Firstlinks
Connecting investors with ideas

THE BEST PART OF MY FUND'S INVESTMENT PROCESS

Firstlinks’ Special 500th Edition

To celebrate the 500th Edition of Firstlinks, we asked a group of about 30 fund managers we have dealt with for many years to consider their entire investment process and drill down into what drives the most success

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firstlinks@morningstar.com

The best part of my fund's investment process

Fund manager investment processes vary widely, from top-down to bottom-up, qualitative to quantitative, growth to value, even intuition and finger-in-the-air. Price should always matter, as Warren Buffett said, "*A too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favourable business developments.*"

To celebrate the 500th Edition of Firstlinks, we asked a group of about 30 fund managers we have dealt with for many years to consider their entire investment process and drill down into what drives the most success, asking:

"What part of your investment process has contributed most to identifying winners?"

Answers varied from the specific to the general with plenty of stock examples.

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Roger Montgomery, Chairman, Montgomery Investment Management

Quality in the factors the market cares about

In a word, Quality. We are wedded to the idea many investment sins can be avoided if there is a single-eyed focus on correctly identifying quality or change in quality. Of course, there are many definitions of 'quality', from a demonstration of sustainable competitive advantage through a persistently high return on equity to a change implemented by management or in the competitive landscape that results in a hitherto unidentified acceleration of the rate of earnings growth.

While many value investors refer to the requirement for a margin of safety in the price paid for an investment, a margin of safety is also required in the characteristics of the business. Whether that's a competitive advantage, a high rate of return on capital, little or no debt, or bright prospects - these are all versions of quality and provide safety for the investor.

Defining quality alone, however, is an incomplete application of the philosophy in an investment process. Lest the investor endure harrowing drawdowns, quality needs to be evident in the factors the market cares most about. Typically this is earnings growth at a rate different to that anticipated by other investors. Finding the source of change within a business that will lead to an acceleration in the rate of earnings growth can help reduce the time an investment is held until the markets identify the investment's merit. Apple, REA Group and Credit Corp in 2010 and The Reject Shop in 2004 all come to mind.

Rudi Minbatiwala, Head of Equity Income, First Sentier Investors

Don't focus on the current dividend yield

Identifying the best stocks is not about focussing on its dividend yield. In the world of equity income investing, that is a counterintuitive statement, as investors will typically turn their attention to the stocks paying out the biggest dividend relative to the stock price. But to us, equity income is about the long-term, where the evidence might suggest otherwise.

In celebration of Firstlinks' recent 10th anniversary and now its 500th edition, let's consider the outcome when pitting two stocks against each other on an earnings growth versus dividend yield perspective. If an investor, at the start of January 2013, put an equal amount into both Telstra, a well-known 'income stock', and REA Group, a low yield 'growth stock', which stock delivered more income?

You may find the results surprising! REA generated more income, and significantly more capital appreciation, compared to Telstra because REA paid a low dividend yield on an earnings stream that was growing over time. Identifying equity income winners requires this disciplined focus on long-term income, not simply near-term dividend yields. So, 'winners' are stocks that produce the strongest income over the long-term. That means looking beyond the stock's immediate dividend yield, and instead focusing on the drivers of long-term growth. REA delivered the higher total income over the 10 years because it was able to reinvest what it did not pay out as dividends. It's an approach that has served our investors well over more than 15 years.

Duncan Burns, Chief Investment Officer, Vanguard Asia-Pacific

Avoid the bad decisions

Great investing is not about picking the winners and earning the highest returns, because the highest returns tend to be one-offs that can't be repeated. Many investment processes and bets fail not because they were wrong but because they were mostly right in a situation that required things to be exactly right. The reality is, investors operate in a world governed by odds not certainties. While there are instances where outperforming the market average occurs, it is not easy and certainly harder than most people think. The SPIVA Scorecard tells us that in the last 15 years, only 17% of Australian equity funds outperformed the ASX200 index.

Good investing is not necessarily about making the best decisions but more about avoiding the bad ones. To us, the keys to winning in investing is best explained by what not to do:

1. Don't put all your eggs in one basket
2. Don't follow (or invest in) fads
3. Don't get carried away with debt/leverage
4. Don't panic (ride out the market cycles)

If there is one part of Vanguard's investment process that has contributed to helping investors win more than any other, it's using broadly-diversified index funds and ETFs as the core for their long-term investments. Individual investors can afford not to be the greatest investor in the world but they cannot afford to be a bad one.

Gemma Dale, Director, SMSF and Investor Behaviour, nabtrade

Sometimes, quality is more expensive

Fall in love with quality. Early in my career I loved the idea of buying quality 'at a discount', and was frustrated that the best companies just never seemed to get (much) cheaper. I have come to accept that sometimes you have to pay more than you want to for a high-quality company, but it will pay dividends in consistent long-term performance.

Also, that 'too expensive' price will look like a bargain in five years' time. The ASX has a small number of companies that have delivered over decades (such as CSL and Macquarie), and they have made their investors very wealthy. By all means, try to find similar high-quality companies trading at a discount but build your portfolio around consistent, long-term performers.

Rajiv Jain, Chairman and CIO, GQG Partners

Forward-looking research

GQG's investment process is centred on identifying quality businesses trading at reasonable valuations. Quality is inherently forward-looking and has meaningfully contributed to selecting winners in our portfolios. Forward-looking quality focuses on the compounding potential of a company over the next three to five years, not backward-looking statistical measures like a value-growth style box framework.

We try to avoid anchoring bias. While we want to learn from history, we are careful not to anchor too much on what worked, and what did not work, in prior years. We think the keys are to be open-minded, follow the data, and adapt as circumstances evolve at a company, within an industry, or in the macro environment.

This forward-looking process was evident during the second half of 2021, when we re-positioned the portfolio to be overweight the Energy sector and underweight Information Technology. Our research helped identify select names in Energy that we felt would benefit from supply shortages due to years of underinvestment, discipline in production growth, a renewed focus on profitability, and a commitment to return capital to shareholders. In Technology, we felt the spike in earnings growth during Covid was not sustainable and valuations that had become very expensive were at risk as central banks were threatening to tighten monetary policy to address accelerating inflation.

Adrian Martuccio, Portfolio Manager, Bell Asset Management

Quality with a strict valuation focus

As a 'Quality at a reasonable price' style manager, our analysis over our 20-year track record of all-cap global investing (6.5 years in small and mid-caps) demonstrates that the majority of alpha has come from stock selection. The 'reasonable price' part is key to not overpaying. In times of market volatility and in the current period of rising interest rates, a strong valuation discipline generally helps to provide some downside protection.

A key element of our process is portfolio implementation, or being diligent about adding and trimming existing positions, finding the disconnects between quality and value, topping up the laggards and trimming stocks when upside becomes more limited or when a company experiences a period of positive momentum.

The qualitative part of our process involves extensive, detailed bottom-up research, with six 'quality' factors considered: 1. Excellent management, 2. Franchise strength, 3. Superior and consistent profitability, 4. Financial strength, 5. Favourable business drivers and 6. Environmental, Social and Governance. Companies must pass all six factors to be considered 'Quality'.

The strict importance on valuation comes in after a company has been deemed 'Quality' and therefore investible. Our investment process combined with strict discipline of executing every step of our investment approach, is what allows us to identify outperforming stocks and have delivered consistent performance over the long term.

Ray David, Portfolio Manager, Australian Equities, Schroders

Consistency driven by deep research

One critical element of our investment process is consistency. No matter the market cycle, the team has stuck to its consistent valuation discipline for over 10 years to identify winners and, even more importantly, avoid the losers. As interest rates rose last year, this valuation discipline served the team well as valuations of the most expensive segment of the market came under pressure.

The valuation discipline starts with building out cashflow forecasts and a valuation for a company. An optimistic and pessimistic scenario is considered, and a 'midcycle' valuation is struck. This sanguine valuation then forms the team's ' True North' in determining if a company's share price is under or overvalued, preventing the team from simply chasing share prices.

Accounting interrogation is another crucial step, especially for the Long Short Fund, as some companies may adopt a more creative approach to accounting standards to boost earnings. A recent example was Downer EDI (ASX:DOW), which had to restate earnings (December 2022) due to accounting irregularities.

The third element of the process is field research. The team spends much time meeting management teams and industry specialists to identify trends and themes that could shape cashflow forecasts and valuation. Given the disruptive nature of technology, business durations are shortening. Understanding a company's risks can prevent forecasting errors. Human emotion can be overridden with logic, as share prices can often swing from over-optimism to deep pessimism, by sticking to our valuation process.

Jeremy Gibson, Portfolio Manager, Munro Partners

Themes or 'Areas of Interest'

As growth investors, Munro finds long-term winners by identifying themes or 'Areas of Interest' where we believe growth is accelerating due to structural changes happening in our world today. These Areas of Interest help us organise the world and assist in discovering companies showing faster revenue growth versus their peers, and a growing total addressable market. These growth factors, in conjunction with evaluating 'customer perception' and 'control' are crucial in our six qualitative tests.

For example, we identified early that Amazon sat at the start of two growth runways. The first was eCommerce, the structural shift from bricks and mortar to online shopping. The second was the shift to the cloud. Amazon Web Services was the first to move into the public cloud infrastructure market. Alongside these growth runways, we overlaid our qualitative factors to help us identify Amazon as a structural winner.

For the 'control' test we considered that Amazon was founder-led. Jeff Bezos - who is both a visionary and the controlling shareholder - makes business decisions for the long-term. For the second test, 'customer perception', our view is that customers are Amazon's core focus. In fact, Amazon famously employs an 'empty-chair strategy', leaving a chair empty at meetings to represent the customer. Amazon has been one of our biggest winners since inception.

Douglas Isles, Head of Investment, Platinum Asset Management

The 'outsider' mentality and thinking differently

Avoiding the crowd is the core of Platinum's value proposition. In an industry full of smart people, our edge comes from having an 'outsider' mentality. We know people struggle with uncertainty and seek refuge in the crowd. This repeatedly leads us to two fruitful hunting grounds: overreactions to setbacks and underreactions to positive change (and vice versa for shorts).

A good recent example was during the onset of the COVID pandemic, when stock markets went into freefall, particularly travel stocks. While investors ran for the hills, we saw that as a buying opportunity. We know that travel is a basic human desire, and hence, we bought some travel stocks at exceptionally low prices, which yielded strong returns for our portfolios as the sector rebounded.

With many portfolios anchored to index weights, thinking differently has never been more important. Many investors do recognise that investing with a manager who has a differentiated perspective provides valuable diversification benefits. This can be seen by looking at the Top 10 holdings in our flagship portfolio, which are often significantly different from those of momentum-hungry managers. Taking positions at odds with the market requires fortitude to stay the course. Leaving the 2000 and 2021 technology 'parties' early made us look like 'dinosaurs' to some. Growth managers were widely lauded at the sector's peaks, but the ensuing sell-off reiterated the merit of holding our nerve.

Marian Poirier, Senior Managing Director, Head of Australia & New Zealand, MFS Investment Management

Collaboration and long-term, active management

The two aspects which have contributed most to identifying winners are focusing on the long-term and collaboration, both easy to say but extremely hard to do in a consistent manner through the cycle, unless you have the right incentives and culture in place.

We have come from an environment where central banks took rates to zero and suppressed volatility, where the Fed and others stepped in frequently to provide liquidity to the market. We are no longer in that place. The investing environment is more fragile, with higher volatility and dispersion, which provides an exciting opportunity for active management. The era of cheap market returns in passive management is behind us. Differentiation matters and having an edge from a time horizon perspective can make a difference.

Today, there is no information advantage, with the instantaneous distribution of news. We believe we have the time advantage, being the ability to tune out the short-term noise and identify the fundamentals that drive long-term value. Active management can identify companies with strong competitive positions, pricing power and cash flows that can relatively protect earnings. On the collaboration side, bringing smart people together with diverse points of view but with similar values can create great client outcomes.

Sean Fenton, Chief Investment Officer, Sage Capital

Long-short driven by eight broad groupings

Our approach is to utilise a long-short structure as a framework to run broad diversified portfolios, take a lot of different stock positions, and control risk at the same time. Two components form our investment process. First, the foundation is a broad, structured quantitative approach, ranking stocks across the ASX200 using factors such as momentum, value and quality. The aim is to exploit the behavioural biases that exist in the market. The second component is thorough fundamental research.

We use eight broad classifications of stocks more tailored to our process, also known as 'Sage Groups':

- Defensives - supermarkets, telcos and hospitals
- Domestic Cyclicals - building materials or retailers
- Global Cyclicals - broader businesses like Brambles, mining services, agriculture and chemicals

- Growth - any company with above-market earnings growth, such as healthcare companies like CSL or ResMed, technology companies like WiseTech or consumer discretionary businesses like Breville.
- REITS - companies that own, operate or finance income-producing real estate
- Resources - all the commodities except gold, which we strip out due to its volatility
- Yield - banks, insurers and diversified financials
- Gold - companies involved in the gold mining industry.

We select long and short positions across the eight groups, meaning the portfolio is style-neutral and insulated against broad macro swings. We rely on our idiosyncratic views of the companies and the factors that are driving their earnings and valuations to get genuine alpha into the portfolio.

Dougal Maple-Brown, Head of Australian Value Equities, Maple-Brown Abbott

A contrarian look for margins of safety

We are bottom-up stock pickers, so valuation lies at the heart of our process. As part of our valuation discipline we have a sharp focus on the valuation gap (or margin of safety). The best opportunities are generally where other investors are unwilling to play, often because their investment horizon is the short term, whereas we are prepared to invest on a longer-time frame.

Finally, we are usually contrarian as investors rarely make money running with the crowd. That can be uncomfortable, particularly in the short term, but for us, that is almost always where the biggest opportunities lie. A recent example would be our overweight to Energy in 2022. At the beginning of the year the Energy stocks globally were unloved, even more so in the Australian equity market, and that provided rich pickings for those prepared to wait.

We are not in the business of forecasting 'catalysts' (there are plenty of brokers and market commentators who try!) but when Russia invaded Ukraine the commodities moved sharply higher, it enabled us to realise value for our Energy holdings.

Dushko Bajic, Head of Australian Equities, Growth, First Sentier Investors

Avoiding the fashionable consensus

The stock market cycles through what is in or out of favour, 'the fashionable consensus'. When we are confident a company will deliver good returns and has structural growth, but the market thinks it is cyclical and will fade, we get the best situation of all – an undervalued stock with a long runway of profitable growth ahead. Our best investments are those where the market underestimates how strong growth in earnings will be and for how long it can endure. Investing against what is considered prevailing 'fact' requires fortitude and patience.

The work that has the most enduring shelf-life is our focus on understanding industry structure and a company's position within it. This part of our investment process most helps to identify mismatches between our conclusions and the 'in-fashion' view. Why? Largely because it is 'timeless'. The work has been tested by factual observations and is unobscured by the 'fashion of the day'.

It is a common misnomer that being contrarian is only something value mangers can channel to achieve success. Equally common is the view that growth managers over-estimate how long strong growth can persist. Our long-term winners have all outgrown our initial forecasts by a wide margin and for much longer than we estimated, but we were on the right side identifying this via our detailed industry and stock studies.

Daniel Moore, Portfolio Manager, IML

Identify a major change

Great investment ideas can come from anywhere, but the one thing we've found most consistently generates winners is identifying change – specifically, major changes to a company, or to the environment it operates in. We have a fundamental investment process to identify companies which have: a strong competitive advantage, recurring earnings, capable management, can grow their earnings, and represent good value.

We have identified four types of change that can create great investment opportunities:

- CEO or Chair
- Industry structure (e.g. consolidation)
- Balance sheet (e.g. recapitalisation)
- Company structure (e.g. acquisition/divestment/demerger)

Here are two good historical examples.

First, change in Chair at BHP: BHP historically had a poor track record of acquisitions, which destroyed shareholder capital. Then, in 2016, Ken MacKenzie was appointed to the board and became Chair. This led to a significant improvement in BHP's governance, capital allocation and consequently its share price.

Second, change in telecommunications industry structure in 2021: Prior to 2021 Australia's telecommunications industry had been in a period of intense price competition, which led to declining margins and returns. After Vodafone and TPG, and Optus and Amaysim merged, it led to more rational behaviour, increased pricing, higher returns and a strong rebound in Telstra's share price. The market is generally slower to pick up and assess these kinds of qualitative changes. This is in stark comparison to earnings upgrades/downgrades, which the market prices within seconds.

Chad Padowitz, Co-Chief Investment Officer, Talaria Asset Management

Recognise the market's behavioural biases

Behavioural biases can negatively impact stock selection and therefore the likelihood of picking winners. It is often the biases, whether conscious or not, that stand between strong fundamental skills and a good investment performance.

An example is that we do not meet company management as this can impose confirmation and authority biases. A positive forward growth story delivered by an influential and successful CEO or CFO can lead to a very appealing narrative for investors to buy into but can relegate the fundamental data to a lower level of importance for the analyst who is researching.

We do not have biases to sectors or regions and we are not led by a theme or 'flavour of the day' story. Moreover, our investment team is relatively small, with only six people. A large team can often lead to group think which amplifies rather than alleviates biases. Finally, our holding period is on average three years, reducing the risk of overtrading, that is often costly, distracting and short-sighted. When we combine rigorous bottom-up analysis alongside these important ways to reduce potentially damaging biases, we greatly improve our ability to identify winners.

Steven Bennett, Direct CEO, Charter Hall

The right tenant is crucial for property investment

Charter Hall's investment process recognises the importance of the tenant customer. By that, I mean we have real estate experts located on the ground where our properties and tenants are located so we understand both the underlying property markets and what our tenants value. We focus on financially strong tenants in growing markets and because we understand tenants' requirements, we have a high level of tenant retention. This maximises the rent we achieve for our investors and the tenant relationships are deep. We often have the same tenant across multiple property sectors, such as Coles, where we own their head office in Toorak, Victoria, and many of their warehouses and shopping centres throughout the country.

Identifying a winner in property also means being able to access the highest quality real estate. Charter Hall owns more real estate in Australia than anyone else and this scale brings access to property deals and opportunities that competitors don't even get to see. Examples range from off market property acquisitions to sale and leaseback transactions, of which we have completed $10 billion in transactions. We understand that property is a relationship business and our deep relationships in the Australian market unlock great assets for the benefit of our investors.

We develop high quality assets so that our suite of property funds obtains access to modern well-located property with strong environmental credentials and great amenity. These are the kind of properties that tenants want to be in long term.

Christopher Demasi, Portfolio Manager, Montaka

Structured prospecting for new ideas

Our organic research process, or structured prospecting, has contributed the most to identifying winners. On a daily basis, our investment team spends time researching industries and companies which generates numerous new ideas for us to consider analysing. This process has led to investments in winners like Microsoft, ServiceNow and Blackstone over the years.

Arian Neiron, CEO and Managing Director-Asia Pacific, VanEck

Answering the 'why'

There is no identifiable aspect of our process that has contributed to VanEck's success. Rather you could say our 'winners' are due to our 'why', which has been our DNA since 1955 when Mr John C. van Eck Jr was recognised the potential opportunities in the post-World War II economic recoveries of Europe and Japan by offering an international portfolio to investors.

Likewise, VanEck's Australian business was launched by a local executive team with deep investment management experience and that passion to bring the best quality investment solutions to clients. Coincidently, our 10-year anniversary is in the same year as Firstlinks and equally our business is also about better access and transparency.

Some of the 'winners' in our first 10 years include our Australian Equity (MVW) and International Equity (QUAL) ETFs which allow investors to achieve the outcomes of active management with the low costs of passive management. Other highlights that exemplify our 'why', include ASX:SUBD, which is an opportunity borne from APRA's new capital adequacy requirements for Australian banks; and ASX:CLNE and ASX:XCO2, which give investors access to the energy and carbon opportunities of the future. Our 'winners' democratise investment opportunities with forward-looking, intelligent ideas that enable investors to drive outcomes for their portfolios.

Trevor Gurwich, Senior Portfolio Manager, American Century Investments

Identify positive inflection points

A key driver of selecting winners is our focus on identifying positive inflection points that lead to accelerating and sustainable earnings growth. A positive inflection could be driven by a new product launch, an acquisition, or an expansion into a new geography.

As global small cap investors, we benefit from a universe of over 6,000 companies and an asset class that tends to have lower levels of sell-side coverage compared to large caps. This translates into persistent inefficiencies allowing us to identify companies with improving fundamentals and where that improvement has not been fully appreciated by the markets. If we can recognise the inflation point soon enough, both the earnings growth and the valuation re-rating benefit our portfolios. Change, including both in company fundamentals and share prices, tends to occur more frequently in small caps relative to large caps and we believe that creates opportunities for our bottom-up approach.

For example, Crocs, a footwear company specialising in casual footwear and accessories, has delivered accelerating and sustainable earnings growth supported by strong pricing for its core brand, continued digital engagement with its customers, and its recent acquisition of HEYDUDE, another casual footwear company. Its acquisition will also likely have a much greater impact on earnings growth compared to a similar acquisition by a large cap company like Nike or Adidas.

Jun Bei Liu, Lead Portfolio Manager, Tribeca Investment Partners

Find a strong franchise and management team

Consistently picking winners in the share market has always been the holy grail that investors seek. But there isn't just one factor or a switch that can lead to this outcome. Finding winners starts with the right investment process and doing the right thing again and again with rationality and clinical assessment.

There are two important things that will drive a company's share price. The first is its fundamental quality (the core earnings drivers, revenue strength, cost measure, and future growth drivers and projections). The second, particularly for the shorter term, is the investor's risk appetite that will determine the share price outcome. With decades of market experience, we have found that the driver of return is finding businesses with a strong franchise and management team, and most importantly finding the right time to invest. We spend a lot of our time performing due diligence on the assets and understanding competitive market dynamics. A strong relationship with management teams in the Australian market also provides us with incredible insights into the drivers of the business. We often have 20 companies on our watch list that have passed our quality assessment. The next step is to wait for the right time to invest. The great thing about the share market is that there are always bargains available as a result of changes in investors' risk appetites, so we take advantage of those opportunities whenever they appear.

Matt Reynolds, Investment Director, Capital Group (Australia)

A system to tap into the ideas and insights of many

Doing one thing, and one thing only for more than eight decades tends to make any organisation rather good at that one thing. This type of active focus enables ideas and processes to be tested and validated; it helps identify your own decision-making strengths and weaknesses; it builds resilience to noise that comes from periodic volatility; it enables an organisation to adapt to evolving client needs; and it inspires them to remain committed and actively focused on that one thing.

A major part of what makes Capital Group a global leader in investing is its investment approach – the Capital System (SM). Rather than relying on the ideas, preferences and decisions of one or two key portfolio managers, the Capital System (SM) taps the intelligence of many, each individual acting independently, with conviction and according to their personal experience and insight.

While managers collaborate and share insights, each invests independently according to their strongest convictions. The resulting portfolios are a diverse collection of investment ideas, not just one manager's perspective. This process, the Capital System, has for many decades underpinned Capital Group's ability to identify 'winning' investment ideas and it remains the bedrock of our investment process.

James Abela, Portfolio Manager, Fidelity Future Leaders Strategies, Fidelity International

Blending quality with momentum

A key element of my investment process that helps identify winners is my blended approach to incorporate both quality and momentum stocks into my portfolio. If I look at the top contributors to the Fidelity Future Leaders Fund since inception nearly 10 years ago, the list is dominated by global quality long-term growth 'compounder' companies in the Australian mid and small-cap universe; Resmed, Altium, Fisher & Paykel, Corporate Travel Management and Wisetech Global.

These are companies that are market leaders in their field, with high returns on capital, and are solving problems or operating in a brilliantly unique way. Moving down the list, the next 15 stocks include a mix of quality growth and opportunistic momentum themes across consumer staples (2017/2018 - a2 milk, Bellamy and Blackmores); electric vehicle resources (2018-2022 - Pilbara Minerals, Galaxy Resources, IGO Ltd); consumer services (Aristocrat Leisure) and property services (Charter Hall Group).

Share prices in the long run are ultimately driven by the reality of earnings, however, the multiples they can hold are determined by the market perception of the duration of these earnings or the scarcity of the earnings. Quality growth companies tend to trade at high multiples because of the longer sustainability of the earnings stream. Momentum companies tend to trade at high multiples when they are experiencing high growth, higher returns on capital as they hold a unique exposure to a theme that the market is seeking at that point in time.

Investors need to consider however, the pitfalls for both quality and momentum stocks. For quality, the red flags tend to be new or intense competition, higher capex investments that reduce returns or poor management behaviour that will ultimately drive earnings, trust and valuations down over time. For momentum, it's being aware of the triple peak in earnings, valuation multiples and sentiment when the 'animal spirits' place stocks at high risk of disappointment.

Shane Woldendorp and Eric Marais, Investment Specialist and Analyst, Orbis Investments

Search where fear hits markets

We look for ideas in out-of-favour parts of the market, where fear has taken hold. This contrarian approach builds on traditional value investing – buying shares trading at low multiples of earnings, book value or cash flow – which itself has worked well for hundreds of years. Value investing works because it's driven by the human instincts of greed and fear, leading investors to run with the winners and away from the losers.

The temptation in markets is to extrapolate what worked well recently far in the future because it seems so obvious that the winners will keep winning, but in doing so the winners become expensive and the losers are left in the dirt. History shows that value shares outperform growth shares, and our approach is to try to own the best of the value shares.

For example, we bought Apple shares after Steve Jobs passed away and Toyota during a large vehicle recall. More recently, we've invested in Korean banks, which are out of favour with many investors following a decade of repressive financial conditions, and trade at less than five times earnings despite what we believe is a brighter outlook. Our contrarian approach means we're also unlikely to find ideas in the most exciting areas of the market. For example, in the late 1990s TMT bubble we had almost no exposure to the sector.

Romano Sala Tenna, Portfolio Manager, Katana Asset Management

A trigger that the market misses

Such a good question that it requires two answers. I'll start with classic investment theory, right out of the repertoire of Warren Buffet. The criteria that most likely identifies a winner is the combination of a high growth stock with a high return on invested capital (ROIC). Identify stocks that can grow at an above average clip and have a high return on each additional dollar invested. Such companies literally become compounding juggernauts.

However, the problem is that such companies are truly rare in the Australian landscape, everyone knows who they are and they trade on increasingly higher valuations. So in the absence of identifying such companies early, there is a second and more common hallmark that our process attempts to identify. It is companies that have an imminent trigger which (additionally) has been missed by the market, often due to a competing rhetoric. A trigger that becomes more certain and more imminent as time passes yet market noise has drowned it out.

A good example in the past 12 months was Woodside Energy Ltd (WDS). As the ESG and decarbonisation chorus grew increasingly louder, many investors missed what was happening with WDS's underlying commodities, in particular LNG. By the end of 2021, WDS was still plumbing around the $20 level. Yet LNG futures had risen almost five-fold from ~US$8/mmbtu at the beginning of the year to nearly US$40/mmbtu by year end. This dramatic rise in spot prices guaranteed a record profit and an inevitable rerating in the share price.

John Malloy, Co-Head of Emerging & Frontier Markets, Redwheel

Top-down macro drives bottom-up research

Our process combines top-down macroeconomic and thematic research that channels the direction of bottom-up research, with the in-depth local knowledge and company analysis work from equity analysts. The team selects securities with the most attractive risk-adjusted return profile, often driven by being early adopters of key thematics that drive research efforts.

One of the strategy's key thematics is New Auto Tech. There is a dramatic change taking place in the world's transportation sector. New Energy Vehicles (NEVs) are replacing vehicles with internal combustion engines (ICEs). NEVs powered by batteries (Battery Electric Vehicles) and hydrogen require a different composition of materials for their construction and operation, which leads to a new set of beneficiaries within the automobile supply chain. The growth in orders and production of NEVs should benefit the end producers of these types of vehicles.

However, the team also recognises there is a considerable growth opportunity within the upstream segment of the New Energy Vehicle value chain. Demand for commodities such as lithium, nickel, cobalt, copper and platinum group metals should rise exponentially as the penetration of NEVs increases worldwide. One key beneficiary of this thematic is Sociedad Química y Minera (SQM). SQM is a lithium-focused mining company that has contributed to +757 bps of relative outperformance so far as at the end of January 2023. The strategy continues to hold a position in the company's stock.

Adam Grotzinger, Senior Fixed Income Portfolio Manager, Neuberger Berman

Seek multiple sources of income returns

Neuberger Berman's Strategic Income fund seeks to add value from multiple sources including a combination of duration/yield curve decisions, asset allocation, rotation across fixed income sectors, and security selection. The strategy has the flexibility to pursue opportunities across global fixed income markets in an unbiased way.

Allocations are made based on where we see the most value, as opposed to what is included in an index. We implement a disciplined and repeatable investment framework that includes multiple layers of risk management. Bottom-up fundamental credit analysis informs security selection. Through various market cycles and during recent market dislocations, we successfully navigated volatility by relying on our process, which helps us minimize downside capture and reposition portfolios to generate attractive, forward-looking returns. We have done this without incurring excess credit, interest rate or liquidity risk.

Brad Dunn, Senior Credit Analyst, Daintree Capital

For bonds, nothing is worse than a default

For a bond or credit investor, there is nothing worse than a default. Even the perceived risk of a default can be enough to create deep scars on portfolio returns. What's more, if losses are realised by selling the asset, recovering that lost performance is a long and laborious process. Thus, it is imperative that the portfolio manager and credit analyst have a constant dialogue and a clear process to identify potential credit quality risks as early as possible. By being cautious and acting quickly, we have a better chance of protecting performance.

A recent example from our portfolios is Credit Suisse. Following the losses revealed from the collapse of Archegos and Greensill, we knew this would have capital impacts. We cut our exposure to Additional Tier 1 capital securities, realising a small loss that was mitigated by proper diversification. This was despite the yields screening as attractive relative to peers. Subsequently, further concerns arose around governance and liquidity, leading us to review our only remaining exposure, a senior secured offering with less than one year to maturity. The market had already begun to reflect some of these concerns in the form of a widening spread, which made the security appear attractive. Knowing how quickly a bank can get into real trouble, we severed all links to the issuer. This might seem drastic, but if the situation had deteriorated further, we would have few options to mitigate our position. Sometimes, high returns just ain't enough.

Angus Dennis, Investment Director, Australian Ethical Investment

True-to-label investing in future-building companies

Australian Ethical's unique investment process combines rigorous ethical assessment and bottom-up, fundamental investment analysis to determine the companies we include in our portfolios. We're a true-to-label ethical investor and our Ethical Charter's 23 underlying principles favour lower-carbon, positive-impact sectors, resulting in portfolio overweights in future-building sectors like healthcare, information technology, communications and renewables. The difference between what we do and what others do is that we're more focused on identifying resilient and sustainable business models than we are about trying to pick macroeconomic trends.

An example of this is Pilbara Minerals (ASX:PLS), which supplies lithium for electric vehicles and energy storage and was one of our top performing holdings in 2022. We invested in PLS several years ago at around about $0.70 and, despite some interim volatility, it's currently trading at over $4 due to increasing demand and improved pricing for lithium on the back of faster electrification of the automobile industry and the increased use of battery storage in electricity supply networks. PLS is successfully expanding its lithium mining production volumes and investigating downstream lithium processing in order to meet the expected future demand and retain a higher share of the profit margins available.