InvestSense

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How do fund managers think?

A large part of our fund research work focusses on trying to understand how a fund manager thinks. While most businesses want you to believe that it's all about 'philosophy' or 'process', in reality it is people who manage funds and people who make investment decisions, not processes. Understanding the inner workings of the individual is then a critical element when forming views on who should be managing investor money.

Firstly, to differentiate between different ways of managing money. Despite the multitude of labels out there (think: Value, Growth, Momentum, Quality, Quantitative, Core, etc.) there are just a few components to return:

"Return = dividend yield + earnings growth + price re-rating"

1. The dividend yield. How much income you can expect to receive from a share in time. Dividend yields are generally quite reliable inputs to evaluate; stable by nature and set in terms of policy by the company. Higher dividend yields indicate high cash flow or low price, or both.

2. The rate of earnings growth. What will the company earn in future? This is often a hard one to measure and the evidence of managers broadly making accurate earnings estimates is quite weak. Earnings at a company level can be impacted quite materially in the short run by a wide range of factors, making it a difficult item to place reliance on.

3. The price you pay relative to what you get – mostly the Price: Earnings ratio (PE Ratio) is used as a measure to gauge value for money. Return is then earned as the multiple changes, as investors are prepared to pay more (or less) per unit of earnings.

These three items constitute the expected return of any share. They also attract different fund managers in different ways.

For example, the 'Value' manager who is always looking for a cheap price will be attracted to low PE's, and will therefore require a substantial rerating to earn their return. By implication, they are buying the unloved, the disappointing and the neglected, and they get more excited the more negative the news is around a share. Mindset wise, a natural contrarianism is required as well as a strong constitution to weather the bad news, which hopefully results in the re-rating they seek. On the softer side, they tend to be thrifty by nature, look after the pennies and the pounds will follow, and can quite often be the pessimist in the room. They also need to guard against the problem of the value trap (cheap stays cheap) and also the vicious circle of needing to be proven right and holding on to losers too long. This is a naturally higher risk approach to investing as the items they require to change trajectory (the companies' fortunes, earnings, etc.) are not observable, hence the low price. For value managers, their risk sits in diversification, because to their mind the cheap price has taken care of capital risk.

To illustrate this mindset, consider the Charlie Munger[1] viewpoint:

"All intelligent investing is value investing, acquiring more than you are paying for. You must value the business in order to value the stock."

A 'Quality' investor on the other hand will be attracted by safer companies with reliable earnings and will care less about the price they pay. In simple terms, the quality investor doesn't require any form of re-rating of the price, in fact quite often there is a de-rating. But given the high-quality earnings which generally translates to stable and growing dividends, they are generally quite relaxed when compared to the Value investor as they do not have re-rating anxiety, or the prospect of the value trap. Mentally though they are exposed to the flaw of overconfidence: the fact that a company is high quality today doesn't mean it will stay that way. Numerous examples spring to mind – Kodak being one – where the 'buy and hold' mentality of the quality investor can cause them to miss the weaknesses creeping into their favourite shares. The traits we look for in such managers is whether or not they have an awareness of price paid; the extent to which they will sell their winners and their ability to diversify risk away from the traditional sectors which fit the quality definition.

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FUNDHOUSE
investment clarity

In the words of Charlie's business partner Warren Buffet:

"When we own portions of outstanding businesses with outstanding managements, our favorite holding period is forever."

By contrast, the growth investor requires a somewhat different personality – generally an optimist by nature, they make decisions where the difficult to track earnings growth number is their core focus, believing that even an expensive price to pay is justified when earnings growth will be significantly higher than average. Typically, they will arrive at a low dividend yield, high PE, high growth portfolio. At the extremes, this is characterized by technology shares and other disruptive industries such as biotech or electric driverless cars. Mentally, they need to be risk-taking rather than conservative, they need to ride the winners rather than sell down, and they also tend to trade more often, contrary to both Value and Quality investors. Their pitfalls? Overconfidence in their ability to pick the winners, not recognizing that there is often a limit to what price can be paid for a share.

Charlie also explains how it's not all about price paid:

"Over the long term, it's hard for a stock to earn a much better return that the business which underlies it earns. If the business earns six percent on capital over forty years and you hold it for that forty years, you're not going to make much different than a six percent return - even if you originally buy it at a huge discount. Conversely, if a business earns eighteen percent on capital over twenty or thirty years, even if you pay an expensive looking price, you'll end up with one hell of a result."

These examples illustrate that while all fund managers may see the world differently and require different 'DNA' to make effective decisions, they are in fact playing the same game and so the overlap between these examples is high (just refer back to the quotes, where the same individuals have made compelling arguments for value, growth and quality investing!).

We incorporate this subjective assessment in the funds we research so that we can gauge firstly if the individual is up to the task at hand given their chosen approach to investing, and so that we can understand their decision making dynamic and how it relates to what we employ them to do as investors.

Two final quotes from Charlie about manager behaviour:

"A lot of people with high IQs are terrible investors because they've got terrible temperaments."

Temperament is an evaluation we make across individuals and their respective teams, quite often extending to the entire organization.

"Envy, huge self-pity, extreme ideology, intense loyalty to a particular identity – you've just taken your brain and started to pound on it with a hammer."

These highlight that having a keen sense of a manager's personality and decision culture – how they think - is a critical outcome of our fund research work.

[1] *Warren Buffett's business partner*

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data provided by Reuters and Datastream

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	-6.0%	-6.1%	9.6%	5.1%	10.0%	9.7%	11.2%	14.6%
FTSE/JSE SA Listed Property	ZAR	-19.6%	-10.8%	-7.1%	-0.5%	7.1%	13.7%	14.7%	15.2%
SA All Bond Index (ALBI)	ZAR	8.1%	6.1%	16.2%	8.6%	7.7%	9.6%	8.2%	7.7%
SA Cash Index (SteFI)	ZAR	1.8%	1.1%	7.4%	7.2%	6.6%	7.0%	0.3%	0.5%
Balanced Benchmark	ZAR	-3.7%	-3.5%	7.6%	6.0%	10.1%	10.0%	7.1%	8.8%
SA Inflation (1 month lag)	ZAR	1.5%	1.1%	4.0%	5.8%	5.4%	5.7%	1.4%	1.4%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	-1.2%	-6.1%	14.2%	8.6%	10.3%	6.5%	10.2%	16.3%
Emerging Markets Equity (MSCI EM)	USD	1.5%	-6.3%	25.4%	9.2%	5.4%	3.4%	15.0%	22.5%
Global Bonds (Barclays Global Bond Index)	USD	2.5%	0.8%	8.5%	3.5%	1.2%	2.0%	5.4%	6.5%
Global Cash	USD	0.5%	0.3%	1.5%	0.9%	0.6%	0.7%	0.1%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-6.0%	-6.1%	9.6%	5.1%	10.0%	9.7%	11.2%	14.6%
Global Equity (MSCI World)	ZAR	-5.4%	-6.3%	0.9%	7.8%	16.1%	10.6%	13.9%	14.4%
Emerging Markets Equity (MSCI EM)	ZAR	-2.9%	-6.5%	10.8%	8.4%	10.9%	7.3%	13.2%	15.6%
SA All Bond Index (ALBI)	ZAR	8.1%	6.1%	16.2%	8.6%	7.7%	9.6%	8.2%	7.7%
Global Bonds (Citigroup)	ZAR	-1.9%	0.6%	-4.1%	2.7%	6.5%	5.9%	12.4%	14.8%
COMMODITIES									
Gold (US Dollars)	USD	1.5%	-1.4%	6.1%	3.7%	-3.7%	3.6%	15.7%	18.2%
Gold (Rands)	ZAR	-2.8%	-1.6%	-6.2%	2.9%	1.4%	7.5%		
CURRENCIES									
Rand / Dollar	ZAR	-4.3%	-0.2%	-11.6%	-0.7%	5.2%	3.8%	14.2%	16.6%
Rand / GBP Pound	ZAR	-0.7%	-1.6%	-0.9%	-2.6%	3.6%	0.3%	15.4%	15.7%
Rand / Euro	ZAR	-2.0%	-1.5%	1.6%	3.8%	4.3%	1.2%	12.9%	13.4%

Spot Rates		4-Apr-18	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	11.90	11.85	13.41	9.17	8.13	5.04
Rand/GBP	Rand	16.75	16.62	16.78	13.93	16.16	8.44
Rand/EUR	Rand	14.63	14.57	14.34	11.78	12.88	-
RATES							
Libor 6m $	US$	2.46	2.45	1.42	0.44	2.61	5.75
Repo Rate	Rand	6.50	6.50	7.00	5.00	11.00	15.00
Prime	Rand	10.00	10.00	10.50	8.50	14.50	18.25
All Bond Index Yield	Rand	8.71	8.62	9.38	7.24	-	-
COMMODITIES							
Gold ($/oz)	US$	1,337.16	1,323.43	1,247.25	1,595.80	932.40	301.35
Platinum	US$	919.00	936.00	940.00	1,576.00	2,040.00	407.00
Oil (Brent Crude) $	US$	67.79	70.09	52.62	109.57	104.27	13.92
INFLATION							
SA Inflation	%	-	-	6.1	5.9	11.6	-

Fundhouse is a leading investment adviser specialising in fund research, ratings and portfolio construction services. We help clients manage investments on behalf of the end investor. Our experienced team understands the complexities of the fund management world. We apply this knowledge alongside a client?first mindset to improve the outcome for the end investor.

Fundhouse was founded in 2007 by professionals from the investment management industry. We currently operate from offices in the United Kingdom and South Africa, where we cover the local and global fund industry first hand. Our business is 100% independent and owner managed which means we can offer objective advice and services in the best interests of our clients.