Investment Insights From Morningstar's Investment Management group

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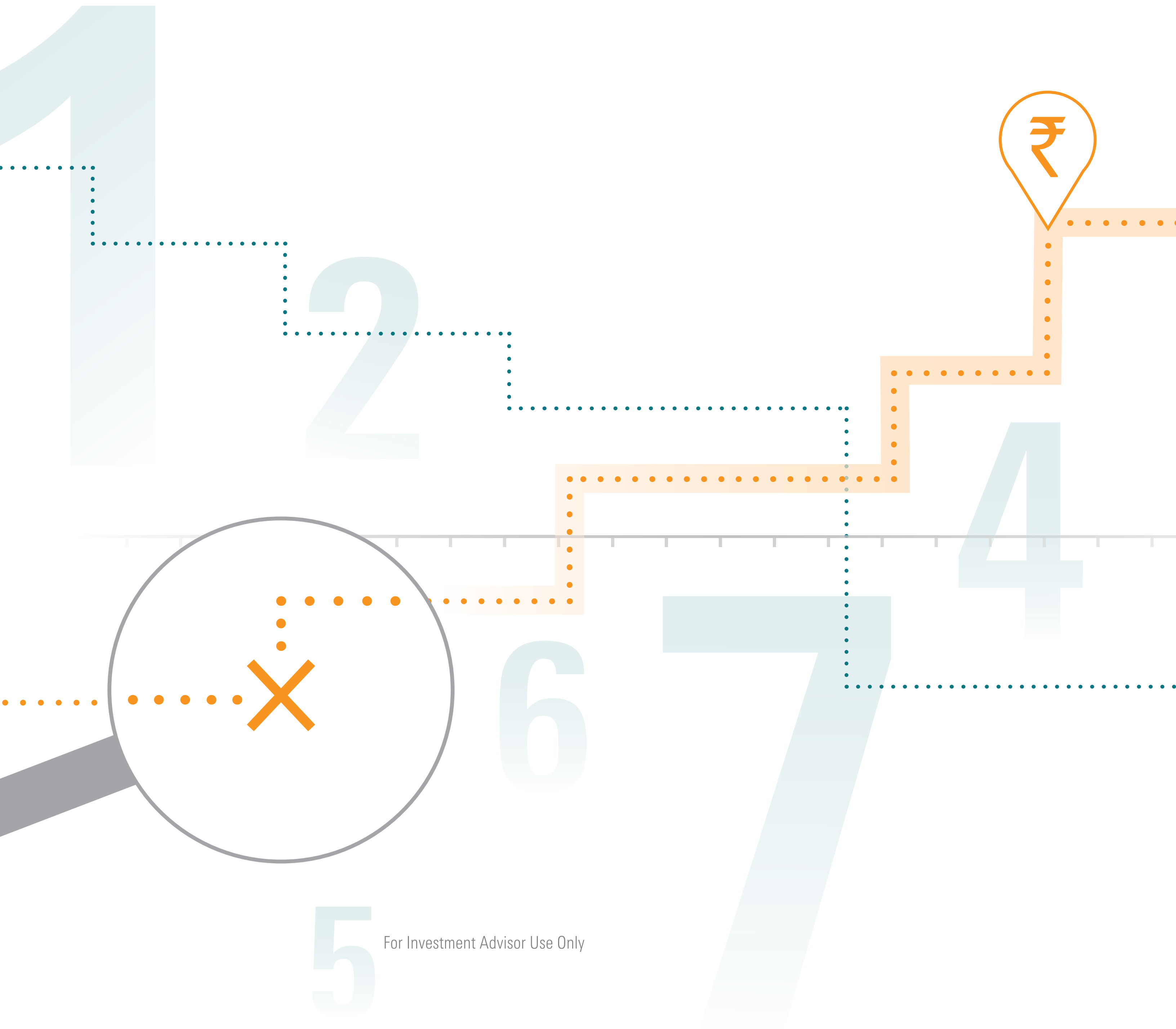
Seven Pointers for Valuation-Driven Investing



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What You'll Learn

- Pointers to help keep your valuation-driven strategies on track
- The difference between risk and volatility
- Behavioral biases to be aware of

At its core, valuation-driven investing is simple: find the fair value of an investment, and only buy it if the price is sufficiently below that fair value to provide a margin of safety against error. Then sell it when the price is significantly above the fair value of the investment.

The mind's lies

But as valuation-driven investor Warren Buffett said: "Investing is simple, but not easy." Investor biases, including overconfidence, the tendency to "find" evidence that confirms our views and undue focus on recent performance all undermine our ability to make wise investment choices. It is exactly these challenges, as well as our mind's ability to steer us off course, that valuation-driven investors seek to overcome.

What valuation-driven investing can do

A valuation-driven approach cannot help investors or portfolio managers predict short-term returns or avoid short-term losses. It is intended solely as a strategy that strives to deliver superior long-term returns. It can help investors of all kinds define the different possibilities open to them, potentially determine realistic estimates of future returns and losses, and identify which assets are most attractive at their current prices.

Valuation-driven investing may be challenging, but we believe it can be ultimately rewarding for investors because it can provide a path to help them meet their long-term investment goals.

Seven pointers for valuation-driven investing

Staying on the road less travelled

For valuation-driven investors to potentially succeed, they must do so unconventionally. They must overcome their biases and often take actions that may directly contradict the views of their peers. It requires great mental toughness to do this consistently, which is why few investors are able to beat the market benchmark over long periods.

What helps valuation-driven investors reach their goals is a process they can stick to that gives them the confidence to always stay the course. We have identified seven tips to help keep valuation-driven investors focused on meeting their long-term goals, even when market changes threaten to distract them.

1 Find the right opportunities

This requires a consistent valuation framework for estimating the fair value of an asset. It also requires a willingness to consider out-of-favor assets. Some of the greatest value opportunities often lie in unglamorous markets, sectors or in companies that have recently experienced bad news, but remain fundamentally strong.

2 Do the fundamental research

You need to be able to distinguish the low-priced assets that will likely recover (the bargains) from those that will likely not (the value traps). You will need to analyze the investment's fundamentals and pay close attention to its qualitative characteristics, such as its underlying growth drivers and governance, to determine whether these characteristics indicate it's a sound investment.

3 Stay mentally tough

Cheap assets or markets tend to be unpopular. Valuation-driven investors must avoid being swayed by other investors' sentiments or market trends. That's why it is so critical to build a solid investment process that includes a rigorous valuation framework and an insistence on a substantial margin of safety. This will help give you the confidence to stick with your decisions, as well as the willingness to change them when circumstances change and an asset no longer appears attractive.

4 Play the long game

Buying an undervalued asset is only the beginning. It may take a considerable period of time for an underpriced asset to return to its fair value. Investors must be willing to hold investments for many years. Don't waste time thinking about unrealized profits and losses along the way. The market only really matters at two points: when you enter and when you exit.

5 Wait for the right moment

Markets do not always offer the same number or quality of opportunities. There are periods in the market cycle when prices are low and opportunities are plentiful and other periods when prices are high and opportunities are scarce. If investors cannot find assets that offer good value, they should consider conserving cash and wait for more-attractive opportunities, rather than commit capital to lesser opportunities with limited prospects.

6 Avoid trading too much

Many investors believe that activity is good and low turnover in a portfolio is a sign that the manager is not making decisions. In reality, exceptional opportunities can be rare, while active trading boosts costs that act as a big drag on returns. Many successful valuation-driven investors devote as much time as possible to research and as little as possible to buying and selling.

7 Hold a range of return drivers

A portfolio that depends too heavily on a single factor to drive returns effectively becomes a forecast of that factor. For example, returns for a portfolio concentrated in energy stocks will be too dependent on oil prices. Such factors are often very difficult or impossible to forecast accurately. So investors should aim to fundamentally diversify their portfolio among different markets and securities in such a way that returns will be driven by a range of unrelated factors.

About risk and volatility (there's a difference)

All investment involves a degree of risk—without risk, there would be no additional return. Rational investors accept as little risk as possible in the investments they're making to reach their financial goals. Yet investors define risk in different, and sometimes contradictory, ways.

Valuation-driven investors define risk as a permanent loss of capital. An example of risk would be lending money to a borrower who only pays back 50% of the loan.

The origins of volatility

While this definition of risk may appear intuitive, it is very different from the concept of volatility, the preferred definition of risk used by many professional investors. Volatility describes the periodic variations in the price of an asset. While volatility may be related to changes in the fair value of an asset, it often represents variations in market sentiment. Investors tend to react to bad news more extremely than good news, so high levels of volatility are associated with falling prices. When volatility is low, prices typically rise.

When to look for bargains

For the valuation-driven investor, periods of high volatility represent the best opportunities to buy assets at prices significantly below their fair value. At the same time, bargains become scarce during periods of low volatility, when valuation-driven investors tend to take a buying break. In contrast, investors who use volatility as a proxy for risk shun bargains in volatile markets and enthusiastically purchase overpriced assets when volatility is low, eating into their returns as a result.

The madness of the crowd

The crowd mentality that sometimes takes over the investment community during periods of volatility can drive prices to extreme levels of overvaluation or undervaluation. This in turn can lead to periods of severe underperformance by fund managers and other investors.

The lonely contrarians

Few investment firms are prepared to tolerate prolonged periods of underperformance. As a result, many fund managers have powerful incentives to follow the crowd in an effort to deliver short-term returns that are similar to the rest of the pack. Keynes described this best when he stated that it was seen as better to "fail conventionally than succeed unconventionally".

This phenomenon was powerfully demonstrated during the dot-com boom at the beginning of the century, when investors who rejected overpriced stocks were ridiculed by their peers, abandoned by investors and in some cases, lost their jobs. Shortly after, the market's correction proved them right.

Morningstar’s approach and investment principles

Why investing isn’t easy

The greatest challenge to valuation-driven investment is not the difficulties of estimating the fair value of an asset or of avoiding value traps, but overcoming the behavioral biases that affect all investors to some extent. These biases were first highlighted by John Maynard Keynes in the 1930s, but were fully identified by the pioneering work of Amos Tversky and Daniel Kahneman in the 1970s. Biases can cause investors to act irrationally when faced with solving the complex problems associated with investment, leading them to make bad decisions and experience poor performance.

Bad news and bear markets

There are many examples of these biases, but one of the most harmful is the availability bias, which encourages us to regard recent information as more valuable than older data. This error, when coupled with the aversion to loss that most people suffer, partially explains why cheap assets can become cheaper. Investors tend to remember the bad news that caused the fall in price more vividly than previous good news. They also prefer avoiding losses over experiencing gains. As a result of these combined behaviors, investors may sell the asset or avoid buying it at the very time they should be considering it.

How Morningstar’s Investment Management group does it

Morningstar’s Investment Management group follows a series of seven investment principles that help our portfolio managers focus on the long term and remain steadfast in their behaviour.
These principles reflect both the findings of academics and Morningstar Inc.’s 30+ years of experience analyzing fund managers. Our principles are designed to counteract the pressures felt by all valuation-driven investors.

We put investors first.

We’re independent-minded.

We invest for the long term.

We’re valuation-driven investors.

We take a fundamental approach.

We strive to minimise costs.

We build portfolios holistically.

Valuation-driven investment is most commonly used to select individual securities, but can also be applied when building multi-asset portfolios. Traditional strategic asset allocation involves relatively static allocations to each asset class and offers little flexibility when market conditions change. Valuation-driven asset allocation, in contrast, allows for total flexibility.

Our principles help empower our portfolio managers to strive and capture the excess returns that are available by consistently applying the valuation-driven approach throughout all types of market conditions.

We regularly publish research and guides on valuation-driven investing. We also put our valuation-driven investing approach to work in Morningstar® Managed Portfolios™, our discretionary portfolio management service designed to meet a diverse range of client needs. The service is available directly and through financial advisers.

Our managed portfolio services can help enhance your investment offerings, strengthen client relationships and streamline your business. Together, we strive to bring your clients the best of both worlds: A plan you've tailored to their goals with many of the advantages of professional portfolio management.

Learn more about how Morningstar® Managed Portfolios™ can help your business.

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