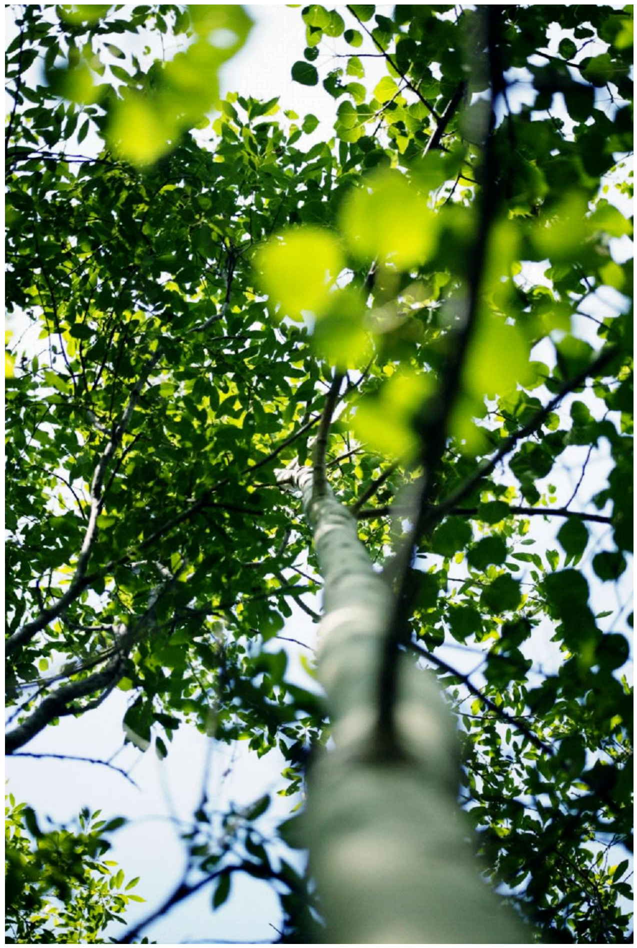
Why Value Works

Not All Funds Are Born Equal



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"If you really want to "beat the market," most professionals can't help you …"

(Joel Greenblatt, *The Little Book That Beats the Market*, xviii)

Historically, equities constitute the top performing global asset class. However, the available evidence shows that most active investors are unable to achieve similar returns. To the contrary, a wide body of evidence shows that the market beats about three-quarters of professional fund managers over reasonable investment periods. This is an unfortunate and expensive result for investors and an indictment of active portfolio management.

Despite this result, in our last note we made a case for active management by recognising that not all managers are beaten by the market. Instead, the set of managers that succeed in producing superior investment results exhibit common characteristics in their investment processes (see our note, *In Search of Success: A Contrarian Case*), which means that investment performance has little to do with luck. But, this argument demands a key qualification: those managers that have been most successful in producing long runs of "abnormal" returns share a further common factor, namely their subscription to the value philosophy.

This outcome rests on the simple, but powerful result that markets are not efficient: investors pushing prices down too far and up too high. This behavioral pattern of overreaction is not unique to capital markets. If you want evidence of this, talk to supporters of winning or losing sports teams as the result of the game is delivered.[2] One group is swept away in a wave of euphoria whilst the other wallows in morbid gloom – until the next game, of course. In any event, it is this human act of emotional overreaction that causes assets to be habitually mispriced. Moreover, because investors "herd", it follows that many investors make the wrong decisions together. Conversely, and as argued in our previous note, by standing apart from the crowd and

[1] [1] This note was originally published in *Funds on Friday* by Sanlamǒs Glacier (October 2007).

2 A recent example of crowd euphoria and hysteria is provided by comparing the general reaction of South African supporters during the recent Twenty 20 World Cup which saw South Africa blast 208 runs to beat the West Indies by 8 wickets with 14 balls to spare. A little over a week later South Africa were knocked out of the competition as they struggled to achieve 126 runs to progress to the semi-final stage of the competition, let alone the 153 runs that India scored to win the contest. The result is that optimism and euphoria are rapidly displaced by pessimism and gloom. This type of emotionally charged reaction is commonplace, and generally eclipses sensible, long-term analysis.

stripping emotional influences out of the investment decision, an active investor is afforded the opportunity to beat the market.

Why Value Works

Returning to the argument, one of the best documented sources of consistent outperformance caused by investor overreaction and herding is found in the pricing anomalies of value shares. Value shares commonly are identified by characteristics such as low price-earnings ratios, high dividend yields, high cash flow-earnings ratios, low price-net asset value ratios and high rates of return on equity and return on assets relative to market valuations. Significantly, equities that carry such distorted valuations often do so because they are out of favour, neglected or sometimes just misunderstood. Yet, active managers who diligently pursue value strategies demonstrate some of the best investment results.

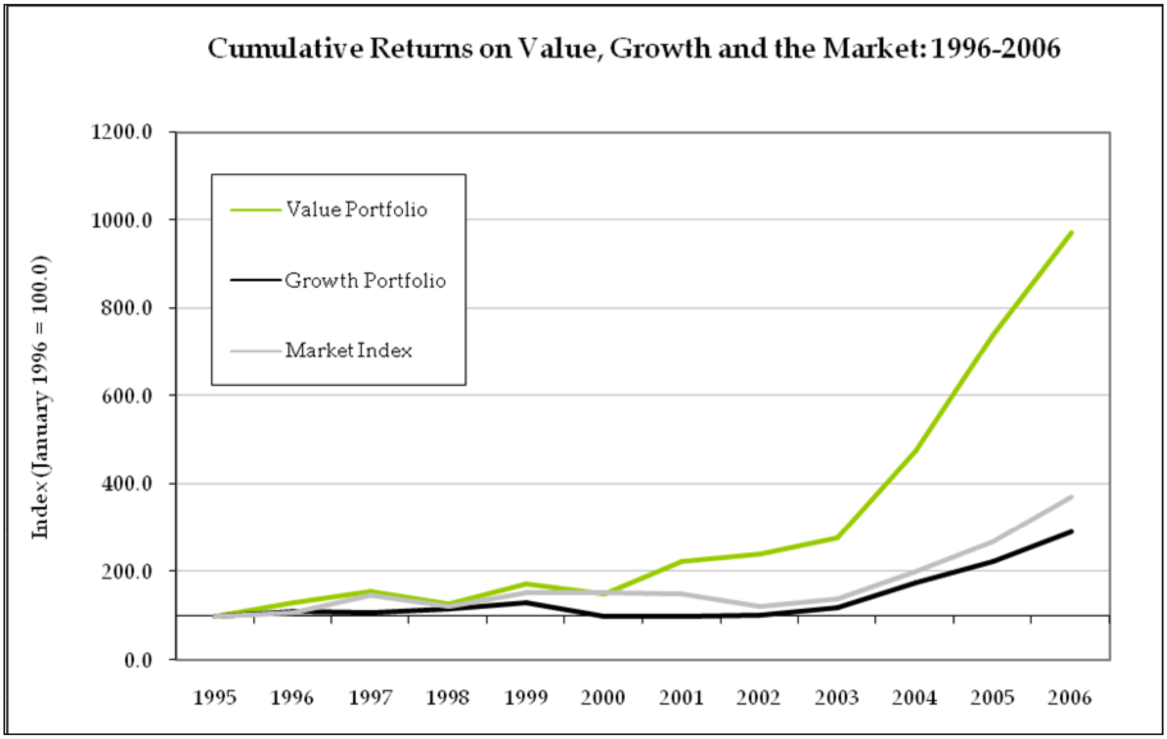
The investment literature is rich with cases of the success of value strategies. By far the most well known study undertaken on the value effect is Eugene Fama and Kenneth French's (1998) examination of equities listed on 12 exchanges over the 20-year period 1975-1995. Their findings show that value shares outperformed growth shares in all but one of the countries examined (Italy) with value shares delivering an average return that outpaced growth shares by more than five percentage points per annum. More recently, in *The Little Book That Beats the Market*, Joel Greenblatt (2006) showed that a portfolio of 30 shares that traded at below-market price-earnings ratios but with above-average returns on assets would have earned the investor 30.8 percent per annum over the period 1988-2004 as opposed to the market average of 12.4 percent per annum. This annual difference would mean that the investor in Greenblatt's value portfolio would have had a terminal portfolio value 13 times greater than an index portfolio.

Based on the wider evidence, it is difficult to avoid the conclusion that the value phenomenon is "global" and "deep": it is universal and it persists over time. Over reasonable investment periods, value shares beat growth shares and value shares beat the market. This finding begs the question: "Does the value phenomenon exist in the South African setting and, if so, does it persist?"

To this end, Cannon Asset Managers' investment team has constructed a "deep value" portfolio that has run for the past 11 years. The stock selection rule is straightforward: the value portfolio consists of the three counters with the lowest price-earnings ratios in each of the large financial and industrial sectors, that is, the most shunned companies.[3] The portfolio's performance is measured against returns generated by a suitable market index (the passive argument) and a portfolio made up of the companies that are most highly rated by the market (the growth argument).

The results of this exercise are astounding: on a compound basis our value portfolio has consistently beaten the market and the portfolio of growth shares by a wide margin. Over the period 1996 to end 2006, a passive investor who owned the market index would have earned an average annual return of 14.7 percent (including dividends). An active investor who had held the high price-earnings ratio portfolio would have earned a lower rate of return of 11.7 percent per annum over the same period. In sharp contrast, the value portfolio returned an average 25.8 percent per annum. On a cumulative basis, an investment in the index delivered a compound return of 270.5 percent, whilst the cumulative return on the growth portfolio was 192.9 percent. An investor in the value portfolio would have experienced a cumulative return of 871.4 percent. The figure below summarises the result.

[3] The method and results are detailed more fully in the research report *Super Dogs: The Value of Active Value* which is available at www.cannonassets.co.za.



Source: Cannon Asset Managers and McGregor BFA

In addition to the substantial outperformance delivered by the value portfolio, an analysis of risk metrics shows that this performance has been generated in a favourable fashion. For example, downside analysis reveals that the average return during the market's three down years was a negative 12.6 percent. Over those periods the value portfolio outperformed the market by 25.2 percent per annum. Furthermore, 60.1 percent of the counters held in the value portfolio over the 11 years delivered positive year-on-year returns. The figure for the growth portfolio is 61.3 percent. Of course, given that the value portfolio is constructed out of neglected companies, one would imagine that the failure rate amongst this grouping is higher than the growth counters. Although this proves to be the case –– the failure rates are statistically insignificant. Moreover, corporate action suggests that true opportunity lies hidden in the value portfolio where almost one in ten of the companies were the subject of a take-out or change in control versus one in twenty in the case of growth companies.

In short, the case of the South African market confirms the global experience: value holds as a successful investment philosophy. Of course, there is nothing to suggest that this strategy will not "hiccup". Unlike Douglas Adams who told us that the answer to everything is exactly determined – by the number 42 – there is no way of knowing just how irrationally the market is behaving at any moment or whether it will become more irrational before it recaptures sanity. What we can argue however, is that the market is irrational most of the time. This provides active managers, who are willing to stand away from the crowd, with the platform needed to "beat the market".

The point was made eloquently by Friedrich Nietzsche:

> Most individuals are sane whilst most crowds are not. Crowds regularly behave in a way that the constituents, as individuals, would never countenance. Crowd behaviour is both magnificent and complex, and it is astounding that anyone believes that this type of behaviour should not affect a market (which is another collective).

Putting the point differently, if we have the ability to step away from the crowd and strip emotion out of the investment decision, we have the potential to put together a sustainable, market beating investment approach. Ultimately, the ability to adopt value investing as an active management style hinges on discipline, patience and the ability to withstand the sense of isolation brought about by being apart from the herd.

End Note: Delivering Value

Cannon Asset Managers' investment philosophy is founded on the principles of value investing. Over the period 2000 to present Cannon Asset Manager's All Equities Portfolio outperforming the All Share Index by 9.9 percent per annum to produce a cumulative return of 699.5 percent against the market's 360.0 percent. Cannon Asset Manager's portfolios exhibit the characteristics of the value philosophy. By way of example, the firm's general equity fund, the Cannon Equity Fund, currently trades on a price-earnings multiple of 11 times versus the market's multiple of 14.9 times. Similarly, the Cannon Equity Fund offers a dividend yield that is materially higher than the market's yield and owns companies whose price-book ratio is 30 percent lower than the market average. The Cannon Equity Fund was launched in mid-2005 and has consistently produced top-quartile performance.

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