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Concentrated value investing

Introduction

"…concentrated investing should only be undertaken by people who are prepared to do intensive research and analysis on their investments."[1]

Value investor. Not an easy cross to bear in recent years. Value is a style that believes an investment should, first and foremost, be anchored in an assessment of fundamental worth. It is research driven. It is an intuitive style that prefers not to overpay and it requires a degree of safety (insisting on actual earnings and cash flow). It is also a style that has strong academic backing. To paraphrase Ben Graham (or Warren Buffett), Value investing believes that the market is a weighing machine and the scales should favour verifiable intrinsic value.

But in a changing investment landscape over the last decade, Value investing has faced challenges. Central banks and the weight of loose monetary policy have favoured Growth stocks and the search for yield; a shift to passive investing has fuelled Momentum and extreme positioning. The market as voting machine has enjoyed an unusually long term.

We think the investing environment is on the cusp of change. Global interest rates are trapped against the lower bound while coronavirus has pitched the economy into recession. Active management will reassert its importance as individual companies are affected differently. The market will become less about momentum and more about idiosyncratic risk. At the same time, the fiscal hand of previously inert governments has been forced. Historically wide budget deficits will eventually fuel growth (and possibly even inflation). This is a productive backdrop for Value investing. Financial repression has reached its zenith – the market scales will tip back towards fundamentals and mean reversion. To paraphrase Rob Arnott, "reports of Value's death may be greatly exaggerated"[2].

This doesn't mean Value investing can't be modernised, however, and this paper will outline our core investing tenets.

Philosophy

There is a difference between risk management and risk aversion. Too often active managers believe their role is to minimise portfolio risk. As managers of Perennial Concentrated strategy, we see our role as targeting risk – optimising our exposures to be aligned with our views. Equally, our role is to identify and mitigate any unintended risk. Portfolio management should be about risk management.

Style selection is often part of the asset allocation process. This generally does not sit with the fund manager but with the asset consultant, institution, or retail advisor. When a client allocates to a particular style, that decision forms part of their broader portfolio design. Any style drift by the fund manager invalidates the client's asset allocation decision. Perennial's Concentrated strategy maintains a Value and Quality[3] tilt.

Our portfolio has a maximum cash weight of 10%. We believe the decision to be in equities is the client's and is determined with a view to their own objectives. As such we are always well invested in equities.

Our philosophy is to give our clients the best version of what they ask for. Whilst always a true to label portfolio, we realise that all our stocks cannot be better than market on every metric. We prefer to treat the portfolio as a whole in order to provide the desired outcome.

Portfolio Construction

Portfolio construction is generally an undervalued part of the investment process. In a typical equity fund, with 50 or more stocks, reference is often made to bottom-up stock picking. With that many stocks, a portfolio is likely to have one of everything and portfolio construction is not regarded as important. With concentrated strategies, holding 15 to 30 stocks, it is imperative to use a wider approach that looks for portfolio alignment with investment views, while ensuring risk in the portfolio is adequately balanced between companies, industries and correlation to factors.

[1] Allen Carpe Benello, "Concentrated Investing"
[2] Arnott et al, Research Affiliates, "Reports of Value's Death May be Greatly Exaggerated", 23 July 2020
[3] We consider quality metrics to include earnings strength, operating margin, cash flow yield and a strong balance sheet.

3 step approach

Stock selection is the main part of the process.

Macro environment analysis of risk and opportunity.

A strong post portfolio construction **risk assessment** rounding out the process.

Stock selection should always be the main driver of a share portfolio. But this means an understanding of top-down risks and the bottom-up story. Factor risks are hard to avoid, especially in a large-cap book – factor analysis in the stock selection process will give the portfolio manager a good understanding of how market forces may impact the investment thesis. But the more idiosyncratic risk a portfolio can take, the better. This should mean the alpha is multi-variate.

Macro analysis is the process of understanding broader, top-down influences in the market. This includes macroeconomic factors – measuring exposure to US 10-year interest rates or to commodity exposures such as Oil – but also incorporates styles and factors. For example, when there are multiple indications Value as a style is coming into favour, certain expressions will have a higher Value beta. Price to Book, for example, is considered a "deeper" Value sub-style. When there are multiple indications Value as a style is moving out of favour, it may make sense to be conservative – owning a defensive Value name like Atlas Arteria where its earnings certainty and yield characteristics will be rewarded by the market.

Risk analysis should always be the concluding piece of the portfolio construction equation. There is an enormous difference between knowing what is owned and knowing what the exposures are. This can be as simple as understanding a stock's dollar bet size compared to its contribution to active variance. There is more detail on this below.

Valuations matter and investments should be driven by fundamental research

Perennial Value has a large investment team. It is a significant resource and this commitment to fundamental analysis drives the Perennial Concentrated portfolio composition. As with most investors, we foster relationships with industry across supply chain, customers and management teams to understand the companies we invest in. Perennial has hundreds of meetings each year across all industries.

As a value investor, it is important to discuss what the Concentrated portfolio considers to be good value. Cheap stocks with moats, great management, discounts to intrinsic value giving safety, stable industries, margins and good balance sheets are all valid. A portfolio manager also needs to be practical. Over time, we have found that we want to own companies that are able to tick at least some of the following three characteristics:

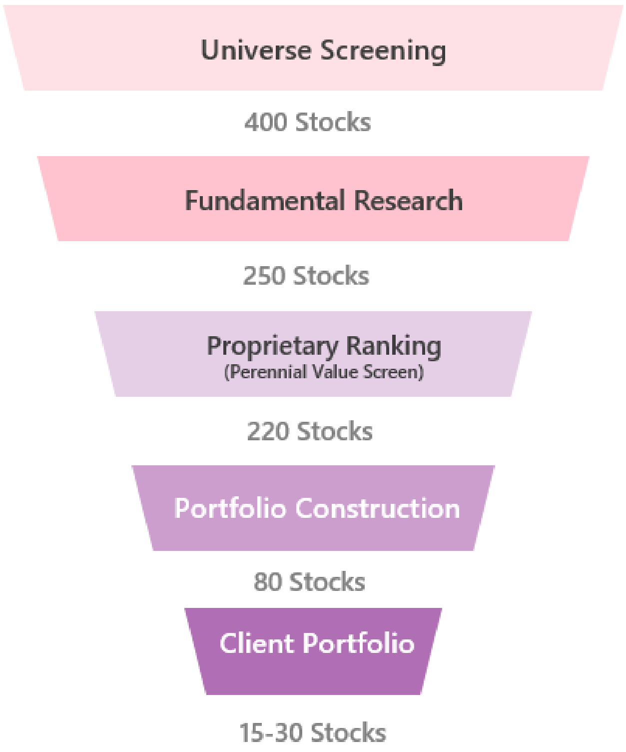
Yield – decent yield to the investor and free cash flow yield to the company.

PEG – decent price for the growth you get.

Quality – reliability of earnings and balance sheet.

The chart below describes our stock selection process - this investment process is a key part of the concentrated strategy.

Investment Process



Screen for

- $50 million min. capitalisation
- Concept stocks, high debt, poor management
- Initial screen on metrics offering a better value than market (P/E, dividend yield, int cover)

Conduct company visits & peer reviews

Characteristics sought:

- Sound financial position
- Good management
- Initial Profit track record
- Strong market positions

Six key measures sourced from company models

- P/E
- P/FCF
- P/NTA
- Net interest cover
- Forecast 3yr EPS Growth
- Gross Dividend Yield

3 step Portfolio Construction approach as described above

Portfolio Investment size then based on a function of:

- Risk Limits
- Liquidity
- Portfolio analytics

Concentration – combines diversification and agility

We try not to diversify excessively and limit stock numbers to 30.

Does concentration sacrifice risk mitigation? Surz and Price showed that at approximately 30 stocks, you capture most of the diversification benefit (when measured by standard deviation) while still maintaining an appropriate tracking error[4]. Anything beyond that number sees only marginal improvement in diversification. Broadcap funds often run the risk of near-index replication. Increased stock numbers also introduces dilution, reducing the impact of high conviction ideas, and adding to the research, operational and compliance burden. We want to focus on our best ideas.

At the other end of the spectrum, concentrated portfolios can become dominated by a risk in one bet. For example, an overweight in resources so significant that the opportunity for relative performance is entirely reliant on that bet. If a story changes, it becomes hard: behaviourally, the portfolio manager has to admit that their thesis is wrong (not always an easy self-reflection); from a risk perspective, too far to one side of the boat increases the chance of capsizing. We want sufficiently dispersed sources of alpha. Concentration should not mean a binary outcome.

Macro matters alongside bottom-up, idiosyncratic stock stories – they are not mutually exclusive

We often hear equity investors tell us the macro environment is too hard to call and therefore it is not part of their process. We take the opposite stance. Ignoring macro is ignoring data that can help in the stock selection process. Why

[4] Surz and Price (2000)

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would you disregard the supply and demand equation in commodity markets? Why would you not place some value in the possible direction of central bank policy?

Peter Lynch, the highly successful investor once said:

"If you spend more than 13 minutes analysing economic and market forecasts, you've wasted 10 minutes."[5]

We think he meant that basing your portfolio on what the forecasters say about the future is dangerous. On that we agree. But macroeconomic and political risks of the present are becoming more and more important, and are amplified as the investor base has become increasingly (quantitatively) rules-based. Ignore at your peril.

We see macro split into 3 general areas.

Geopolitical risk

- How do the changing relationships between countries influence the supply chain in companies I am exposed to?
- Does the tension between East and West increase the risk to stock markets in general?
- Will the Fed change policy and has the bond market priced this in? How will that impact the rush to expensive defensive names in my index?
- Are we likely to have a significant scale up in tension in the Middle East and resultant impact on oil?
- Sometimes you need to own gold stocks as safe haven, other times they are an inflation story, and other times a fundamental story.

Market risk

- Have quantitative investors increased the number of "same-way" bets? Does that influence the power of market momentum? How does it impact position concentration?
- Has the Volker rule taken the price makers out of the market and impacted liquidity?
- Does rules-based investing make the market more fragile?
- The plumbing in markets is very important, across all asset classes. Ignoring these known risks outside your own benchmark is naive and opens a portfolio up to endogenous shocks.

Economic risk

- Clearly economic forecasting has a poor track record. Understanding the current state and the potential outcomes however is useful.
- Is curve inversion always a recession indicator or is the market different now because of the absolute level of rates? What does that mean for growth companies in my benchmark?
- Will Yield Curve Control sustain the bid for yield in equities?
- Where do we think we are we in the business cycle and what does that mean for the stocks in my portfolio?

Risk management is key – identify risk drivers (both intended and hidden)

We regularly run a quantitative risk filter over our portfolio. This helps to interrogate the portfolio, making sure portfolio risk drivers align with our investment intention and identifies any unintended risk exposures.

This (perhaps slightly different) mindset takes us from knowing our biggest overweight relative to a GICS sector to knowing our risk exposure – this includes contribution to active variance, factor betas, style exposure, amongst others. The risk in a stock with 30% realised volatility is bigger than one with 15% volatility, ceteris paribus. Another way of saying this: "dollar weight is not risk weight".

This causes us to ask the following questions.

- Are the largest overweights also the largest contributors to tracking error – is there dollar and risk alignment?
- What percent of active variance comes from underweights or Not Held stocks and are we ok with that?

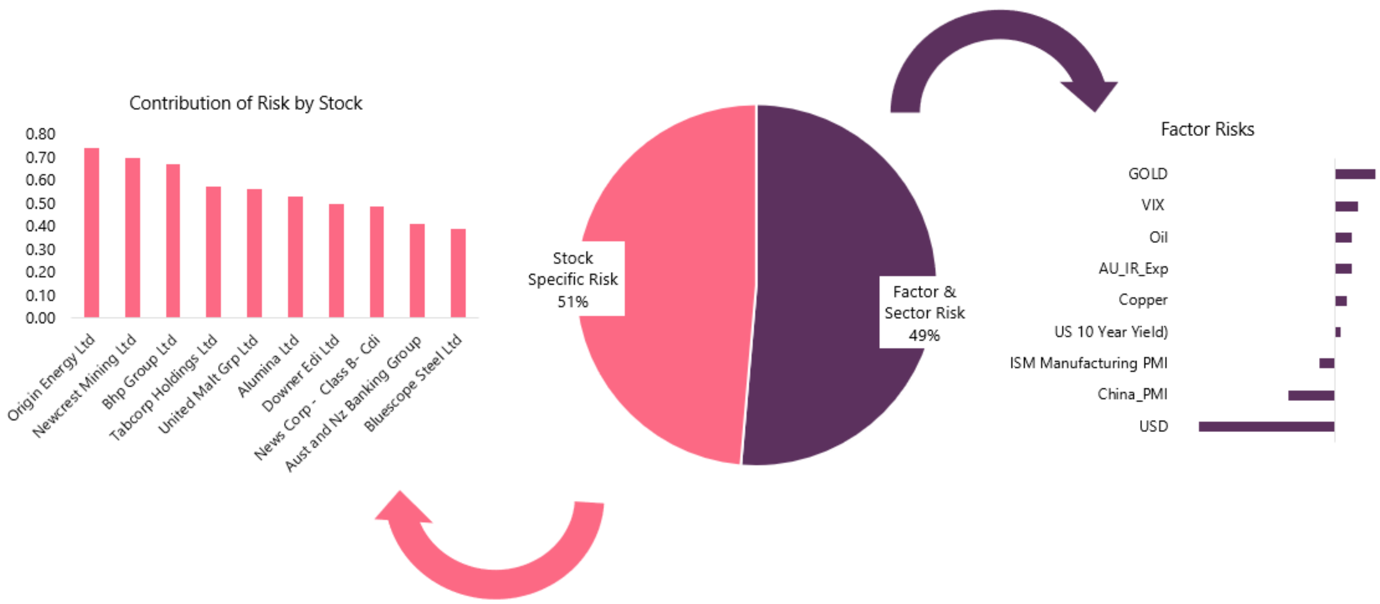
[5] Peter Lynch

- Are the active weights meaningful enough in absolute terms, adjusted for their contribution to risk?
- What is the split between Factor risk and Stock Specific risk?
- How influential are Sector exposures?
- What is the exposure to Style factors that are working versus those that aren't?[6]
- What is the exposure to Macro risks?[7]

These risks are often inter-related. For example, a view on (persistently low) interest rates may increase the attractiveness of free-cash-flow yield. A view on macro volatility may increase the desire for earnings certainty (and a tilt towards Quality).

Understanding the portfolio risks in a statistical way, using a robust portfolio analytics system is imperative to knowing what our known risks are and to uncovering our unknown risks and their relative size.

An example of one of our common outputs is shown below.



We believe this is an irreplaceable part of the concentrated portfolio process.[8]

Position size should reflect conviction and investment asymmetry

Lastly, position size should reflect conviction.

We distil our analysts' work into Bull, Bear and Base cases and attach probabilities to those three states. This helps us gauge analyst forecasting confidence, as well as variability and skew. Additionally, it provides a probability weighted target price for all our stocks.

We also use a variant of the Kelly criterion[9]. It is a formula that helps to size positions and leads to portfolios in which the dominant ideas have the greatest edge and the smallest downside. For two investments with the same probability distribution, Kelly will prefer the one with a better PnL skew and/or smaller negative tail. Admittedly, Kelly himself was trying to optimise long-term portfolio value in a binary framework. For our portfolio, because investment choices are not mutually exclusive (and can co-vary), and because we have to deal with parameter uncertainty and estimation error,

[6] For example, low price / book or High free cash flow yield.
[7] For example, portfolio correlation to Gold price or US10 year bonds.
[8] Perennial uses the Portfolio Analytics System (PAS) via UBS Investment Bank
[9] Kelly, J, "A New Interpretation of Information Rate", (1956)

this is used as a relative ranking tool. It also provides information as to the analysts' core assumptions and recommendations.

Importantly, it helps to shape the book into an asymmetric opportunity set.

Conclusion

In managing a portfolio of equities, we need to be sure we have analysed our portfolio properly and know the risks. We need to be sure they are understood AND optimised, within tolerance.

We need to remember we are here to take risk, but we also need to remember to be conservative at the same time. The best way to achieve that is through a solid risk management framework.

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