AURORA
FUNDS MANAGEMENT

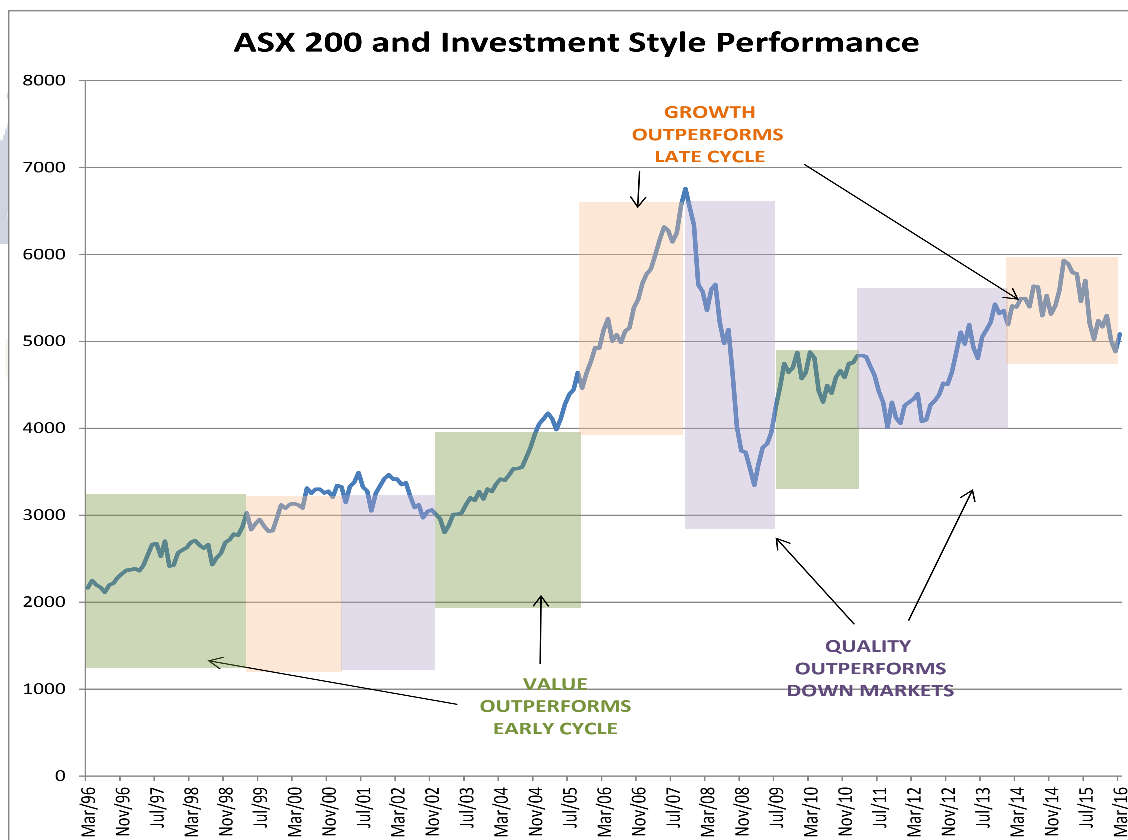
THE ALTERNATIVE VIEW

By Hugh Dive
15th April 2016

Investment Philosophies Part II

Almost every month the financial press will publish an article lauding the top performing fund manager over the previous 12 month period; generally accompanied by a picture of the manager looking quite pleased with themselves in an expensive suit, together with an after match report detailing which stocks they had in their portfolio that allowed them to outperform their peers. The assumption underlying these articles is that all equity funds are managed using the same investment philosophy and that a manager's outperformance is solely due to their skill.

In the piece Investing Styles Part 1 we looked at the four basic investment styles (index, growth, value and quality). In this week's note on investment styles we are going to look at the market conditions under which each style tends to outperform, as no single investment style outperforms in every market condition.



Source: IRESS, Aurora Funds Management

No one single investment style outperforms in all markets, though for obvious reasons an **index fund** should deliver investors the return of the underlying index less a small management fee.

Generally **growth-style** managers, along with momentum-based quantitative funds tend to outperform during market rallies, as investor exuberance leads to excessive optimism about the future prospects of new and exciting companies and increased investor appetite for risk. Similar to growth-funds, **quantitative funds** relying on **momentum** signals perform well in strongly rising markets. This style of quantitative fund will tend to buy companies

whose share prices have performed well over the last 12 months, as this is determined by the underlying mathematical or quantitative computer model to be the optimal signal for future outperformance. This can be a self-fulfilling prophesy that can work very well driving certain stock prices higher, until a fundamental change occurs. We saw such a break earlier this week from market darling and vitamin company ***Blackmores,*** which fell 19% as the Chinese government made moves to restrict the sale of foreign "health'' foods into China via e-commerce portals.

The above table on the previous page shows that prior to the bursting of the Dot.Com bubble in 2001 and the onset of the GFC, **growth** as a style outperformed. For example, in early 2000 investors were willing to buy ***NewsCorp*** on 85 and Telstra on 34 times trailing earnings, overestimating the potential impact of both companies' investments in digital technology. Similarly in April 2006 the share price of ***ABC Learning*** and ***Babcock & Brown*** were bid up to an extent that their share prices represented 20 and 21 years of current earnings respectively. Whilst neither of these two companies fulfilled their debt-fuelled promise of conquering the US childcare and global structured finance markets; fund managers who held these stocks in their portfolios would have outperformed between 2005 and 2007. Over the last year growth has outperformed; not due to a frothy market as in 2001 or 2006, but rather as investors were willing to reward companies such as ***Domino Pizza*** for delivering earning growth in a low growth market. The outperformance of growth was aided by major sectors such as banking and mining facing dilutive capital issues and falling commodity prices respectively.

Value funds tend to outperform during the first stages of a recovery. During this time value fund managers will own a portfolio of stocks that face some issues or the market has taken an overtly pessimistic view of the outlook for these companies. Over the period 1999 to 2000 value funds would have generally avoided internet and telecom companies such as ***One.Tel*** and ***eCorp*** and invested in "tired old economy" companies such as and ***Amcor*** and ***Westfield,*** and thus would have underperformed. I clearly remember in 2001 attending a presentation in Canada given by a tech entrepreneur in a black skivvy who told the group of fund managers that shopping malls were finished and that shareholders would be left holding obsolete, crumbling retail caverns, after all retail transactions moved online sometime around 2005.

Value-style funds are often rewarded during the early periods of economic recovery, as earnings recover and companies priced on a low price to equity (PE) multiple enjoy an expanding multiple. Over the period 2003 to 2004 typical value stocks like ***Caltex***, ***Origin Energy*** and ***Orica*** all outperformed the market by greater than 30%. However **value** funds also have to avoid companies that are "value traps", or companies that look cheap as they trade on a low multiple of earnings or are priced below the book value of their assets. Often these companies are cheap for a reason due to some negative structural factors impacting the industry in which the company operates such as ***Fairfax*** or the domestic steel companies.

Similar to value, **quality** as a style tends to underperform in markets being driven by increasing investor appetite for risk. Quality investing seeks to avoid risky stocks and focus on owning companies high quality earnings and strong governance and balance sheets. Quality funds tend to outperform the overall market during a downturn, as investor's risk appetite reduces sharply and companies that were previously perceived to be "boring" become favoured by investors for their stable earnings, dividends and conservative balance sheets. During the GFC from 2007 to 2009 stable high quality companies such as ***AGL Energy, Coca-Cola*** and ***JB-Hi Fi*** delivered positive returns in a market that declined by -23%, as these companies delivered rising dividends without having to make dilutive equity raisings.

At Aurora we manage the ***Aurora Dividend Income Trust*** (ASX:AOD) and ***Aurora Property Buy – Write Income Trust*** (ASX:AUP) both as quality style equity portfolios. We view that though the cycle a portfolio of good quality stocks with lower volatility and higher yield will outperform the market with fewer headaches, especially during periods of market corrections. Additionally, stable and predictable distributions allow us to better achieve our income objectives to investors and we would rather pay a slightly higher multiple for a more consistent earnings stream.

Our Take

No one single investment style outperforms in all markets, but most fund managers will argue that their style is superior. However if a value style manager was outperforming most growth managers during the heady days of 2005-06, this could indicate that the value fund manager has departed from their stated investment process. To gauge manager skill, investors should compare performance amongst managers adopting similar investment philosophies.

As mentioned last week individuals should invest with managers whose style most closely represents their own investing personality and most importantly their risk profile. Clients with high risk tolerances and a desire for "sizzle" in their portfolios that they can talk to their friends about could find value and quality style managers too staid. Alternatively the volatility of returns delivered by even the best growth managers could give conservative investors too many sleepless nights.

Hugh Dive CFA
Senior Portfolio Manager

AURORA
FUNDS MANAGEMENT

Aurora is the issuer of the:

- **Aurora Dividend Income Trust (Managed Fund) (ASX code: AOD)**
- **Aurora Absolute Return Fund (ASX code: ABW)**
- **Aurora Fortitude Absolute Return Fund**
- **Aurora Global Income Trust (ASX code: AIB)**
- **Aurora Property Buy-Write Income Trust (ASX code: AUP)**
- **HHY Fund (ASX code: HHY)**

AURORA
FUNDS MANAGEMENT

Level 4, 1 Alfred Street, Sydney NSW 2000
PO Box R1695, Royal Exchange NSW 1225
Telephone: +61 2 9080 2377
Visit:
Email:

Disclaimer: The above information is commentary only. It is not intended to be, nor should it be construed as, investment advice. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. Before making any investment decision you need to consider (with your financial adviser) your particular investment needs, objectives and circumstances. For further information please visit www.aurorafunds.com.au.