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STRATEGIES FOR SUCCESSFUL INVESTING

VALUE INVESTOR

Protect your portfolio in this unchartered market

THINK VALUE

Phillip N. Davidson, CFA

WHAT DO THE RECENTLY ROBUST U.S. equity markets, low interest rates and the U.S. Federal Reserve's tapering of quantitative easing all have in common?

All these factors have investors more concerned about how to manage their downside risk and protect their capital.

With stocks, there are two broad approaches to investing: value and growth. *Value investors* aim to invest in stocks that are fundamentally undervalued, while *growth investors* look for stocks that are expected to outperform their peers regardless of current valuation.

Phillip N. Davidson, CFA, is Senior Vice-President and Chief Investment Officer, U.S. Value Equity for American Century Investments. He has been with American Century Investments since 1993. Mr. Davidson co-manages the Renaissance U.S. Equity Income Fund, an underlying fund in the Renaissance Optimal Growth and Income Portfolio. CIBC has a 40% equity interest in American Century Investments.

Here's how value investing may provide some downside protection in this unchartered market.

A high-quality bias decreases downside risk: High interest rates and inflation have historically been detrimental to stocks. We believe, however, our higher-quality bias may moderate downside risk in the event of a less robust market.

As the Federal Reserve has gradually introduced the idea of tapering to its bond-buying activities – the three-stage program known as quantitative easing – the focus from lower-quality to higher-quality businesses is potentially in play, which could shine a favorable light on our value security selection process.

Portfolio Characteristics: We have been managing value-oriented funds for over 20 years, and buy what we believe to be quality stocks.

Our focus is on companies that have a sustainable business model through high returns on capital, market leadership, financial productivity, free cash flow generation and, finally, balance sheet strength, generally through lower degrees of leverage.

THE "INVESTIBLE CRITERIA"

Our team maintains a universe of companies that have met our "investible criteria." These names are typically perceived to hold a competitive advantage relative to other companies within their industries.

Our selections tend to be relatively steady, as only so many companies can fulfill our stringent requirements. This stability lends itself to a higher level of familiarity for our team.

Dividend payers and, more specifically, dividend growers, are also an important component of many of the high-quality companies we select.

The value of any leading business usually grows in direct proportion to the cash it generates. If dividend payments are internally funded through free cash flow generation, the quality of the company becomes less in question and less prone to "creative accounting" methods.

ATTRACTIVE VALUATION

Value equity investment strategies are built on the belief that undervalued businesses have the potential to provide solid, risk-adjusted investment performance. We use fundamental research to identify and invest in quality companies that we believe are trading below their fair market value.

The primary driver in our portfolio is rigorous security selection. We look for sustainability of the business model (through high returns on capital and market share leadership), financial productivity (higher financial returns and free cash flow generation) and balance sheet strength (generally with lower degrees of leverage).

Range of position sizes for all portfolio holdings are then determined, with each being evaluated within the context of the entire portfolio.

ACCESS TO CAPITAL

Higher-quality companies not only carry negligible amounts of debt, they also produce ample cash flow to fund operations, including paying dividends and buying back stock.

A rising rate environment makes it increasingly difficult for companies that need to borrow money to do so without feeling the impact of the increased costs.

Investors might shift their quality tolerance in the future based on access to capital. The simple explanation is that lower-quality companies usually have significant debt on their balance sheets and rely on the ability to access capital as a lifeline to fortifying operations.

THE PROCESS

Our value-investing experience has led us to the conclusion that companies themselves have had more of an influence over time than broader macroeconomic trends that surround the individual businesses.

Using a repeatable, bottom-up investment process helps us determine which undervalued stocks are likely to recover (because of purely cyclical issues) and which are likely to continue struggling (because of secular or more deep-rooted issues).

Once the stock clears that hurdle, we determine a range of potential position sizes for all our portfolio holdings. Risk is also actively managed throughout the process, as higher-quality companies that generate better financial returns will likely have less volatile businesses than can be more easily modeled.

Our value foundation is built on investments in higher-quality companies selling at a discount. We believe this emphasis, combined with active portfolio construction, is essential in managing downside risk.

Consider it an evolution towards more sophisticated diversification methodologies that we believe have helped reduce risk without materially compromising expected return.

The goal: produce solid risk-adjusted performance. That means we are as concerned about limiting downside risk as providing opportunities for long-term capital appreciation.

In other words, we seek to deliver competitive returns in rising markets and limit losses in market downturns by maximizing rewards for risks taken.

Since World War II, there has been a market correction of at least 10 per cent every two years on average (source: S&P Dow Jones Indices; Data from Jan. 1946 through Dec. 2012).

We believe there are protective benefits to investing in higher-quality companies with an income focus temporarily trading at a discount to their fair market value.

VALUE OUTLOOK

We have been concerned for a few quarters about the sustainability of corporate profit margins. This follows some significant belt tightening post-Financial Crisis, and China's impact on global cyclicals and broad asset valuations.

The average name in our value proprietary follow list is approximately eight per cent above fair value, which is in line with 2007 levels. Key themes in our value portfolios are:

☛ Energy (integrated and natural oil and gas companies, as well as energy services)

☛ Consumer staples (relative valuation)

Is it truly a value stock?

In order for a stock to be considered, it must fall in the least-expensive third of at least two of the following five price filters/valuation metrics.

✓ Firm value-to-EBITDA
✓ Price-to-earnings
✓ Price-to-book value
✓ Price-to-free cash flow
✓ Dividend yield

☛ Financials (commercial banks on fair valuation with economic and interest rate tailwinds)

☛ Utilities and REITs (relative valuation declines)

Our energy investments are concentrated in large integrated oil and gas companies, such as **Chevron Corp.** (NYSE-CVX, $119.00) and other companies in the energy services industry.

We view information technology valuations as generally additive, and have an underweight in REITs and utility stocks because we believe these companies are currently overvalued. (These sectors are also susceptible to rising rates.) REITs have benefited from the low interest-rate and credit-spread environment; as interest rates increased, the REIT industry underperformed.

We have also benefited from an overweight position in trust banks. In particular, the portfolio owned **Northern Trust Corp.** (NASDAQ-NTRS, $65.75), which has faced profitability challenges due to its positive correlation with interest rates. As rates rose, Northern Trust's stock price appreciated.

OUR STRATEGY

It seems like every 10 years or so there's a bubble of some kind. We've done a good job of avoiding those by sticking to our strategy. We're also willing to take active bets against an index and not buy stocks with excessive downside risk. Not all stocks have a price at which we will buy – for example, we never bought Enron.

Sticking to our basic strategy kept us from owning technology/Internet/media, and not buying them even after they came down some. Why? Because they were still overvalued.

With the Financial Crisis, corporate balance sheets were getting worse with the stocks that were doing the best. This time around, any bubbles are not as obvious. There has been a slowdown in some of the cyclicals, because specific companies were over-earning. But those companies are not broken. They aren't going to zero.

LOOKING AHEAD

Whether it's the next 12 months or 12 years, investors should have a strategy to meet their long-term objectives. In other words, they need to be able to stick with it.

Investors also need to lean against the wind and, to the extent they have a diversified mix of funds, reallocate back to target when some things outperform and others underperform.

Value is important, but it may not be the answer to all of one's assets. It is important to stick to sound strategies. Remember: there will be volatility and unexpected surprises, so you have to be able to stay the course. ▼