NRI

lakyara vol.203

Special Edition

Contrarian conviction

- Transcript of the interview of Mr. Craig Bodenstab by Sadayuki Horie -

6.October 2014

Nomura Research Institute, Ltd.

Executive Summary

Investment managers usually use comparisons with benchmarks to assess their performance. But for at least one manager, benchmarks are only one part of the evaluation method. That firm is Orbis Investments, which invests according to a fundamental, long-term, and contrarian philosophy. We discussed this approach with Mr. Craig Bodenstab, who is in charge of Orbis' team of investment counsellors.

Craig Bodenstab

Head of Investment Counsellor Group

Bachelor of Commerce (Dalhousie University), Master of Business Administration (Columbia University and London Business School), Chartered Financial Analyst. Craig joined Orbis in 1998 and in addition to sitting on the firm's Operations Council, he serves as a Director on several of the Orbis group companies. Craig was accountable for the firm's Global Trading operation for 15 years and has also been the head of Orbis' team of investment counsellors for the past 5 years.

Sadayuki Horie

Senior Researcher,

Financial Technology and Market Research Department,

Nomura Research Institute

Joined Nomura Research Institute in 1981. Developed NRI Bond Performance Index (currently Nomura-BPI). Seconded to Nomura Asset Management from 1996 to 2001. Currently deputy chairman of investment committee of Government Pension Investment Fund (GPIF), a visiting professor of the graduate school of Osaka University of Economics, and a member of expert panel on the development of Japanese stewardship code (Japanese Government).

A benchmark-agnostic approach

Horie: Orbis is not well known in Japan. Please explain the defining characteristics of your firm.

Bodenstab: Orbis was founded by Allan Gray in 1989 to provide performance-driven investment management services based on our core skill of bottom-up stock selection. We manage roughly $30 billion. We now have 10 offices worldwide with more than 350 staff globally. Portfolio construction and trading functions are based in Bermuda. Our investment universe includes about 10,000 companies and our portfolios will typically hold the stocks of 100 to 150 companies.

Horie: I believe that your investment philosophy and strategy are very different from those of other asset management companies.

Bodenstab: I think our investment philosophy is simple to understand, but very difficult to execute. We start from a simple concept—that the stockmarket is not necessarily efficient all the time. What we try to do is find opportunities where a company's share price is a lot less than the intrinsic value of the business. Over time, we believe a company's share price will reflect this intrinsic value. But we can never know when that gap between price and value will close—and sometimes we're just plain wrong. So we take a long-term perspective, and we only invest in a company after conducting in-depth fundamental research. We believe this approach can provide investors with higher long-term returns than the broader market with no greater risk of loss.

Our approach to risk may also be different. In our view, risk is the possibility of a permanent loss of our clients' capital. We don't regard short-term underperformance or tracking error as risk—in fact we want our portfolios to be very different to their benchmarks, as this is the only way we can deliver superior returns for our clients.

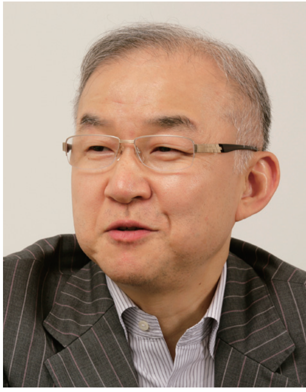
Horie: I think your definition of risk makes a lot of sense. Many institutional investors use tracking error and relative return to define risk. Why is Orbis able to define risk as you just explained?

Bodenstab: I think two principles of our organizational philosophy are especially important in helping us take an independent view of risk.

The first is our ownership structure—Orbis has no outside ownership. Our contrarian philosophy means that we can often underperform in the short and medium term, and these periods can sometimes be uncomfortably long. Our ownership structure, however, is designed to let us make tough, unpopular decisions and stick with them in the face of short-term pressure. We like to say we're "comfortable being uncomfortable".

The second important principle is co-investment. Orbis itself is one of the largest holders of its own funds, so every day, our job is to manage our own money alongside our clients'. As a result, we do not manage with an eye on what other managers are doing—we are able to think from the standpoint of managing our own money as effectively as possible.

Horie: So Orbis has been managing customers' money along with its own money since the company was established?



Bodenstab: That's right. We believe that investing alongside our clients—in the same vehicles—is the best way to align our interests with theirs. This is why we have invested alongside our clients since our establishment, with our owners and employees paying the same fees as our clients do. We view our clients as partners.

Horie: Why was Orbis established in Bermuda?

Bodenstab: There were a few reasons. When our founder was setting up the firm in 1989, one consideration was where we could best serve a global client base. Bermuda's political stability and status as a reputable offshore jurisdiction made it a good choice in that respect. Another important issue is that our founder believed that maintaining a contrarian perspective would be easier if we moved away from the noise of the world's financial centers. Of course, it also helps that Bermuda is a great place to live and work.

Horie: In other words, you are saying that looking at financial centers from the outside is better for using your methods.

Bodenstab: I think it helps. If we were in the middle of Wall Street, I think it would be very difficult to avoid being influenced by consensus views.

What really matters most is maintaining an independent view and our research process is designed to preserve and encourage independent thinking. For example, we go through almost our entire research process before speaking with management. This includes a thorough study of a company's financial data, operations, competitors and valuation. It is only after we have formed our own independent view that we speak with the company's management team.

Horie: Many institutional investors now understand the importance of your approach of not placing emphasis on benchmarks. But Orbis started using this method more than 25 years ago. At that time, how did you convince clients that your approach would be effective?

Bodenstab: Ultimately we hope to find like-minded clients. It is vital that our clients have the same stance that we do and are willing to stick with us through inevitable periods of short-term underperformance. Orbis has never had a sales team. Instead most of our clients have found us through word of mouth. But with any new client, we do try to give them the information they need.

Horie: How do you talk with your clients when your short-term performance is poor?

Bodenstab: When performance is poor, that is when we need to be as candid as possible—we believe we owe this to clients. But the first thing is to set realistic expectations. Given our contrarian approach, we must ensure that clients understand that there will be times when their portfolio is out of sync with the benchmark. We explain our long-term track record—good periods and bad periods—before the client decides whether or not to invest with us. We emphasize to them that there may be difficult times, and we ask them whether they would be able to stick with us during a period of underperformance.

Some investors aren't comfortable with this, and part of our job is helping those clients make a smart decision not to invest with us. We don't view that as bad thing. The worst thing that can happen is for a client to invest with the wrong expectations, only to redeem at the worst possible time when our short-term performance is poor. If that happens, then we have failed in our mission.

Horie: Orbis has many types of clients. Are there characteristics that are shared by all of the “outstanding clients” who experience good performance?

Bodenstab: The clients we have that experience the best returns tend to share our contrarian mindset and long-term perspective. Clients willing to invest during a period of underperformance, for instance, often see better returns as our performance recovers.

For pension funds specifically, many of the outstanding investors we have seen use an incentive system for the chief investment officer that aligns their interests with those of the pension fund’s beneficiaries. These clients will also assess performance over a longer term period of three or five years, and compensate their CIOs accordingly. Unfortunately, many pension funds evaluate the performance of the chief investment officer every quarter, even though the funds say they want to create value over the long term for their beneficiaries.

In what types of companies does Orbis invest?

Horie: My next question is about your portfolio companies. In general, what types of companies do your Funds tend to buy?

Bodenstab: We do not limit ourselves to particular types of companies. We believe many kinds of companies can be undervalued by the market, and we look for these opportunities wherever we can find them.

We do prefer to invest in companies that have an incentive package for executives that is consistent with the interests of the Funds as shareholders. That means they pay compensation based on the company’s medium- and long-term per share performance. We also want to know if a company’s executives are able to make good capital allocation decisions. Buying a stock is equivalent to entrusting our money—and our clients’ money—to the company’s managers, so we want the managers to use that money in the manner we believe will be most effective.

Horie: Most fund managers who prioritize long-term fundamentals make the quality of management and business operations a condition for selecting portfolio companies.

This thinking is based on the belief that companies like this can generate stable, long-term cash flows. What is your view of this thinking?

Bodenstab: Asset managers must be careful not to confuse good companies with good investments. If a company's quality is well-known, other investors may have already bid up its shares to a high price. If the valuation is too high, the stock may not be a good investment even if the business is great. But we do get interested if the market has scorned an otherwise excellent company due to a temporary setback.

Horie: How long does Orbis usually hold a stock?

Bodenstab: We invest with a three- to five-year horizon. Sometimes the Funds have held shares much longer than that, and sometimes the holding period is shorter.

Horie: When do you sell a holding?

Bodenstab: There are two criteria we think about when deciding when to sell: 1) does the stock still offer a discount to its intrinsic value? And 2) do other opportunities offer a more attractive balance of risk and reward?

When we buy a stock, we do not set a target price for selling it. A company's intrinsic value can change, and if the business is growing, a stock may remain attractive even if its price performance has been good. Instead, when a new idea appears, we compare it to others in the portfolio. If it is more attractive than existing holdings that offer similar exposures, we will typically buy the new idea and sell down the less attractive ones.

What is your stance regarding your relationships with portfolio companies?

Horie: I believe that gaining a thorough understanding of a portfolio company's operations requires holding discussions with its executives. How does Orbis conduct these discussions?

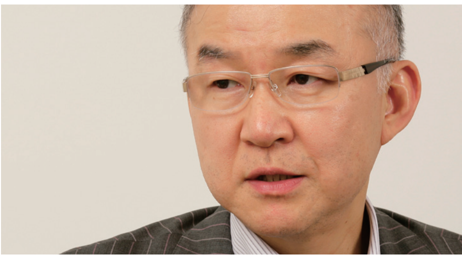
Bodenstab: In most instances, there are two aspects to our meetings with a company's managers.

The first is how the company is managed. We try to understand the executive's incentives to see whether they are aligned with shareholders. We also want to know about capital allocation—does the management team plan to allocate capital in a way that adds value for shareholders?

The second aspect is the confirmation of our assumptions and outlook. Is the company well managed? Is the stock undervalued? Is there anything strange going on at the company? We try to get answers to questions like these.

Of course, we don't simply believe everything the executives say. This is one reason why we establish our own view of a company before meeting its managers.

Horie: Earlier, you said that a partnership between investment managers and customers is vital. What about partnerships between investors and their portfolio companies? At Orbis, a stock is sold if the market value of a portfolio company climbs to the point where it exceeds the intrinsic value. Doesn't this make it difficult to build partnerships with these companies?



Bodenstab: Our clients' interests always come first. We are stewards of their capital, and accordingly we have a duty to ensure that the companies held by the Funds act in shareholders' best interests.

Whenever we do engage with management, we prefer to do it privately. Hopefully this gives management the trust they need to view us as constructive partners.

Horie: Orbis invests in global equities, which I believe includes Japanese stocks. What is your view of the quality of management at Japanese companies?

Bodenstab: I think it is misleading to treat Japanese companies as a single category. Management is outstanding at some companies and not so at some others. This is also true in the United States, Canada and the United Kingdom—making a generalized statement is difficult.

Japan is obviously very strong in industries like automobiles that are associated with engineering technology. I think Japan has many excellent companies in this sector.

Based on my experience, I have the feeling that the senior managers of some Japanese companies do not place as much importance on shareholder returns as executives in some other countries do. This is not necessarily a bad thing, so long as the managers are working towards appropriate long-term goals. But there may be a tendency for some Japanese companies to keep large amounts of cash on their balance sheets and to have low returns on equity as a result.

Horie: Japan is currently creating a corporate governance code. I am taking part in this process. Prior to establishing this code, Japan has announced a stewardship code. Personally, I believe that building positive ties between company executives and portfolio managers will be vital to improving capital productivity at Japanese companies. This is why efforts must be made to build these ties.

Bodenstab: I agree. I have read the stewardship code and my hope is that it will be very effective.

I think that the code will help companies as well as investors by making them more aware of the importance of sustainable growth.

Horie: Hearing that makes me want to work even harder on the governance code. I will continue to do the best I can. Thank you for taking the time from your busy schedule to talk with me today.

about NRI

Nomura Research Institute, Ltd. ("NRI", TYO: 4307) is an independent, global IT solutions and consulting services provider with annual sales of 385.9 billion yen as of FY ended March 2014. With front-to-back support for the buy- and sell-side, NRI's tradition of innovation has positioned them as a trusted international market leader. Leveraging NRI's global consulting business, NRI is able to provide innovative financial IT solutions for investment banks, asset managers, banks and insurance providers. For more information, visit www.nri.com.

Inquiries to : Financial IT Marketing Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

http://www.nri.com/global/opinion/lakyara/index