AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive

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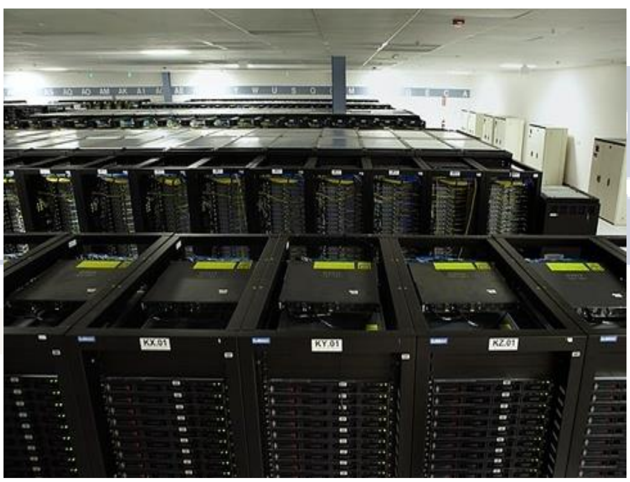
Investment Philosophy

Investors looking for a professionally managed Australian equity portfolio face a dizzying array of options. The February Morningstar survey looked at 123 different institutional fund managers delivering Australian equity portfolios and this number expands further when you include model portfolios and stock lists offered by stock-brokers, asset consultants and investment newsletters. The individual stocks in this enormous range of portfolios are selected and then blended into Australian equity portfolios based on a range of investment philosophies or investment styles.

In this piece we are going to look at the different investment styles used to manage equity portfolios and the investing foundations upon which these styles are built.



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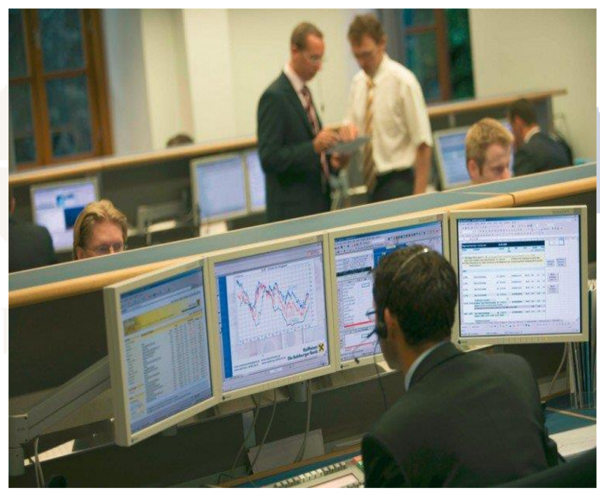

When investing in an **index fund** such as the ***State Street*** Global Advisers' SPDR S&P/ASX 200 Fund, the investor simply receives the return of the underlying index less a small management fee. In this ETF (exchange traded fund), BHP is mechanically bought to a weight of 4% and the fund manager makes no judgement as to the prospects of BHP; nor whether BHP is currently over or under-valued or whether iron ore will stabilise at US$60/tonne or fall back to US$30/tonne. If BHP's weight in the index increases due to its share price outperforming, the manager simply buys more BHP and if it underperforms BHP will be trimmed.

Whilst index funds can be a cheap way to obtain exposure to t0he equity market, investors also get exposure to all companies good or bad, overvalued or undervalued. For example in 1987 and 2007 the index was contained weighted towards companies such as ***Bond Corporation***, ***Qintex, Babcock & Brown*** and ***Centro*** that subsequently went into liquidation. As an investor in these markets albeit a younger one in 1987, it seemed quite clear prior to their fall that these were companies with shaky business models reliant on high levels of leverage and benign credit conditions.

Philosophically **index fund** investors ascribe to Nobel Prize winning economist Fama's efficient-market hypothesis[1], which states that it is impossible to beat the market because prices already incorporate and reflect all relevant

[1] Efficient Capital Markets: A Review of Theory and Empirical Work *The Journal of Finance*, Vol. 25, No. 2. (May 1970), pp. 383-417 by Eugene F. Fama

information. This has been a controversial theory as it not only holds that stock markets are always efficient and that all security analysis is ultimately worthless as the current price of a stock such as ***Woolworths*** or ***BHP*** reflects all available information.

Funds managed in the **growth style** select securities based more on the brightness of the company's future rather than how the company is currently being valued. The rationale is that a high growth company such as digital advertiser ***RealEstate.com***'s or dairy company ***a2Milk***'s future growth prospects are stronger than the market expects. Here ***a2Milk***'s earnings and dividend yield are expected by the growth manager to rise rapidly and thus justify buying the company at its current multiple of 45 times next year's earnings per share (EPS) that does not pay a dividend. Unlike an index fund, analysts at growth funds would spend many hours meeting with a company's management team to understand why profit growth is going to exceed the market's current optimistic assumptions. Examples of growth-style fund managers include T Rowe Price and Ausbil Dexia.

Unlike growth funds that tend to buy well-loved high growth stocks, **value-style** funds adopt the strategy of picking stocks that are trading below their net worth. This style was famously developed in the 1930s by Benjamin Graham and David Dodd and is based on the concept that incorrectly valued stocks will revert back to their intrinsic value, thus allowing the investor to buy $1 worth of assets for 85c. Characteristics of this investing style include buying companies that are trading on a low price to book value, low PE (price to earnings) ratio or indeed buying companies whose liquidation or wind-up value is greater than their current market value. A classic example of a stock that would have featured in many value-style portfolios was Telstra. In 2010 Telstra was trading at $2.80 which equated to 8.5 times its projected earnings per share (PE) and with a dividend yield of 10%. Here the market was concerned about the uncertainty around the telephony market in Australia with declining fixed line usage, increased competition in mobile phones and the National Broadband Network. As the market's fears towards the company ultimately proved to be exaggerated, Telstra's share price has doubled and now trades on 15 times forward earnings.

Typically a value-style fund will have a lower price to earnings ratio, lower beta and a higher dividend yield than a growth-style fund, as the portfolio will tend to be populated by currently unloved stocks. Examples of value-style fund managers include Warren Buffett's Berkshire Hathaway and Investors Mutual.

Following the Dot Com Bubble of the early 2000s and the aftermath of the GFC, investors have begun to pay more attention to the quality of a company, rather than just the raw numbers being presented to the market. This approach or style has been called quality investing and focuses on hard factors such as the quality of a company's earnings or balance sheet along with softer factors such as the quality of corporate governance and transparency of information being given to investors, whilst still seeking to buy companies that are undervalued. This is the approach we use at Aurora Funds Management to construct the *Aurora Dividend Income Trust (ASX:AOD)*.

Quality investing seeks to avoid risky stocks and focus on owning both high quality companies and indeed stocks with improving quality. In the case of improving quality, here the market may be mispricing a company as low quality, when the underlying fundamentals of that company are improving. For example in early 2015 private health insurer ***Medibank*** was added to our portfolios. At this time we viewed that the market was not pricing the potential profit uplift that Medibank's management could generate from cutting out costs and inefficiencies that crept in over the decades of government ownership see Going Private. As the market recognised the improving quality of Medibank and the company upgraded profit guidance by $100 million, Medibank began to be rated higher by investors and the share price rose.

Our Take

The criteria that mutual fund managers use to select the investments to construct a portfolio vary widely according to the individual manager or firm, indeed within Aurora our funds are constructed in vastly different manners, albeit under the overarching theme of defensive income. As the manager of the Dividend Income (ASX:AOD) and Property Buy Write (ASX:AUP) Trusts I strongly favour the quality approach and this reflects my training and experiences under some cynical "*glass half empty*" chief investment officers in Canada and Australia. Further,

whilst the value approach to investing resonated with me earlier in my career, after being involved in a few "value trap" investment situations, I strongly see that paying a slightly higher multiple for greater earnings certainty results in superior returns and fewer sleepless nights. However when choosing to invest in a fund, it is critical that the manager's investment style matches your risk-reward profile. If an investor is looking for the sizzle (and volatility) that comes with a growth style technology fund chasing the Facebook or Amazon, they are unlikely to be satisfied with a more staid income fund. In Part II of investment styles that will come out next week we will look at the market conditions that favour particular styles of investing.

Hugh Dive
Senior Portfolio Manager

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)**

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