Source: Morningstar Investment Management calculation to 31/12/17

Return-on-equity will be a key metric to watch for Japan...



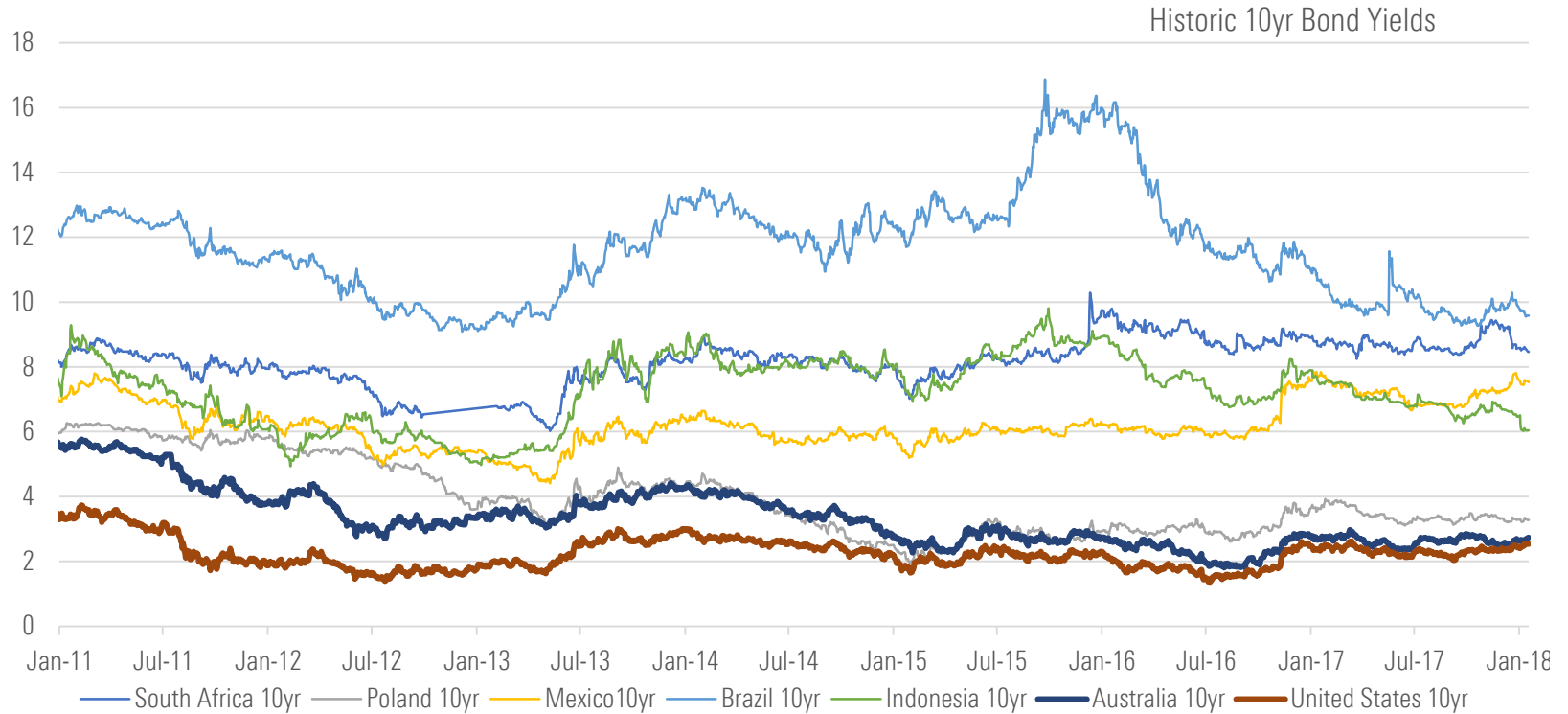
Source: Morningstar Investment Management calculation to 31/12/17

Emerging markets equities



Source: MSCI, IMF, Morningstar Investment Management. For illustrative purposes only. Past performance does not guarantee future results.

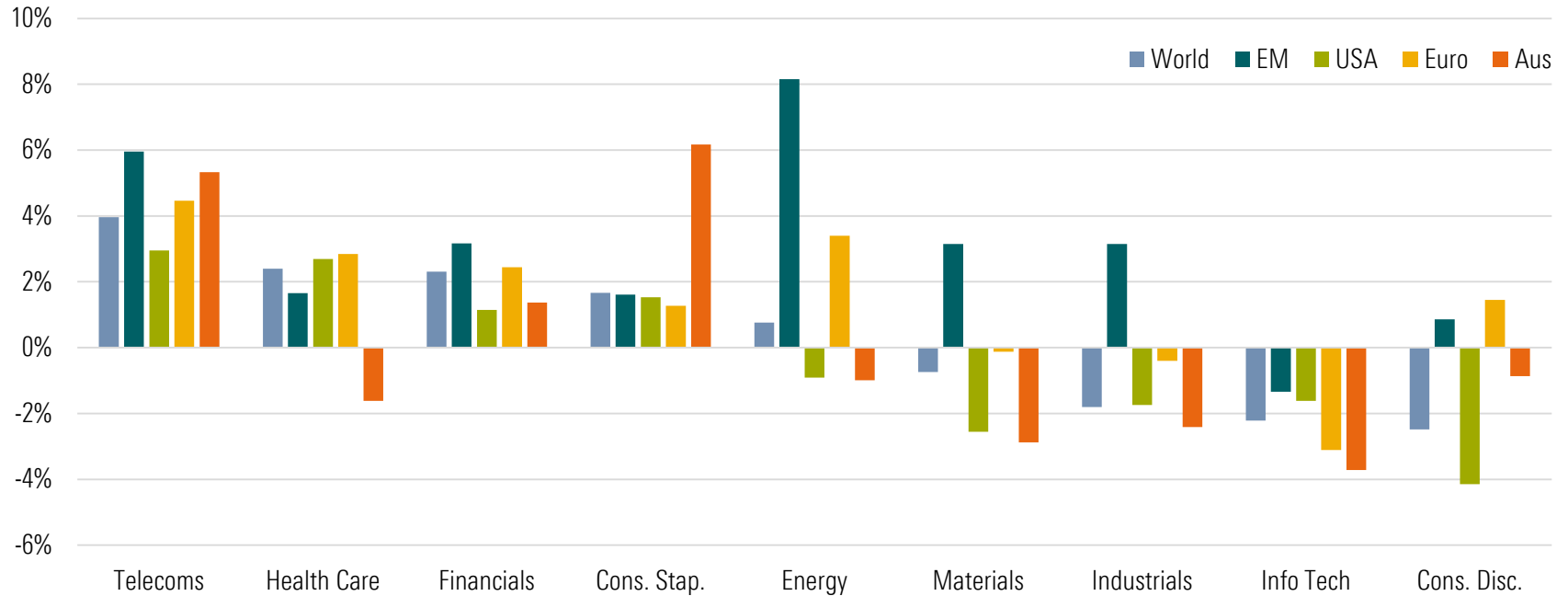
Emerging markets debt



Source: MSCI, IMF, Morningstar Investment Management. For illustrative purposes only. Past performance does not guarantee future results.

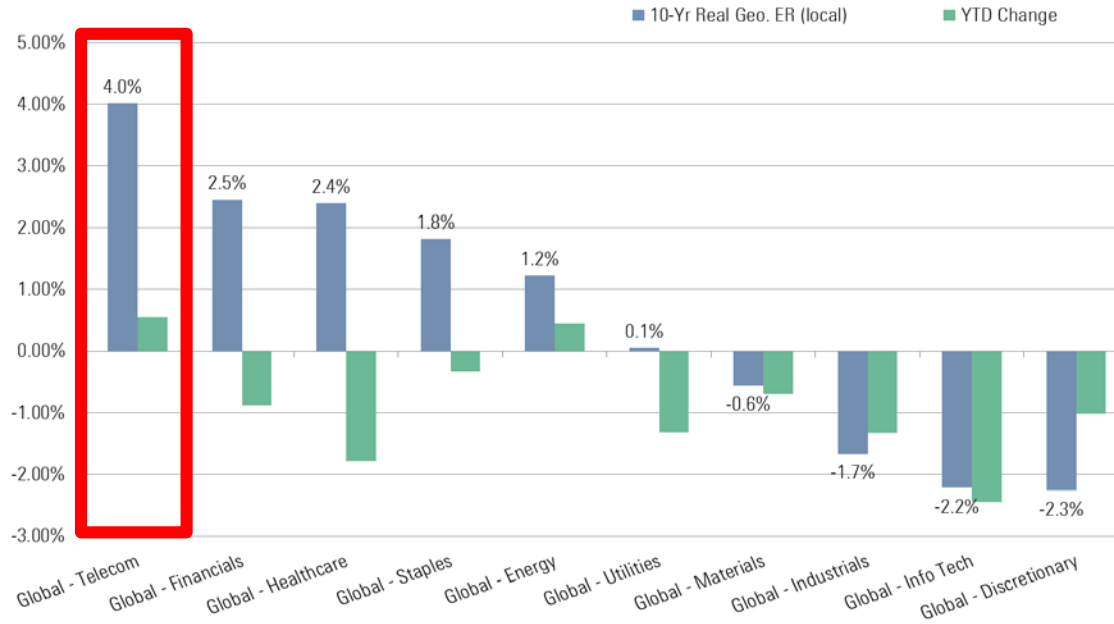
At a sector level, selective opportunities are more apparent

Global Sector Valuation Implied Returns Over 10yrs



Source: Morningstar, data as of 31/12/2017

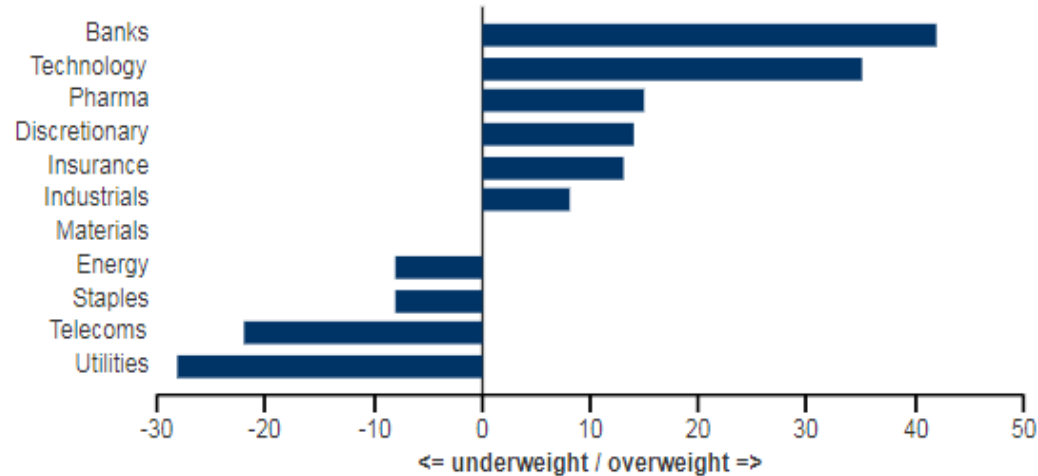
Global telecoms standout on relative valuation



Source: Morningstar. Data as of 30/11/2017

Pessimistic investor sentiment towards global telcos

Global Sector Sentiment (% saying overweight - % saying underweight)



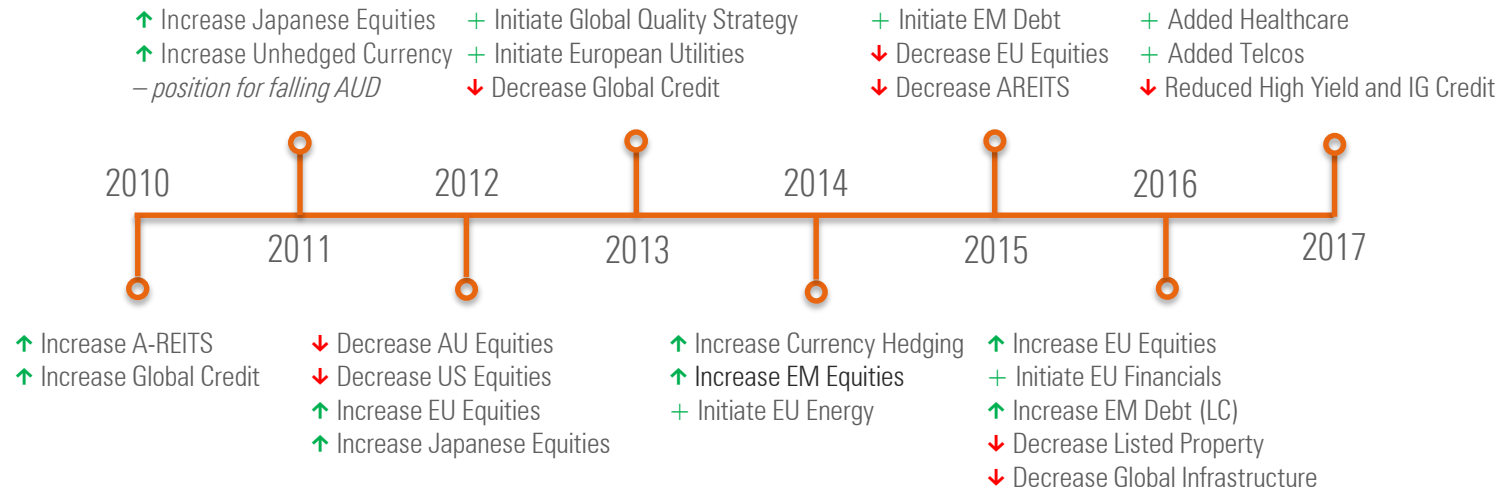
Bank of America Merrill Lynch Fund Manager Survey – October 2017

Source: Bank of America Merrill Lynch Fund Manager Survey

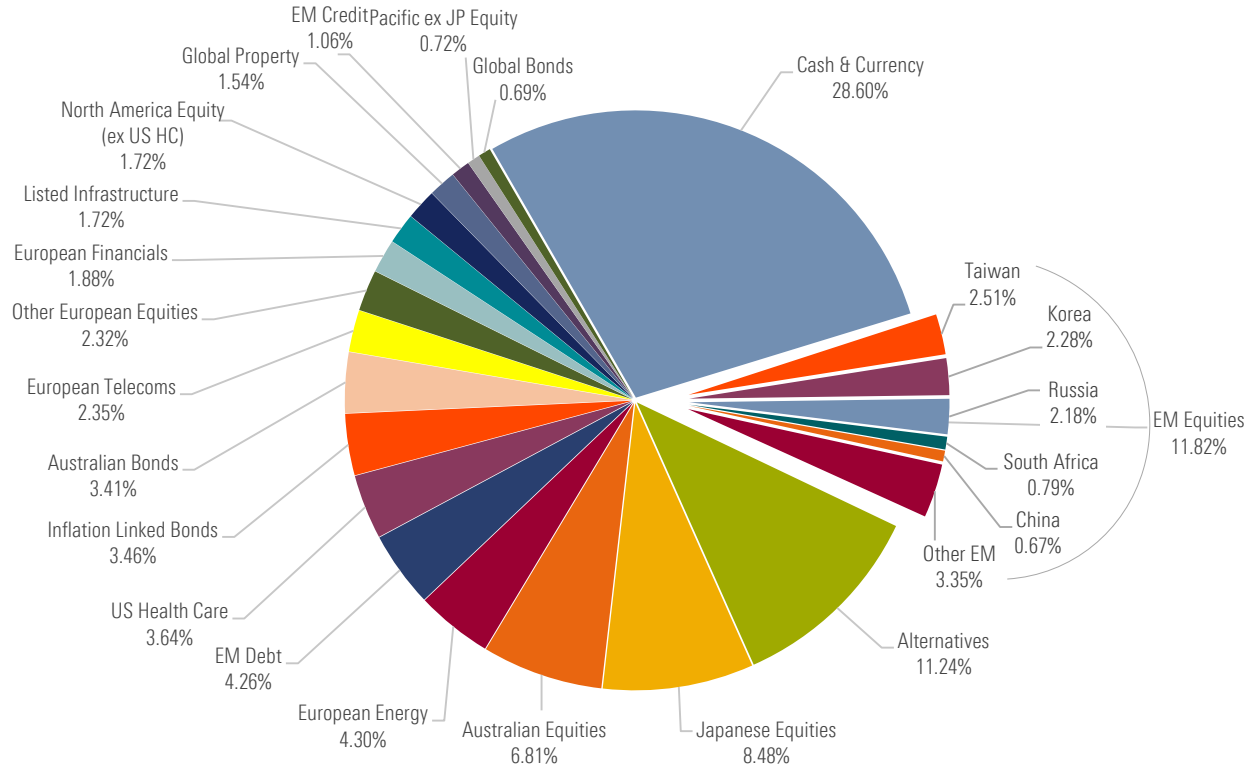
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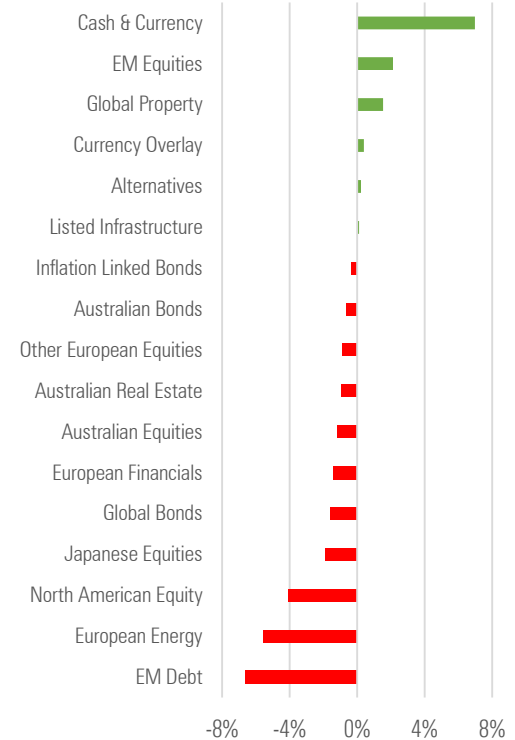
High conviction investment positioning of different vintages



Morningstar Growth Real Return Fund – Dec 2017



12m Position Changes



Source: Morningstar. As at December 2018.

Key takeaways and summary

- ▶ Valuation-driven asset allocation is a long-term investment approach that can generate significant returns across asset classes
- ▶ Holding overvalued assets can lead to significant underperformance
- ▶ Collective wisdom breaks down when there is insufficient diversity and investor errors correlate, creating opportunities for long-term contrarian investors
- ▶ We believe an iterative approach that is driven by valuations, fundamental research and a willingness to be different will help maximise reward for risk in this environment
- ▶ We favour Emerging Markets, Japanese and European shares; cash; and emerging markets debt, avoiding developed world government bonds)
- ▶ We continue to look for select opportunities in international sharemarkets – e.g. European Telecoms and US Healthcare

*“To buy when others are despondently selling
and to sell when others are euphorically
buying takes the greatest courage,
but provides the greatest profit.”*

– Sir John Templeton

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