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We do it the contrarian way! “Talk with our expert”

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Europe is becoming a more attractive place to do business. That’s why investors must have European stocks in their portfolios. But tracking down the right stocks isn’t easy in such an extensive and far-flung region. Michael Clements has a consistent track-record of doing so. Get to know more about Michael and his team with the following interview.



Michael Clements
European Equities Expert

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Michael Clements, let’s first talk about your investment philosophy. How is it applied to the funds you and your team manage?

First and most importantly, we rely heavily on a team approach. After extensive primary research and fundamental analysis we target a few stocks. We do so based on contrarian investment ideas with an investment horizon of three to five years. We focus on high-quality companies that are temporarily distressed or are in the midst of a turnaround. To minimise downside risk on share prices it is essential to be very familiar with the companies in question and their market environment and to analyse various scenarios in order to assess the impacts of all negative events. The portfolio is set up in such a way as to take advantage of investment opportunities over a full investment cycle.

You just mentioned quality in companies. How does this fit into your considerations?

These are companies whose business models are based on a sustainable competitive edge. For example, strong, well-known brands that often possess market dominance or pricing power. They are also endowed with a solid balance sheet.

What must a contrarian pay attention to?

To beat the market you either have to possess better information, which is hardly realistic in most market segments, or a long enough time horizon for good investment ideas to play out. Buying low is easier said than done. Patience is essential there, as well. First, you have to do your homework and then wait for the right entry point. And then you have to wait again – often for years – until the broader market changes its mind and recognises that this company is an attractive investment. Another key is to avoid so-called "value traps" – shares of companies that are cheap for a reason, i.e., because their general operating conditions are worsening on a structural basis. Asset managers must also be familiar with each stock’s performance drivers and the quality of the company’s balance sheet and to be able to simulate worst case scenarios.

Unfortunately, quality companies that generate heavy cash flow do not grow on trees.

That’s certainly true. That’s why it is essential to understand why a company looks inexpensive at a given moment. This is usually due to any of three reasons. It could be that investor sentiment has turned against a certain country or sector, as was the case in Spain after 2008, for example. Negative moods can also be cyclical in nature, for example, when investors desert the equity markets in a flight to safety. A third reason involves companies and their business models, as I detailed earlier.

Looking at the investor sentiment cycle, what factors stand out?

Some examples of a receding phase occurred with Brexit or the Italian economy. Another example can be found in emerging markets, which are slowly pulling themselves together and can once again be considered to be on the rise. The same goes for the oil price or companies related to the European construction industry. A contrarian sees selling signals when the investor sentiment cycle has peaked. This most often happens when a sector or a market in general is positively valued or when equities are generally seen as fairly valued. We currently see the automotive sector as being in such a situation.

And how do you generate investment ideas?

This is another example of the importance of teamwork. The team members generate ideas from industry conferences they have attended, meetings they have had with companies, or research they have carried out, for example, in value creation chains or, of course, balance sheets. The latter raises the question of whether a company can generate cash throughout an entire cycle, whether its balance sheet is stable over a long period, and whether the company is an active player on its market. We also get some important indicators from hedge fund managers' short lists'. Once we have successfully carried out the second-stage filter, we begin a detailed analysis, including valuation and, hence, downside risk.

We suppose that you also exercise strict risk management in so-called high-conviction portfolios.

We do indeed. We focus tirelessly on the risk of loss, which requires an in-depth understanding of a company, its business model, and its market environment. Stress tests and the aforementioned worst case scenarios are also a part of valuation analysis and the matter of whether a given price is justified. In the case of stocks already in the portfolio, there is naturally the question of when to get out and portfolio risks, such as undesired correlations and correlation risk are, of course, a point of interest.

To wrap things up, let's look at an investment case.

OK. Let's take Burford Capital as an example. Burford is a leading supplier of litigation finance. In concrete terms, Burford provides financial support to law firms and/or their clients in cases of litigation and, in case of success, receives a share of damage awards. Since 2009 more than USD 600 million has been "invested". We regard Burford as currently undervalued. Its market segment is narrow and growing and offers returns that are uncorrelated with the portfolio's other stocks. At 71%, return on invested capital is very high, and the team is highly experienced. True, the business model is capital-intensive, but Burford can raise the capital it needs on relatively favourable terms. When we got in, P/Es were relatively low and Burford's success have now raised them to the attractive level of 14x. It is now trading at a price-to-book ratio of 1.65x. Its business model risk is no doubt subject to false litigation claims, aggressive law firms, and shifts in regulations.

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