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The Importance of Understanding Periods of Underperformance

We are all aware that selecting investment managers based upon performance alone usually leads to very unsatisfactory results. Using performance, and especially recent performance, as the only selection criteria causes investors to invest with managers too late and hence, to disinvest unnecessarily. For performance analysis to be useful, an investor has to understand the main drivers of a manager's long-term track record. And to do this they have to understand the manager's investment philosophy and approach. Performance should also preferably be analysed over a whole stockmarket cycle i.e. under all conditions.

Despite only having experienced two periods of significant underperformance in our 28-year history, we always spend time, in our presentations to potential clients, explaining the reasons for these periods. This allows them to understand better our investment philosophy and the conditions under which it can deliver below average results. Hopefully, if our clients understand this they will be able to tolerate the occasional but inevitable periods of underperformance and thereby benefit from our superior long-term performance track record and its considerable wealth building affects.

Our two periods of underperformance occurred in 1991/2 and in 1997/8. Stockmarket conditions were similar but most pronounced in 1997/8. Before we analyse what happened, we need to briefly describe our investment philosophy. We invest in good quality companies that are trading on the stockmarket at a significant discount to what we determine to be their fair value. We spend very little time trying to forecast short-term movements in macro variables like the direction of the stockmarket, interest rates, economic growth, political trends, etc. It is our experience that the ability to constantly correctly forecast these macro variables is just about impossible and that selecting fundamentally undervalued companies is a far more rewarding and less risky occupation.

Our approach is therefore rational and based upon applying a large dose of common sense. In the short-term, prices on the stockmarket are driven by human sentiment, which often tends to be irrational. This over-optimism and over-pessimism causes the prices of companies to move away from fair value, which gives us the opportunity to apply our investment approach.

As you will all remember in 1997 and the first quarter of 1998, the stockmarket was in love with I.T. and financial services companies, which were 'new economy or new paradigm stocks'. P.E ratios of 90 and 40 respectively, prevailed at the peak. At the same time resource companies were hated and called "old economy stocks." Most traded on around 10 P.E's. Our research clearly indicated that the ratings and earnings growth (a lot of which was financially engineered as opposed to being organic) of the I.T. and financial services sector was unsustainable and totally irrational. Conversely, the resource stocks were very undervalued and earnings were at a low point in their cycle. Our clients' portfolios therefore had almost no exposure to the overvalued sectors and were heavily weighted in resources. Sentiment and money flow continued to push the prices of I.T. and financial service shares higher and resource stocks lower. The final push came when two large asset managers eventually relented and sold their resource shares to purchase I.T. and financials as pressure from their marketing teams and clients got too severe.

Our clients suffered considerable underperformance during this period of market madness. It was an immensely difficult time for us but what sustained us throughout this period was our firm belief in the logic of our investment strategy and that it was in our clients' best long-term interest. We would rather have had clients take their money away from us than face the exceptionally high risk of losing their money if we changed our strategy.

At that time it was vitally important that our clients understood and believed in our investment approach. Those that did were very well rewarded. Our client's annualised share return from 1/1/1997 to 31/3/2002 (including this period of underperformance) has been 29.1%p.a. versus 16.2%p.a. for the All Share Index. Had a client invested R100 000 with us on 1/1/1997, their portfolio would have been worth R296 000 on 31/3/2002 compared to R190 000 had they earned the All Share Index returns. Therefore, our client's portfolio would have been 56% larger with R106 000 more capital over a 4.25-year period.

Commentary by Mark Herdman, Chief Operating Officer