

Now's the time for contrarian investments

By Philipp Wörz

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Investment markets move in cycles. Sometimes, opportunities abound to acquire the businesses we love to own: higher quality companies that are out of favour and hence cheap. Now is such a time.



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Our process is designed to capture contrarian investment ideas. We seek out mispriced quality assets in uncrowded areas, where above-average quality companies are available at below-average valuations. These companies often have strong inherent qualities that are obscured by temporary issues.

We believe that investors can put the odds in their favour by allocating capital to companies with 'hidden qualities', as they come with vastly different price tags relative to those where quality and growth attributes are visible to all. Additionally, once these hidden attributes become more visible to everyone, the potential to unlock value can be immense.

If you are prepared to expand your investment universe and invest in what is not popular, you can buy companies that are trading at big discounts to what we think they are worth because expectations are very low. By contrast, visible quality and secular growth stocks are attracting a very high rating that carries a lower likelihood of meeting expectations, and hence long-term returns are likely to disappoint.

Opportunity exists where fear abounds

While the performance of global stock indices have been flattered by expensive large caps, a large proportion of global stocks are in deep bear markets and we calculate that 84% of SA stocks are in a bear market. Emerging markets and cyclical companies are more vulnerable to the deep global recession and hence find themselves deeply out of favour. The market in 2020 has treated cyclical companies with operating leverage harshly, and has been particularly brutal for businesses with financial leverage.

We have observed many examples where limited recognition was given to out-of-favour companies that have strong business models and which should recover swiftly. In many cases, stocks that have the capacity to carry higher levels of debt were unduly punished. This opened the opportunity to buy more resilient companies that are temporarily impacted by the recession. Local examples include Discovery and the JSE. Offshore we have been buyers of AB InBev, Liberty Global, Prudential and Berkshire Hathaway. We also favour cyclical companies that can be acquired on very low valuations such as AECI, Imperial and Exxaro (domestically) and Glencore, Mosaic and Simon Property (globally).

The current opportunity is perhaps best illustrated by the case study below looking at Berkshire Hathaway.

Why is Berkshire currently so out of favour?

The market is currently obsessed with new economy growth stocks. The Berkshire portfolio, except for its large holding in Apple, is dominated by old economy investments: financials, energy and utilities. Also, its current size makes it difficult to match the exceptional growth rates of the past and increasingly, commentators are viewing it as conglomerate.

In a market where momentum investors are winning, it has become popular to refer to Warren Buffett as a 'has-been'. As a result of these and other factors such as the US recession, Berkshire is currently trading at similar valuation levels to the more recent excellent buying opportunities in 2008, 2011 and 2015.

We think the 'old economy conglomerate run by a has-been' narrative is far from the mark. What is missed by this narrative is the quality of the business and its investments, especially its insurance operations, and the price paid for a superior company. The long-term track record of this business bears testimony to the inherent quality of its operations and the competence of the capital allocation. Its insurance businesses are the jewels that sit at the centre.

Not only are they uniquely consistent generators of underwriting profits – they also provide permanent capital in the form of a massive float. Berkshire also sits with a remarkable US\$130 billion war chest that is ready to be deployed if opportunity arises. This fortress-like balance sheet and willingness to provide capital in times of distress has been one of the key factors behind strong relative performance in tough times in the past.

Now is the time to harness opportunities

Investment markets will always move in cycles. There will always be reasons for companies falling into and out of favour. The current circumstances have given rise to a number of exceptional companies falling from grace. We remain firm in our belief that investors who are able to harness the opportunities available will be rewarded in the long term, as has been the case in previous cycles.

ABOUT THE AUTHOR

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