

# Evans and Partners Asset Management

MAY 2015 WHITE PAPER

## Concentrating on Risk and the Equity Investor

### Introduction

Investors often wish to distill the idea of risk into a checklist of financial equations and Greek alphabetical letters, with a view of quantifying the unquantifiable. Risk is popularly defined using financial jargon such as Value At Risk, Volatility, Beta, Tracking Error and the Sharpe ratio, to name a few. These measures are efforts to apply precision to an inherently imprecise concept.

The financial market, and its inherent risks, cannot be reduced to a single variable - it is complex, persistently changing and subject to left field surprise. While the statistical measures mentioned above may provide a semblance of analysis after the fact, we argue these measures do not provide a meaningful signal of future risk events, nor do they provide an all-encompassing definition of risk.

We argue that risk management is less a measurement, and more an action, less a destination and more a process. The changing nature of financial markets ensures that that the techniques set to measure risk from a statistical standpoint are, by their very nature, flawed at the outset when used as risk management tools. These metric often fail as risk management tools because they do not provide a sensible framework for thinking about the outcome of risk.

In this paper we investigate how the traditional measures of risk and our definition of true risk differ. We also turn the idea of the “Efficient Frontier” and Modern Portfolio Management Theory on its head, and look at how this inverted approach can lead to superior investment returns. In doing so, we demonstrate that by avoiding the major buckets of fundamental risk a conservative approach can add to returns rather than detract from investment outcomes.

Lastly, we demonstrate how a concentrated portfolio of high quality, attractively priced stocks can be less risky than a highly diversified portfolio.

### Volatility – a traditional yet flawed measure of risk

The first problem with risk tools such as the Sharpe ratio which measures short term volatility against long term performance is that they offer a timing mismatch. Where equity investment

mandates are typically long term in nature - in place to compound returns for retirement or other long term goals - the Sharpe ratio typically measures volatility over a one year period. Measuring volatility over a short time frame does not marry with the objectives of long term investing. Furthermore, the ratio penalizes positive volatility and negative volatility equally – surely positive returns are a good outcome?

Rather than attempting to guess the “expected volatility” of a stock price, based on the mood of buyers and sellers on a given day, we believe it is far more important to understand the value of a business based on its profits, the resulting cash flows, and the risk of those cash flows materially changing over time. In order to do so, it is important to understand that the impact of risk is not cumulative in nature, but rather it is exponential. Combining business risk (for example, customer concentration risk) with operating leverage (high proportion of fixed cost), with financial leverage (on balance sheet and off balance sheet liabilities) will create a compounding effect through the profit and loss statement. This compounding effect, coupled with valuation risk, will amplify what we view as the true risk score – the risk of permanently losing capital.

### High Risk, High Return: The Efficient Frontier? We prefer low risk, high return

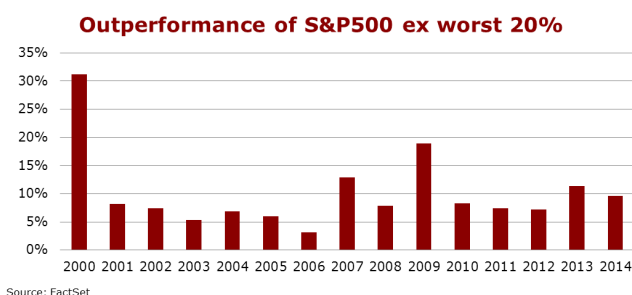
As demonstrated by the “efficient frontier” chart the common view of investment returns is that as an investor moves along the risk curve, the expected return of the investment also increases.



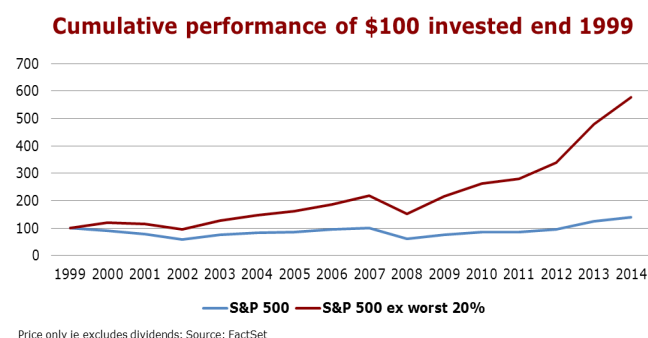
As we have covered in the preceding paragraphs, we are not big proponents of volatility as a measure of risk. In addition though, we do not believe it is necessary to move meaningfully along the true risk curve (the risk of permanently losing capital) to drive good returns. In fact, we turn the whole idea of the “efficient frontier” on its head. We deliberately take out those investment candidates that we consider to be highly risky with a view of staying out of the parts of the market that could be expected to deliver meaningful losses – and in the process, we look to drive outsized returns. Sounds boring? Maybe, but it is also a very powerful way to avoid the losses that impede the power of compounding investment returns over the long term.

## Low Risk – High Return

To illustrate this approach, take the example of an investor in the year 1999. If this individual had done no better than stay out of the bottom 20% of the listed securities comprising the S&P 500 each year until 2014, on average investment returns would have increased by 10% pa. when compared to the index.



Looking at the same data in a different way, and drawing out the power of compounding returns over long time horizons, we can see an equally compelling story. If an investor had managed to stay out of the bottom 20% of the market from 1999 to 2014, that individual would have compounded \$100 out to \$578 over that period. This compares to just \$140 for the overall market over the same period - quite the difference.



At this point, it would be fair for the reader to point out that this analysis is backward looking - and in reality, picking the bottom 20% of each year isn't easy. We are inclined to agree, however there tends to be a few major areas of underperformance in every year which can be the source of permanent loss of capital. We think those major causes can be found in the list below;

**Rapid Change** - While rapid growth can be seductive due to the short term nature of returns on offer, chasing rapid growth can often be a source of greater losses. Consider this; in the 4<sup>th</sup> Qtr 2013 Samsung had the #1 position in the Chinese smartphone market with a 20% market share. Fast forward just twelve months and this market position had slipped to #5, with a market share of just 6%. While volatile market structures can lead to outsized gains, changes in these structures are very difficult to predict and on balance are typically a source of loss for the majority of investors.

**Business Risk** – Business risk takes many forms but as an example, we pay particular attention to key contract risk and single product risk. In both cases, there is a chance that a large portion of revenue may disappear unexpectedly. When coupled with a high degree of fixed costs, permanent loss of capital is a likely outcome.

**Macro Dependency** – Oil at \$52 per barrel, \$1.7tn worth of bonds at negative yields globally, Chinese growth rates below 7%, iron ore prices below \$50 a tonne, the Euro losing 25% in value against the \$USD over twelve months, and Brazil in outright recession were not being widely written about in the financial press or being mentioned as a possibility by economists two years ago. Betting on one-way macro events increase the risk of landing in the bottom 20%, in our view.

**Poor Management** – It's easy to find examples where management hubris or poor decisions have led to deterioration in business fundamentals. Take for example Segway, Dean Kamens's self-balancing scooter that was introduced to the market in 2001. Kamen felt that his scooter would revolutionise travel within metro areas and rather than build capacity on an incremental basis, he built a 75k sq ft manufacturing facility to product 40,000 units per month. The facility was built on the assumption that the product would be appealing to 0.1% of the population. Not only did the forecasts turn out to be bullish, but in the rush to get the product to market, manufacturing quality was substandard resulting in a recall of the entire installed base of 23,000 units within the first year of production. Avoiding poor management is a sure-fire way of reducing the odds of landing in the bottom 20% of the market.

**Financial Leverage** – Taking on leverage to increase returns, especially where a low Return on Invested Capital is leveraged to create an acceptable Return on Equity, is a strategy that is typically met with underwhelming results. The Evans and Partners International Team do not invest in companies with

excessive leverage, nor do we employ leverage at the Fund level, so here is some commentary from an operator in the market that we respect - Pzena Investment Management.

“We’ve looked over time, not just 2007- 2008, and all of our big losses have resulted from excess financial leverage. We make a lot of mistakes, but if you make a mistake and the company doesn’t go bankrupt, you shouldn’t as a value investor lose that much money. The key is to double your money on the ones you get right and when you get something wrong, only lose 20%. Do that a majority of the time and you’ll have a great long-term record.” Source: Value Investor Insight, Feb 2015.

If a company runs into a problem, and leverage is added, that problem tends to become exponentially larger. Under stressed circumstance, the investment outcome for existing equity holders can be dire. For example, debt holders may extract exorbitant fees, debt rollover may be executed at higher rates, non-core assets might be sold off at un-attractive prices, a dilutionary equity raising might be conducted or the business may be starved of reinvestment capital, and unwelcome takeover offers may surface that are not representative of the longer term value of the company.

**Overvaluation** - Even if investors are able to avoid the risks listed above, overpaying for perceived safety will also result in poor investment outcomes. In 1972, The Nifty Fifty – widely viewed as a group of high quality, low risk stocks - sold on an average Price to Earnings Ratio of 42x, compared to the S&P 500 at 18.9x during the same year. Over the next eight years, this group of companies had in aggregate lost 35% of their value, and it would take a further sixteen years for stock prices to regain the highs reached during 1972. A postmortem by Forbes magazine sums up the investor mindset at the time;

“What held the Nifty Fifty up? The same thing that held up tulip-bulb prices in long-ago Holland—popular delusions and the madness of crowds. The delusion was that these companies were so good it didn’t matter what you paid for them; their inexorable growth would bail you out. Obviously the problem was not with the companies but with the temporary insanity of institutional money managers—proving again that stupidity well-packaged can sound like wisdom. It was so easy to forget that probably no sizable company could possibly be worth over 50 times normal earnings.” Source: Valuing Growth Stocks: Revisiting the Nifty Fifty by Jeremy Siegal

Systematically overpaying for assets will be a consistent contributor to ending up in the bottom 20% of the market, and will often lead to permanent loss of capital.

## Active Share

Just as we see a mismatch between traditional measures of risk and the true risk of permanently losing capital, likewise we view the idea of Active Share as also missing the mark.

By way of background, Active Share is a measure of the percentage of stock holdings in a manager’s portfolio that differ from the benchmark index. A popular paper written by Cremers and Petajisto (C&P) examining the idea of Active Share (2006) concluded that managers with high Active Share outperform their benchmark indexes and that Active Share significantly predicts fund performance. Examining 2,650 funds from 1980 to 2003, the C&P study found that the highest ranking active funds, those with an Active Share of 80% or higher, beat their benchmark indexes by 2.00-2.71% before fees and by 1.49-1.59% after fees.

On balance, we agree with the C&P study’s conclusion that high Active Share is indicative of a portfolio that is differentiated from the underlying index used for performance comparison, and therefore has a greater ability to outperform. It simply makes sense. However, while high Active Share has tended to outperform over the long term – this does not mean that high Active Share in itself, on an individual basis, will increase the odds of winning.

The C&P study doesn’t discriminate between high Active Share in stable earnings companies and those at the more exotic end of the investment universe – for example, biotech or loss making technology stocks. The study simply paints all concentrated funds with the same brush, which we believe is misleading and not particularly useful.

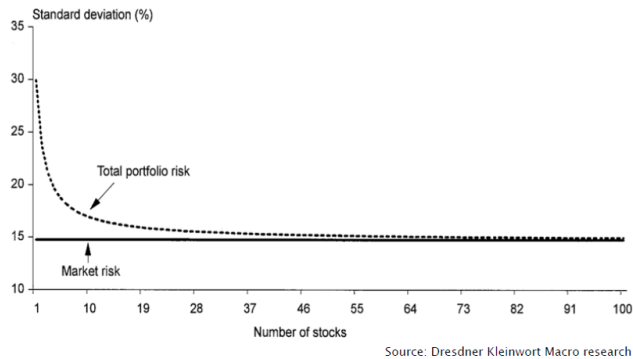
## Isn’t a concentrated fund risky? What about diversification?

There are few global investment candidates that fully satisfy our criteria. High quality companies, with the low risk characteristics outlined earlier, run by shareholder friendly management teams, do not often go on sale. When we find these opportunities, we tend to put a large portion of our investable capital to work. What we try to avoid is diluting the quality of the portfolio by dropping our standards by taking on investee companies that do not meet our criteria simply to improve our “diversification” metrics. By having a portfolio of low risk businesses, and avoiding the companies more likely to destroy value over time, we are more likely to protect capital than by increasing the number of holding that will on average dial up the true risk score.

This view is supported by a number of academic papers. For example, in their book Investment Analysis and Portfolio Management, Frank Reilly and Keith Brown reported that in one set of studies for randomly selected stocks, “...about 90% of the maximum benefit of diversification was derived from portfolios of 12 to 18 stocks.” In other words, if you own about 12 to 18 stocks, you have obtained more than 90% of the benefits

of diversification, assuming you own an equally weighted portfolio. This is a view also supported by research conducted by Dresdner Kleinwort and borne out in the chart below.

Figure 1: Diversification – total portfolio risk as a function of number of stocks held (%)



Where ever possible we attempt to marry academic research with results published by practitioners and service providers within financial markets. As such, we note an article provided by Analytix (2003) that measured the performance of the 599 equity portfolios submitted by the firm’s clients. This database represents the largest active sample globally. Analytix found that the more concentrated the fund, the better the performance. Portfolios with the lowest quartile number of holdings performed almost 400bps per annum better than the highly diversified portfolios. (Footnote 1)

Average annualized contribution, relative to peer group average.				
Annualised Performance	Highly Concentrated	Concentrated	Diversified	Highly Diversified
bps	196	53	-55	-194

The findings of this Analytix research sound sensible to us – if a portfolio is too diversified, it becomes difficult to know each individual business well. After all, how well can an individual portfolio manager know 100 companies? This point is well articulated within the paper “Best Ideas” (Cohen, Polk, Silli, 2009):

“When asked to talk about his portfolio, the typical investment manager will identify a position therein and proceed to describe the opportunity and the investment thesis with tremendous conviction and enthusiasm. Frequently the listener is overwhelmed by the persuasiveness of the passionate presentation. This leads to a natural follow-up question: how many investments make up the portfolio. Informed that the answer is, e.g., 150, the questioner will often wonder how anyone could possess such depth of knowledge and passion for so many disparate companies. Pressed to answer, investment managers have been known to sheepishly confess that their portfolio contains a few core high-conviction positions – the “best ideas” and then a large number of additional positions which may have less expected excess return but which serve to “round out” the portfolio.” The paper has strong implications for the optimal behavior of investor’s in managed funds. It suggests that while the

typical manager has a small number of good investment ideas that provide positive alpha, the remaining ideas in the typical managed portfolio add no alpha at all. Managers have understandable incentives to include these zero-alpha positions. Adding additional stocks to the portfolio can not only reduce volatility but also increase the portfolio Sharpe ratio. Perhaps most importantly, adding names enables the manager to take in more assets, and thus draw greater management fees. But while the manager gains from diversifying the portfolio, it is likely that typical investors are made worse off. The paper suggests that investors can have substantial gains if managers choose less-diversified portfolios.

### Is a buy and hold strategy using a low cost passive fund a lower risk approach?

Passive funds are far more risky than popular literature would have us believe. Firstly, by buying passive funds an investor is locking in underperformance - simply because an investor can expect to receive the benchmark return less fees. Secondly, investors within traditional ETFs are forced to buy high and sell low. Why is that? As ETFs are designed to track market indices, which in turn are market capitalization weighted, investors are typically buying sectors which have experienced a period of transitory outperformance. Perhaps the best example of this was during the technology bubble of the late 90’s where passive investors were effectively forced to buy shares in increasingly egregiously priced securities that were not backed by cashflow, and in many cases were not even backed by revenue.

But don’t passive funds statistically outperform over time? We believe the debate has swung too far in favor of passive funds in this regard. The analysis conducted to compare passive versus active returns pays no regard to either investment style, or fund size. Nor is the distinction made between “lazy” active funds that track the index, or those that have higher active share. Factors such as value and quality show a statistical uplift to returns over time; however no attempt is made to determine if outperforming funds are constructed with any particular investment style. Simply comparing all active investment funds against the market isn’t particularly useful in our view – after all, one funds loss is another funds gain.

Furthermore, the methods used to measure performance of active managers versus passive managers are questionable. Despite strong evidence that smaller funds outperform larger funds over the long term, the calculation used to determine returns for the active industry overall does not use a weighted average ie. an equal weight is afforded to a \$50bn fund against that of a more nimble \$1bn fund in calculating active fund returns.

There is also evidence to suggest highly active funds do a better job than both passive and “closet indexers” during a bear market. In their paper, Do Active Funds Perform Better In Down Markets? (Zheng Sun, Ashley Wang, Lu Zheng, 2009)

the authors found that active funds as a group do not significantly outperform the passive index funds during the down market, however, a subgroup of the most active funds earned significantly higher returns than index funds when the economy was in severe contraction. The paper found that the degree of performance counter-cyclicality increases with funds' degree of activeness. The result is in sharp contrast to the one when in economic expansion, where the paper found a slight underperformance by active funds to index funds after fees and expenses.

## Conclusion

Investment risk can exist in many different forms, many of which we have not touched on in this paper. When investing it is important to focus on the information which is most identifiable and proven over time. In our opinion concentrated investing is about reducing risk rather than increasing risk.

Richard Branson, Chairman of Virgin Group once said, "Complexity is your enemy. Any fool can make something complicated. It is hard to make something simple". In an ever more complicated world we at Evans and Partners prefer to remain focused and keep processes and investments decisions as straight forward as possible.

## The Evans & Partners approach

Our investment philosophy is conservative and straightforward, and based on four clear and demanding criteria:

**Business Quality** – We look to own businesses whose intrinsic value is rising over time. This is achieved by earning returns on invested capital well above their cost of capital on a sustainable basis and where risk of erosion of these returns is regarded as low.

**Balance Sheet Quality** – We want businesses with low levels of financial risk. Typically this means net debt to EBITDA of below 2.5x, high interest cover ratios, and moderate levels of pension and other off balance sheet liabilities.

**Management Quality** – We look for management that allocates capital to the benefit of shareholders. This means an emphasis on small, accretive acquisitions over large deals where value destruction is common. We also favour management that repurchases shares when they are attractively priced and pay consistent dividends.

**Attractive Valuation** – We aim to own businesses that satisfy the above three criteria only when they trade at a meaningful discount to intrinsic value. This margin of safety is integral to our capital preservation approach and also key to achieving our absolute return objective.

We build a portfolio that takes out the major buckets of investment risk - we take a pass on macro bets, highly leveraged balance sheets, imprudent management teams, key contract risk and highly cyclical revenue streams. We believe that by having a very clear sense of what we don't want, what we are left with will do just fine.

We continue to believe that concentrated portfolios that are managed with an overriding emphasis on value, coupled with a thorough understanding of fundamental risk and earnings quality will produce returns superior to an index over an investment cycle.

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