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Is there *value* left in the cycle?

Asset managers are often classed as being either 'Value' or 'Growth' orientated. The theory behind this is that the market goes through both these cycles. E.g. in a value cycle, value managers do well and vice versa. Allan Gray is often branded as a 'value' manager and our performance over the past five years is attributed to a huge value cycle that is likely to end soon. In theory then, when the next growth cycle starts, Allan Gray should underperform whilst the growth managers will be in the ascendance.

As with most popular theories, the growth / value cycle hypothesis in our opinion has some element of truth, but does not represent reality. We believe that there are three ways in which a manager can attempt to outperform for their clients:

1. Identify companies with sustainable competitive advantages that allow them to grow at rates well above that of the overall stockmarket. Sometimes these superior qualities are not recognised by the market and they can be acquired at an average price. Even though the price is not cheap, the extra growth will reward investors.
2. Buy mediocre companies at cheap prices. This is most often when business conditions are tough for such companies. As conditions improve with the economic cycle, the companies will revert to fair value and the investor will earn a good return due to the low purchase price.
3. Buy companies where the outlook for the next year or two is bright with improving business conditions and a high growth rate in earnings per share. As the positive news flow comes though the price of the shares will rise. Price is not very important. The positive news will lead to higher prices and the manager will sell the share and move on to the next idea before the cycle turns.

Most managers are heavily biased towards the third option. Thus the huge focus is on newsflow such as economic data releases, pronouncements by central bank governors and profit updates. Forecasts from most brokerage houses rarely look more than two years ahead, since they do not expect their clients to hold the shares beyond that period.

At Allan Gray, we search for favourable prospects amongst the first two options whilst avoiding those in the third. The reason is that while the third option certainly offers the most exciting returns, it suffers from low levels of predictability. Changes in trend are very difficult, if not impossible, to predict. Almost no one called the peak of the Internet bubble in early 2000, just as the local new listings boom in 1998 ended without warning.

But proper analysis and a long-term focus can give rewarding returns in both of the first two cases. Which is better often dependent on the changing character of the stockmarket. Following a strong rise in the stockmarket, investors are often optimistic. On these occasions little notice is taken of risk and the recent good earnings performance of companies is extrapolated far into the future. This results in high prices for 'growth' shares. Yet shares with less promising recent histories are often neglected in such markets and even sold down in the rush to jump on the bandwagon and buy shares that promise more growth. These unpopular or 'value' shares will then offer great investment opportunities for knowledgeable investors with the patience to wait for conditions to normalise. These were the conditions prevailing in South Africa in 1997/8, which remained in force in the western world until early 2000.

At other times investors are fearful of the stockmarket, often after an extended period of poor stockmarket returns and highly publicised corporate scandals. Shares for which people had high expectations (e.g. Didata, Coronation, Rebhold) disappoint, because the base for the high growth rates were the stockmarket boom rather than business fundamentals. This makes investors distrustful of high earnings growth. Yet there are companies that offer superior products, management, business models and free cash flow. While these companies will have their cycles, over extended periods of time they will grow their earnings faster than the market. For such companies one should expect to pay extra, but in tough markets investors often cannot distinguish these shares from the others with which they were disappointed. The real opportunity for a fundamental investor then lies in those shares. Currently we are finding companies with excellent long-term prospects at prices no higher than average. These include Sasol, Tigerbrands, Mr Price, Aplitech, Sisa, Kersaf, Woolies and Aspen.

Even at Allan Gray we thus see times to buy 'value' shares and times to buy 'growth' shares. Now is the time to be looking to buy good quality shares with above average growth rates at reasonable prices. Yet what we will not do is to pay very full prices for shares where the immediate outlook is rosy, but there is no reason to believe the company has a sustainable edge on its competitors. To us this amounts to speculation, because you depend on another less rational investor to buy your investment before the cycle turns.

In conclusion, we do not think that our relative performance is dependent on so-called 'growth' and 'value' cycles. In fact, at the moment a more appropriate valuation of shares with strong long-term growth characteristics will most likely benefit your portfolio significantly. The markets in which we underperform are those where the prices of certain shares rise or fall far beyond their intrinsic business value. This is what happened to Allan Gray in 1997/8 where certain companies were valued at prices that, with the benefit of hindsight, were many times too high or too low compared with their intrinsic value. The same happened to Orbis in 1999/early 2000 during the Internet bubble.

These investment manias seem to occur about once a decade. In Allan Gray/Orbis's 40-year combined history, we have experienced four periods of significant underperformance. When, and in what area, the next such bubble will be, we cannot predict. What we can say from our past experience is that while these periods (lasting one to two years) may test the resolve of our clients, historically the period of disappointing performance sets the stage for spectacular outperformance as markets return to normal. In all cases, clients that stayed the course with Allan Gray and Orbis reaped returns well in excess of their benchmark.

Commentary by Simon Marais, Chairman