OCTOBER 2004 ISSUE 24
PWM
PROFESSIONAL WEALTH MANAGEMENT
SOLUTIONS FOR EUROPEAN DISTRIBUTORS

VALUE INVESTING

BUYING A STYLE FOR ALL SEASONS

A thorough knowledge of the company being valued is essential for this investment philosophy to work

During the 70 or so years of its existence, so-called value investing has clearly established itself as an investment style for all seasons. Starting with Benjamin Graham in the 1930s, practitioners of the value investment approach have steadfastly sought out companies that represent compelling investment opportunities based on their intrinsic worth and quite irrespective of prevailing stock market trends.

Basic tenets in the application of the value approach include an intense qualitative understanding of the targeted company's management, combined with a thorough analysis of the company's discretionary cash flow. This is the cash that is generated from operations, less the capital expenditure and other investments necessary to sustain and grow the business.

'This investment approach requires management which is both active – performance must be constantly monitored – and disciplined'
Michael Metcalfe, Nordea

RULES

Value fund managers seek to preserve capital by strictly observing the rule that the fund being managed will not buy into a company at greater than about 50 per cent of its fair value. In calculating the fair value, the managers make estimates of the free cash flow over the coming three to five years and apply a discount appropriate to the business.

If a company is being managed well, then it is also likely that its value will grow over the given timespan. To profit from a company's success, the value fund manager must exercise patience and disregard stock market movements that, more often than not, are likely to be of a short-term nature.

HOW IT WORKS

A value fund manager, then, invests in companies which, in his view, are undervalued. The equity price of a company is compared with the estimated value. If the price is considerably below the estimated value, the equity is purchased in the hope that both values will move closer together. Value investors believe that, while the equities they choose may not currently be arousing interest among the broader public, it is only a question of time before the equity market discovers them, leading to a rising equity price.

If, after a certain time, the equity reaches the value estimated by the fund manager, the latter sells the equities and realises his profit, irrespective of whether further profits are anticipated. Therefore, this investment approach requires management which is both active – performance must be constantly monitored – and disciplined.

GROWTH METHOD

In contrast to value investing is the growth-oriented investment strategy. Advocates of the growth strategy take the view that long-term stock-market success is possible only if one relies on a sector's 'giants', who have proven themselves in the market over many years, who operate profitably and who have an unassailable lead over their competitors.

Unlike the growth investor, the value investor looks very carefully at the price at which he buys an equity, which makes value investments correspondingly lower-risk. In periods when the entire market is going down, it is logically impossible for undervalued equities to fall as far as overvalued equities, so that they offer greater security in the event of price falls.

CRITERIA

Value investing means not being oriented to any reference index but focusing on individual equities and identifying companies with a high intrinsic value. But how can this intrinsic value be measured? What criteria are required to assess how companies compare with one another?

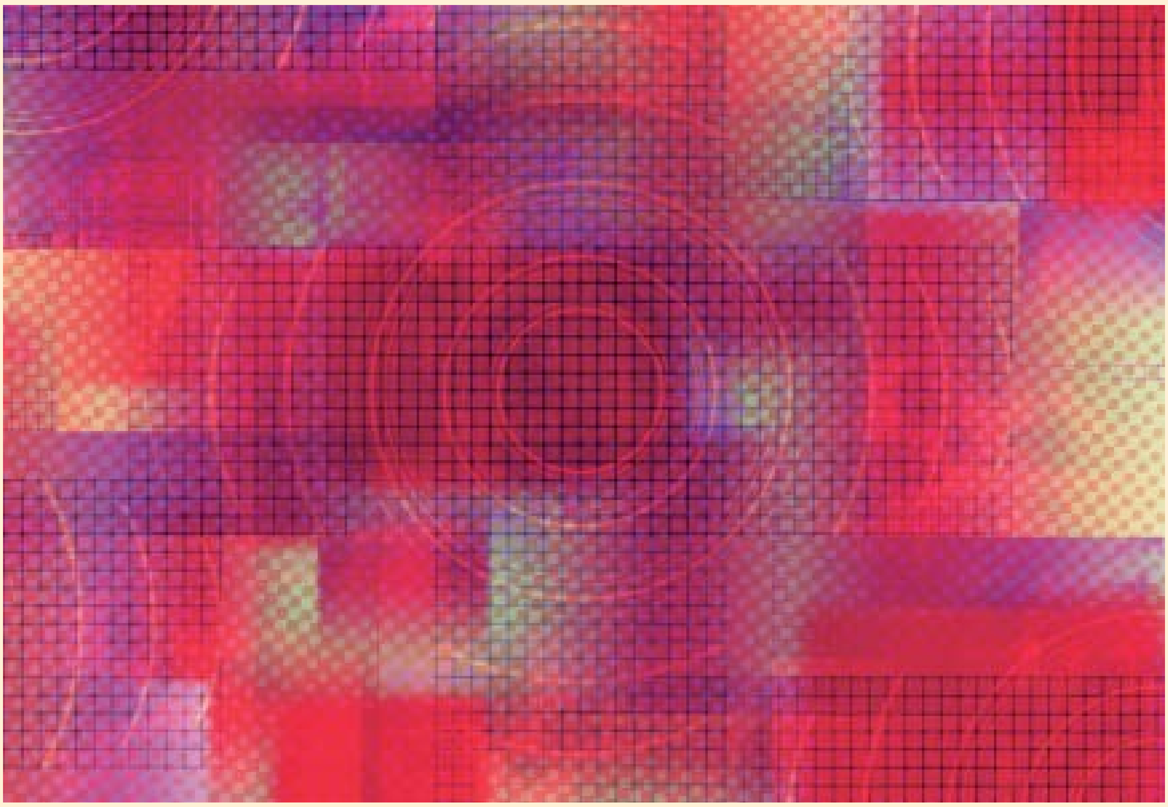
The basis for this is the so-called ‘free cash flow’, which the fund manager understands as the sum of money remaining once all requisite and expedient investments have been made in order to keep a company competitive. It is therefore the amount which is actually freely disposable. As a rule, analysts calculate this free cash flow according to specific rules.

Besides a favourable price and intrinsic-value assessment, positive income prospects represent a further key decision-making criterion. For a fund manager to be clearly one step ahead of the rest, he must not shy away from making personal visits to those individual companies he has selected in advance and gaining an impression in situ.

In the financial markets, too, appearances can be deceptive. By taking a closer look, one is able to better assess whether the price of an equity actually reflects its value. Thus, value investing is extremely attractive for investors with a long-term investment horizon.

The concept of value investing, as applied in the five value funds under Nordea 1, SICAV and managed by the Nordea Value Management team in Nordea Investment Funds SA out of Luxembourg, focuses on the earning power of the business of a particular company.

‘In periods when the entire market is going down, it is logically impossible for undervalued equities to fall as far as overvalued equities, so that they offer greater security in the event of price falls’



We define earning power as the ability of a company to generate a substantial discretionary cash flow to its owners. This means that the company produces an amount of money after having invested to keep itself in business and allowing for the working capital to operate the business.

Discretionary means that it is left to management to choose how this cash is used, ie investing in future growth, buying back shares, dividends, etc. Only in this way can the company generate wealth to its owners, ie the shareholders, and provide long-term capital appreciation.

As value investors, we operate with two central elements that are never compromised. Firstly, in order to protect the investment principal, we perform a disciplined investment process which includes an analysis of management and influence agents in the company, a thorough analysis of financial statements, industry structure, product lifecycles, the operating environment and the company's place in the value chain.

PROTECTION

An analysis of these parameters provides us with an insight and understanding of the fortunes of a particular business. We believe that knowledge reduces risk. As a consequence, we do not like to invest in companies whose balance sheet we cannot verify and whose discretionary cash flow we cannot analyse.

Secondly, an additional element in the protection of the investment relates to the valuation of a company. We require a discount of about 50 per cent to the fair value of the cash flows to be an interesting investment opportunity. This discount is referred to as the margin of safety. It will also allow sufficient upside for appreciation to achieve our return target.

Buying a growing business at around 50 per cent of what we believe it to be worth makes it realistic to expect a doubling of the investment over five years, translating into an annual average of 15 per cent.

Our investment philosophy will generally lead us towards companies with a good business enjoying healthy prospects, ie companies that are undervalued with respect to their real earning power. This is opposed to merely cheap companies, which have low valuations but also boast low profitability. We will often find our investment ideas in medium and smaller sized companies, as most research analysts do not follow these as closely as blue chips.

To invest in a structured and effective way, we generate the majority of investment ideas ourselves. This is done through screening a set of qualitative factors against price. The model is designed to lead our attention towards companies in a good business with healthy prospects that appear to be undervalued. These companies form the platform for our analysis.

DIALOGUE

Value investors should ideally perform their own independent research and not merely rely on the work of others. An important part of our analysis is communication with the companies in question, remaining in continuous dialogue with company management via company visits and telephone. The portfolio will typically consist of about 50 holdings. The Nordea Value Funds include the European Value Fund, Far Eastern Value Fund and North American Value Fund, the Japanese Value Fund and the Global Value Fund. We find it of utmost importance to stress that 'portfolio replication' is anathema to the value investing principle as we apply it. By portfolio replication, we mean that upon arrival of new capital, one simply copies the existing portfolio.

If, as we have stated, a stock must represent a potential for doubling in value over a five-year time horizon, then it is also true to say that over time, this under-valuation will be eroded. In the process, the upside potential will gradually disappear. Stocks that do not anymore represent a 100 per cent price potential are in principle not interesting, as they represent a smaller margin of safety and lower potential.

FAIR PRICE

If we take stocks in our existing portfolios, which are at 50 to around 60 per cent of fair price, we can take larger positions in each of these stocks than in a mature portfolio, and we will leave a cash position for new ideas. We expect to be fully invested only after six to nine months.

With an investment horizon of five years or perhaps less, we can realistically count on a portfolio turnover of 25 per cent per year.

Michael Metcalfe, International Media Manager, Nordea Investment Funds