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How Stanlib Value thinks about stock selection

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Hlelo (Lo) Giyose is the STANLIB Value Fund Manager and Head of the Value Franchise at STANLIB, South Africa's largest unit trust company. He holds a BSc (Hons) in Business Administration from the University of New Hampshire and an MSc in Investment Management from the City University Business School in London. He joined the investment industry in 1994 at HSBC in Connecticut as a research analyst. Lo later became a financial services and insurance industry analyst at Investec Asset Management, Cape Town, before working on the Investec Growth Fund. Prior to joining STANLIB, he was head of the portfolio management division of the Industrial Development Corporation.

The Stanlib Value investment proposition is centered on identifying and quantifying intrinsic value relative to ruling share prices at any one point in time. Simply put, we want to pay value prices (less) for companies whose micro-economics have momentum implicit in them. If this sounds like a difficult way to invest, and it is, it is only because it has significant advantages over all others, if not many other methods of investing. So, the way to describe intrinsic value investing is by reduction – explaining other methods first in an effort to isolate what remains under the spotlight! Let's go.

In many markets around the world, there tends to be a sector that typically dominates the capitalization of the stock exchange by size. In the USA, for instance, it is the financial sector (it used to be the industrials and rail-roads) while in South Africa and Australia it is the mining sector. And it turns out, at various points of the economic cycle, as determined by inflation and interest rates, resources either lead or lag financials and industrials (FINDI) as a group. As a result, a sizeable proportion of investors try to pick stocks they think will do well in a particular economic environment. For instance, in a rising inflation and interest rate environment, investors will want to stack resources into their portfolios and then switch to FINDI if macro-economic indicators reverse direction. This toggle back and forth between sectors is known as sector rotation. It occurs because investors anticipate greater growth in profitability (earnings) from companies exposed to that sector. Here is an implicit promise sector rotators are making: they can reliably forecast inflation and interest rates. If you are inclined to believe that there is such a person, ask yourself if you know of any rich investor (a la Warren Buffett) who made their money through sector rotation? I don't. And I am very familiar with the history of investing to know if that method of investing has produced its own version of Warren Buffett.

The next group of investors up the intellectual capital chain is statistical (value and growth) investors. These folks have observed from the history of businesses over time that some financial ratios tend to oscillate from high to low and vice versa. So they tend to calculate a whole bunch of statistics such as means, medians, standard deviations, and so on, and use these as decision markers for their investment decisions. For instance, a statistical value manager would want to buy stocks with a price earnings ratio below its 5yr or 10year mean while a growth manager may want to buy stocks with a revenue momentum as indicated by a price to sales ratio greater than its 5yr average.

The implicit promise such an investor makes is that is not only that what goes up must come down and vice versa but also, like clockwork, the portion of the portfolio that goes up will far outweigh the portion of the portfolio that goes down. There is a lot more evidence of successful (and rich) investors who have utilized this strategy, particularly in value investing. Of course the downside of this strategy is exactly what we know – sometimes companies stay cheap forever or even go into bankruptcy. And curiously, on the high side, some companies exhibit expensive statistics for intolerably long stretches of time.

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Enter intrinsic value investing. This form of investing attempts to enhance statistical value returns by (i) weeding out stocks that go bankrupt and (ii) indentifying stocks that have the ability to go for long stretches of time looking expensive - renewing corporate value. Practitioners of this form of investing employ the big ideas from various disciplines to explain the nature and depth of micro economics (competitive advantages) implicit in a company's ability (or lack thereof) to renew corporate value. The micro economics we focus on are (i) economies of scale which facilitate low cost advantages (ii) intangible assets e.g. brands, patents, regulatory approvals, etc. which facilitate pricing or volume power (iii) switching costs which tend to discourage loss of customers to competitors, and (iv) network effect which tends to aggregate buyers and sellers in one gated community and charges them to 'play' transact with one another.

The ideas of both a network and economies of scale (critical mass) emanates from the fields of engineering while both intangible assets e.g. a brand and switching costs are borrowed from the field of psychology (social proof and Pavlovian phenomenon). Share prices of companies that exhibit anyone of these qualities in strong form rarely trade below their statistical long term averages as their operating momentums allow them to create shareholder value that investors typically find suitable for long term investing. Charlie Munger, the Vice Chairman of Berkshire Hathaway, states that he and Warren Buffett made the majority of their money from these types of investments as their growth is more structural than temporal (cyclical). In fact, he states that the father of value investing, Benjamin Graham would have been horrified by both how they make money and stupefied by how much they make!

To bring it closer to home, let us use the micro economics of Truworths, a clothes retailer, for illustration. Analyzing Truworths, it becomes clear that what a company does is nowhere near as important as how it does it. How does Truworths report the highest gross and operating margins as well as return on equity (ROE) than any other mass clothing retailer in the country, and second best in the world? Well, most of its advantages emanate from its very high gross margins which flow through to an operating expense base relative to sales (expense ratio) comparable to its peers, thereby resulting in, again, a much higher return on equity than its peers. Operating costs in check, it turns out Truworths has a number of aspirational brand names for customers between 14 and 30 that it can charge more for. It may sound silly to say, but some companies don't know that the market can take it if they raised prices!

These aspirational brands are: Limited, Inwear, Ginger Mary, Essence, and Daniel Hechter. I call them aspirational brands because they allow a customer to transition from internal generic brands such as Truworths, Identity, YDE or external generics like Mr. Price, Foschini, etc as his income rises. Truworths has spreads its peer-beating, brand-driven pricing power over an expense ratio equal to its peers. The fact that the company extends you credit 'affords' you its higher priced products. Which micro-economic quality is Truworths exploiting? Intangible assets: branding, to be exact. Which external discipline underpins this competitive advantage? Psychology: social proof to be exact. How well entrenched is this 'psyche' in the minds of Truworths customers? Very!

Last, once we arrive at this insight, we devote not a second of our time prognosticating on macro-economic indicators such as inflation, interest rates, etc. If Gill Marcus whispered the direction of interest rates into our ear in the middle of the night, it would not change a thing we're doing! We would wake the very next morning to simply determine the extent to which Truworth's customers' psyche to pay up (the source of Truworths' intrinsic value) is underestimated by investors. In other words, are investors misjudging both the period of time, and rate at which Truworths can create shareholder value from its customers on the basis of its customers' affinity to its brands? How long would it take to disabuse a customer of his affinity to a brand? If Truworths maintains investment into its brands to ensure that it fulfills its promise to the customer, how long can the customer stick with the company? The answers to these questions allow us to determine the competitive advantage period in which Truworths can generate normal earnings and returns for what seems to be a low risk endeavor.

To wrap up, we bought Truworths at R22 when the share price was implying a competitive advantage period of 2.5yrs and a long drought of earnings going back 7yrs! At the time, we estimated that Truworths earnings, at worst case, could be muted over a 3 year period but could withstand an onslaught of competition from its peers for 5.6yrs before its returns trend downwards. That brought our computed fair value to R48 with a pretty high degree of certainty. In conclusion, to a statistical value investor Truworths at 5.6x price-to-book may be expensive. If it is, it deserves to be for the next 5.6yrs! This explains why Edgars launched a brand driven concept store (Fabulous Brands) at Melrose Arch?

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Glacier Research wishes to thank Hlelo for his contribution to this week's Funds on Friday.

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