Investment Insight

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Valuation Driven Investing

Investing when it makes sense to do so

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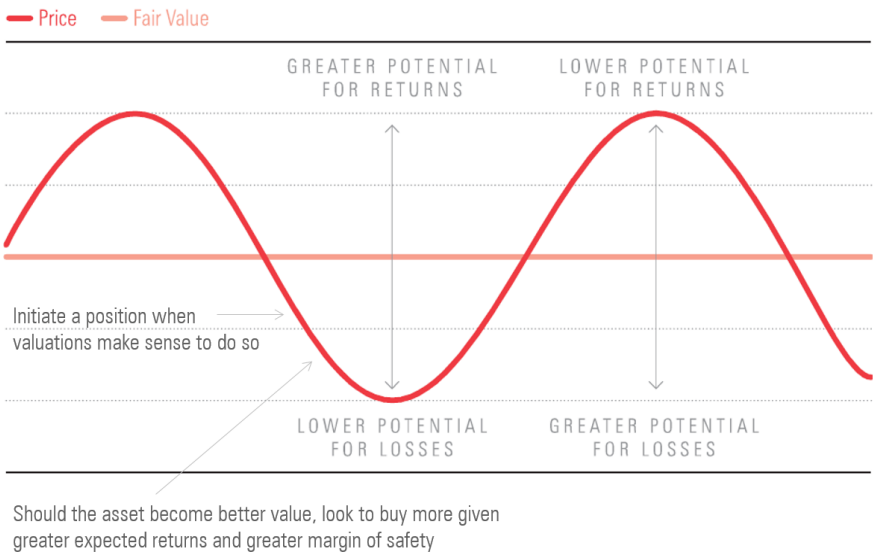
As legendary investor Warren Buffett once stated, *"Price is what you pay, value is what you get"* but what do we mean when we talk about valuation driven asset allocation, investing with a margin of safety and using behavioural analysis of investors to give us a better return for a given level of risk?

In this note, we explore our process in more detail, while also delving into some of our higher conviction positions and how they have impacted recent portfolio performance.

Clients will be well familiar with our seven investment principles, which underpin everything that we do as an investment manager. While all are equally important in striving to reach the goal of delivering the best portfolio outcomes for clients, investing with valuations in mind stands among the more widely quoted principles, given its prominent place in our investment process, and the vast body of empirical evidence that supports this approach to investing.

Perhaps it can be best described through illustration in the diagram below:



While the diagram is unquestionably stylized (markets never move in this orderly a fashion), it does highlight the two key components in making a valuation decision:

1) Understanding what the fair value of an asset is (or what it is really worth), based on the quality and sustainability of the cash flows that are expected to be generated over time, and then;

2) Having a sense for its price- how much is the asset currently trading for?

In this respect, the difference between the two will suggest that you are getting a 'good deal' when the current price is below its fair value, and vice versa. Key in this process is an appreciation of having a "*margin of safety"* which is a buffer, or a layer of fat if you will, that still makes the investment a 'good deal', should your timing of entry be slightly wrong, or if your assumptions aren't perfect. When the difference between price and fair value provides a sufficient margin of safety, that is the signal that it is time to invest.

Consider for a moment, the circumstances that might lead to an asset's price trading below its fair value. Quite often, this is in response to some near-term issue; perhaps it's something macroeconomic or geopolitical that would see the entire asset class temporarily undervalued; maybe the issue is stock specific, like an earnings downgrade.

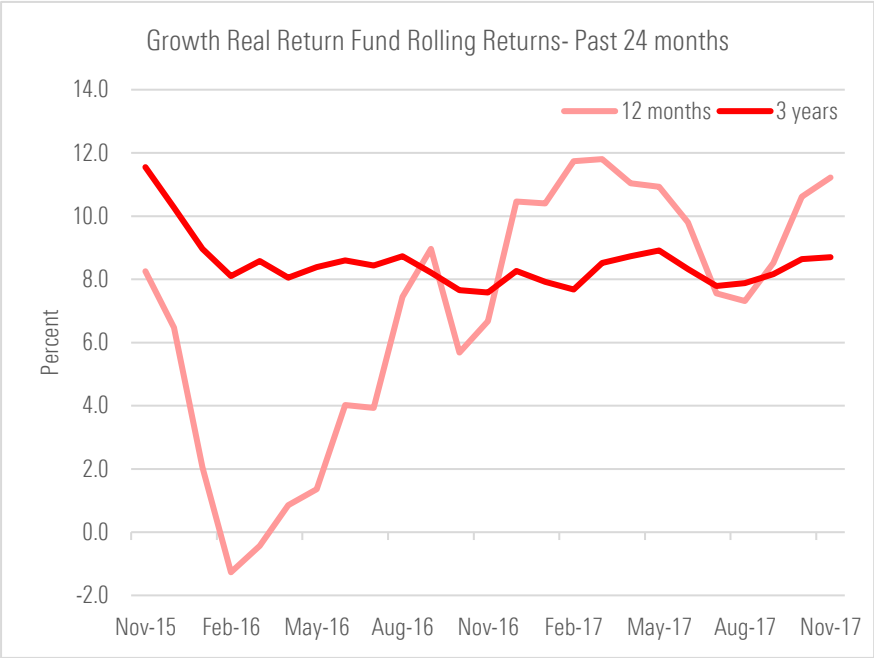
Regardless, the point is that, typically, value only presents in times of fear and uncertainty. Because it *feels uncomfortable* to hold an investment in the face of such overwhelming negative sentiment, investors often sell, without any regard for the price. This is an irrational behaviour, and one that has a destructive impact on achieving longer term investment goals. However, by anchoring investment decisions to value, we are able to navigate challenging circumstances and look through market noise and emotion to identify and take advantage of opportunities that may present in times of market stress. This often sees our views as contrarian to others in the market.

It is important to realise that our decision to buy, when we have sufficient margin of safety to do so, may at times seem early and will not necessarily coincide with a reversal in the negative sentiment that created the opportunity in the first instance. Indeed, fear and uncertainty can persist for some time, potentially weighing further on the asset's price. In this environment, with a greater margin of safety and greater expected returns on offer, we may look to buy more of the asset, (assuming, of course, that the quality of the cash flows has not deteriorated during this period). If we are right, over time, poor sentiment will fade, clearing the way for the asset to appreciate toward its fair value.

In this respect, it's interesting to observe that many of the investments that have been added to the Real Return portfolios over the course of 2017, have undergone a period of depressed pricing before finding their feet. Our positive view of U.S. Healthcare springs to mind. Initially sold down following the election of Trump (given his threats to repeal Obamacare and reform drug pricing policy), we felt that investors were being adequately compensated for the increased risks of what Trump may do, leading us to initiate a position. Over time, the negative sentiment began to abate (partly due to delays in policy reform), with the healthcare sector rebounding. This type of bounce is typical of investors initially overreacting to bad news, resulting in a material difference between the share price and the share's fair value.

While it's early days, a similar theme is emerging in both European Telecoms and U.K. equities. Telecoms have underperformed most other sectors amid investor concerns around the robustness of their business models in this data driven age, while U.K equities struggle to match global peers, being impacted by cautious sentiment toward Brexit negotiations. Again, in both cases, investors are being reasonably well compensated for these potential issues, in our view.

Despite these periods of short term underperformance, longer term portfolio returns remain impressive. Indeed, 12-month numbers for the Balanced (+9.5%) and Growth (+11.2%) portfolios are well above what we might reasonably expect to receive. However, we caution against looking solely at rolling 12-month returns, with this just too variable a data set to provide meaningful analysis, thereby encouraging irrational investor decision making. By contrast, analysis of rolling 3-year returns (and risk) provides a much more accurate assessment of portfolio performance, that is less vulnerable to short term fluctuations (and is therefore more aligned to how we invest as long-term investors). In this regard, the portfolios continue to achieve their longer-term objectives, delivering a more stable return profile that is consistent with the valuation-driven manner in which we invest, as below.



It is difficult to know with certainty how long it will take for an attractively priced asset to appreciate toward its fair value, however, as long-term investors, we are patiently prepared to wait for this to happen. Our positive view on Australian listed property, for instance, took six years to play out, while our conviction toward Japanese equities stance is now into its sixth year (and still going strong). Other vintages may deliver value sooner. Emerging Market and European equities have begun to realise their potential after less than three years in our portfolios, while more recent investment themes, such as global healthcare, are showing encouraging signs, at this early stage.

Conclusion

Morningstar Investment Management believes that the key driver of investment returns is this the price you pay for the asset in the first place. Buy something that is cheap, and you stand to be well rewarded; purchase something that is expensive and returns tend to be more muted, with you opening yourself up to the greater likelihood of losses. Often, the opportunity to buy better valued assets comes from a short-term headwind that creates a long-term valuation opportunity. While often this headwind is accompanied by extremely poor sentiment, the challenge is to understand how much of the bad news is being priced into the investment (i.e. are investors overreacting?). In this regard, Morningstar remains well positioned, using a robust and repeatable analytical framework combined with a behavioural advantage to seize these opportunities as they rise. M

Morningstar's Investment Principles

We put investors first. We believe the firms that put investors first win in the long term because their investors win.

Since 1984, Morningstar, Inc. has been helping investors reach their financial goals. Our fiduciary duty to our principals is paramount.

We're independent-minded. To deliver results, we think it's necessary to invest with conviction, even when it means standing apart from the crowd.

Our research shows that making decisions based on fundamental analysis, rather than short-term factors and sentiment, delivers better long-term investment results.

We invest for the long term. Taking a patient, long-term view helps people ride out the market's ups and downs and take advantage of opportunities when they arise.

Investing with a multi decade horizon aligns with investors focus on increasing their purchasing power over their lifetimes.

The long term is the only period where fundamental, valuation driven investing works.

We're valuation-driven investors. Anchoring decisions to an investment's fair value—or what it's really worth—can lead to greater potential for returns.

Valuation-driven investing through a long-term focus on the difference between price and intrinsic value enables investors to get more than they're paying for.

We take a fundamental approach. Powerful research is behind each decision we hold, and we understand what drives each investment we analyse.

Fundamental investing incorporates a focus on the future earnings of an investment and not its prospective price change.

We strive to minimise costs. Controlling costs helps investors build wealth by keeping more of what they earn.

Investment returns are uncertain, but costs are not.

Lower costs allow investors to keep more of their returns.

We build portfolios holistically. To help manage risk and deliver better returns, truly diversified portfolios combine investments with different underlying drivers.

Portfolios should be more than the sum of their parts.

True diversification can have a powerful impact on a portfolio's risk-adjusted returns – but simply holding more investments isn't the same as true diversification.