AORIS INVESTMENT MANAGEMENT

Value investing: Why cheap is not cheerful

Aoris Investment Management

Aoris is a *specialist* international equity manager founded in 2017.

We are a *focused* business and manage a single international equity portfolio.

Our investment approach is *conservative*, fundamental and evidence-based.

The Aoris International Fund

Our portfolio is long-only and highly *selective*.

We own a maximum of 15 stocks, each of which has considerable breadth or *internal diversification*.

We aim to generate returns of 8–12% p.a. over a market cycle.

Our Quarterly Reports

We are *business owners*, not economists. As such, our reports focus on the performance of our investee companies.

We report on portfolio performance and changes with candour and transparency.

Each quarter, we include a thought piece or feature article on a topic area with direct relevance to our investment approach.

About the cover image – the Palace of Versailles was the principal royal residence of France from 1682, under Louis XIV, until the start of the French Revolution in 1789, under Louis XVI. The 2,300-room palace is a UNESCO World Heritage site, notable especially for the ceremonial Hall of Mirrors.

Value investing: Why cheap is not cheerful

INTRODUCTION

The investment world likes to split companies, as well as those who own them, into two neat categories, 'value' and 'growth', with the latter really being a catch-all bucket for everything that isn't value. We frequently read about an investment firm being described as a 'value manager', and another as a 'growth manager', while a market environment may be described as one where value stocks have been out of favour. This begs the question as to who or what is the arbiter of whether a particular stock fits in the value camp or not. Shakespeare's Montagues wore blue and the Capulets wore red. What colour does value wear?

There is a strong human tendency to think in terms of single variables. In investing, seductively simple as it is, designating stocks as good value or not based on their PE multiple is flawed. So too is designating investment managers as being value managers or not based on the PE multiple of the stocks they own.

WHAT IS 'VALUE'?

A stock is considered 'value' if it trades on a lower PE multiple than a market average. This is flawed. Value is price relative to worth.

The word value, as commonly used outside the investment world, refers to the *price* of something in relation to its *worth*. If a product or service sells for less than it's worth, we would describe it as being good value.

In investing, however, the term value does *not* equate the price of a company in relation to its worth; rather, it equates the price to earnings (PE) ratio of a company in relation to the average of all companies. If Company A's share price is $10 and it reported earnings of $1 per share last year, then its PE ratio is 10x. If the market average PE ratio is 15x, then Company A would be considered a value stock as it trades at a discount relative to the market average.

Equating a PE ratio that is a discount relative to a market average with value is deeply flawed. Designating a company trading on a lower PE multiple as better value than one trading on a higher multiple assumes away any reason why two businesses should be valued on a different multiple. By extension, it assumes that every business should trade on the same earnings multiple. The appropriate measure of value is *price relative to worth*, not *PE relative to average*.

BUSINESSES ARE NOT EQUAL, AND SHOULDN'T BE VALUED AS SUCH

The value or worth of a business is a function of just two things – its risk, or quality, and its growth prospects.

A PE ratio relative to a market average is easy to determine; how, though, should we determine worth? There are two ways, and only two ways, in which businesses differ that should be reflected in how they are valued – their *risk* and their *growth* prospects. This is true when valuing any asset.

In credit markets, a corporate bond trading with a yield of 6% (equivalent to a multiple of 16.7x its interest payments) may represent very poor value and one yielding 3% (33.3x interest) may be considered very good value. Why? Because of their different risk characteristics.

In commercial property, a building generating a rental yield of 3% may be much better value than one producing a yield of 7%. Why? Because of differences in their growth prospects. The 3% yielding building may offer the opportunity for redevelopment or rezoning, or be in an area of rising demand and offer the prospect of attractive growth in rental income.

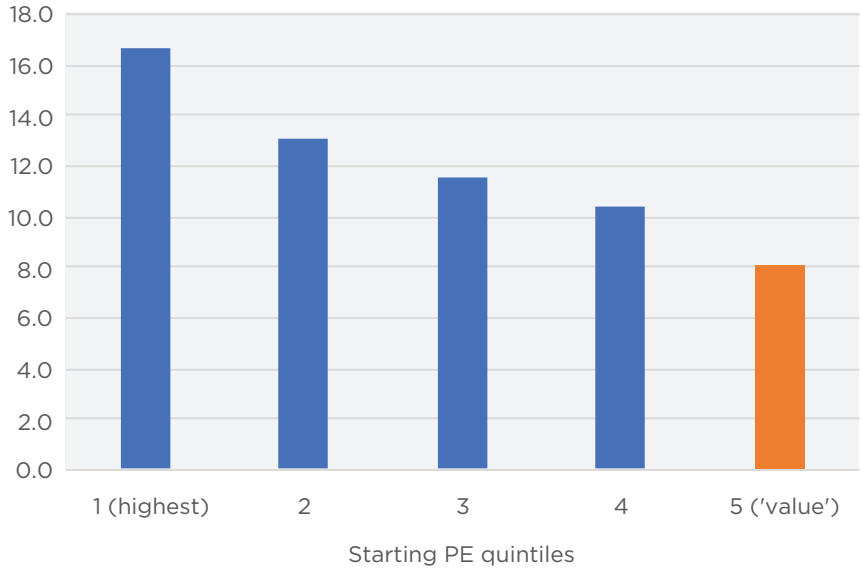
Risk and growth are the two variables relevant for determining the value of any particular business.

- Higher than average growth prospects make a business worth a higher than average multiple of earnings, all else being equal.
- Lower than average risk characteristics make a business worth a higher than average multiple of earnings.

What you got for your money

Warren Buffett famously said 'price is what you pay, value is what you get'. Let's explore this. A 'value' manager prioritising companies that trade on low PE multiples will, perhaps unwittingly, favour businesses with poor growth and/or high-risk characteristics. In the analysis that follows, we have taken the largest 2,000 publicly traded companies globally by market value in 2014 and excluded from this group those that were loss-making in that year (as it makes calculation of PE non-sensical). We split these companies into five groups, or quintiles, based on PE ratio as at the end of 2014 (the starting PE), as shown below. The 'value' or 'cheapest' group is quintile 5. All the data is sourced from Factset and the analysis is our own.

Median PE at end of 2014



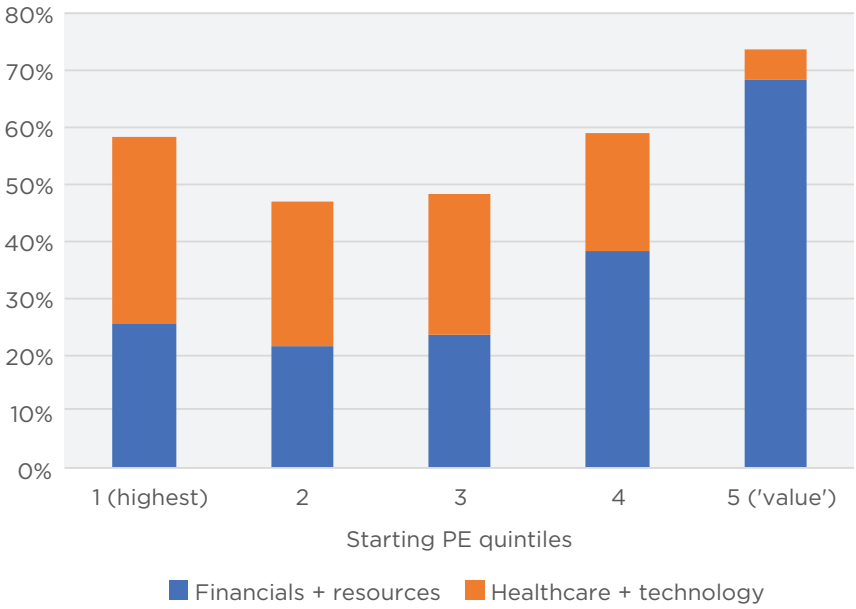
Let's now see what you got for your money. We show how the value group differed from others, first in terms of the industries it skewed towards, then the two key variables – growth and risk.

Sectors

The lowest PE quintile is heavily weighted towards financials and resource companies; companies that trade on a low multiple of earnings for many good reasons. On the other hand, there is barely any representation in the 'value' quintile of companies from two highly profitable and high-growth sectors, healthcare and technology.

The 'value' sector is heavily skewed to financials and resources with little representation from healthcare and IT.

Representation of key sectors

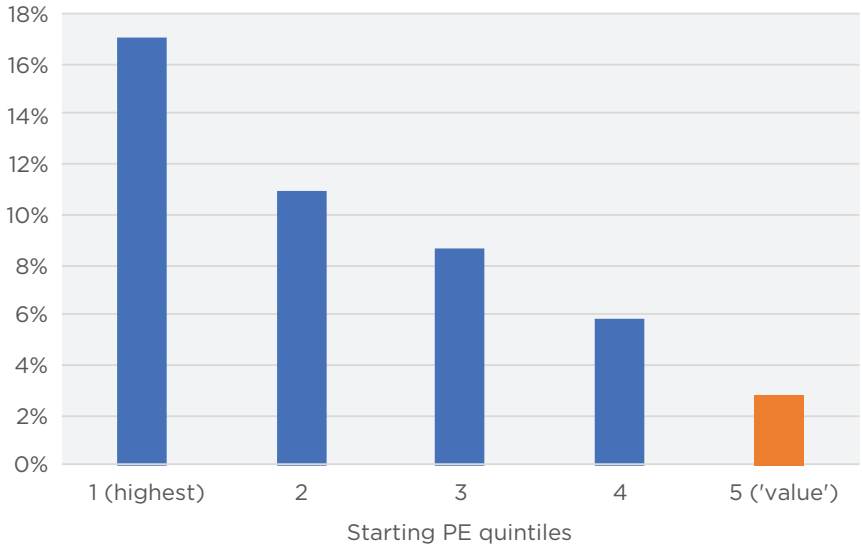


Growth

There is a linear and rather dramatic relationship between starting PE ratio and subsequent 5-year earnings per share (EPS) growth – companies in the 'value' quintile barely grew earnings over five years while EPS for those with the highest starting PE ratio more than doubled over that period.

The 'value' cohort delivered the poorest five-year EPS growth outcome.

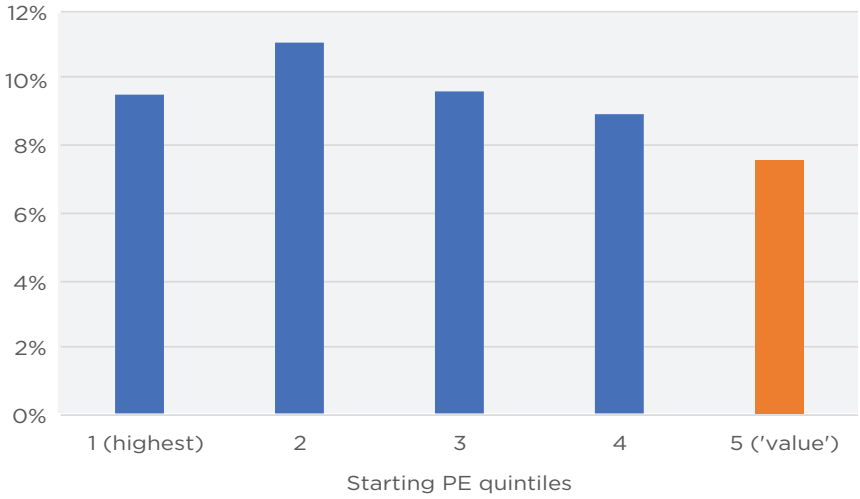
EPS growth p.a. 2015-2019



Part of the reason for the poor earnings growth from the 'value' group is they are the least profitable cohort in terms of return on invested capital (ROIC). ROIC can be thought of as a key source of 'fuel' for growth. The higher the earnings of a company in relation to the capital it employs, the more capital is available to drive future EPS growth, whether it be in the form of share repurchases, acquisitions, or organic investment back into the business.

The 'value' quintile earned the lowest return on invested capital.

Median return on invested capital non-financial companies 2015-2019



Risk

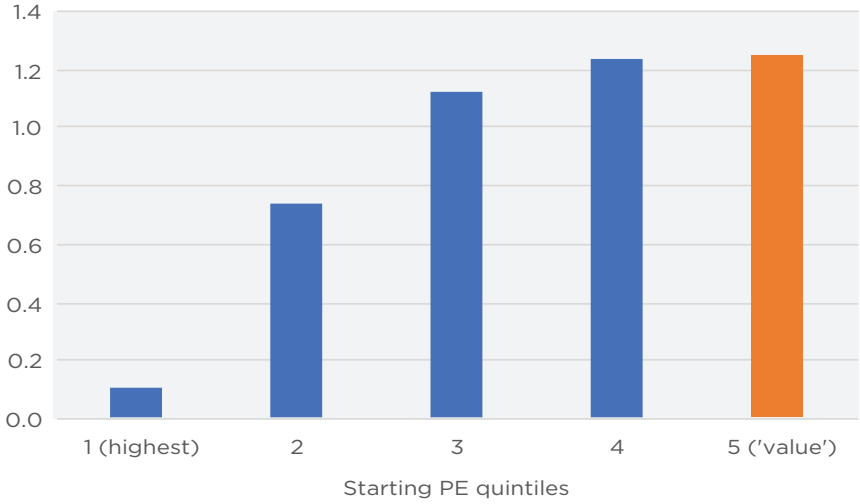
We think about risk in three categories:

- financial risk
- business risk
- management risk

Financial risk is directly quantifiable, and we can measure it by comparing the amount of debt less cash (net debt) to a company's earnings before interest, tax, depreciation and amortisation (EBITDA). Business and management risk ultimately show up in the financial performance of a company. We measure these risks two ways – whether the earnings of a business went backwards over the 5-year period, and whether a company cut its dividend over the period.

The lowest PE quintiles had the highest financial risk.

2014 net debt to EBITDA ratio (x) for non-financial companies

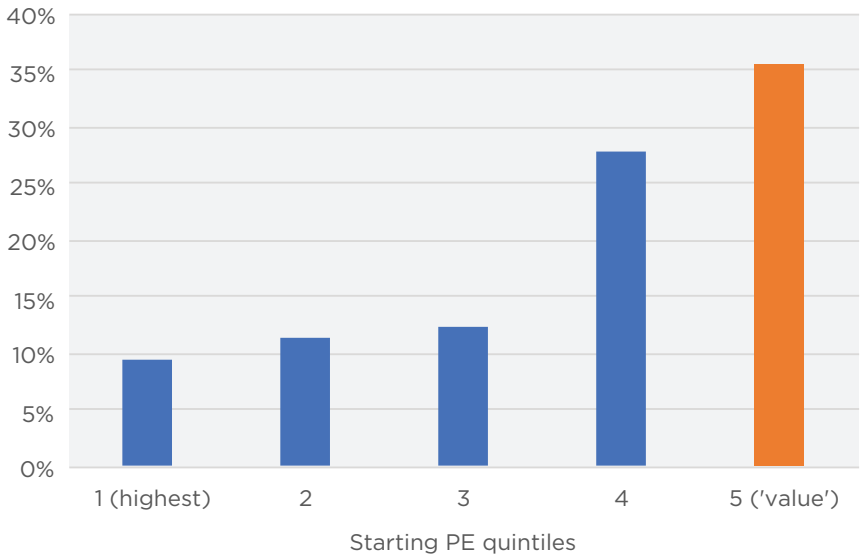


We can see that net debt relative to EBITDA is much higher for the groups trading on low PE ratios than for the high PE quintiles.

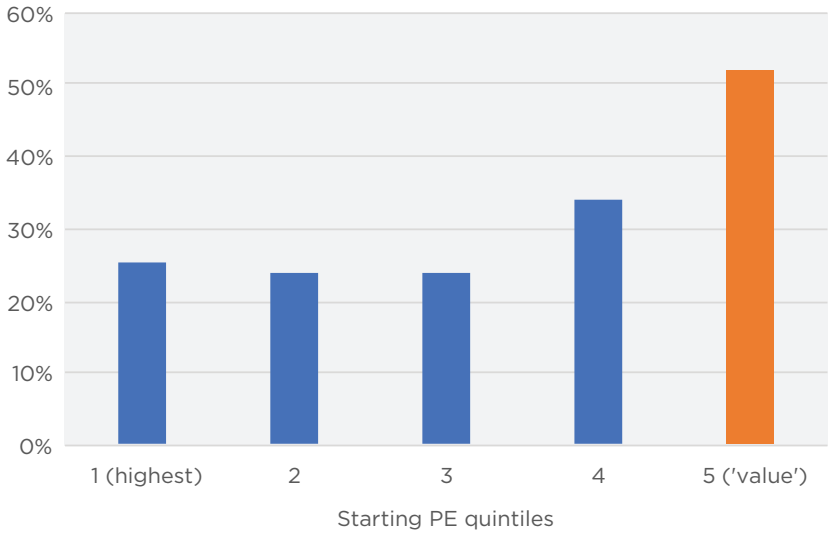
Returning to earnings risk, we see stark differences between the 'cheapest' or 'value' quintile and the rest. For more than one-third of the 'value' quintile companies, earnings per share declined over the five years to 2019, and more than half of those companies cut their dividend at least once over that period.

The 'value' quintile had the worst results in terms of EPS declines and dividend cuts.

Percentage of stocks whose EPS declined over 2015-2019



Percentage of stocks that cut dividends at least once over 2015-2019

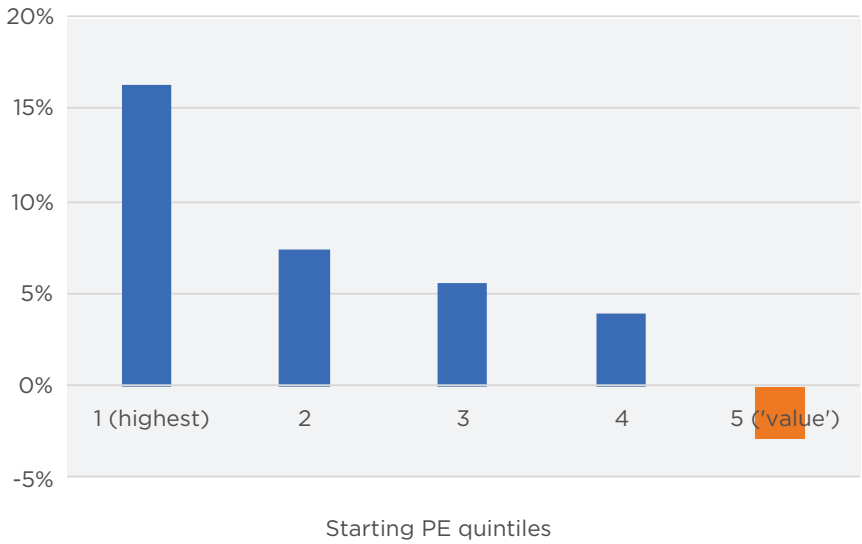


What you got for your money in 2007

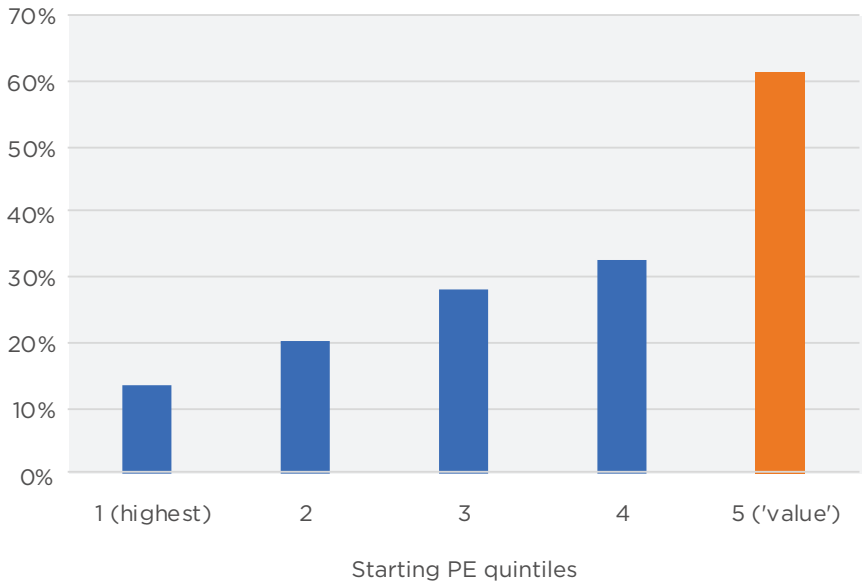
It might be argued that the characteristics of value stocks shown over the five years to 2019 are not representative of low-PE stocks through time. The following four charts show quality, growth and risk characteristics over the seven years to 2014, based on PE multiples at the end of 2007[1].

The weakest earnings performance by far belonged to the 'value' quintile.

EPS growth p.a. 2008-2014



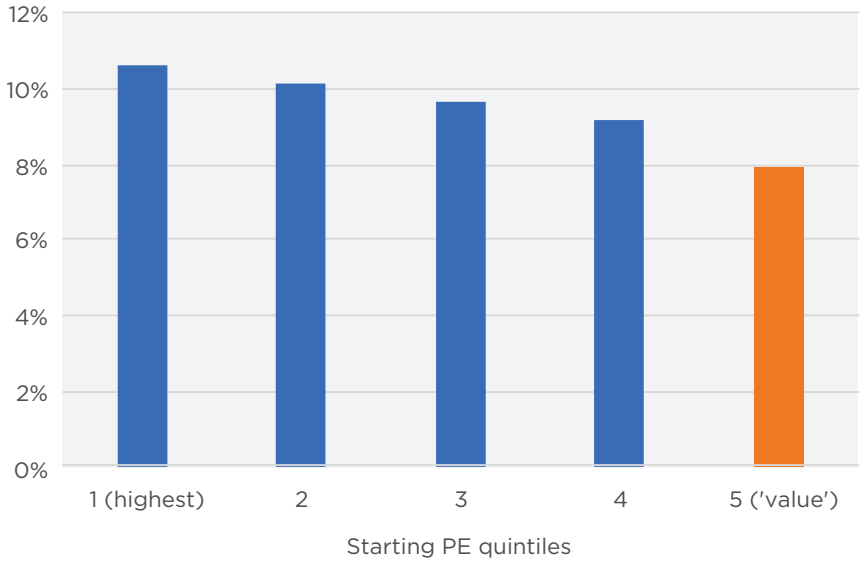
Percentage of stocks with EPS decline over 2008-2014



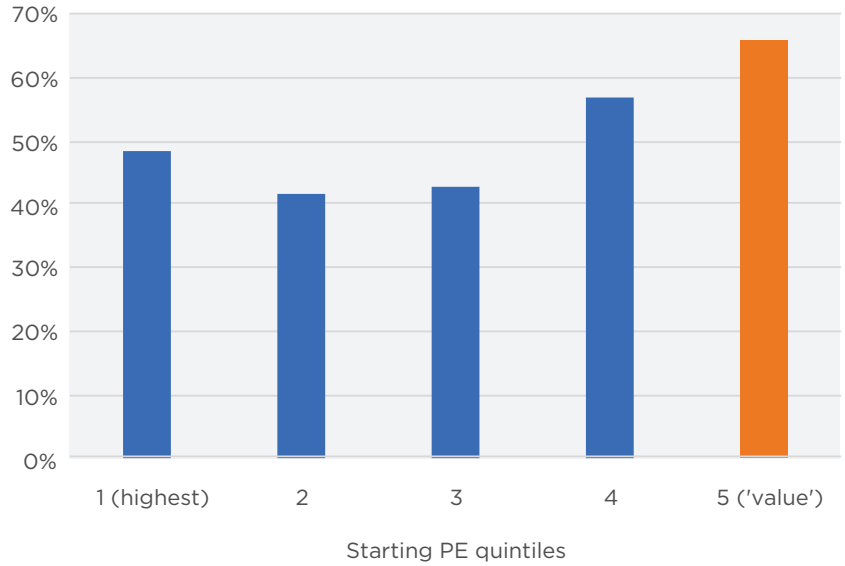
1 Note that we chose 2007 as the starting period to minimise the impact of the GFC period on starting PE multiples.

Profitability of the 'value' quintile was the poorest of the five groups.

Median return on invested capital non-financial companies 2008-14



Percentage of stocks that cut dividends at least once over 2008-14

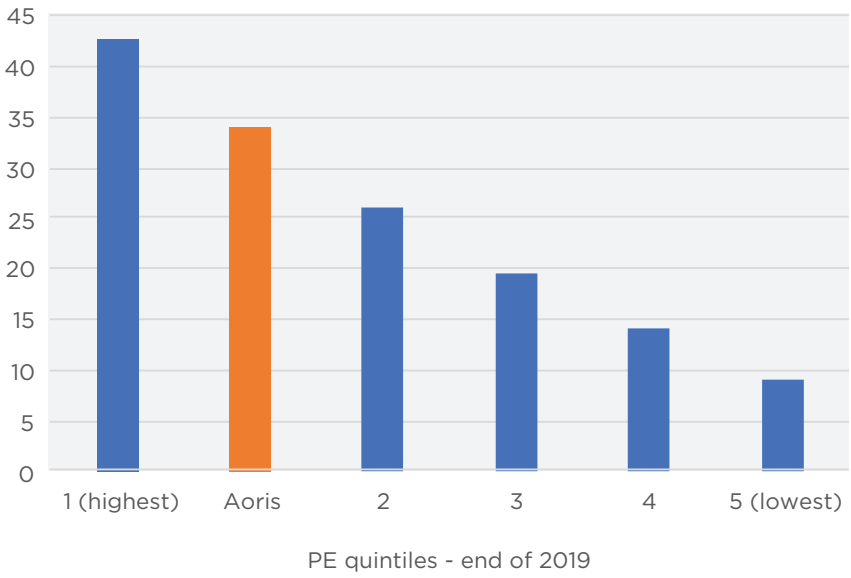


The Aoris portfolio

You won't find any of our holdings in the 'value' quintile today. In fact, all of them trade at a PE *premium* relative to a market average. Does this mean the stocks we hold are expensive? We think not.

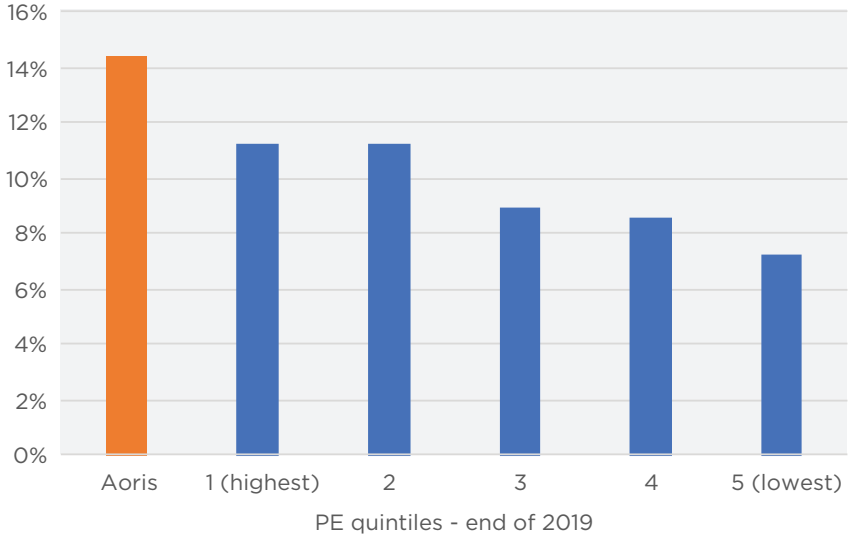
Companies in the Aoris portfolio all trade on higher PE multiples than the market average, but a lower multiple than we believe they are worth.

Median PE end of 2019 (x)
Aoris portfolio vs. market quintiles



Let's see what *we* get for our money. Firstly, in terms of composition, we own no financials or resource companies. In terms of quality and profitability, our businesses earn far superior returns on capital than even the highest PE group.

Median return on invested capital non-financial companies 2015-2019



The companies in our portfolio have grown earnings over the last five years at a rate comfortably above the market average and, more importantly, we expect them to continue to do so.

Not one of the companies in our portfolio reported a decline in earnings over the five years to 2019, and not one of them cut dividends over that period. The median net debt to EBITDA of our group of companies is 0.5x, about half the market average for non-financial companies.

We seek to own high-quality businesses whose *worth* is on an upwards trajectory, where we consider the risk of a disappointing outcome to be low. Such businesses trade on PE ratios higher than a market average, for reasons of superior growth and risk characteristics. There are many high-quality, wealth-creating businesses that we do *not* own, simply for the reason of price being in excess of worth. We currently own 14 businesses where *price* is at or below our appraisal of *worth*. We believe a premium multiple is entirely consistent with these businesses representing sound investment *value*. We are quality first, *value* investors.

CONCLUSION

'Value' has not been out of favour. Investors selecting low PE stocks have biased towards higher risk, lower growth and lower quality companies.

The central flaw in the value approach is that it expresses value in terms of a PE multiple *relative to an average*. Whether a company is good value is a function of its share price *relative to its worth*. The value approach implies every stock should trade on the same PE multiple. Companies differ in terms of their growth prospects and their risk characteristics, and these differences should be reflected in their PE ratios.

We have shown that companies trading on relatively low PE multiples five years ago on average generated poor earnings growth. They were much riskier than average, as measured by financial leverage and the likelihood of earnings decline and dividend cuts. The value group skews heavily to the financials and resources sectors, companies that are inherently cyclical and, on average, earn poor returns on capital over an economic cycle.

> *Sometimes the 'bargain bin' contains more trash than treasure.*

Value, thought of in terms of relative PE multiples, is a flawed concept. So too is the concept of a 'value style' or a 'value manager'. Many commentators note that value stocks have significantly underperformed the equity broader market over the last five or more years, but are quick to defend value investing on the basis that value has simply been out of favour. We offer a different perspective. Value hasn't been out of favour at all; rather a low PE investment approach biases a portfolio to low growth, high risk and poor-quality companies.

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A COMMONSENSE APPROACH EXECUTED WITH UNCOMMON DISCIPLINE

Important Information

This report has been prepared by Aoris Investment Management Pty Ltd ABN 11 621 586 552, AFSL No 507281 (Aoris), the investment manager of Aoris International Fund (Fund). The issuer of units in Aoris International Fund is the Fund's responsible entity The Trust Company (RE Services) Limited (ABN 45 003 278 831, AFSL Licence No 235150). The Product Disclosure Statement (PDS) contains all of the details of the offer. Copies of the PDS are available at aoris.com.au or can be obtained by contacting Aoris directly.

Before making any decision to make or hold any investment in the Fund you should consider the PDS in full. The information provided does not take into account your investment objectives, financial situation or particular needs. You should consider your own investment objectives, financial situation and particular needs before acting upon any information provided and consider seeking advice from a financial adviser if necessary.

You should not base an investment decision simply on past performance. Past performance is not an indicator of future performance. Returns are not guaranteed and so the value of an investment may rise or fall.