momentum

asset management

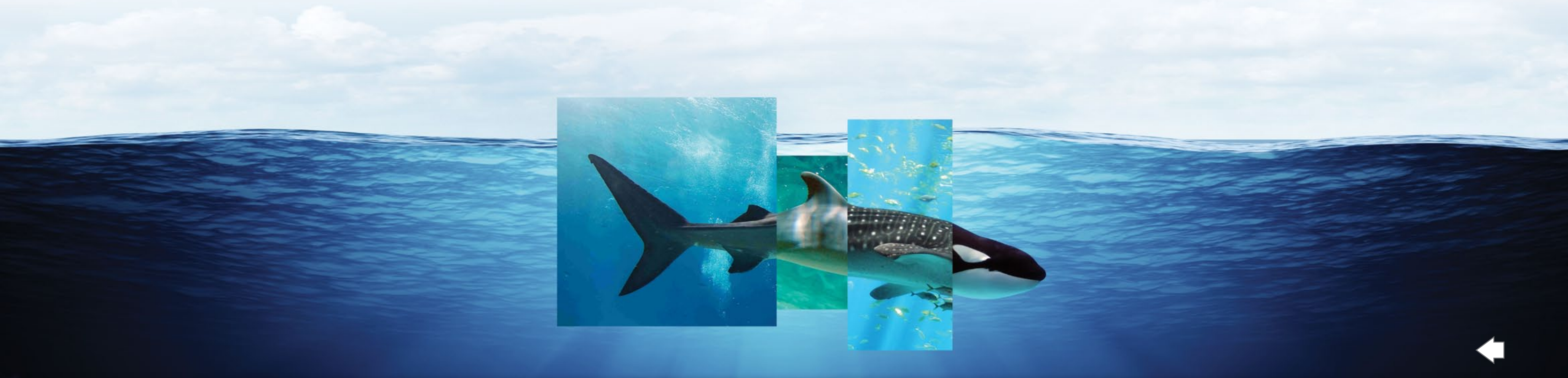
on the contrary

momentum asset management unconstrained strategies

february 2014

Philosophical alignment, independent thought, cognitive diversity.

contents



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foreword

Welcome to 2014 and our second edition of *On the Contrary*. We are typically sceptical of New Year's resolutions and the convenience of calendar year-ends. This time around, however, we embrace the potential of a fresh start and, in some ways, are happy to have 2013 behind us.

Last year was a very challenging year for us, as well as the clients who have entrusted us with the responsibility of allocating capital on their behalf. Our positioning proved to be completely out of sync with the eventual market outcome and, in that context, the current edition is filled with a full spectrum of backward and forward-looking articles. There is much to learn from the past year, but there is also much more to look forward to.

Also included is an update on our team and how we have navigated markets since our inception eighteen months ago. In *Back to the future*, we look back on 2013 and provide some of the insights and learnings we believe have relevance for the future. We provide some additional background on the Momentum Value Fund and showcase one of our best equity ideas. In addition to a book review, we also provide clarity on our current positioning and our investment rationale.

All the best for 2014 and thank you for your continued support.

Sam Houlie

Rodger Walters

Shwebi Gqosha

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Shawn Stockigt

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Mpandekazi Maneli

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team and investment update

By Sam Houlie: Head of Unconstrained Strategies

How is your team settling in and how have things progressed?

Our team was established in July 2012 and we have been going about the business of investments for close to eighteen months. The team was established and settled very early on. It was important for me that the team was able to focus on investing, with minimum distraction.

The nicest thing is that a high percentage of the team have worked together successfully before and that our investment offering is no different to what we have delivered in the past.

More importantly, we are managing real money in all our key underlying capabilities, which was my primary objective from the outset. In practical terms, it means that we are not asking new clients to seed us or be a significant proportion of our assets under management.

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Please remind us of your underlying philosophy?

In domestic equities, we are traditional value investors. In practice, this means that we invest in stocks that discount very low expectations (as reflected in a low price to fundamental valuation metric, like sales, assets or earnings).

Normally, the above paragraph would suffice, but, in South Africa today, the paragraph needs additional qualification or clarification.

- Today, everyone calls themselves value investors (because the term rolls off the tongue very easily and is accepted by listeners as a sign of credibility).
- This is important because saying that you are a value investor in South Africa today provides no differentiation, everyone describes themselves as value investors and can articulate it very well (this is in direct contrast to the late nineties, when just a handful of managers were brave enough to label themselves as value investors).
- In my view, the huge success of value investing up to mid-2010 has contributed to this phenomenon. This period included three major financial crises (the emerging market crisis in 1997/1998, the Dotcom bubble crash in early 2000 and the late 2007 to early 2009 global financial crisis (GFC)) and value investing typically comes into its own during crisis-induced market corrections.
- The reputation of value investing was thus enhanced during the various crises and, as a result, describing yourself as a value investor resulted in a positive association with the philosophy (even if your actions were not aligned with the approach).
- It is, however, very clear that things have changed quite dramatically in recent months. The absence of a significant crisis/correction since early 2009 (and, particularly, the strong market performance in 2013) has led us to a situation where value investing is again laughed and scoffed at.

I would also add that value investing is typically contrarian in nature. Stocks trade at low multiples to fundamentals because they have a variety of issues or challenges and sellers are willing to exit at ever-lower prices. Which is why we say value investing, necessarily, requires you to go contrary to the prevailing opinion when you buy a stock. So, value investing is inherently contrarian.

Finally, the empirical evidence supporting value investing is very compelling, but, while it works over time, it does not work all the time.

Why is a contrarian view particularly relevant in the current market?

In general terms:

A contrarian view offers the most value when diversity has broken down within any market or asset class. It is not what market participants say that matters the most, but what they do (the old adage about actions speaking louder than words).

We often say: "Just look at our portfolio and make up your own mind". Reverse engineering actual portfolios reveals that only a handful of domestic managers are currently positioned contrary to the market (those managers will, in all likelihood, be the worst-performing managers over the last 24 months). They have been early, but timing it right is impossible. Our view is clear: we would rather be early than a day late.

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We have seen this happen before. The post-GFC recovery (March 2009 to present) has hidden a multitude of sins and made everyone look better. I can, however, clearly recall 2008, when only a handful of managers were willing to avoid resource stocks (and being early then was better than being late because the market correction was both sudden and deep). Holding the benchmark index in 2008 exposed investors to deep and permanent drawdowns and the importance of being contrarian was obvious and very evident then.

As it turns out, market participants have already forgotten 2008 and yet it is the most recent example of how value-conscious, contrarianism can add significant value and avoid permanent capital losses.

More specifically, with regard to the current market environment:

The current market is even more extreme than 2008 and has many features that increase the importance of a contrarian view:

- Since mid-2010, the unashamed efforts of central banks to support asset prices via quantitative easing (QE) have distorted the market. Market participants are not unaware of the distortion, but continue to buy risk assets because they believe central bankers are omnipotent and there appears to be no incentive to distrust their ability to navigate the future.
- A massive and growing disconnect between the rising level of the market and deteriorating fundamentals exists. In aggregate, markets have risen due to multiple expansions, while earnings have declined.
- The disparity between cheap and expensive stocks continues to widen (cheap stocks are getting cheaper, while expensive stocks are getting more expensive). This disparity is even more extreme than it was at previous market peaks in early 2000 and June 2008. Trend-following and price-momentum strategies (which both ignore valuation and fundamentals) have been extremely effective for the last 24 months. As a consequence, indexation and benchmark-cognisant strategies are now fully exposed to the most expensive and popular themes in the market. Financial market history shows that a market is most vulnerable when it is most overvalued and overbought.

So, in summary, the prospective payoff for a contrarian portfolio today is huge, precisely because investor complacency is high and very few are positioned for a reversal in the tailwinds that have supported the market for so long.

How long do you see this view holding value?

This is the million dollar question. Unfortunately, timing and valuation are not comfortable bedfellows.

I would say that this view will hold value until such time as there is adequate diversity reflected in the composition of the market (and we are a long way away from that today). In truth, there is no way of knowing exactly how things will play themselves out. It could be quick and deep (like 2008) or it could be longer and more drawn out (like 2000 to 2003).

Why would some investors shy away from a contrarian manager?

The reasons are mostly behavioural. It is very difficult (from a behavioural perspective) to watch the market go up relentlessly while the performance of your contrarian manager lags or even declines. Investors want full exposure to the peak of the market and they typically believe that it is possible to time your exit perfectly. This is the most common reason for investors avoiding a contrarian manager.

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The outperformance of contrarian managers is lumpy. Most investors would prefer steady, incremental outperformance as it is more pleasant (incidentally, nobody has been able to achieve the Holy Grail of steady, incremental outperformance over multiple cycles, except Bernie Madoff, and we now know what was happening there).

Contrarian managers are willing to embrace controversy and their portfolios have very little exposure to popular or good-news stories. They typically express a minority view and, if the market goes against such a manager, there is no place to hide. This could be an unpleasant experience (for obvious reasons).

When should an investor not consider a contrarian view?

Valuation and being contrarian are linked. A cheap valuation protects you against uncertain events (things that you cannot anticipate or forecast often happen).

So, firstly, if the valuation is not cheap or you have doubts about the robustness of the valuation, you should avoid being contrarian (it will be like playing with fire).

Secondly, you need a rational framework for deciding whether you should go against the prevailing view of the market (this involves both quantitative and qualitative considerations). If you don't have a meaningful variant perception, you should similarly avoid being contrarian.

Why should pension funds consider contrarian philosophies?

Pension funds are ideal because they have a long investment time horizon and this gives them the theoretical ability to make a long-term commitment to an investment strategy on a rational basis.

They should, therefore, consider contrarian philosophies for two predominant reasons:

- The empirical evidence supporting value investing is very compelling. Value investing is inherently contrarian and makes sense on a long-term basis. The key is finding a manager with the discipline and patience to execute consistently over long periods of time and multiple cycles.
- There are a variety of ways to invest successfully and contrarian investing is only one such style. On the premise that investing styles move in and out of favour over time, it makes sense to increase (decrease) your allocation to the contrarian style as it moves in (and out) of favour.

Anti-cyclical allocation is preferred, which means a bigger allocation after contrarian investing has underperformed for an extended period of time (and vice versa). ■

'Pension funds are ideal because they have a long investment time horizon and this gives them the theoretical ability to make a long-term commitment to an investment strategy on a rational basis.'

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back to the future

By Sam Houlie: Head of Unconstrained Strategies

A strategy of buying stocks with high near-term earnings momentum, while ignoring high valuations, worked very well in 2013. In contrast, our typical strategy of seeking low valuations and depressed returns on equity only applied to two of the stocks in the top 15. Reverse engineering the list of winners, however, reveals that none of our preferred investment criteria were present and our lack of exposure is therefore entirely consistent with our articulated approach to investing.

2013 was a phenomenal year for equity markets worldwide and the JSE ALSI was certainly no exception when measured in local currency. Buoyed by the tailwinds of a weakening rand and rampant liquidity, our local bourse mimicked the global trend.

It is a market of stocks and, as in any given year, there are winners and losers. Table 1 and 2 on the next page list the winning and losing stocks respectively and offer valuable insight into the strategies that were most successful in 2013.

Table 1

Winners		2013 absolute performance		Price to book		PE (x)		
Rank	Share name	Capital return	Total return	31 Dec 2012	31 Dec 2013	31 Dec 2014	2013 EPS growth	Latest ROE
1	Coronation	101.6	113.2	8.5	14.0	19.2	110.3	72.6
2	Mondi plc	98.7	104.0	1.6	2.7	20.1	54.8	10.6
3	Naspers	101.8	102.6	12.3	20.0	61.6	28.1	9.3
4	Mondi	95.0	100.2	1.6	2.7	20.0	54.8	10.6
5	Grindrod	76.8	79.7	0.9	1.4	21.9	12.9	8.2
6	Capco	68.7	68.9	1.2	1.7	124.7	90.8	24.1
7	Steinhoff	64.5	67.7	1.0	1.5	12.9	21.7	12.4
8	Telkom	66.7	66.7	0.3	0.7	4.0	311.0	-49.8
9	AECI	56.6	60.9	1.6	2.3	16.6	34.6	15.6
10	Aspen	59.0	60.0	4.1	5.4	34.1	25.5	15.4
11	Richemont	57.3	59.0	3.7	3.9	22.5	29.2	21.5
12	New Europe Prop	48.6	56.4	2.1	1.8	34.8	51.9	13.6
13	Omnia	47.1	50.8	2.1	2.5	15.4	15.5	19.1
14	Sasol	41.8	47.8	1.8	2.3	9.8	24.9	17.6
15	Hosken	44.3	45.6	1.0	1.3	15.6	0.9	9.9

Source: I-Net Bridge and Factset

Table 2

Losers		2013 absolute performance		Price to book		PE (x)		
Rank	Share name	Capital return	Total return	31 Dec 2012	31 Dec 2013	31 Dec 2014	2013 EPS growth	Latest ROE
1	Harmony	-65.0	-64.7	0.9	0.4	-36.5	-112.3	-9.7
2	Goldfields	-68.3	-63.9	1.5	0.6	49.1	-93.5	-6.8
3	Abil	-62.6	-61.9	1.8	1.5	26.7	-86.8	-42.8
4	Anglogold Ashanti	-53.1	-52.9	2.2	1.4	12.3	-55.8	-43.3
5	Massmart	-32.0	-30.3	8.7	6.1	23.9	-1.4	16.2
6	Foschini	-32.0	-28.4	4.6	2.8	11.1	4.5	25.8
7	Truworths	-29.4	-26.5	6.9	5.2	13.7	8.4	38.7
8	Impala Platinum	-26.7	-26.1	2.0	1.5	37.3	-51.8	2.0
9	Shoprite	-19.8	-18.2	8.2	5.9	24.3	11.3	24.2
10	Kumba Iron Ore	-22.0	-16.7	12.2	7.3	11.4	-18.6	84.0
11	Tigerbrands	-17.9	-15.7	5.2	3.8	16.9	-4.2	19.5
12	Assore	-16.4	-15.1	3.5	3.0	10.0	-2.7	24.4
13	Aveng	-13.8	-13.8	0.9	0.7	22.8	-3.3	3.5
14	Tongaat	-15.7	-13.5	1.9	1.3	12.2	-1.5	12.3
15	Amplats	-11.7	-11.7	2.4	2.0	-122.3	-181.7	-10.0

Source: I-Net Bridge and Factset

The winning stocks had some very admirable qualities. They generally exhibited strong growth in earnings and relatively high returns on equity (ROE). Price/earnings (PE) valuations at the end of the year were very high (and remember that this is after incorporating the strong growth in earnings over the course of the year, which is another way of saying that high starting valuations were compensated for by subsequent earnings growth). Price to book valuations increased significantly from already high levels, supported in most cases by high and sustained ROE. In that context, a strategy of buying stocks with high near-term earnings momentum, while ignoring high valuations, worked very well in 2013.

In contrast, our typical strategy of seeking low valuations and depressed ROE only applied to two of the stocks in the top 15

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(Steinhoff and Telkom), both of which we owned at the start of 2013. We remain holders of Telkom, but we sold our entire position in Steinhoff in the fourth quarter of 2013.

We believe that one year's earnings are a poor proxy for the present value of all future cashflows that a business will generate. We are even more sceptical when ROE are already at peak levels and earnings are expected to continue growing from very elevated levels. In addition, high price to book multiples are only justified in those rare cases where the underlying business has a sustainable competitive advantage and/or dominant intangible assets.

Reverse engineering the list of winners in **table 1** reveals that none of our preferred investment criteria were present and our lack of exposure is therefore entirely consistent with our articulated approach to investing.

The losing stocks had very few admirable qualities. They generally exhibited negative growth in earnings and abysmal ROE. Price/earnings valuations at the end of the year were reasonable and price to book multiples decreased significantly from relatively low levels, justified in most cases by low and declining ROE.

In that context, a strategy of buying stocks with horrendous near-term earnings momentum and very low price to book valuations was disastrous in 2013. As depicted in **table 2**, the significant decline in price to book valuations meant that these cheap stocks simply became even cheaper during 2013.

The losing stocks have much more in common with our typical approach of buying cheap and un-loved stocks. It should, therefore, not be surprising that we owned eight of the 15 stocks listed in **table 2**. In particular, we have to highlight that we had zero exposure to the retail stocks listed and you will notice that their stock prices (and price to book valuations) declined in 2013, despite generating solid earnings growth and maintaining high ROE. It would appear that there is a point (that cannot be precisely predicted) at which no amount of good news can induce new buyers to pay ever-increasing prices for a stock.

The natural question that flows from the **table 2** is: Why would anyone be interested in any of the losing stocks when they are so obviously disastrous?

Given our high exposure to the stocks on the losing list, we are happy to give you some of our high-level reasons for purchasing them:

- Mean reversion in profits and valuations remains a powerful force in financial markets. It is not uncommon for sustained growth in profits and valuations to be followed by a period of reversal (and vice versa).
- Periods of short-term earnings destruction are often correlated with substantial company and industry upheaval (which improves the quality and sustainability of future profits). We don't enjoy short-term earnings declines, but we enjoy what they often signify: a low base for future growth.
- We are attracted to extreme mispricing and fat tails. They are more likely to occur when things are unfavourable and negative conditions are being extrapolated.
- Finally, the empirical evidence supporting low price to book investing is very compelling over the long term (even though it is less effective over shorter time frames and during the euphoric phase of an extended stock market cycle).

So, looking back (to 2013), we know what worked. However, looking forward, we would be surprised if the same strategy prevails in 2014. ■

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momentum value fund

By Sam Houlie: Head of Unconstrained Strategies

"...not a year on which I shall look back with undiluted pleasure. In the words of one of my more sympathetic correspondents, it has turned out to be an Annus Horribilis."

***Queen Elizabeth II**, in a speech to the Guildhall on 24 November 1992*

"...defeats are part of tennis. What matters is how you react. What is also important for me is that I am honest with myself. I am the sort of person who often questions everything; I did the same when things were going really well for me. I can see no reason why I shouldn't play better again in 2014, and have some great wins. I have still got some major goals, because I certainly haven't forgotten how to play tennis."

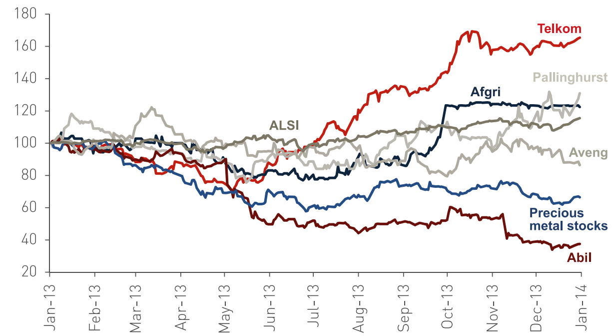
***Roger Federer** in a late-2013 interview*

2013 was indeed an *Annus Horribilis* for the Momentum Value Fund, which continues to have an above-average weighting in resource stocks (relative to both the market and the average fund). In a similar vein, a sector which seems to have been ignored by the flood of liquidity during the last 24 months has been the domestic resource sector and, as a consequence, we are naturally drawn to the potential disconnect between price and fundamental value.

I quite enjoyed the response from Roger Federer after what, by his ultra-high standards, was a disappointing season. It resonated with us as 2013 was a difficult performance year for us and we have been as introspective as we would have been had it been a great year. Investing is not tennis, but we share his view that there is no reason for 2014 not to be a much better year as we have not forgotten how to apply value, contrarian investing and have a very good understanding of the conditions that need to prevail for our performance to improve.

Graph 1 provides a good depiction of why our overall fund performance lagged the market. Although our fund allocation included winners, our losing positions overwhelmed and dragged down our overall fund performance.

Graph 1



Source: I-Net Bridge

Our winners possessed all the attributes we seek: deep undervaluation, out of favour and no obvious catalysts at the time of purchase. The extent of undervaluation was so

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significant that we continue to hold the stocks after such strong appreciation. Afgri is the exception as we are awaiting the cash after the company was the subject of a cash offer at 700cps. Our winners prove that value investing remains effective and our valuation methodology is robust.

In a similar vein, a sector which seems to have been ignored by the flood of liquidity during the last 24 months has been the domestic resource sector. As a consequence, we are naturally drawn to the potential disconnect between price and fundamental value. As also depicted in graph 1, our high and concentrated exposure to precious metal stocks contributed to our lagging performance in 2013.

The Momentum Value Fund and the Momentum Small/Mid-Cap Fund continue to have an above-average weighting in resource stocks (relative to both the market and the average fund).

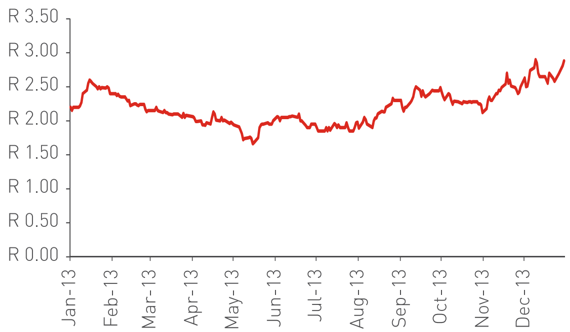
At the individual stock level, Pallinghurst is a perfect example of the compelling value we are finding in the resource sector.

Pallinghurst has a strong management team (which includes ex-BHP CEO, Brian Gilbertson, as chairman and Christo Wiese as independent non-executive director) and well-capitalised balance sheet.

The business is really the aggregation of three investments:

- Gemfields (listed in the UK), which is a world leader in producing emeralds and includes the luxury brand, Faberge.
- Steel materials, which includes Australian-listed Jupiter Mines.
- Platinum Group metals, which include the Sedibelo properties formed last year through a consolidation of Sedibelo properties and Platmin (previously listed).

Graph 2: Pallinghurst



Source: Bloomberg

The stock has really taken off since the fourth quarter of 2013 and, despite the recent rally; we believe that it remains cheap. We built our position during the early part of 2013 when Pallinghurst traded below the value of its listed investments (which were both cheap in their own right, trading at tangible net asset value). The recent increase in the stock price has unlocked some of that value, but we believe the market is still placing too little value on its share of platinum asset, Sedibelo.

Precious metals and related stocks are currently out of favour and the continuous spate of negative headlines seem to fuel the negative sentiment. Our valuation estimate of Sedibelo is conservative (and well below the value placed on the asset by well-informed third parties). Furthermore, Sedibelo is likely to be listed in the near future and this could unlock substantial value. Pallinghurst has a fortress balance sheet, with substantial cash after a 2012 rights issue.

2013 was indeed an *Annus Horribilis* for the Momentum Value Fund. 2014 is a new year and we have not taken our eye off the ball (pun intended). Our premature positioning (in hindsight) has remained virtually the same and there is no reason why market conditions cannot swing back in favour of our value, contrarian style (as it eventually always does). ■

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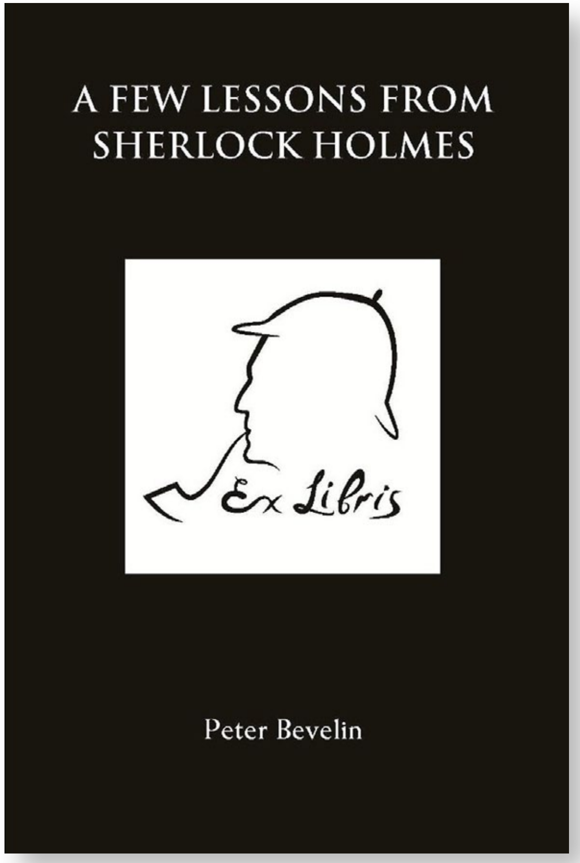

book review

By Sam Houlie: Head of Unconstrained Strategies

As you may already know, the title of this publication was inspired by my love of, and fascination for, the Sherlock Holmes character and his inimitable phrase: *"On the Contrary, my dear Watson"*.

You can well imagine my delight when I read the recently published book on Sherlock Holmes, written by one of my favourite authors, Peter Bevelin (incidentally, I would also recommend that you read one of Peter's earlier books entitled *Seeking Wisdom: From Darwin to Munge*).

I really enjoyed his latest book, but recognise that my inherent bias could blur my objectivity. In my view, the fictional character of Sherlock Holmes has much relevance to the art and craft of investing.

The book is an easy read and does not require prior knowledge of the Sherlock Holmes stories and plots. The author has taken the time to organise the stories into timeless lessons and principles and, in that way, the book provides a great framework for thinking.

There were a few gems that relate quite well to the craft of value, contrarian investing:

- *More information isn't necessarily better information, but it may falsely increase our confidence – what is not worth knowing is not worth knowing.*
  We have intentionally limited our team size as we always try to focus our attention on the most critical and relevant issues.
- *It is useful to know something about human nature and what motivates people.*
  We try to have a heightened awareness of the many systematic biases exhibited by human behaviour and in human decision making.
- *Considering many ideas over a wide range of disciplines gives us perspective and helps us consider the big picture.*
  We recognise the benefits of cognitive diversity and looking at investment opportunities from a variety of perspectives.
- *And learning never stops.*
  Self-explanatory. Ideally, experience and introspection should lead to better judgement and decision making.

Needless to say, I **strongly recommend** giving this book a read. ■

fund positioning

Momentum Small/Mid-Cap Fund

Top 10 holdings
Pallinghurst Resources Ltd
Afgri Ltd
African Bank Ltd
Sun International Ltd
Pick 'n Pay Holdings Ltd
Stefanutti Stocks Holdings
Aveng Ltd
RCL Foods Ltd
Sibanye Gold Mining Ltd
Harmony Gold Mining Co Ltd

Portfolio characteristics	
P/BV	1.2
P/E (normalised)	9
Dividend yield	2.9%
Number of holdings	51
Top 10 % total	41%

Momentum Value Fund

Top 10 holdings
African Bank Ltd
Anglo American Plc
Reinet Investments SCA
Gold Fields Ltd
Impala Platinum Holdings
Anglo American Platinum C
Afgri Ltd
Harmony Gold Mining Co Lt
Sibanye Gold Mining Ltd
Pallinghurst Resources Ltd

Portfolio characteristics	
P/BV	0.95
P/E (normalised)	7
Dividend yield	3.1%
Number of holdings	28
Top 10 % total	57%

Momentum Global Franchise Fund

Top 10 holdings
Nestle SA
British American Tobacco
Unilever Plc
Altria Group
Phillip Morris International
The Coca Cola Co
Kellogg Co
Pepsico
Procter and Gamble
Imperial Tobacco Group

Portfolio characteristics	
P/CF	14.5
P/FCF	16.4
P/BV	4.9
P/E	18.8
Dividend yield	3.8%
Number of holdings	32
Top 10 % total	52%

Momentum Global Contrarian Fund

Top 10 holdings
Cheung Kong Holdings
Dundee Corp
Reinet Investments SCA
Loews Corp
Microsoft Corp
Accenture Plc
Fairfax Financial Holdings
Ultra Petroleum Corp
Apple Inc
American International Group

Portfolio characteristics	
P/CF	11.1
P/FCF	13.4
P/BV	1.7
P/E	15.2
Dividend yield	3.2%
Number of holdings	71
Top 10 % total	24%

Momentum Institutional Global Balanced Fund

Asset allocation	
Domestic equity	38.4%
Domestic cash	20.3%
Domestic bonds	15.6%
Foreign equity	26.1%
Total	100%

Momentum Flexible Fund

Asset allocation	
Domestic equity	38.9%
Domestic cash	2.2%
Commodities	3.5%
Domestic bonds	24.9%
Foreign equity	17.2%
Foreign cash	13.5%
Total	100%

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Back page and disclaimer

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