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Ninety One

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Investing for a world of change

Value investing Q&A: Finding opportunity in uncertainty

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Key takeaways

- The Value team hunts for mispricings in moments of rising uncertainty in markets.
- Returns come from two sources: emotional arbitrage (seeking to be rational when others are irrational) and time arbitrage (being more patient than others).
- The team's competitive advantage is behavioural and enduring. They are willing to move towards uncertainty and tolerate investing through discomfort. Investment decisions are underpinned by deep fundamental analysis.
- For each investment, a satisfactory return must be achievable through cash distributions and earnings growth alone, without relying on re-rating. Re-rating is seen as a free option.

Where does the Value team find investment opportunities?

It helps to think of markets as places where people come to debate the fair value of securities. Everyone has their own perspective and biases. Most of the time, the 'mistakes' market participants make in assessing fair value are uncorrelated, and so tend to cancel each other out. Consequently, markets are usually efficient. In this environment, it takes a lot of work to uncover relatively minor mispricings of shares. We do not believe this is the most profitable use of our time.

But sometimes there is an event – be it market-wide, sector-specific or idiosyncratic to one company – that colours the views of all participants. When such events are negative, they generate an increase in uncertainty; or rather an increase in the perception of uncertainty. This almost always leads to lower stock prices. In such instances, the errors investors make become correlated because they are all affected by the same input. Markets become less efficient, potentially leading to significantly mispriced securities. These instances of rising perceived uncertainty are the conditions in which we like to hunt for investment ideas[1].

How does the investment team generate a return on value investments?[2]

When share prices become dislocated from intrinsic values, we look to generate returns in two ways. The first is through 'emotional arbitrage': exploiting the sub-optimal behaviour of market participants during periods of high uncertainty. We look at stocks that are unpopular, neglected or misunderstood, seeking to be rational when others are irrational.

The second way is through 'time arbitrage', which means being more patient than others. This is useful when investing in 'quality compounders' – good companies that can reinvest and grow – where patience allows for the intrinsic value of the company to increase over time. Patience also yields returns when investors need to endure a temporary setback for a value opportunity to be realised. We have found it typically takes three to five years, sometimes longer, for an investment thesis to play out fully.

How has your approach to value investing changed?

There has been a gradual evolution in our understanding of what contrarian investing is for. In our value strategies' earlier years, we were primarily focused on capturing negative sentiment: studying markets for instances where participants were being particularly negative, and using that negativity as a proxy for irrationality. Today, we think of ourselves first and foremost as students of business who employ contrarianism as a tool to make asymmetric investments – i.e., shares that are trading at prices we believe offer more potential upside than downside. The behavioural edge (monitoring shifts in market sentiment to identify mispricings; see below) is the mechanism by which we access investment opportunities at the right price.

The philosophical shift is subtle but consequential: the starting point now is not the behavioural aspect of the price dislocation, but the quality of the business and the attractiveness of the risk-reward. We think the result of this evolution is lower risk of being led towards businesses that are cheap for a good reason, or of holding positions through protracted periods of disappointment without sufficient compensation.

[1] For further information on investment processes, please see the Important information section.
[2] All investments carry the risk of capital loss and past performance does not predict future returns.

How do you decide whether a stock is sufficiently good value to invest in?

We look to buy cashflow streams at a significant discount to intrinsic value. Our threshold is a minimum internal rate of return (IRR) of 10%, though we typically target at least 15% on a three-year view[3]. Crucially, we require that this return is achievable through cash distributions and earnings growth alone (the combination of which we call 'owners' return'), without relying on a re-rating of the stock (an increase in the valuation multiple). We treat multiple expansion as a free option. In low-growth companies, we generally want our entire minimum return hurdle of 10% to be covered by distributions, while in growing companies it will be more balanced between distributions and earnings. In this way, we have exposure to potential upside through two drivers: fundamental returns (distributions + growth), and the less predictable returns from re-ratings.

How do you decide what size position to take in a company?

The size of the position is driven primarily by our assessment of downside risk, rather than upside potential. For a business where the range of outcomes is narrow and we feel the downside is understood, we are willing to hold a larger position. For a business where the potential outcomes are wider or the balance sheet less robust, we will size more conservatively regardless of the potential upside. In short, expected upside informs the decision to invest or not; downside assessment determines how much capital we commit.

As a team, what is your investment edge?

Our edge is primarily behavioural, supported by an analytical foundation that makes the behavioural advantage actionable.

From a behavioural perspective, we think two characteristics are key to capturing mispricings. First is the willingness to move towards uncertainty when other market participants are retreating. This sounds straightforward but is difficult in practice, because the moments when doing so is most valuable are precisely when it feels most uncomfortable. The second is patience: the ability to hold an investment through periods of discomfort long enough for a fundamental thesis to play out.

From an analytical perspective, investment edge comes from the depth and independence of our fundamental research. We build conservative intrinsic value estimates from first principles, focus heavily on downside analysis, and have developed pattern-recognition across a wide range of businesses and industries over many years. It is this analysis that gives us the confidence to act on our behavioural instincts when others are retreating.

What type of person makes a good value investor?

Above all, we look for independence of thought. You need to have a self-starting attitude; the courage and confidence to stand up for your own views and back yourself in hard times; kindness and humility, so that you can accept that you might be wrong; and the ability to engage in debate with an open mind. Many of these traits are in tension with each other – the right balance between humility and self-belief is hard to define precisely, but we know it when we see it.

Also, it is crucial to be willing to be uncomfortable. Moving towards uncertainty, buying stocks that are falling, holding through periods of underperformance when you believe the thesis is intact – these are things that most investors find difficult, and that the structure of most investment organisations actively discourages. We have built a team and a culture where this behaviour is not just tolerated but expected, and where the social and professional cost of being early or wrong is absorbed collectively rather than falling on any individual.

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[3] The IRR is an investment screening threshold, not a fund return target.

How important is team culture to value investing?

Team culture is perhaps the least visible, and most underappreciated, aspect of risk management and return generation. We think the culture and working environment we have built is a core pillar of our differentiated investment approach. It is easy to dismiss as unimportant, hard to observe from the outside and very difficult to replicate. But allocators who focus only on the mechanics of an investment process (stock screens, research outputs, position limits, etc.) can miss the fact that culture is doing at least as much work as any of these mechanics.

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