

Manager Magazine, June 2007, pages 114 -116

## **Time to look for the values**

*By Przemysław Szubański*

The managers of large funds have noticed that the best they can do now is to purchase shares in large firms operating in mass media, financial, pharmaceutical and biotechnical sectors. Emerging markets, small- and medium-sized companies are passé.

The evaluation of particular regions based on price/profit indicator shows that shares in numerous markets, including, in particular, Poland, are too expensive. Therefore, one should look for values, i.e., underestimated companies, and earn profits on the increase in their quotation rates, based on the general idea of investing: buy for less, sell for more. How can we achieve that if Polish shares, which were too expensive already six months ago, now cost 30% more? And the growth seems to be more likely than a correction? The best you can do is to rely on the history – says Aleksander Jawień, President of Investment Fund Managers. Investors are tempted by fashion, they favour certain sectors and industries, while other sectors remain unappreciated. This was what happened with TMT sector companies in 1999 (technology, mass media, telecommunications) and with high capitalisation firms.

What values were not appreciated by the investors? – asks Jawień. These were, first of all, goods and raw material, emerging markets, firms of the so-called old economy. At that time no one was interested in public utility companies or in banks.

At present (in 2007), goods and raw material, fast developing countries (including China and India) as well as low capitalisation firms are in fashion now although they were not appreciated in the past. Japan, the USA and Western Europe are no longer in fashion. While attempting to find what will be in fashion soon one should compare market behaviour. Developed countries such as Japan, the USA and Western Europe are not in fashion. Their growth levels seriously depart from the market average. Since the speculative bomb blew in the years 2001 – 2002, the then “stars” from TMT sector are now quoted at the level of 1998. Large enterprises are not appreciated at all.

We are worried that this is yet another fashion – says Aleksander Jawień. Investors have concentrated on Poland, Asia and small- and medium-sized companies. This may end up with severe consequences. Jawień is of the opinion that any person who wishes to invest on long-term basis (thinking of his/her retirement) should return to the strategy of cheap purchases. This is the strategy of the best investors in the world. Warren Buffett, Benjamin Graham, George Soros or John Templeton looked for underestimated companies and earned profit on them. This is not a full list. They applied the so-called value investing, i.e., investing based on value estimation. The list of ten persons who achieved the greatest success in the 20<sup>th</sup> century contains only two names of persons who represented a different approach.

We have a very positive approach to this style since it is understood as a real investment – underlines Jawień. This is not a speculation. You buy a firm or a fund and keep it for 20 years.

The value investing approach is based on economic evaluation of an enterprise. Investors concentrate on three indicators, beginning from the simplest ones, i.e., price/book value, price/profit, profit per share. One should check the firm's cash flows, its indebtedness, i.e., in other words, prepare a detailed analysis of assets. It is not an easy task. A few years ago there was a problem with evaluation of a conglomerate such as Elektrim. It has continued to be such conglomerate. This applies to the majority of huge world firms. Siemens, in addition to household appliances, manufactures electronic equipment, telephones, computers; it is a large supplier for railways, air transportation and army. It has several business lines, each of them triggering a different investment risk. The same applies to General Electric or other firms offering diversified financial services. It is highly difficult to evaluate such firms. This can be achieved exclusively by the best experts who can devote their time and resources to this task.

The above was just a starting point of the investment process (the easiest stage). The key to success is to find a factor – the so-called catalyser – which will cause that underestimation will be noticed and investors will be encouraged to invest in the company. This catalyser can include changes in the company, for example, new management, restructuring process, auxiliary sale of assets, repayment of debts, buy-out of own shares or mergers and acquisitions. ABN Amro may be a good example of the above - a consortium headed by the Royal Bank of Scotland is “fighting” for this firm. I worked at that bank and I remember that, at the end of the nineties, all of us had a feeling that the bank was not effectively managed – says Jawień. In 2001, a new management was appointed and was to change the situation, i.e., to make underestimated assets reach the profitability of American banks. They were not successful. Now, it is time for a take-over. During one month of take-over negotiations the quotation of ABN Amro grew by almost 20 percent.

Analysis, catalyser ... That is apparently all you need to do. Just apparently...

There are always reasons for underestimation of a firm – says Jawień. Stock exchanges do not usually forget about firms with good balance sheets, operating in profitable sectors. Therefore, one needs to estimate the investment risk, i.e., check chances for further fall in quotations. Investment discipline is important, i.e., sale of shares at a proper moment, investing earned funds in other underestimated assets, resignation from the investment when indices fall or if the catalyser of changes does not work in the proper direction. Risk management and capital protection are just two other investment rules. They are obviously of high importance.

Results? Dutch Robeco, one of the firms offering value funds in the Polish market, has analysed the result of investing one thousand US dollars in the American market for the period from 1975 to 2005. After 26 years, underestimated companies gave almost 38 thousand dollars, high quoted companies – 29.4 thousand US dollars, and those of high growth potential – 20.4 thousand US dollars.

Bruce Greenwald, a professor at the Columbia University's Graduate School of Business, underlines that thirty tests (carried out in Europe and the USA, covering the period from the thirties of the 20<sup>th</sup> century up to these days) show that focusing on portfolios of low price/book value and price/profit indices brings about a 3 – 5 percent higher efficiency than the market average. Moreover, such investments have the highest efficiency among all currently applied investment styles.

Value funds concentrate on the so-called value search – says Michał Kurpiel, a financial advisor at Xelion Doradcy Finansowi. Therefore, they often invest their assets in firms, in long-term perspective (over five years), whose shares, upon purchase, are valued below their value following from the fundamental analysis.

Searching for value companies is nothing else but looking for a bargain – says the analyst. The goal is to find an enterprise whose shares are sold below their target value (surrounded by pessimists) and to sell them when the mood is highly optimistic. From practical point of view it is recommended to keep growing companies in the portfolio on a long-term basis. In case of significant movement of indices, selectively chosen value companies may bring extraordinary profits – sums up Michał Kurpiel.

The question arises: where to invest? Where to look for bargains?

This should be done in developed markets as shown by indices, and in companies of high capitalisation – says Aleksander Jawień.

At present, investors favour small- and medium-sized companies. This is a consequence of existing fashion for emerging markets (where such enterprises dominate). The largest Polish companies are classified in the world as medium-sized companies only.

What can we say about a firm whose shares are still quoted at the level of 1998 and which increased its sales from 18 up to 48 billion dollars, and its last year's gross profit is higher than the entire sales revenues of 1998, its cash resources amount to 50 billion dollars, with the price/profit index equal to 16-17? In addition, this firm has recently introduced another profitable product into the market.

The above firm is Microsoft. The same concerns Carrefour, General Electric or BMW (whose quotation rate is almost the same as ten years ago despite improving results). Another examples of underestimated financial groups include AIG (price/profit index at the level of 10) or HSCB (price/profit index equal to 11), whose dividend (5 percent) is higher than profitability of State bonds in various countries.

Aleksander Jawień recommends to start the search for shares in underestimated companies from developed countries, in sectors which were at the top six or seven years ago. Obviously, one should use the services of value funds. They have been accumulating the shares of large firms for some time now. Within two years the portfolio of Templeton Growth increased the share of significant American firms from 20 up to 40 percent. One third of the portfolio includes shares in companies operating in mass media, financial, pharmaceutical and



biotechnological sector. Robeco Global Value Equities purchases shares in HSCB, Royal Bank of Scotland, GE, AG, as well as in Exxon and Vodafone.

The fashion will obviously change and, in 2010, the investors will start asking why they invested in emerging markets – predicts Aleksander Jawień. This means that the Polish stock exchange may be in trouble soon. Unless ... there are any underestimated bargains left...