Dumpster diving for deep value

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10 years into a bull market, and with most major indices showing triple-digit percentage gains from their lows, finding value is tough. Compounding the challenges, 'value stocks' by the traditional definition have underperformed throughout this period. Despite this, some value investors are still posting outsized returns. If history is any guide, a 'reversion to mean' could result in strong returns for this investing style in the not-too-distant future. So, how do the contrarians and deep-value specialists of the world find their ideas in a market like today's? We reached out to four such managers to get their thoughts. Responses come from Allan Gray, Lanyon Asset Management, Forager Funds, and Collins St Value Fund.

3 indicators of potential value

Tim Hillier, Allan Gray

We describe our investment approach as contrarian, long-term and fundamental. Consequently, we often find ourselves investing in 'deep value' opportunities. This does not preclude us from investing in what some may consider 'high quality' companies (a label that can have questionable durability) when they are cheap enough, but **companies carrying this label at any point in time are less likely to be found at cheap valuations.**

Our focus is on identifying companies selling at a significant discount to fair value. We search for these opportunities by doing plenty of reading, listening and watching. From time to time there are a few indicators that show it may be worth focusing our efforts a little more:

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1. Changes in market valuation: Market valuations can vary widely over the short, medium and long term, due to price movements and/or changes in capital structure. Changes relative to the market, other businesses and assets can be the most insightful, and large dislocations often present interesting opportunities.
2. Unfavourable cycles: Taking a long-term view, we may find opportunities by looking at companies that operate in industries navigating a downturn. We assess individual companies, their competitors, the industry, and other markets that may experience similar cycles. We try to evaluate how much a company should make across the business cycle, where we are in the business cycle, and the company's ability to weather the downturn.
3. Analyst sell recommendations: If an increasing number of brokers are telling investors all the reasons to sell a company's shares, more and more of those reasons may start to be reflected in the share price. If the price fully accounts for those risks, or the market starts to lose sight of offsetting factors, an opportunity may emerge to invest.

Sometimes it just takes a good dose of bad news or uncertainty for us to start asking, are things really that bad? Is there another way we can look at this?

How we discover deep value diamonds

Marcus Guastella, Lanyon Asset Management

Whilst Buffet's 'high quality at a discount' style can be tremendously successful, markets don't cough up high quality assets at a discount very often. The deep value approach requires a healthy dose of contrarian thought, and as a result the idea generation process is quite different to what would likely be employed by the broader funds management industry.

In the same sense that a loved stock's price might reflect unrealistic future growth, an unloved stock's price might reflect an unrealistic level of future earnings deterioration. Some of the disciplines we employ to find these unloved stocks are:

Scour the 52-week-lows: Benjamin Graham, often regarded as the Father of Deep Value Investing, sifted through the 52-week low list every day of his career and it was one of his key sources of idea generation. Nearly 80 years on, we still hunt through the 52-week low list every day, looking for undervalued stocks and sectors.

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which allow us to seek stocks that may be undervalued, using metrics and financial variables that we feel are most likely to indicate mispriced opportunities.

Extensive reading: We spend most of every day reading, meeting and thinking. Warren Buffet devotes 80% of his day to reading and credits many of his better investment decisions to this voracious habit. Amongst other sources, we pour over several newspapers looking for broad negative industry sentiment or companies that may have experienced a temporary setback, which is often reflected in the market via depressed stock prices.

It's not easy being different

Michael Goldberg, Collins St Value Fund

> *"It is impossible to produce a superior performance unless you do something different from the majority" - Sir John Templeton*

It amazes us how popular bad ideas can be. I've lost count how often we've been horrified by companies that have entered the mainstream consciousness and been pushed up to nose bleed multiples. At the same time, we've sat in our office scratching our heads trying to work out why a company that is fundamentally so strong is failing to demand the price we think they deserve.

At times like those we simply recall Benjamin Graham's famous quote:

> *"In the short run, the market is a voting machine but in the long run, it's a weighing machine."*

We tend to find our potential investments through one of three avenues.

1) Seek out bad news

When companies report under consensus earnings or make the paper for all the wrong reasons we tend to get interested. As fund manager Anthony Bolton said,

> *"Investors underestimate the likelihood of rare events happening when they haven't happened recently and overestimate them when they have."*

We've seen good quality companies suffer the wrath of the investment community for something that is contextually small and short term.

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earnings. When iSelect announced to the market that its EBIT had fallen from $22m to $8m, the market panicked, and the share price dropped to 33c. This is despite the value of its tangible assets (based on its trailing commissions book) at the time being more than 60c per share. The company has since recovered to 80c which we think is still too low.

2) Find unpopular ideas

Broker recommendations tend to come after a company has performed well, making the conversation between broker and client an easy one.

We don't want easy, we want profitable. As such, when a broker calls us with a popular idea, we ask them to stop and tell us their favourite unpopular idea. We don't want to know what everyone else is talking about. We want to know about the ideas in which they have conviction but for one reason or another aren't prepared to discuss with their client base.

A great example of this is when we received a call to discuss a mining services company which we had no interest in. When we asked the broker to tell us their favourite unpopular idea, we were introduced to the nuclear energy sector – **a highly unpopular sector with very favourable asymmetric risk/reward.**

3) Scuttlebutt

We believe that consumers have an advantage over the investment community. Almost without fail, consumers will recognise a business as thriving or failing well in advance of the investment community. In fact, we've learned more about trends in retail and fashion from our wives and daughters shopping habits than from any analysts' report.

A perfect example is **Myer** (MYR). While the investment community have held out hope for a turnaround in profitability for a long time, shoppers have known for even longer that Myer was no longer the fashionable place to go shopping.

Look for the hate

Alex Shevelev, Forager Funds

What stocks do investors hate? What stocks are so unpalatable that investors have almost a physical reaction when you mention their tickers? That is a good place to start looking for deep value.

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expensive on near term multiples. It has a lot more to do with the psychology of the sellers.

High flying tech stocks falling 20% from euphoric highs don't make the cut. There is still lots of attention, hope and greed. Deep value is on the opposite side of that spectrum.

Think capitulation, despair and fear. You've probably seen it before: a 54% fall post the April downgrade in **iSelect** (ISU) is a good example.

> ***Sell it all, investors were thinking at the time. All of it. No matter the price.***

So next time you speak to your broker ask him what other clients hate. If you want deep value, that's a good way to find it.

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J

JOHN SPANNENBURG
13TH SEP, 18

10 years in and we still aren't back to where we were.. So the ASX has gone backwards since the 2008 peak.. There's another way to look at it

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