

LESSONS FOR CONTRARIAN INVESTORS IN A NEW ERA OF VOLATILITY

HIGHLIGHT

One thing that is certain in this era of market volatility is our skills will be thoroughly tested. Read on for the 10 lessons in investing to help contrarians navigate this new stage of the cycle.

Last year, US-led trade tensions and emerging market troubles rocked global markets, throwing up pockets of volatility throughout the year. In Europe, economic data and earnings growth remain robust but the equity market has been buffeted by bouts of indiscriminate selling due to prevailing geopolitical storms. While macroeconomic shifts do not influence our investment process and decision-making, this type of short-termist trading erodes investor confidence and pushes up volatility in the market.

As low-turnover, bottom-up investors, our focus is on stock fundamentals and we are seeing growing signs of an increasingly asymmetric market. Stocks have become more sensitive to any negative earnings surprises, while conversely, earnings beats are not being relatively rewarded. With this shift in risk / reward dynamics, we are continually assessing risk management in relation to the sizing of positions. In a highly sensitive market, it can pay dividends to take a more incremental strategy in building positions, to allow for more flexibility amid volatility flashpoints.



Mike Clements
Head of European Equities
Portfolio Manager

"Re-awakened volatility are creating opportunities to exploit market flux and take advantage of attractive entry points."

On the positive side, the top-down and bottom-up trends that have re-awakened volatility are also creating opportunities to exploit market flux and take advantage of attractive entry points. It is this type of market that tests the skills of an active contrarian investor. As investors brace for a potential new stage in the cycle, I discuss the ten lessons of contrarian investing I have learned over two decades of analysing European equities.

WIDEN YOUR TIME HORIZON

How can one make a difference against hundreds competing to get ahead of the herd? One way is to have more information than the competition, but, in this age of instant information, it is either impossible or illegal. Another option is to do a better job at analysing the information. But this is also quite a challenge considering the sheer volume of research carried out by thousands of global analysts. Therefore, the only realistic way to beat the market is by adopting a longer time horizon in order to allow good ideas sufficient time to come to fruition.

TURBULENCE WILL BE EXPERIENCED

Air turbulence on a flight is uncomfortable but not detrimental. The same can be said about pockets of underperformance over the course of an investment. Sometimes, contrarian investors can arrive too early and an unloved stock has further to fall before it

finds its bottom. This is the time where the courage of conviction counts. It may not feel particularly comfortable, but being on the wrong side of the market is often the short-term price an investor must pay for long-term alpha.

It is important to remember that a contrarian by definition will undergo periods of underperformance. The key thing is not to succumb to market pressure and knee-jerk reactions: stay true to your process and avoid style drift. At the peak of market pressure, high-conviction portfolio managers must display resilience to reassure investors they have the confidence to deliver on longer-term strategy objectives.

LEARN FROM YOUR MISTAKES

It isn't enough to just merely be contrarian, you must react to the changing dynamics of the market. Measuring and right sizing risk is crucial to long-term sustainable alpha generation. As a team, we are constantly appraising how we access and exit positions and the respective impact and attribution those position have on the overall volatility and investment return of the portfolio. While the contrarian idea might be great on paper, we must consider it within the framework of overall portfolio returns, volatility and diversification.

IT MAY TAKE A WHILE TO BE PROVED RIGHT

It may sometimes take longer than expected for the market to catch on to value anomalies or mispricing your analysis has uncovered. As with periods of underperformance, conviction in analysis and process is crucial to realising price discovery.

It also means shifting thinking when the market does turn. At this point, it may be time to start considering rotating out of the stock.

PATIENCE IS A VIRTUE

Buy low and sell high. This stock market adage sounds easy, but it hides a painful truth: buying low is easier said than done. Indeed, it requires great courage to resist peer pressure and avoid fashionable but expensive stocks. It can also entail buying companies that nobody likes or investing in times of panic.

Above all, investors should be patient. This means doing your homework and waiting for the market to fall so you can find a good entry point from a valuation perspective. And then waiting again, sometimes years, until the market changes its mind and other investors realise the merits of the stock.

ANTICIPATE AN EVOLVING MARKET

It's important to remember the market is in a constant state of flux. Anticipating the next stage of the cycle can pay dividends. For example, we took a position Flow Traders towards the back end of 2016, after its share price tumbled due to low volatility and diminished trading in ETFs.

The EBIT margin dropped from the mid-40s to the mid-20s as the market summarily dismissed its growth potential. Flow Traders is an example of a stock where we believe it's conducive to be six or 12 months early. Indeed, in the first week of February, the Vix went through the roof and Flow Traders' share price jumped 60% in a month – and we expect further volatility will participate in more price moves.



AVOID VALUE TRAPS

Unfortunately, cheap stocks can stay cheap for a long time. If you're a fund manager, you can convince your investors to show some perseverance. This means holding your nerve to stay on the side-lines when the rest of the market rises and companies which you consider far too expensive continue to make daily gains. However, what your investors will never accept is to see your 'hidden gem' stocks turn out to be 'value traps' – companies that look cheap but are in fact suffering from a structural deterioration in their business model.

As a result, when investing for the longer term, it is absolutely essential to minimise downside risk and avoid sharp drawdowns. The way to achieve this is through forensic and demanding analytical research in order to understand the drivers of a company's performance, assess the soundness of its balance sheet, and perform in-depth 'worst-case scenario' simulations.

IDENTIFY SUSTAINABLE COMPETITIVE ADVANTAGES

The two key rules to selecting the right stocks are quite straightforward. The first is to buy high-quality companies; the second is to buy them at an attractive valuation. This seems self-evident but, as is often the case, it's easier said than done.

So, what makes a company good? If you're going to invest for the long term, you need a business that has a fundamentally sustainable competitive advantage. This can mean a strong brand, like LVMH; market dominance that gives pricing power, like Legrand; a low-cost provider, such as easyJet; or a technological advantage, like Sanofi. In order to stick to the second golden rule – attractive valuation – a successful alpha manager needs to focus on free cash flow generation, as this is the real engine to wealth creation and less susceptible to accounting manipulation.

UNDERSTAND WHY IT'S CHEAP

Unfortunately, good companies generating a lot of free cash flow that are attractively valued do not grow on trees. It's therefore important to understand why, at times, this may be the case. There are three possible reasons: negative investor sentiment against the country or the sector – as was the case for Spain after 2008; negative sentiment due to cyclical or 'flight to safety' reasons when investors indiscriminately stampeded out of equities; or company-specific fears about its business model. Once the reason for the cheap valuation is determined, you can assess whether it's justified or not.

THE PROOF IS IN THE INVESTMENT PUDDING

Like all good ideas, contrarian investing relies on basic common sense and seems relatively simple. However, what appears effortless in fact requires a huge amount of work, courage and discipline. More than in any other aspect of investing is patience a virtue; positions are usually held for three to five years, many of them at the initial low-price stage. A true alpha-generating contrarian manager requires nerves of steel and loyal investors, but significant outperformance and low volatility are the rewards to be reaped.



Contrarian investing relies on basic common sense and seems relatively simple. However, what appears effortless requires a huge amount of work, courage and discipline.