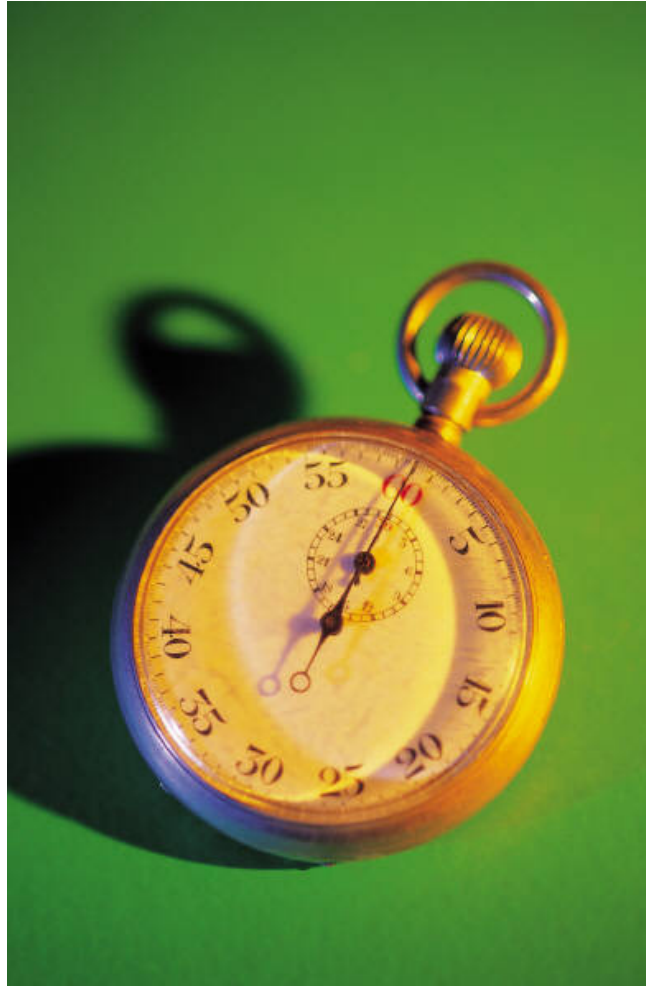


A Last Gasp for Growth?

Why It Pays to Remember



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“History does not repeat itself, but it does rhyme.”

Mark Twain (Samuel Langhorne Clemens) (1835-1910)

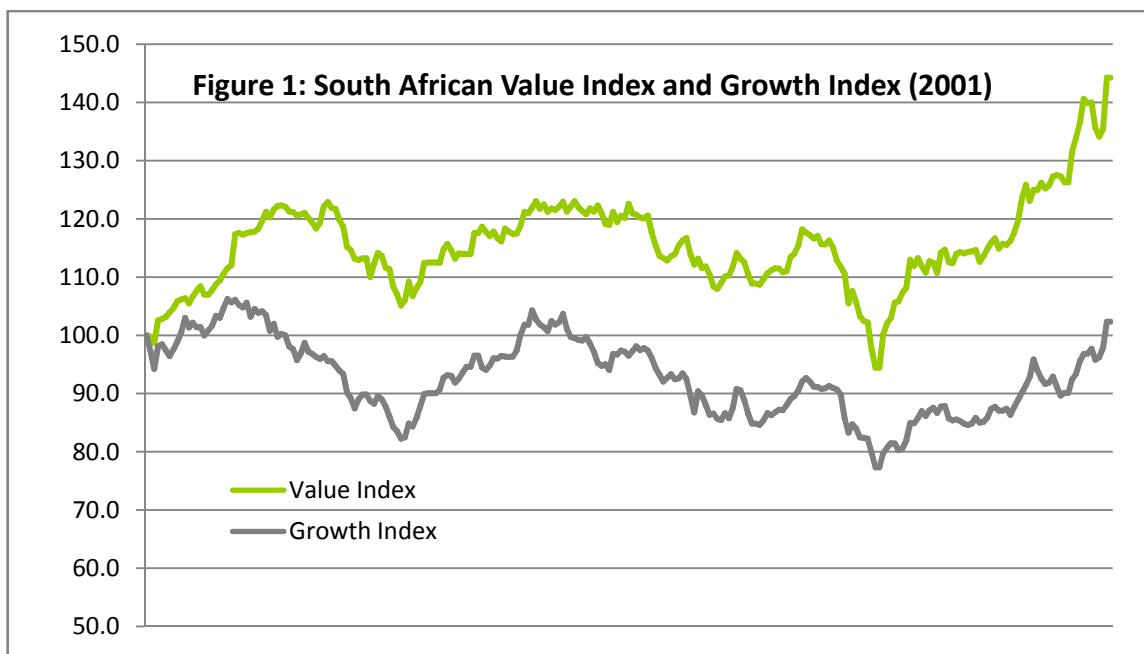
1. Value versus Growth: The Evidence

Active investment managers belong to one of two philosophical camps, namely the value school or growth school. Each stance has its strengths and weaknesses.

The growth philosophy, for instance, runs the risk that blue sky potential does not materialise or that high growth environments disappear faster than anticipated. An example of strength in growth investing resides in the powerful upside available where great companies are identified early, as was the case with DiData in South Africa in the late 1980s until 2000.

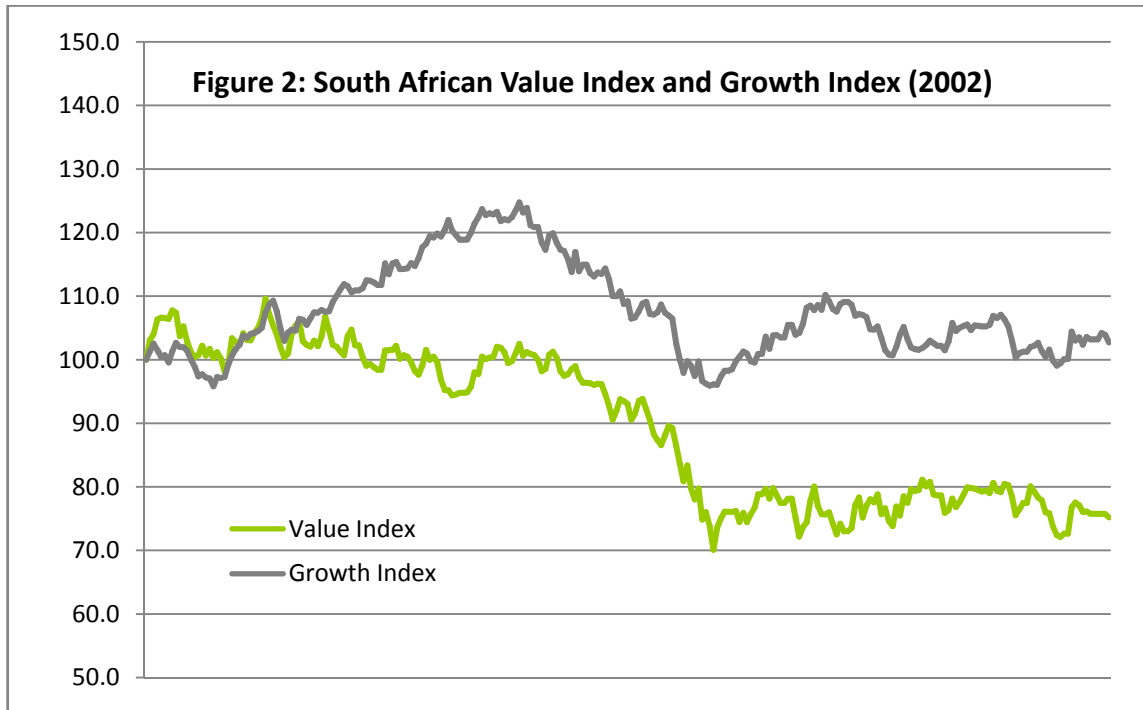
By contrast, failure in the case of value investing might stem from value remaining trapped because catalysts do not materialise, or from management failing to recover underperforming assets. Telkom stands out as a possible contemporary example of this type of risk. An example of strength in the value philosophy is its lack of reliance on forecasting – something that investors are hopelessly bad at. In this vein, because value investing places emphasis on known elements, it means that downside risk tends to be much smaller than in the case of growth investing.

The bold differences that exist between the two schools of thought mean that at times one philosophy presides over the other. Considering the performance of South African stocks, for instance, it is the case that value stocks outpaced growth stocks by a wide margin in 2001 as the latter fell from grace with the collapse of the technology-media-telecommunications bubble (see Figure 1).



Source: Reuters and Cannon Asset Managers (Pty) Ltd

However, the following year, 2002, as South African equities struggled under the bear market environment, growth stocks outperformed value stocks by a wide margin (see Figure 2). Then, over the next three years, to the end of 2005, value stocks again outpaced growth stocks.



Source: Reuters and Cannon Asset Managers (Pty) Ltd

In short, style success rotates though time. Most recently, growth investing has had the upper hand. Since early 2007 to present, South African growth stocks have taken up the running – reflective of growth’s outperformance during the bear market environment of 2003, noted above. To be sure, since the middle of last year, growth stocks have outperformed value stocks by about nine percent.

2. The Global Evidence on Style

Notwithstanding the most recent victory for growth, investors would do well to remember that of the two philosophies, value has demonstrated itself to be the superior philosophy through time and across geographies. In this regard, the most compelling evidence was led a decade ago by Eugene Fama and Kenneth French in their now-famous 1998 article Value versus Growth: The International Evidence. In that study, Fama and French showed that over the 20-year period 1975-1995 value stocks outperformed growth stocks in all of the world’s major markets by an average

of 5.8 percent per annum. Further, value stocks beat the market by an average of 2.9 percent per annum.

The case is no different in South Africa. By way of example, value stocks delivered an average annual return some 10.2 percent ahead of growth stocks over the period 2000 to end 2007; and the performances of value stocks against growth stocks in earlier decades reinforces this result. In short, if history is any guide to the future, the value approach holds out the greater prospect for investment success.

3. The Growth Seduction

Unfortunately, the recent strong market for growth stocks alluded to above has resulted in many investors losing the advantage of this perspective. Furthermore, style drift, which sees investors changing horse midstream, is an enemy of long-run success. It is expensive to sell a value portfolio into a growth portfolio; and it will be costly to convert a portfolio of growth stocks back to value stocks when market sentiment returns.

Against this backdrop, drawing on a recent note by Martin Jetzer, Chief Investment Officer at HSBC Geyerzeller Bank in Switzerland, it is useful to revisit some of the key aspects of value investing and to reflect what it means to be a value investor.

4. What It Means To Be Value

Value investing is a conservative approach; it buys what is 'safe and cheap', which is sharply different from growth investing. 'Safe' refers to survival of the business, 'cheap' to a stock price that is significantly below what a competitor or private equity fund would be prepared to pay (consider the case of Edcon, taken off the market by Bain Capital in 2007 at a hefty premium to the pre-transaction price).

In value investing much more emphasis is put on price than is the case with growth investing, where the analyst is outlook-conscious rather than price-conscious. Yet, it is often when the outlook is most bleak that deep value emerges. Being in the heart of the sub-prime crisis, and surrounded by pessimistic economic forecasts, now is an ideal environment for a value orientation.

Value investing is usually associated with asset value (broadly defined to encompass intangible assets) rather than company growth. Indeed, it is often the case that investors overlook asset value as they concentrate on 'growth'.

Taking a single year's earnings seriously remains one of the biggest mistakes in financial analysis. The most successful value investors have warned about this aspect of investment analysis since 1934 when Graham and Dodd's first edition of *Security Analysis* was published. The book remains the bible of value investors to this day. Earnings volatility is uncomfortable and hard to stomach when the surprise is negative, but earnings volatility is an inescapable aspect of any modern corporation. Recall Buffet's observation on this score: "I'll take a bumpy 15 percent over a smooth 10 percent any day."

In value investing, headline indicators such as forecasts of interest rates or gross domestic product are ignored. Businesses are viewed as going concerns. Value investors are reluctant to predict. Value investors are often opportunistic, taking advantage of falling prices and focusing on the quality of resources that a firm can and should utilise rather than worrying about this year's profits. The dream is to buy a good business at a cheap price (or at least at a reasonable price).

Depressions occur in industries as in economies. For example, the last 40 years has seen depressions in steel, energy, banking, real estate, airlines and motor industries. Stocks in depressed industries often become ultra-cheap (even if they appear expensive based on myopic metrics). Few investors were enthusiastic about Bear Stearns before JP Morgan Chase rescued the company by offering USD2 a share. A sharp recovery in price to USD10 a share revealed the deep value present in Bear Stearns.

A fast growing company does not necessarily have to belong to a fast growing industry. More often than not, value shows up in low-growth industries. The problem with growth stocks is that they often become cyclical stocks and later 'value stocks'. It is worth recognising that the same error appears at the country level: stocks belonging to fast growing countries underperform stocks located in slower growing countries.

Recently, business school professors Michael Cooper, Huseyin Gulen and Michael Schill have shown that corporate events associated with asset contraction (the opposite of 'growth'), such as spinoffs, share repurchases, debt prepayments and dividend initiations, tend to be followed by abnormally high returns. Tangential to this point, spinoffs often are value for two reasons. First, they have no market history but have a deep corporate history. Second, parent companies do not want to see their spinoffs get into trouble, thus they provide the new firms with strong balance sheets and good management who want to succeed (they usually begin with cutting costs). Recent South African examples include the spinoff successes of Kumba Iron Ore and Exxaro out of the former Iscor; and Spar and Astral spun out of TigerBrands (with Adcock Ingram soon to follow).

The research by Cooper et al shows also that corporate events associated with asset expansion (the epitome of 'growth'), such as acquisitions, public equity offerings, public debt offerings and private debt initiations, tend to be followed by abnormally

low returns. Related to this, firms that diversify by bloating capital must be seen as risky firms. They tend to destroy value (the reverse of the spinoff argument above) as illustrated by the acquisition craze of the 1960s which ended in one of the greatest bear markets of all times: in 1973 and 1974 US stocks lost 70 percent in real terms.

Value investors should never use just one valuation indicator, such as the price-earnings ratio, but always a set of factors that emphasise value as well as quality and investment return potential. The combination of factors used in Cannon Asset Managers' process includes the price-earnings ratio, price-book ratio, price-sales ratio, a metric called the F Score (which emphasises liquidity and solvency) and dividend yield.

Regarding dividend yield, Graham and Dodd, the fathers of financial analysis, discovered long ago that earnings paid out as dividends have a greater market value than earnings retained. This is a piece of financial wisdom that flies in the face of the famous Modigliani-Miller theorem (where the Nobel Prize winning economists showed, conditional on certain assumptions, that the value of the firm is independent of how earnings are used).

If institutions do not own the stock and analysts do not follow it, then the stock in consideration stands an above average chance of being 'value'. Remember, however, that caution and circumspection govern the investment decision.

Finally, beware: value can remain value for a long time because momentum investors often continue selling long after the stock has already fallen to below 'fair' value. Value investors must be patient. It pays in the long term.

5. It Pays to Remember

Mark Twain famously quipped that '[h]istory does not repeat itself, but it does rhyme'. The current environment will reward value investors who remind themselves of this aspect of investment markets.

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