Centre for Asset Management Research & Investments
NUS Business School

CAMRI ROUNDTABLE DISCUSSION: MEETING SUMMARY
Investment Principles – Beliefs and Truths

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(This is a meeting summary of the CAMRI Roundtable Discussion led by Charles Brandes, founder and Chairman of Brandes Investment Partners, L.P., and also a member of the firm's Investment Oversight Committee. Brandes was an acquaintance of Benjamin Graham, widely known as the father of the value-investing approach and author of the book "The Intelligent Investor". He has also authored a book on value investing. Brandes is also a board member of several organizations involved in scientific, eleemosynary and cultural work. Brandes has 47 years of investment experience.)

The investment world doesn't have to be complicated - keeping it simple is what really works. However, keeping it simple may be quite difficult. What are the important investment principles that investors should know? What are the various beliefs and truths pervasive in the investment world?

1. Review of Investors' Behaviors In General

In the practitioners' world, markets are considered inefficient because investors' behaviors are irrational and have not changed over time. This is pointed out by Benjamin Graham in his 1973 edition of ***The Intelligent Investor;*** that *"most of the time common stocks are subject to irrational and excessive price fluctuations"*. One potential misunderstanding from the academic field is the assumption of market efficiency. This misunderstanding arises from the definition of risk, where in academia; risk is defined as the volatility of stocks prices, which may not actually reflect the real operating risks faced by the business.

2. Back and Forth – Old, Fishy Approaches Emerge, Under New Wrappings

Old	New
Top Down Forecasting	Macro Hedge Funds, Risk Factors, Volatility Indexes
Market Timing	Risk On, Risk Off
Portfolio Insurance	Derivative Protection, Risk Parity
Commodities, Commercial Real Estate, Swaps	Alternatives, Currencies, "Real" Assets, Long-Short
Death of Equities, 1979	Desire for Non-Equity Exposure, 2009–2012

Table 1: Comparison of Old vs. New in the Investment World

Table 1 shows a comparison of the "old" versus the "new" in the investment world. The investment world has come back and forth several times with many new names emerging to describe methods of protection against downside risk. In reality, there is nothing really new, except for their names.

For example, the first 'old' term on the left side of Table 1 describes how investors need to know how to forecast to manage money well. For its corresponding 'new' terms, we see that nowadays there are still comparable indicators for the determination of risk factors and the use of volatility indices to forecast what the future will bring to stock market prices. Another example is Portfolio Insurance. It was said during the 1980s that Portfolio Insurance will save investors from downside volatility. However, it failed to work in October 1987 when the U.S. stock market declined as the S&P 500 dropped 22% in one day. Nowadays, there are still similar concepts such as risk parity, which says investors can seek protection by building a portfolio with risk parity measures.

The present thinking is that investors should not only buy equities because equities do not provide risk avoidance. Instead, investors should have all sorts of alternatives investments exposures. Since 2008 and 2009, investors have become very apprehensive about public equities. Statistically speaking, the big U.S. pension plans and endowment funds used to historically allocate 60% to equity and 40% to bonds with some alternatives investments in their portfolios. As of 2012, the allocations have transitioned to 40% in public equities, with bonds and alternatives comprising 60% of the portfolio.

During the 1970s, public equities were not considered good investments. For example, the Business Week magazine touted "Death of Equities" on its cover in 1979. Incidentally, 1982 marked the biggest bull market in equities, and we will see that equities have provided superior capital growth compared to other asset classes.

3. Superior Performance from Equities Compared to Other Asset Classes

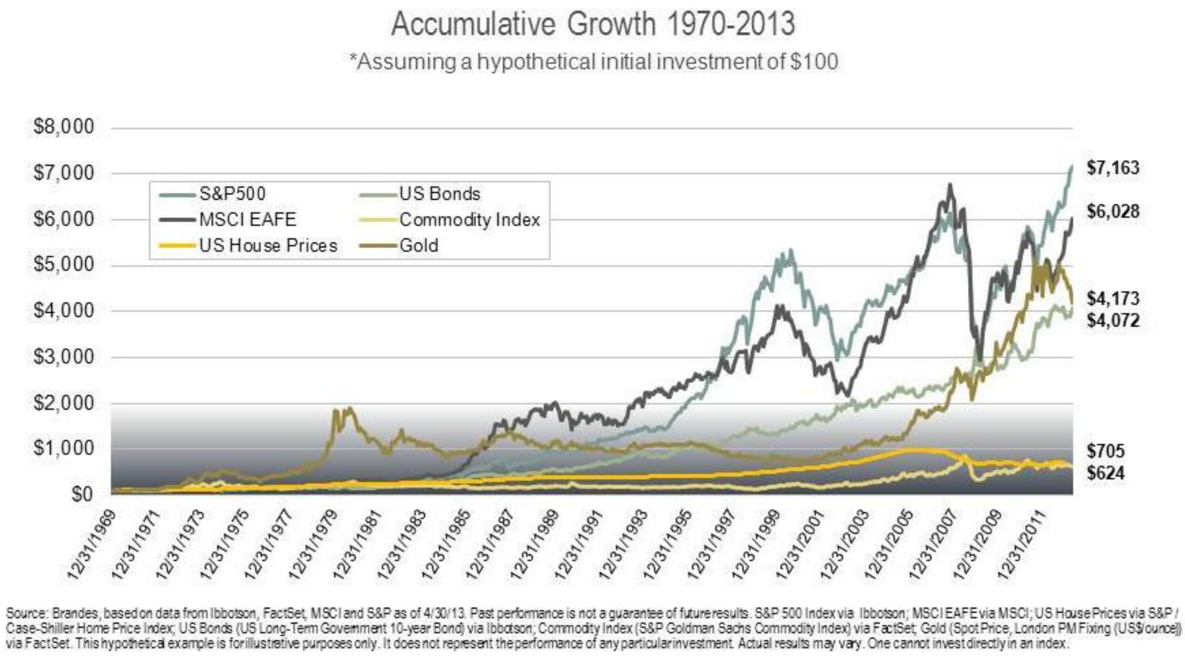

Chart 1: Equities Have Provided Superior Capital Growth Compared to Other Asset Classes

Chart 1 illustrates the different results of $100 was invested in different asset classes starting from 1970. As shown in the chart, $100 invested in the S&P500 was worth $7,163 in 2012, while $100 invested in MSCI EAFE Index was worth $6,028 in 2012. The bull market for gold started in 2000, and gold has had its biggest rally since. In spite of equities recent underperformance, over time they have still outperformed both gold and bonds, for $100 invested either in gold or bonds was worth around $4,000 in 2012. At the bottom of the chart, $100 invested in a commodity index was worth $624, while based on unlevered U.S. housing prices, $100 invested in real estate was worth $705.

Why is it that equities have such superior performance? This is because equities is where the new wealth is produced through businesses that create goods and services that people buy and create growth in the economy. Therefore, it has to be the best place to invest.

Brandes Investment Partners had its $175 million pension plans 100% invested in public equities using only one style - value investing. From 2000 onwards, 10% was withdrawn from equities and allocated into bonds. The track record from 1978 showed a rate of return outperforming the benchmark by 700 bp per year. However, this return would not be accepted in most big institutions that have different requirements for different funds. In general, investors invest in hedge funds for portfolio protection, but hedge funds underperformed on average in 2013 with a 5% return, compared to an increase of 30% for the S&P500.

4. The Two Principles for Successful Long-term Performance

I. Follow sound principles of selection related to the value of securities and not to their market action.

II. Have a method of operation that is *different* than the majority of other security buyers.

Value investing is different because of the two main factors: having very long-term thinking and buying "unpopular" securities where the prices will give you a margin of safety.

Benjamin Graham once spoke about investment philosophy in his investment class, saying, "*You can have an extraordinary difference in the price level mainly because not only speculators but investors themselves are looking at the situation through rose colored glasses rather than dark blue glasses.*"

5. Value Investing Has Outperformed Over Long-term Period

There were many studies conducted on value versus growth, with the first study done by Brandes Institute. Over all the studies, the conclusion is that value has outperformed growth as shown in Chart 2 below.

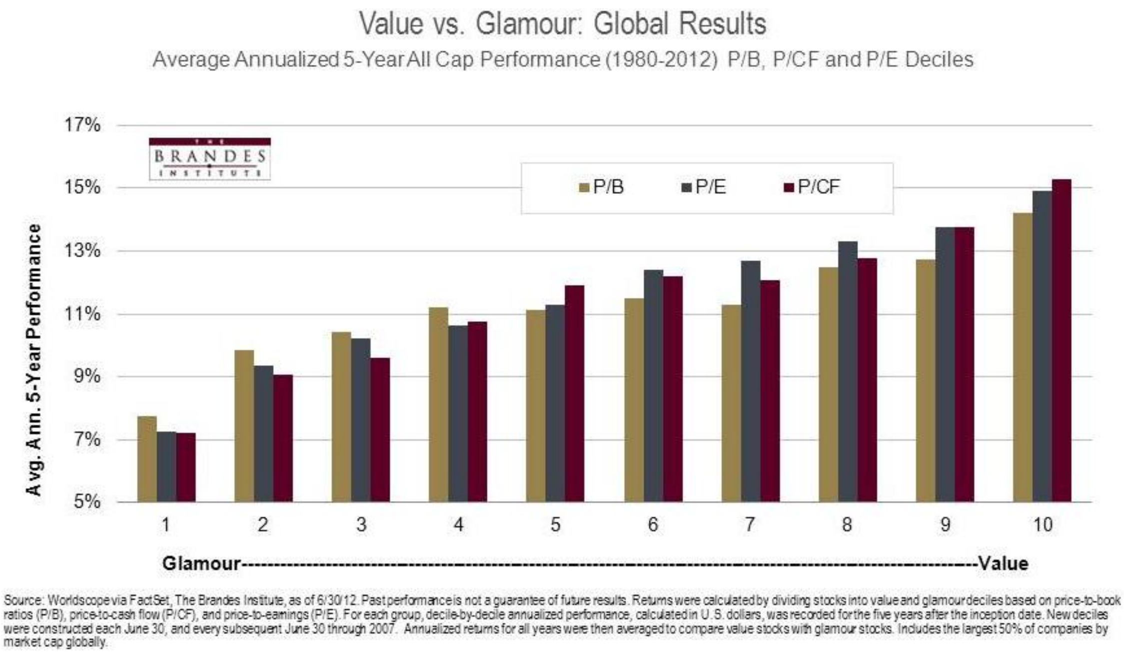

Chart 2: Value investing has outperformed over long-term period

The scale of 1-10 on the horizontal axis are deciles, where growth stocks, i.e. stocks with higher P/B, P/E and P/CF ratios, fall in deciles 1-3. The vertical axis shows the rate of return on a rolling 5 year basis starting from 1980. The rate of return of growth stocks is approximately 7%. Moving towards the right side of the value stocks with lower P/B, P/E and P/CF, the return on rolling 5-year basis is close to 15%, about twice the growth stocks' performance returns.

6. Important Investment Philosophies

I. Think as the owner of the business.

II. <u>Stock price declines might create compelling investment opportunities.</u> Price declines are not permanent and provide great opportunities to own good businesses. The majority of investors think declines in stock prices are something one should avoid. However, risk has nothing to do with stock market volatility except for investors who are short-term thinkers or speculators. For a real investor, volatility is not related with risk. Instead, risk is overpaying for businesses and securities such to the extent that investors are unable to obtain a good rate of return on their investment.

III. Risk of permanent capital loss can be minimized by not "overpaying" for a security.

IV. A long-term perspective provides investors with a key advantage.

7. Other Issues Discussed in the Meeting

I. The definition of risk. There are many definitions of risk. One definition is how well the business would perform in a period of time as well as the economic fundamentals of the business that investors actually own. It is not about the stock price fluctuations. There are other risks as well - investors need to take a look at companies from different perspectives such as: environmental, cultural, country differences, political, social, and potential fraudulent issues.

II. The problem of drifting. The importance of adhering to the stated investment strategy only and do not necessarily follow what the clients' mandate.

III. A great majority of value investors' portfolios are different, although they share the same bottom-up approach philosophy. According to Warren Buffett's paper titled, ***The Superinvestors of Graham-and-Doddsville***, although the portfolio holdings of value investors were very different, all were able to achieve superior performance.

IV. Transparency from emerging markets. Understand the base of the business and the regulations in that country. Different valuation tools/ multiples will be used for that country. Investors should be aware of the rule of law and the different political agendas present in different countries, particularly for government-linked listed corporations.

V. Market efficiency. Markets are inefficient because momentum will affect stock prices. Sometimes prices go down not only from an economic stand point of view, but also because of momentum. There are some beliefs that the market is getting more efficient as it used to be previously and that large cap companies are more efficient than mid and small caps. However, this may not be true because momentum will continue to drive stock prices.

VI. Value and growth are two sides of a coin. The important principle is to look at a company from a fundamental point of view to determine whether it is a value company or a growth company.

VII. The market is not efficient but the market tries to get the information right. To be practical, in order for students to tell their judgments are right, it is essential to understand historic conditions and how they came about in the past. Students should think in the future, "What is different this time around?" Their judgments do not need to be absolutely right, but after trying to understand the business over a period of time, their judgments will become more accurate.

VIII. Use other fundamental metrics for valuation. While the primary valuation method is DCF analysis, analysts should look at other fundamental metrics to support their analysis and to confirm that value actually works.

IX. Beliefs about shorting. The gains are limited with shorting securities and there is not much new economic progress from shorting.

X. Individual investors should to have some understanding of how economies work. They need to have their own thinking to avoid making more mistakes under the effects of false thinking from the media and the public. Individual investors should also review the investment performance after a period of time, instead of purely looking at short-term performance, since it will not be helpful to infer from these results.