



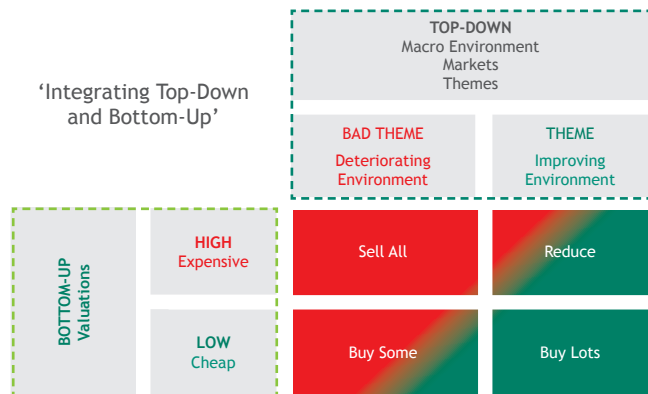
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Actualising our philosophy

For regular readers of our monthly newsletter, our philosophy framework of ‘theme’ and ‘price’ should be a familiar sight; for the sake of new readers: when we are considering an investment idea we combine both ‘top-down’ and ‘bottom-up’ inputs in our decision-making process.

The ‘top-down’ input identifies prevailing themes by examining the macro environment and using long-term proprietary performance data to assess whether these themes are improving or deteriorating in relation to the asset or sector under consideration.

‘Integrating Top-Down and Bottom-Up’



‘Bottom up’ focuses on establishing the differential between what a company is intrinsically worth (valuation), as indicated by fundamental analysis, and its market value (current price). We determine this through the detailed analysis conducted by Old Mutual Investment Group SA (OMIGSA)’s team of equity analysts, and internal and external research. We then combine the outcomes of these approaches to evaluate the overall attractiveness of the investment idea. For example: an asset with an improving theme and cheap valuation would fall into the ‘Buy Lots’ quadrant. Then, as the share price increases and the environment remains strong, it will move to the ‘Reduce’ quadrant, top right, as we start to sell to lock in profit.

However, it is not always so clear. For example, we may identify a share that is attractive from a valuation point of view but is not supported by a theme; in this case we would potentially ‘Buy Some’.

The next steps

Once we have decided that we want to ‘Buy Lots’ or ‘Buy Some’ of a share, the next part of our process helps us determine its weight in the portfolio.

Roadmap

Our roadmap provides the details of what we believe will be the future path of the investment idea. Aspects such as the duration of the potential investment – whether is it a strategic or tactical call; and the nature of the investment – whether the share is defensive or cyclical, are documented.

For example: for a ‘Buy Lots’ share the roadmap may say: “This is a core holding and I expect the theme to play out over a longer period

of time, resulting in earnings growth above the current market expectations.”

Or, the roadmap for a share that is cheap, but is not supported by a theme may state: ‘Based on the relative underperformance and valuation of this share, I am buying some on a shorter-term tactical basis, and would look to sell 10% higher.’

Risk

The trade-off for return is risk. And while it is factored into our price and theme analysis, it is a crucial consideration that also needs to be addressed independently. This includes how volatile the share is and how it interacts with the market; its sensitivity to macroeconomic variables such as interest rates, currency fluctuations or the market itself (beta to the market in financial jargon) is also measured.

And, because we run integrated portfolios where the sectors and asset classes we include hold dynamic tension, we need to identify how the share fits in with the rest of the portfolio.

Position size: the last step

Once we have established which quadrant the investment fits into, defined its roadmap, and identified prevailing risks, we then determine the optimal amount to include in the portfolio.

Our framework in action: Life Healthcare

Top-down themes

On the diagram the theme falls in the ‘Improving Environment’ half, despite some regulatory headwinds. There are three primary themes that indicate a favourable environment for the company:

- **Low return world:** this environment favours defensive companies with earnings certainty
- **Search for yield:** this is a cash generative company with a growing dividend
- **Emerging markets:** emerging market exposure opens up good expansion opportunities; Life Healthcare has just announced an acquisition in India.

Price: valuations

According to our bottom-up analysis, Life Healthcare is currently trading at fair value. This means that it is no longer cheap; nor is it excessively overvalued.

Roadmap

This share is a core holding and we are currently overweight. We expect to remain invested unless the share outperformance is significant, in which case it will move to the ‘Reduce’ quadrant.

Risk

This is a defensive, lower beta share and provides good diversification for our portfolio. There are some regulatory headwinds, such as the proposed National Health Insurance; however, the risks to theme and price are fairly low.

Position Size

Everything considered above, our call is to have an overweight position in our portfolios.

Hopefully the above example sheds some light on our process framework.

For more information, visit www.omigsa.com/msi

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October 2011

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