



Alida Jordaan
Equity Portfolio Manager

THE ROLE OF INTUITION

In a Q&A a few weeks ago, a client asked us if there was room for intuition in our investment process. The knee-jerk response to this question is: no, due to the negative connotation of basing investment decisions on a gut feeling, versus the confidence inspired by detailed research and a disciplined process. After all, at Macro Strategy Investments (MSI), the bedrock of our philosophy centres on integrating theme and price, both of which are based on scientific analysis.

On a bottom-up basis (price), we use HOLT's CFROI (cash flow return on investment) valuation methodology for our equity valuation work. This basically examines the cash generated by the business relative to capital invested, and helps us to compare the current share price to the actual value of the company. This valuation helps us determine whether a share is cheap or expensive, and therefore where it finds itself on the vertical axis of the diagram below.

On a top-down basis, we use longer-term macroeconomic analysis to determine our themes, and even though economics is often mocked as the "dismal science", it is backed up by rigour and logic.

Figure 1: Our philosophy illustrated

'Integrating Top-Down and Bottom-Up'		TOP-DOWN Macro Environment Markets Themes	
		BAD THEME Deteriorating Environment	THEME Improving Environment
BOTTOM-UP Valuations	HIGH Expensive	Sell All	Reduce
	LOW Cheap	Buy Some	Buy Lots

Source: Macro Strategy Investments

Clearly our philosophy is rooted in the common sense and insight that are the results of this detailed top-down/bottom-up analysis.

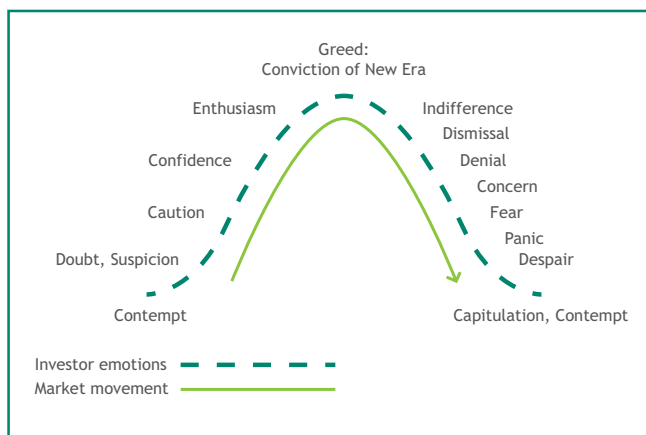
So, if a share is cheap, we buy; conversely, as assets become more expensive, we sell. Thus the trick, as you will read later, lies in the ability to assess when a theme is about to strengthen and the price is at its cheapest, just before it begins to rise, or where both theme and price have peaked, and are about to weaken.

All this analysis is contrary to the Efficient Market Hypothesis (EMH), which negates the need for valuations analysis and macro research. However, the recent extreme events in markets make a travesty of the EMH. Further, it has always been apparent that behavioural finance, or investor psychology, also plays an important role when assessing share price movement, as investors react emotionally to prevailing conditions. The following diagram illustrates the wide range of emotions experienced by investors at various stages of the market cycle.

EFFICIENT MARKET HYPOTHESIS IN A NUTSHELL

EMH refutes the need for both macroeconomic analysis and fundamental valuations and states that there is no such thing as an undervalued share, as markets automatically price in the effects of all available news and economic events that could impact their value, and therefore fair value is inherent in the nature of a share price.

Figure 2: Investor psychology cycle



The emotions of fear and greed have the ability to push markets well away from fair value, disproving EMH, resulting in abnormal distributions and fat tails (that is, a marked deviation from the expected return due to events or investor behaviour).

Our philosophy takes this into account and guides us to be cognisant of prevailing conditions. The key is to move against the herd; intense discipline is required to step away from human emotions, and to maintain a rational and objective approach. This discipline is reinforced by process. Therefore, if you refer to the diagrams, you will see that as investors are fearful and despairing we are "Buying Some". On the other hand, we are "Reducing Exposure" when investors are confident and enthusiastic, and the stock price is buoyant. This protects us from falling in love with a company or theme and holding on to the stock for too long.

Intuition, on the other hand, defined as "thoughts and preferences that come to mind quickly and without much reflection", is an anathema to fund managers as it seemingly flies in the face of this required rigour.

And it is here that the "knee-jerk" reaction mentioned previously is proven wrong, for arguably the most challenging aspect of making investment decisions is gauging exactly when a theme has run its course and the environment is about to turn. It is at that point that we want to sell and lock in profit - just before the theme weakens, and while the price is still high. This is typically when theme is at its most popular. The converse is also true, with the world appearing darkest before dawn - then we seek to buy.

It is the extreme psychological states of "greed", "conviction of a new era", "fear" and "capitulation" that signal the turning points of major themes, and an investment manager must be able to recognize these, and use them to their advantage.

For instance, at the worst of the sub-prime crisis, bad news became good news as it forced central banks to panic, which pushed interest rates to zero and created the liquidity that markets needed in order to recover. These "turning points" in markets are obvious in hindsight, but when they are happening, it is often intuition that guides a portfolio manager to choose the right time to shift into either a "Sell All" or "Buy Lots" position (figure 1).

Therefore, we would conclude that there is a role for intuition in asset management. Importantly, the reliability of that intuition is improved by experience, which is why we place great value and emphasis on the breadth and depth of experience of our team.

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Old Mutual Investment Group (South Africa) (Pty) Limited

Mutualpark, Jan Smuts Drive, Pinelands 7405
PO Box 878, Cape Town 8000, South Africa
Tel +27 (0)21 509 5022, Fax +27 (0)21 509 4663
www.omigsa.com



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