



# VALUE EQUITY INVESTMENTS

Feroz Basa and Michael Schroder | Boutique Heads

## BOUTIQUE OVERVIEW

As value equity investors, we believe that markets are inherently inefficient. We believe that shares are mispriced by the market due to sentiment and lack of information. We build risk-adjusted portfolios from shares that are cheap relative to their intrinsic value, with the view of profiting from this pricing anomaly.

Our approach is essentially contrarian in nature: when the market overreacts to bad news, like disappointing earnings, negative publicity or legal issues, shares often fall below their intrinsic values. This is typically when they are moved onto our BUY list. Conversely, we are always seeking opportunities to sell once shares have reached their full value.

We are bottom-up stock pickers and construct our portfolios through in-depth fundamental research. We are unconstrained in terms of our share selection, which is based on the independent, well-proven characteristics of lower price-to-earnings ratios, higher dividend yields and lower price-to-book ratios than the overall market. This provides investors with lower volatility and, ultimately, higher risk-adjusted returns.

## INVESTMENT PHILOSOPHY

Historically, value stocks have consistently outperformed other investment styles and the market as a whole. We are absolute believers in the long-term superiority of this 'value' philosophy - buying shares when they are cheap and selling them when they are pricing in expectations we believe to be too optimistic.

We rely less on forecasting earnings and more on a company's fundamental valuation. We do not spend our time trying to predict the catalyst that will cause a share's expected value to improve, or 'rerate'. Given that we are normally buying stocks that have fallen out of favour with the rest of the market, it is very important that the companies we invest in are fundamentally sound.

## INVESTMENT SOLUTIONS

- Value equity portfolios (institutional)
- Old Mutual High Yield Opportunity Fund (retail unit trust)
- Old Mutual Value Fund (retail unit trust)

## VALUE EQUITY TEAM

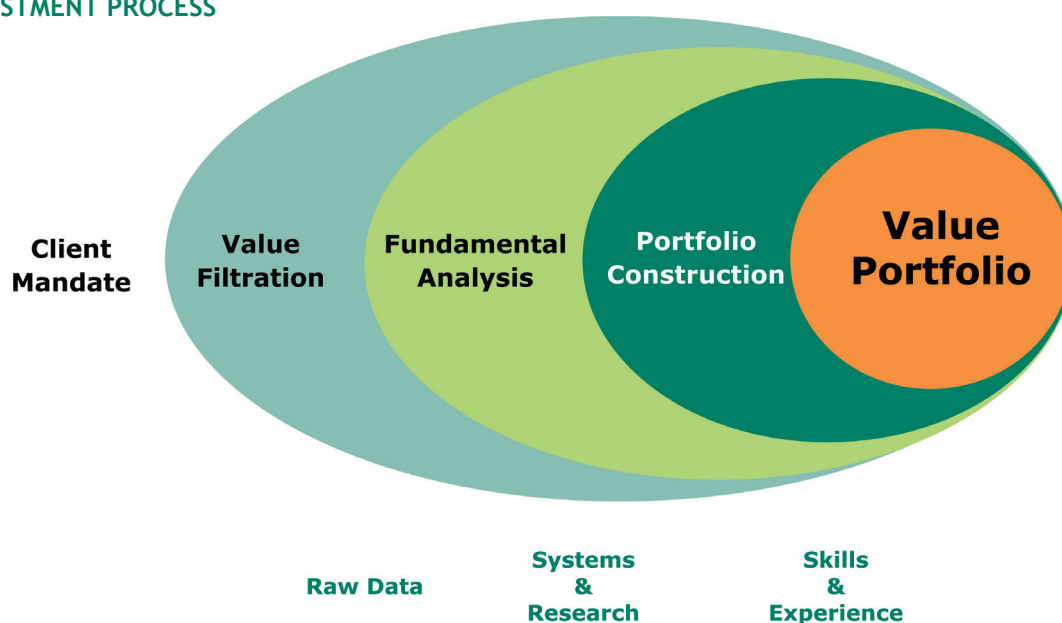


**Michael Schroder**, joint head of the Value Equity Investments boutique, joined OMIGSA more than 20 years ago as an analyst in the resources sector. He subsequently became a portfolio manager and head of equity research. Michael has an MSc and MBA, and previously worked for Anglo American. His fund management awards include several Raging Bull Awards.



**Feroz Basa** is the joint head of the Value Equity Investments boutique. He was previously an equity analyst in OMIGSA's Equity Research team, responsible for industrial counters. Feroz graduated from the University of the Western Cape with a B Com (Hons) and joined Old Mutual in 1998.

## INVESTMENT PROCESS



### Step 1 - Filtering the universe

Our first step is to screen a universe of some 300 of the most tradable shares on the Johannesburg Securities Exchange (JSE), using size and tradability criteria. This reduces the investable universe to roughly 200 shares. We filter this list of shares by using a number of valuation measures in a multifactor dashboard.

#### Dashboard

The dashboard is a visual tool that helps to identify and reduce the number of shares that warrant further analysis. In order for us to identify cheap shares in line with our philosophy, the core valuation measures have a value bias. Typically, the following valuation measures will be employed and displayed on the dashboard:

- Price/earnings ratio
- Price/cash flow
- Price/book
- Price/sum-of-parts
- Dividend yield
- OMIGSA Equity Research analysts' recommendation

The outcome of this first step is a ranking of more than 150 shares. Once the dashboard highlights a share as having many value characteristics, we look at it in greater detail for potential inclusion in the portfolio. Conversely, if the dashboard highlights many negative indicators for a share we currently hold, we also analyse it in greater detail for possible sale. This forms the basis for the second step in our investment process: fundamental analysis.

### Step 2 - Fundamental analysis - What characteristics we look for in a share

We verify that the company is indeed fundamentally attractive in terms of its operations. We do this by asking the following questions:

- Is the respective industry in which it operates healthy?
- Are there any regulatory overhangs?
- What does the corporate governance record look like?
- What is the share's rating relative to its peer group?
- Does it have a clear strategy?
- Is it well placed (or have any competitive advantages) given the market environment?

This process is followed by examining the company's financials by asking the following questions:

- What is the quality of the company's assets and overall balance sheet strength?
- What is the cash-flow position of the company?
- How leveraged is the company and when is the debt due?
- What is its dividend paying history?

Importantly, we engage our team of equity analysts on all aspects of our research. In addition, we interrogate the analysts' valuation models to test the soundness of their assumptions.

### When do we buy?

We buy shares that have fallen 'out of favour' and are being ignored by the market. In most cases, it is a matter of the market over-exaggerating the risks in a share. If the bad news surrounding a share is likely to have a temporary effect on earnings, then it is a good sign to buy. However, if it becomes clear that the problems will be long lasting and the share deserves its low valuations, then we stay clear of the share.

### When do we sell?

We apply strict discipline when analysing shares that we currently hold. For example, for shares whose indicators have moved from positive to negative, we investigate if there have been fundamental changes in the company or environment, or whether it is simply a matter of the share price having moved ahead of the market. However, if something has fundamentally changed, we will trade out of the position as quickly as possible.

### What do we do differently from the OMIGSA equity analysts?

While we do leverage off OMIGSA's extensive equity research capability, we also conduct our own proprietary research, using a value-biased methodology in our analysis of the JSE sectors.

### Step 3 - Portfolio construction

- If a share meets our criteria, we explore how well it fits into our existing portfolio.
- In addition, we determine our level of conviction on a counter. For example, very high conviction calls get considered for a higher weighting in the portfolio than low conviction calls. This is where our level of confidence in the counter is tested, depending on its predictability or visibility and the level of risk inherent in the share. Also important is the absolute and relative levels at which the share price is trading (how unusually cheap is the counter?) and thus the potential upside to its intrinsic value. We also consider risk versus potential reward during this step.
- We aim for the minimum exposure of 1% for a holding to impact materially on the fund. The market capitalisation of a company, its turnover on the JSE and the cash flows of the fund will determine how much of an individual counter will be added. Size and tradability are important because we don't want to take big positions in the fund

where exiting will become too difficult. Therefore, it is unlikely to have a small, highly illiquid share reaching a 10% weighting in our funds.

- The maximum single share exposure we aim for is around 10% of the fund's value. Depending on the benchmark, this measure is inadequate for a handful of shares with very substantial weightings. In these cases, we monitor our exposure versus the mandate and/or regulatory restrictions.
- Similar issues arise for a number of industry clusters, where the shares are highly correlated and together add up to substantial weightings. As our value style is essentially bottom-up stock picking, it is very often that buys or sells are concentrated in particular industries, so again a limitation of exposures needs to be monitored for risk purposes.
- In building our portfolios, we aim for adequate portfolio diversification. Several industry clusters are driven by similar drivers and some of these are highly unpredictable. So, we are constantly monitoring the amount of risk we are taking on in terms of a number of factors such as the exchange rate, interest rates and commodity prices, as these certainly influence our holdings. Once we have built our portfolios, we look at the resultant sector tilts and ask the question: are we comfortable with our split between the broader industries? Here the benchmark is the key risk management tool.
- We also interrogate the quality of our tracking error - does it stem from stock picking rather than from unintended sector tilts? Furthermore, we continuously monitor portfolio risk to ensure that it is manageable and that we are only taking on the positions that we want.
- Typically, this will result in a portfolio of approximately 35 to 45 shares.

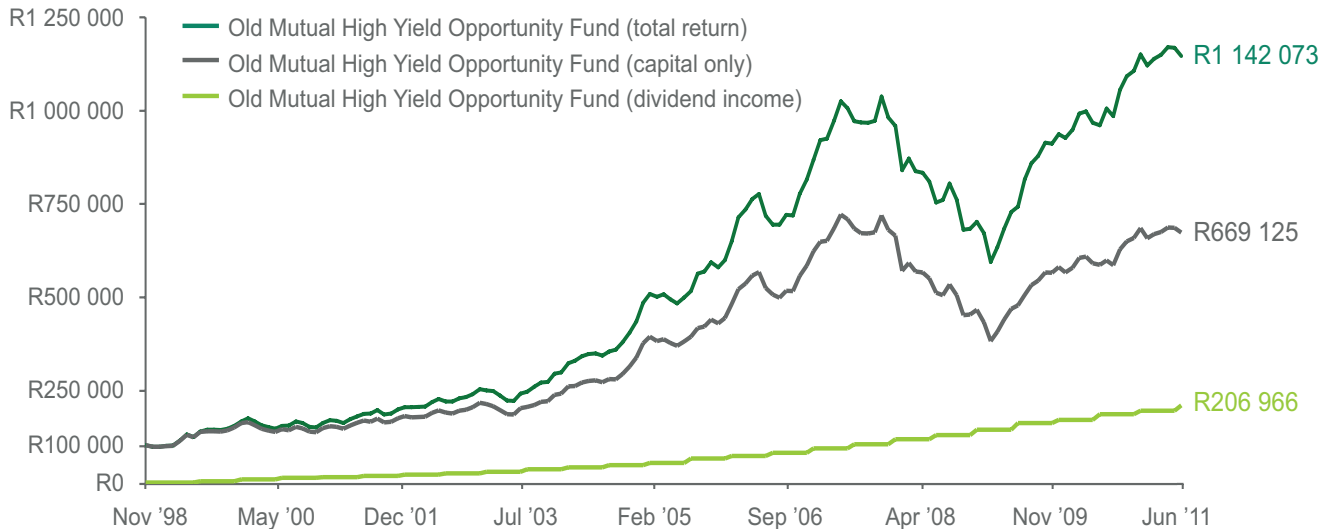
### Step 4 - Portfolio implementation and trading

Once an investment decision has been made, this is sent through to the trading desk via Decalog. All equity trading takes place through OMIGSA's Equity Trading Desk, which has a series of strict allocation rules. As the largest trading desk in South Africa, we benefit from its relatively low trading costs and excellent broker relationships.

## PERFORMANCE TRACK RECORD

Based on our sound and repeatable investment process, the range of funds managed by the Value Equity Investments team has delivered consistent performance.

### R100 000 investment in Old Mutual High Yield Opportunity Fund (November 1998 to June 2011)



Sources: OMI GSA and Morningstar

The Old Mutual High Yield Opportunity Fund, which participates in the General Equity Unit Trust category, is based on the same fundamental analysis as our other funds, but has a higher weighting to high dividend-paying shares. This fund has a very good long-term track record (4<sup>th</sup> out of 32 funds over 10 years and 4<sup>th</sup> out of 74 funds over three years), supporting the view that dividends are a big driver of total return.

By illustration, an investor who invested R100 000 (net of fees) at the inception of this fund (4 November 1998) would have received a total annual payout of more than R23 992 for the 12 months at the end of June 2011. Furthermore, the same investor would have received total distributions since inception of R206 966, which is more than the initial investment. The capital would also have grown by 16.2% p.a. and, at the end of June 2011, was worth more than R669 125 (excluding distributions).

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