Long-term strategy can pay off for disciplined value investors

But it is difficult to buy low and sell high as market forces converge to push you to alter course

It has become distinctly unfashionable to admit to being a value investor. Traditional value investing — buying low-priced, out-of-favour stocks — has underperformed a strategy of buying the most popular growth stocks for most of the past decade. Funds with “value” in their names have generally languished in the lower half of global performance tables over this period.

Conventional value managers have also been drawn to beaten-up cyclical businesses that have in many cases been value traps. We should know: our funds had exposure to the local construction sector in recent years due to what we perceived to be heavily discounted share prices. Regrettably, a tough macro environment, poor corporate governance and a plethora of poorly executed projects have negatively affected investment portfolios, including our own.

Being known as a value investor is nothing to be ashamed of. Value investing, as a discipline, has a wide and loyal following among fund managers and investors who understand that a long-term view and patience are the only sustainable competitive advantages available in financial markets that are increasingly affected by participants with shorter time horizons. Markets that are far from efficient repeatedly create significant opportunity for disciplined, patient investors.

However, there are many ways to determine if an investment offers value. To one manager, it may be a deep discount to asset value, while to another it is a superior business model that allows a company to reinvest in maintaining a dominant market position.

It is intriguing to note how the poster child of value investing, Warren Buffett, has amended his investment approach from a preference for “deep value” opportunities to his current focus on “compounding machines”. We do need to consider market conditions at the time, but his early stock picks would have all come from the value basket, while most of his more significant recent investments have been in higher-quality growth companies at relatively lofty prices.

In a world of prolific investment choice — including hundreds of unit trusts all mining the same limited universe of securities — it is convenient to label funds to appeal to investors with specific behavioural biases or cyclical preferences.

But investors should be aware just how broad definitions such as “growth” or “value” can be and the dangers associated with attaching such an imprecise label to a specific asset manager, particularly when you factor in changing market conditions. Dig a bit deeper into the difference between “growth” and “value” and once you have moved beyond the cut-and-dried outliners on 100 times earnings (growth) or half of book value (value), it becomes clear that the distinction is blurred.

In fact, our highest conviction stock picks tend to be those we expect to grow ahead of the market for long periods of time that we also consider undervalued. They are mostly companies that we think are temporarily out of favour and are categorised “value” opportunities at the time. Hence, we are generally classified as value managers.

However, our portfolios have also been heavily weighted to “growth” shares at times when the market did not pay up for compounding ability, such as between 2000 and 2011.

Similarly, we viewed the 2015 collapse in commodity shares, emerging markets and the rand as an opportunity to buy decent but mostly cyclical companies at distressed prices. While this resulted in a very heavy tilt towards “value”, it was not a reflection of an underlying bias for cyclical businesses, but a function of market conditions.

Does an investor’s investment philosophy and process incorporate the discipline of buying low and selling high? And, importantly, is there evidence that they have done so consistently?

Most investors are likely to suggest that they are price sensitive, but we expect the evidence to contradict this at times. In reality, it is very difficult to buy low and sell high because market forces converge to push you in the other direction.

In times of panic, there is always a powerful narrative that things are going to get a lot worse before they get better. Falling stock prices reinforce this view, creating a negative feedback loop that makes it difficult to pull the trigger on the buy side.

In an equal and opposite way, soaring stock prices tend to coincide with a very compelling narrative of superior long term performance — simply cast your mind back to the narrative around the long-term impact of the Chinese supercycle in 2007.

An investment process should be singularly orientated towards getting the odds of investors’ achieving their investment goals in their favour.

We believe that only by being price sensitive and buying securities that offer a margin of safety and having the discipline to sell stocks that you consider overpriced, can you improve these odds.

This focus on price versus intrinsic value keeps a manager disciplined and compensates for unpredictable future events.

Importantly, preserving capital by trying to avoid permanent losses is a significant contributor to long-term investment returns — something that tends to get overlooked eight and a half years into a bull market.

The market will always be subject to economic cycles and wide fluctuations in sentiment. This creates both opportunity and risk, and what worked last year may not work this year.

Accordingly, there is tremendous benefit in a flexible investment approach that is disciplined and does not compromise the overall philosophy.

There is no right or wrong investment style and many different strategies have proven successful over time. The common ingredient is consistency.

Le Roux is the fund manager of the PSG Equity and PSG Flexible funds.