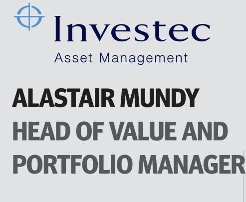
HOW TO MAKE MONEY THROUGH CONTRARIAN INVESTING



ALASTAIR MUNDY
HEAD OF VALUE AND PORTFOLIO MANAGER

Alastair is head of the Value team at Investec Asset Management having joined in 2000 from Morley Fund Management. He manages a number of funds which employ his contrarian approach of investing in unloved, undervalued companies, including the Investec Cautious Managed Fund, the Global Special Situations Fund and the UK Special Situations Fund.

SHARES

RUSS MOULD
EDITOR, SHARES MAGAZINE

Russ Mould has worked in capital markets for 22 years. He started at Scottish Equitable in 1991 as a fund manager and in 1993 joined SG Warburg, now part of UBS investment bank, where he worked as an equity analyst covering the technology sector for 12 years. Russ joined Shares Magazine in November 2005 and was appointed Editor in July 2008.

HARGREAVES LANSDOWN

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HEAD OF RESEARCH, HARGREAVES LANSDOWN

Mark joined Hargreaves Lansdown in 1998 as Head of Research and is one of the most quoted figures in the national media, making regular appearances on TV and radio. He contributes to The Times and The Telegraph and writes a weekly column for the Independent on Saturday.

Today we are looking at contrarian investing which means going against the herd in search of unloved and unfashionable investment opportunities. Warren Buffett, arguably the best known contrarian investor, has built a huge fortune by going against popular wisdom. He bought Goldman Sachs at the height of the financial crisis and last year he surprised even his greatest fans by buying a string of local newspapers at a time when many believe newsprint media is on its last legs.

One of Warren Buffett's most famous quotes is "Be fearful when others are greedy and be greedy when others are fearful". But how do you actually do this in practice? What are the secrets of contrarian investing and the traps to avoid?

Today we are going to explain how you can make money through the contrarian approach. We will also be discussing areas of the market

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which are deeply unpopular at present including banks, miners and Europe, to assess where the best contrarian opportunities may currently lie for longer term investors.

In the hot seat today are Alastair Mundy, head of Investec Asset Management's contrarian investment team and manager of the Investec UK Special Situations Fund, Russ Mould, Editor of Shares magazine and Mark Dampier, Head of Research at Hargreaves Lansdown.

Alastair, some investors believe a contrarian approach is risky because stocks can stay out of fashion for a number of years. How would you respond to that?

Alastair Mundy: I think contrarian investing is seen to be risky because everyone remembers the bad companies that have gone wrong such as Northern Rock. What people forget is there are stocks that go through tough times and bounce back. We are looking for those types of companies that are very out of favour but which have the potential to bounce back strongly in 5 to 10 years' time. The other thing we look for which is very important and should never be underestimated is a decent balance sheet. We are not necessarily looking for the strongest balance sheet in town but a decent balance sheet that can see the company through tough times.

Have you got an example that shows how your contrarian approach has worked in practice?

Alastair Mundy: A stock that has worked very well for us in the last five years or so is Travis Perkins, the builders merchant. In 2007/08 investors were getting very concerned about the length and severity of the economic downturn. We believed that Travis Perkins' very strong market share in the UK would sustain it through the long term and eventually volumes and pricing would bounce back. There were profit downgrades and lots of investors fell out of favour with the shares and decided to sell at almost any price. However we bought them at a very low price and as the stock market and the economy recovered Travis Perkins performed very strongly.

Russ, do you think private investors should consider a contrarian strategy? What traps are there to avoid?

Russ Mould: I believe they should get involved so long as they are prepared to be patient. I don't think this is an approach that brings instant gratification, like momentum investing can for example.

If you are looking to go down this path there are probably three things you need to do. By nature contrarian stocks are unloved - the market is not always right but it's generally pretty smart so you have got to work out why it's unloved and do your research.

Secondly you have then got to work out what's going to change market perception and what's going to help the company through these difficult times. It could be the economic cycle improving, a management change, a restructuring story or a disposal for example. Ultimately, the growth prospects of the company need to improve, the risks associated with it need to come down or the quality of earnings needs to improve. If you can find one of these catalysts to change perception then you are going a long way to finding an unloved stock that could become a loved stock.

Thirdly, as Alastair alluded to, you must make sure the balance sheet is not going to fall apart underneath you because this is probably going to be a bit of a long haul. You need to make sure the company is relatively financially sound and the quickest way to do that is to check the interest cover ratio - operating profit plus interest income divided by interest expense. In a worst case scenario you need that to be more than two.

Mark, for those investors who are considering a contrarian approach, where do you think they should start?

Mark Dampier: You need to start by looking at what you think is already in the share price. Builders merchants such as Travis Perkins were written off a few years ago. Their share price got to the level where things didn't have to get much better, they just had to stop getting worse for the price to recover. Those are the sorts of signs you have to look for. A contrarian approach takes a lot more time and you have to be very patient. But if you can buy things which are unpopular and unfashionable at the right time then that's the way you are likely to make money.

Alastair, turning to contrarian investment opportunities, are there any particular sectors or companies you wish to highlight?

Alastair Mundy: What's quite interesting over the last ten years is how more and more people are calling themselves contrarian these days. Everyone is fishing for out of favour stocks. Typically investors do that when all the other stocks have gone up and you are left looking at the absolute rubbish that no one else wants.

So I think there are certain times when the right thing to do is not to be buying a lot. While we are very happy with our current portfolio at the moment a lot of the stocks which are most out of favour are the mining stocks, which don't have the greatest corporate governance or earnings records. We think it would be incredibly naive just to jump in and buy them because they are out of favour. So for the last 9 to 12 months we have been very inactive on the portfolio.

Clearly you have been finding it quite difficult to find any suitable investment opportunities but surely you must have bought something recently?

Alastair Mundy: Yes, one of the stocks we are most excited about buying at the moment is Carnival. The company owns 46% of the global cruise market and is a fantastic brand name. Everyone loves going on a cruise, especially my parents, and it's a growing industry. Unfortunately, Carnival hasn't particularly profited from that growth. They have had a few tragic accidents recently but we still think it can sort itself out and can be managed better.

In our view cruise holidays are too cheap - this is probably why my parents do go on them. We think that if they stop building new ships then they can get supply and demand back in balance and start pushing up prices. At the moment the cruise companies are continually building more and more ships and not really getting the returns they should be getting from their current asset base.

Russ, have you got any contrarian picks at the moment?

Russ Mould: It is interesting listening to what Alastair said about Travis Perkins in that the company had a good market share and the cycle was eventually going to come its way, as long as the balance sheet could see it through. We think Tesco is quite similar to that. Any company that can make £3.5 billion a year can't be all that bad. It's got a market share of 30% and the new chief executive Philip Clarke has taken some tough decisions to exit Japan and exit the US.

If the company reins in its capital expenditure, as seems likely, we think you have got a potential cash machine on your hands. It's not going to be wildly exciting but you are also getting a 4.5% dividend yield in the meantime. There are about 20 brokers covering Tesco and only 9 rate it as a buy; that's a reasonable starting premise. The company has a decent yield, low-ish P/E (price/earnings ratio) and is relatively unloved so I think that's one where we would be potentially tempted to look right now.

In terms of contrarian sectors, the UK banking sector is still out of favour. Do you see an opportunity there?

Russ Mould: Although the banks are out of favour with the UK public, Lloyds, for example, has been a fantastic performer over the last 12 months - the stock has doubled. So I think the market is holding its nose and getting on with it in some cases. The one that has sagged recently has been Royal Bank of Scotland. The chief executive Stephen Hester left slightly unexpectedly and this discussion of when the government will start to sell down its stake is also weighing on the share price in the short term.

Mark, turning our focus further afield, are there any obvious contrarian opportunities outside the UK?

Mark Dampier: I have been positive on Europe for quite some time. Some of the yields on European growth funds are near 3% or 4%, which shows how unpopular the area has become. It has got some of the leading companies in the world and these companies have got used to politicians messing them around for years and years. They have just got on with it. Hardly anyone is buying Europe and I find that really interesting as a contrarian play.

Alastair, what regions outside the UK do you think offer value?

Alastair Mundy: In our Cautious Managed fund we have been buying a lot of Japan recently, which has been out of favour for so long everyone has almost forgotten about it. What I love about Japan is that over the last 20 years everyone in the investment community has tried and failed to call the bottom of the market. Everyone is sort of embarrassed by that and promised their other halves never to invest there again.

I think Japan has got a lot going for it. There are some fantastic companies out there with great brands and strong balance sheets - when you have been in a recession for 20 years you are going to start looking after your money pretty carefully. It is a country which is very innovative and hardworking and making lots of good products. I just think Japan has been forgotten about because the stock market has done so badly.

However, recently, the Japanese stock market has been rising. All of a sudden those investors who don't own any of it start worrying they are missing out. An investor buying now isn't going to get the cheap valuations but they are buying into a bit of momentum and greater investor interest in the region. I always say to people you don't actually make money as a contrarian investor until other people start agreeing with you. It's absolutely pointless being right on your own. I think Japan is an interesting opportunity to look at now that it is getting a little bit more airtime.

Emerging markets seem to have lost some of their sparkle of late. Although they have considerably outperformed developed markets over the last decade, it has been a different story over the last two years. Emerging markets have registered negative returns over this period compared to around a 20% gain for the MSCI World Index. Mark, why do you think emerging markets have fallen out of favour over the last couple of years and what opportunities might that have thrown up?

Mark Dampier: To some extent I think they have got caught up with the whole commodity cycle. Some emerging markets like Brazil and Russia are commodity exporters. Commodities and mining companies have all fallen a long way which I think is part of the story.

The previous decade has been absolutely marvellous for emerging markets. If you go back to 2000/01 no one wanted to buy these areas because the previous ten years had a most atrocious bear market. Emerging markets have become very fashionable and have been the easy buy. We are seeing some of these gains being given up now as attention has returned to the developed world.

The most recent Chinese growth figures didn't appear to be too bad at all, but then most people don't even believe the figures, so there is that continual worry. A lot of these areas now need some structural reform; in India politicians really need to get their act together and we are not seeing that yet. So I think they are due a bit of a lull.

People should examine their weightings to emerging markets. I have always been passionately keen on this area but I am beginning to think that people with 20% plus weightings to emerging markets should reconsider that and maybe just bring it down for a while. It's a great long term story but in the shorter term I am not so sure. It's become very fashionable which is always a bit of a warning sign – ten years ago I couldn't get a retail investor to buy it.

Russ, it's probably a timely point to remind everyone that we have got somewhat caught up with this BRIC acronym of Brazil, Russia, India and China. However the emerging markets encompass much more than that don't they?

Russ Mould: Absolutely. It's interesting that Mark mentioned the commodities. There are one or two big countries who are net commodity importers, so price weakness there is actually a good thing. If you are Korean it is happy days; the only problem they have got is the Japanese are busy devaluing the yen and

therefore the competitive dynamic is working against them. India is another big net commodity importer so there are angles there. However Mark is right that the majority of them have been net exporters and that's why they have been caught up in the melee.

The other stocks to watch are the UK companies who are big players on the emerging markets theme. Some of the gloss has come off the luxury goods companies recently because they are very reliant on the rising middle classes. The fast moving consumer goods companies like Diageo, Unilever and SAB Miller haven't come off quite so much. It will be interesting to see how they perform over the next few months because they are all quite highly rated with P/E ratios in the high teens.

Alastair, what is your view on emerging markets?

Alastair Mundy: I find the whole emerging market story very interesting. Investors love stories and dreams and they tend to ignore valuations. I think that's where it all goes horribly wrong. That's the concern we have with emerging markets. These are long term stories and quite frankly none of us have got any idea how the long term is going to pan out. I don't even know what I'm going to have for lunch today, let alone where we are going to be in 5, 10 or 15 years' time!

Everyone thinks China is going to be full of middleclass people in the next 10 to 20 years but anything could happen. The last time I looked it was run by a bunch of communists. No mainstream investors I have ever met have had a lot of sympathy in that region and yet they seem to trust them to a certain extent to grow the economy.

We prefer what we know and what has a long track record. If we ever do invest in emerging markets we are much more likely to go to the Unilevers of this world, but even those stocks have had a very good run. Investors have tended to favour stocks with exposure to regions outside Europe.

We bought Unilever more as a recovery story, as a company that was mismanaged or undermanaged for 10 to 20 years and is now growing and catching up. We are not really holding it as an emerging market story per se. We are really holding it as a company that hasn't done as well as its peers and hasn't done as well as it should have done.

Mark, do you have anything to add?

Mark Dampier: Perhaps that brings us nicely on to the domestic UK market. I find that UK investors write off their own market remarkably quickly and easily. They go for the narrative or the great story and forget about their own market. The UK has been a fantastic market to have invested in over the last 10 years, particularly small and medium-sized companies. They have kept up with emerging markets over the last ten years.