

Certainty - The Missing Value Ingredient

The year to September 2001 continued the resurgence in the reward to value investing which can be dated to the burst of the technology bubble in March 2000. Value is one of a number of proven inefficiencies exploitable within the Australian market.

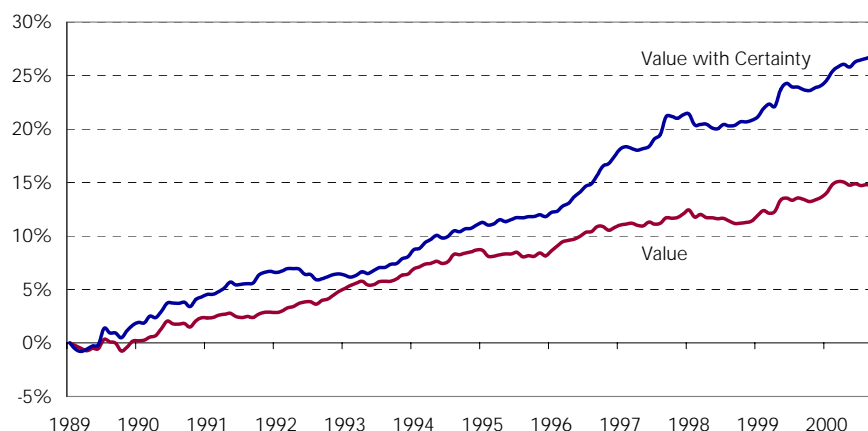
Stocks that looked relatively cheap in September 2000, and experienced healthy price rises in the subsequent twelve months included CSR(+54%), Foodland(+76%), and Leighton Holdings(+50%). However significant price increases occurred for some stocks that already looked expensive back in September 2000, such as Woolworths(+75%) and Westfield Holdings(+33%). Also some cheap stocks became even cheaper such as Pacific Dunlop (-53%) and Orica(-24%). These contradictions can be the Achilles' heel of value investing.

With any stock there are specific circumstances that influence price movements, but there are also common characteristics that drive returns. One such common characteristic that partly explains the contradictory performance of these stocks relative to their value credentials is certainty. Although Woolworths and Westfield Holdings looked relatively expensive, the market had good reason to be very comfortable with their earnings outlook based on past experience. Conversely, although Pacific Dunlop and Orica looked relatively inexpensive, the market was rightfully unsure of the earnings forecasts embedded in their valuations.

Like value, certainty can be measured objectively by examining the behaviour of consensus earnings forecasts for a stock through time. A stock scores well on certainty where these consensus forecasts evolve in a steady way. However where the market is confused about the outlook for a stock, it is not unusual to see volatile shifts in earnings forecasts. In addition, the pricing behaviour of stocks can provide a measure of certainty.

The chart below looks at the contribution to portfolio excess return and compares a sole value focus to a combination of value and certainty. Over the last decade or so, a portfolio focusing solely on value with a well-structured approach would have added a modest 1.25%pa to benchmark performance. Taking into account certainty, the excess return lifts to about 2.30%pa

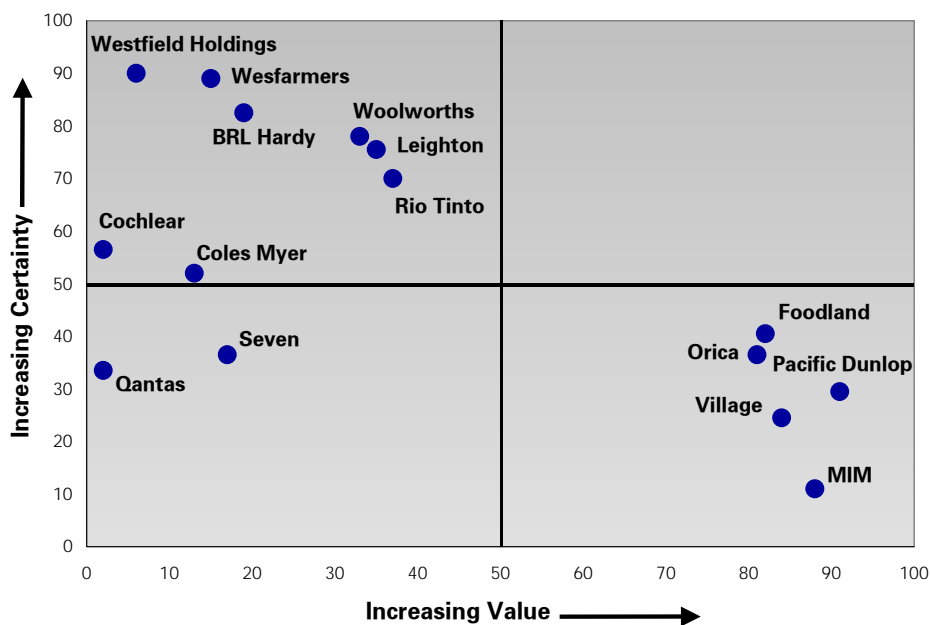
Cumulative Excess Return



The intuition as to why certainty should be rewarded, and conversely why uncertainty should be penalised, has to do with the nature of earnings forecasts. Where the operations of a company are mature and the competitive situation of the company is well insulated, earnings are relatively straightforward to forecast. By contrast where a company is moving in new directions or operating in a highly competitive environment business risks are naturally greater. While in some cases these business risks present opportunities, more often than not they present hurdles to be overcome. Companies in these challenging situations naturally exhibit poor certainty characteristics, and can be exposed to adverse business outcomes. Research suggests that certainty has greater significance in the Australian market than in the United States where results have been insignificant to contradictory¹. The greater transparency of the US market and the greater willingness of US investors to back companies embarking on new strategies may influence this.

The interplay with value is very important. If a stock is trading on a low price to earnings ratio because its business situation is uncertain, there is no reason to expect that valuation rating to change unless the business situation does. Incorporating certainty in the investment process helps avoid stocks that are cheap, but likely to stay that way, and also recognises that stocks in strong business situations may be attractive investments, despite more expensive valuation.

The chart below shows WestAM’s value and certainty scores (out of 100) for several popular stocks.



Certainty was first included in the WestAM investment process in 1998 as essentially a risk control. After three years of experience and comprehensive analysis of its behaviour in the Australian market, this factor was incorporated in the alpha formula earlier this year. The full WestAM investment process in Australia also uses other factors in addition to value and certainty.

The table below shows financial year performance for the WestAM Top 100 Composite since inception in February 1997 to September 2001

¹ Jacobs, Bruce I and Levy, Kenneth N., Disentangling Equity Return Regularities: New Insights and Investment Opportunities, Financial Analysts Journal, May-June 1988

Fama, E. and MacBeth, J., Risk, Return and Equilibrium: Empirical Tests, Journal of Political Economy, May/June 1973

Friend, I., Westerfield, R., and Granito, M., New Evidence on the Capital Asset Pricing Model, Journal of Finance, June 1978, pp. 903-920