ANCHORING VALUE INVESTING

Investors often use equities as a means to access a company's earnings growth. This approach solely focused on 'growth' as an anchor to investment can lead many investors to be blind to the price they pay for the growth they want to tap into.

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THE GREATER FOOL THEORY

Shares in companies that offer the promise of accelerated growth prospects and the perceived comfort of stable, visible earnings streams can become very popular, and hence very expensive as their expected growth success is reflected in their share price. But that does not always lead to financial reward. In fact, we think this can lead to the "greater fool" theory which says that buying these popular companies maybe a nice, comforting experience but that when it comes to selling the shares, an investor needs to find someone willing to buy them at a higher price.

Here's why. One of the key steps stock investors must take when evaluating the purchase of a stock is the right entry point. Investors who overpay for a stock versus a company's real underlying prospect will find it much harder to sell the shares at higher price and thus realise a noticeable gain. This is because it will require finding a buyer in the market who has even higher expectations for the stock with inflated or perhaps even unrealistic expectations to sell the shares. This is the "greater fool" principle in action in the stockmarket.

The presence of investors in the market pursuing momentum and buying stocks with unrealistic growth expectations is a source of persistent distortions in prices that we at Eastspring believe can be exploited to generate strong, long-term, sustainable returns for our portfolios. To do so we use a Value approach to investing.

A true Value style is relatively agnostic towards earnings growth/stability. Instead it is laser focused on understanding the price differential between today's price and the price represented by sustainable earnings of a company at a distant point in the future, extracting the value created as these two prices converge over time. Empirical data tells us that a Value style can significantly outperform over the long term.

But why can Value as a style outperform and why then do all investors not follow such approach to investing?

THE SUCCESS OF VALUE INVESTING AND EMERGING MARKETS:

Looking at empirical data, Eastspring has created simplified versions of the four key active equity investment styles for GEM equities: Value, Momentum, Quality and Growth[1].

The data shown in Chart 1 confirms that a disciplined approach, built around a valuation anchor for companies exploiting opportunities created by emotional/behavioural driven price volatility, can lead to significant outperformance overtime.

We see value investing as a price-sensitive process that takes advantage of asset mis-pricing arising from investor behavioural traits. While recognising that markets are generally efficient longer term, we believe that market mis-pricing occurs because human characteristics (such as fear and greed) can prevent investors from always assessing investments rationally, which gives rise to pricing anomalies.

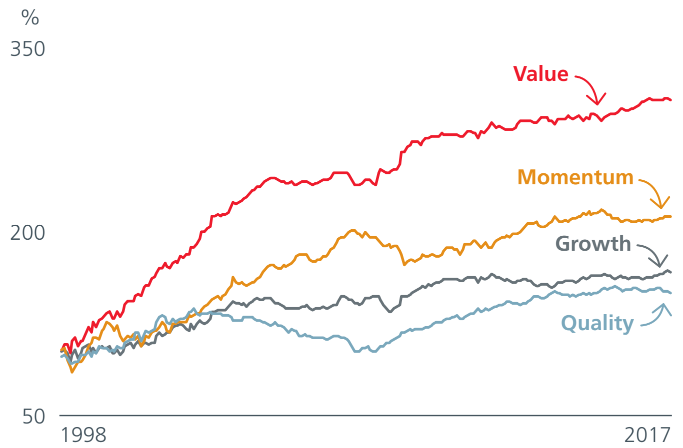
BEHAVIOURAL BIASES

We believe human behaviour and specifically behavioural biases generate persistent opportunity for value investors. Humans, investors included, have hard-wired behavioural biases and emotions and those get in the way of rational, price disciplined investment decision. These biases and emotions lead to consistent errors in investor judgement.

The most fundamental of human behaviours that drive the persistency of this value opportunity is "fear and greed". Research coined by famous psychologists Amos Tversky and Daniel Kahneman in the early 1990s focused on the observation that the pain of loss is larger and felt for longer than the feeling of joy humans get from a positive outcome, leading to loss aversion.

This loss aversion leads investors to have a structural bias away from situations that invoke fear/uncertainty and towards more comfortable, well known, well liked and optically safer investments. When stock prices are driven lower by a negative event they can command strong emotional responses, led by fear. The opportunity to buy an asset at a cheaper price is less likely to be analysed rationally at that point. This in turn means that most investors are less likely due to their structural aversion to uncomfortable situations, to invest in the stock. This fear is an opportunity that value investors can exploit over time.

Fig. 1: GEM equity cumulative factor performance[1]



The drivers of many hard-wired sub-conscious behavioural biases are what is known as heuristics. These are mental short cuts humans make to simplify complex issues and reach solutions faster and with greater ease. While heuristics are helpful in many situations, they can also be a hindrance.

The process of speeding up judgment via a heuristic approach will often lead to information being subconsciously ignored as part of the decision. Emotions, including fear, may then have a greater influence and subconscious short cuts will lead to becoming overconfident in the ability to forecast the future. Those heuristics therefore contribute to a persistent structural bias away from many value opportunities.

There are many examples of hard-wired behavioural biases but in essence if investors don't explicitly identify and manage them, they are susceptible to lead to poor decision making or decision making that is less repeatable.

Working against those biases, identifying and minimizing them, can be uncomfortable. In other terms, as applied to investing, value investors will make investment decisions against the crowd, against most peers. This means that a clear investment process supported by a strong philosophy shared by a team aligned around a Value style can be very powerful.

The alignment of all stakeholders is key. Because Value outperforms as a style over time, it can exhibit bouts of short-term volatility. This is the "price" of a contrarian approach. Increased short termism in asset management can create a challenging environment and therefore it is key that alignment in objectives and interest are clearly stated and agreed.

CORRELATION BETWEEN FUNDAMENTALS AND STOCK PRICE

Many believe that there is a stable relationship between price and fundamentals. In reality, new information influences investor beliefs about fundamentals and causes price to respond in unpredictable ways all the time. As a result, market outcomes are inherently uncertain.

Focusing on sustainable earnings differentiates us as equity value investors in a market that is often obsessed about the short term and specifically about recently reported earnings. This short term focus leads many investors to extrapolate recent events into trends, and ultimately gives rise to herding behaviour. This is a persistent outcome that can also be exploited.

HOW DO INVESTORS EXPLOIT THE LONG-TERM VALUE OPPORTUNITY?

We believe that investors interested in pursuing a Value approach to investing should structure their approach around several key factors. First, strive to identify, manage and exploit behavioural biases that cause short-term emotional price volatility. By focusing efforts on understanding the drivers of long-term sustainable earnings, investors should gain much more insight on companies than by focusing on short-term earnings.

Second, pay particular attention on identifying a company's path to sustainable earnings, including the hurdles and impediments it may face and understanding market concerns. Further, understand that uncertainty and fear often bring emotional stock price movements unjustified by future earnings potential, then look to take advantage of those price disruptions in the market. This is especially in instances in which there are long-term prospects that the market has ignored.

Finally, follow a highly disciplined approach which explicitly separates investment decisions from those positive feedback price mechanisms that gives rise to herd behaviour. This allows a repeatable process to generate potential positive alpha over time.

Sources: [1]Macquarie Quantitative Research, as at 31 August 2017. Market-relative performance of respective style indices (quintile 1 minus benchmark), rebalanced on a monthly basis, from 30 June 1998.

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