

Ugly Values

Market exacts a toll – as it did in the late 1990s

BY MARK NOBLE

One of the tenets of value investing is there will be times when it's going to get ugly. Problem is, for a lot of established value firms, things have never looked uglier – leading some advisors to question the wisdom of the strategy. But fund analysts say there is merit to what value firms are doing right now and investors should wait before they write off their value holdings.

In a research bulletin from early April, independent fund analyst Dan Hallett writes that investors need to be more patient with value firms, which include traditional advisor-favourite brands like Brandes Investment Partners, Saxon Mutual Funds and the Trimark fund family.

"We can draw on our experience from counselling many frustrated advisors in the late 1990s. Then, as now, many value managers with strong track records could seemingly do nothing right. Whatever the market valued highly, these managers saw as too frothy for their bargain-hunting disciplines. What they saw as cheap, they purchased, only to see it go lower or flat-line. Sound familiar?" Hallett says. "Similar to the late 1990s, the way to benefit from their strong subsequent returns was to buy them when they were deeply out of favour – not after a strong five-year run."

BEST MANAGERS SUFFER

Hallett says the problem today is in the last bear market, which

came after the tech bubble burst, many value firms continued to do well. In light of this, Hallett suspects there are a lot of value-convert advisors who are under the impression that value funds are somehow not correlated to market conditions.

"Even the best managers hit rough patches that can last three to five years. When value managers glided through the last bear market smelling like roses, many investors and advisors found the 'value investing religion,'" he says. "The approach makes sense, and the returns were fabulous, so they jumped on the bandwagon. A number of people did that without an appreciation of the history of value investing – in the early '70s and early '80s, there were some pretty awful periods."

Hallett says the majority of funds on his recommended list have a "value tilt" to them, but he believes advisors and clients alike have to look at the track record of value investors to get a sense of what makes a successful value mandate.

GOOD MANAGERS ARE KEY

"The key is selecting good managers. Not everyone that calls themselves value managers is really true to that label or good at what they do," he says. "I would say most of the managers on my list have a value tilt – not all of them are getting beaten up, but lots of them are."

However, one of the things shaking investor confidence in the

strategy is some of the most established value brands are having unprecedented difficulty. Probably most noticeable is Brandes Investment Partners. Brandes, as a firm, has only been in Canada for a few years, but its founder, legendary value investor Charles Brandes, has a three-decade track record of tremendous success.

"I have received a lot of calls from advisors about Brandes because [Brandes has] experienced their worst performance in their history over the past year or year or two," Hallett says. "It really comes down to this – make a firm decision. Do you think Brandes and their success over the last 30 years has been a fluke, or has something really changed?"

Of course, since past performance is not a tell-all indicator of future success, there is no concrete answer to this, but fund analyst Jordan Benincasa with Morningstar Canada believes Brandes' strict adherence to Benjamin Graham and David Dodd's value investing philosophy should pan out.

POINT OF THE STRATEGY

The frustrating thing for investors is a firm like Brandes lets valuations dictate the buys, so it is going to buy value traps, but the point of the strategy is to get enough names in a diversified portfolio so the winners outperform the losers. Benincasa says this has worked in the past over the long term.

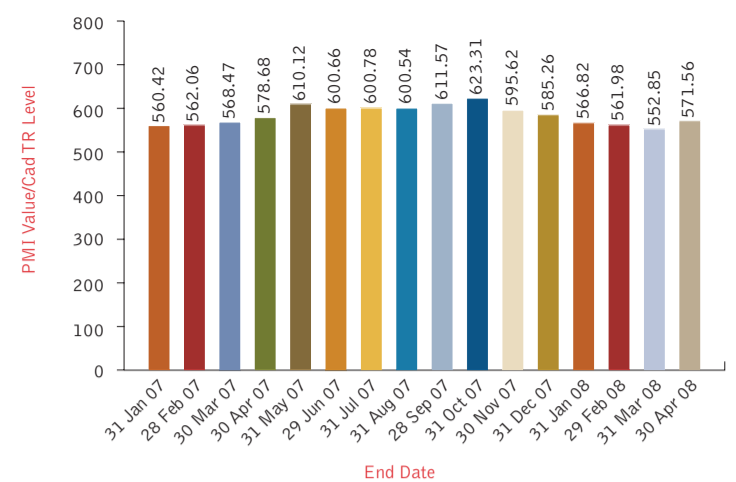
"It's a great time for value managers to buy companies that have been sold off irrationally and over the long term should play out well," he says. "That's the point – you don't know which companies are going to do well on an individual basis. If you pick enough of them overall, you should perform well over the long term."

CURRENCY PROBLEM

Benincasa also notes that Brandes' stock picks aren't as bad as they currently look to Canadian investors because of the fact that the company doesn't hedge its currency. This is a problem that has also plagued the Canadian offering of Legg Mason's flagship Legg Mason Value Trust, managed by Bill Miller. The fund is available to Canadian investors as the CI Value Trust.

Miller, known as the "man who beat the S&P" for his unprecedented 15-year streak of outperforming the S&P 500 benchmark,

S&P/CITIGROUP CANADA VALUE PMI



Source: Standard & Poor's Index Services

is also having one of his worst years on record.

"If you look at Bill Miller's portfolio, 23% is in financials, and the S&P is about 17%, so he has been moderately overweight in the financial sector," Benincasa says. "Financials underperformed significantly in 2007. The CI Value Trust lost 21% in 2007, and the S&P 500 lost 10%. That's in Canadian dollars."

Its one-year returns are even worse. Miller has opted to stay invested in financials and many stocks that are heavily reliant on the depressed U.S. homebuilding industry, such as Sears. As a result, the Legg Mason Value Trust is down 24%. The CI Value Trust is down 33% because of the effects of the Canadian dollar.

Yet, true to his discipline, Miller is sticking to his picks – aside from a recent admission that holding Bear Stearns was a mistake – meaning his investors are likely in for a bit of a ride before things have a chance to get better.

KEEPING VOLATILITY LOW

Some managers will try to keep the ugly side of value investing to a minimum. Kim Shannon, chief investment officer and president of Sionna Investment Managers, employs a relative value approach that keeps volatility in the fund low.

"As much as possible we try to be all industry groups at all times, and index-hugging weight as much as possible and allow strong stock selection skills to win the day of investing for us," she says. "Contrast that with some deep value managers that I admire greatly who just look for absolute value. If they can't find value in a sector they won't buy it all, whereas we will try to be industry group neutral. We will buy the cheapest names in the sector, even though they might not be absolute value."

The strategy has helped Shannon pick out some winners, for

instance, her fund's largest holding is EnCana, which she bought as a value-play a year ago.

"We quite actively chose to have a large position in EnCana; last year, most of the spring EnCana was on our model's best bargain in the oil space. As you know, it's had a good move, as the price appreciates its weight in our portfolio rises. We've actually been net selling it down but it's been growing in terms of its relative weight in the fund," she says.

Shannon, whose successful long-term track record as a value manager was one of the reasons Morningstar Canada named her fund manager of the year in 2005, admits it's been tough going in the current market.

SIGNS OF FERTILITY

"I think it's a classic indicator of a topping bull market run. If you look at the TSX we had a phenomenal rally in the fall of 2002 until recently and it was one of the longest in Canadian market history and one of the highest returns," she says. "You can tell that it's toppy because over half the return was based on three stocks, Potash, RIM, and Alcan. The three of them were not classic value stocks and by not owning those three names were playing a game with one hand tied behind their backs." Yet, she sees signs that the markets may be more fertile for value style.

Even if buying opportunities are starting to pop up, Shannon notes it may be a half-decade before investors see the style really pay off. "If you look at studies about how quickly value styles can start to perform, you tend to get a nice kick in the first year, and then you get your best performance in the stocks you own in years three to five," she says. "It's possible to pick up performance right from the beginning of buying it. You really get homeruns in the third, fourth and fifth years of owning the stocks."

No Gains

It appears history is repeating itself. Despite the recent recovery in the stock market, Canadians are still sitting on cash positions which in real terms are 15% higher than the already elevated

level seen in 2001. In this context, the current rise in excess cash positions to a record \$45 billion follows the trend seen on previous occasions of increased risk aversion. And as was in the past, by doing so, investors are sacrificing billions of dollars in potential investment gains. **AER**

SITTING ON CASH FOR TOO LONG



Source: Bank of Canada, IFIC and CIBCWM

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