Contact Asset Management

INSIGHTS

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The Death of Investment Philosophy

We believe that a "Quality-first" investment approach trumps Growth or Value Investing alone. As markets continue to evolve, it is difficult to argue that a single investment philosophy is an elixir. Our Investment Philosophy is robust and repeatable yet flexible. We certainly want to invest in growing companies that are cheap. However, building quality portfolios often requires a blend of Growth and Value philosophies.

Style Philosophies

Fund managers offer their ability to exploit inefficiencies in equity markets. That is, a capability to identify stocks that will trade differently to the current price because of the investors' superior analysis of the operational performance of the underlying businesses. To gain client trust, fund managers proudly market their services by extolling their philosophy which underpins the investment process.

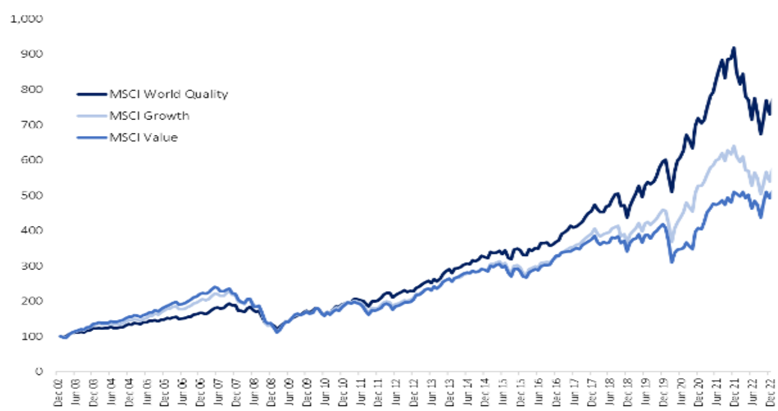
This was once dominated by the Value philosophy which is a classical and fundamental approach to buying stocks that trade below an assessment of intrinsic value (generally based on future cash flow earnings). Benjamin Graham is widely known as the "father of value investing" promoted a common theme, which value investors seek to replicate today: Any stock should be worth considerably more than you pay for it. This could mean a strong balance sheet, lack of debt, high profits or any other underlying financial strengths. But to purchase something at anything but a discount, Graham opined, meant losing money, and that is something an investor should never do.

At the other end of spectrum, Growth managers seek companies whose earnings are expected to increase at an above-average rate compared to their industry sector or the overall market. At a basic level, Growth investors look to the following metrics: historical and future earnings growth; profit margins; returns on equity (ROE); and share price performance.

Investment history shows that extremist approaches, either hardcore Value or Growth, can be out of favour for extended periods. This is due to the macroeconomic and policy environment that overwhelms any stock specific thesis, certainly in relative terms. Value investors often fall into "value traps" whereby they fail to realise that sometimes a stock is cheap for a reason. Similarly, growth investors can come unstuck when stocks trading on high PE multiples fail to maintain earnings or sales momentum. Several "growth" stocks are unprofitable, which adds to the risk if momentum stalls.

Somewhere in between, a Quality focus targets companies with overall fundamental strength. The quality attributes are often reliable generators of consistent total returns. As depicted in Chart 1, over the past twenty years, Quality has trumped Growth and Value. At Contact, we categorise ourselves as "Quality First" and prefer not to pigeonhole ourselves in a Value or Growth camp. We echo the sentiments of US investor Bill Miller, who wrote: *"Sometimes growth is cheap and value expensive. The question is not growth or value, but where is the best value."*

Chart 1: Quality prevails over the long-term



Source: Factset

Quality counts. If you are a long-term investor, it's hard to find a more important factor as to what will power your ultimate investment returns. That said, quality is impossible to measure with precision because it often embodies more subjective qualitative factors than easily quantifiable measurements. Quality is also dynamic and changes over time."

Tom Gayner

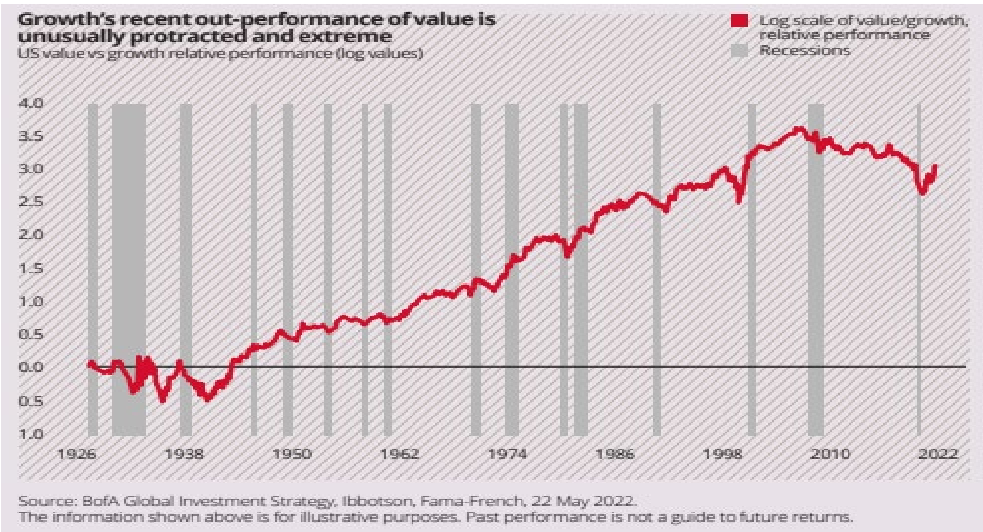
A low interest rate environment has aided the Growth approach.

It has been well documented that until recently, global interest rates have been falling for four decades. Interest rates are critical for valuing investments as they drive the discount rates used to calculate the present value of future cash flows from those investments. As Warren Buffet said in 2016 "Interest rates are like gravity in valuations. If interest rates are nothing, values can be almost infinite. If interest rates are extremely high, that's a huge gravitational pull on values".

Besides also creating favourable business conditions via loose financial conditions where liquidity is abundant and financial leverage encouraged, the secular decline in interest rates increased the value of shares.

The surge in correlations with macroeconomics (mainly interest rates) has overwhelmingly benefited the Growth style and, to a lesser degree, Quality type stocks. This is because their profit growth is generally extrapolated further into the future (meaning they are longer duration) which is discounted less when rates fall.

Chart 2: Growth's performance of value was significant until mid-2022



Source: Bank of America

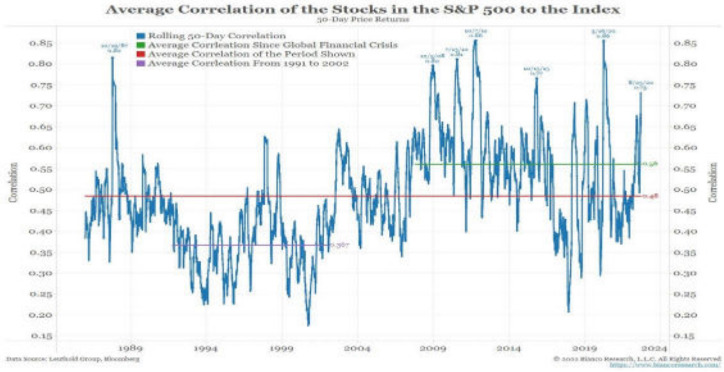
This style outperformance has significantly reversed recently (although the performance fees clients paid have not) as inflation has forced interest rates higher and these Growth names have failed to produce the desired underlying earnings promised.

While the outperformance of "Growth" following the GFC led to narratives that "Value is Dead" (David Einhorn, famed hedge fund founder of Greenlight Capital said on Bloomberg TV in October 2022 about Value: "I don't think that it ever comes back…most of the Value investors have been put out of business"). Yet, the reality is that if any style has genuine through the cycle bona-fides, it is Value.

The rise of Index investing has added to the momentum (and volatility)

Within equities markets, correlations with the index itself are at highs. This has coincided with the mentioned fall in interest rates, and also the massive growth in passive or index investing. While this is challenging for stock selection, it suggests some stock prices are being artificially reinforced (with and by momentum) regardless of fundamentals, which generates relative opportunities for nuanced or more considered processes.

Chart 3: the rise of ETFs has possibly led to increased correlation between individual stocks and the index



Source: Leutbold Group, Bloomberg

The rise of ETFs and passive investing is one area where we see the death of investment philosophy. Passive fund flows tend to exaggerate the prevailing trend. The massive volatility of February and March 2020 is testament to this as Covid-19 emerged but then continued into 2021 as Growth stocks massively outperformed (in a falling rate environment). Then, as rates started to increase, the tide went out on Growth stocks in the second half of 2022, and Value outperformed. But through both periods, Quality stocks performed admirably.

"If you are a long-term investor, buying shares in a good business is more important than valuation*. If you are not a long-term investor, what are you doing investing in the stock market?"*
Terry Smith

Contact Asset Management's Approach

Contact's 6 step investment process includes Income and Valuation, which are more consistent with the Value approach. However, we are agnostic in style terms. The inclusion of Financial Strength is more of a Quality/Growth factor. We also have a focus on the Principal Activities which includes an assessment of competitive advantages and sources of earnings improvement, which are also consistent with Growth/Quality. ESG and analysis of Management are the remaining steps.

This is reflected in Contact's two investment vehicles, BKI Investment Company and the Contact Australian Ex-50 Fund. While at a high level, the portfolios trade at "Value" type P/E and EV/EBITDA discounts and dividend yield premiums, aggregate Net Debt/Equity and ROEs are comfortably above benchmark as Growth managers would desire.

Across both portfolios, we seek Quality first. This means that we invest in both Value companies and Growth companies. Portfolio holdings in the Value style include Ampol (ALD), Aurizon Holdings (AZJ), BHP Billiton (BHP), Harvey Norman (HVN), Metcash (MTS) and Nine Entertainment Group (NEC). Our Quality/Growth investments include Commonwealth Bank (CBA), Goodman Group (GMG), Hub24 Limited (HUB), Sonic Healthcare (SHL), REA Group (REA) and Woolworths Group (WOW).

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