September 13, 2012

Dear clients and colleagues,

The last few years have seen the rise of alternative asset classes such as Private Equity and Real Estate. One of their main selling points has been the lower correlation with traditional investments. But is it so? The low correlation might entirely be explained by the longer time horizon used to evaluate them. Publicly traded equities or bonds get priced daily. Let's consider what Warren Buffet would say: "The market is a voting machine, not a weighing machine". Risk is a function of time. The longer the time horizon, the lower the risk. Private equity and real estate are not less risky; they just do not get priced daily and are evaluated over a longer time horizon.

We would like to argue that equities are not more risky, but that, investors need to take a longer time horizon.

This week's comment will focus on the need to take a longer term approach when investing in public equities. It should be read in conjunction with our comment of August 22nd, "Are small caps really more risky?".

Many clients evaluate their managers on periods ranging from 1 month to a few years, with a 4-year timeframe being the period that a manager is supposed to outperform its benchmark. We believe that this period should differ depending on the short-term risk and liquidity of an asset class. If we take Private Equity as an example, these investments are typically measured on a cycle of about 7 to 10 years. On that basis, maybe an S&P 500 mandate should be judged on a 3 to 4 year horizon; however, small cap or emerging markets need longer, probably a 5 to 7 year horizon.

Giving more time to a manager would probably allow him/her to invest instead of chasing short-term performance or hugging the index.

The outperformance of a stock is often over short periods of time, even more so for smaller cap companies.

The Global Alpha Team takes a long-term approach. Our turnover rate – excluding companies acquired or reaching our upper market cap limit – is around 20%. Combined with our search for growth in many industries, we believe it is a source of sustainable added value.

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Source: Bloomberg

Let us illustrate. The graph above is the stock price of Eurofins (ERF FP), a world leader in food safety and environmental testing. It is a company that we have had in the portfolio since inception and that we profiled in our September 4th, 2008 comment, with the company then trading at €60.

A look at the graph shows that for the period from January 1, 2008 to December 31, 2011, a 4-year period that is normally used to assess managers, Eurofins returned -28.5% compared to +10.4% for the Index. On an annual equivalent, Eurofins not only had negative absolute performance, it also underperformed the benchmark by 10.54%.

If we take a longer time horizon and still start on January 1st 2008, but bring our period to today, that is 4 years and 8 months, we get a much different story. Over that longer period, Eurofins has returned 41% compared to the Index at 27%. On an annualized basis, 7.6% vs. 5.3%, an annual difference of 2.3%. Of note, Eurofins' performance to date this year has been +93%.

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GLOBAL ALPHA

Source: Bloomberg

Eurofins should continue to grow. The forecast for next three years is for sales to grow in excess of 10% annually with earnings expected to grow 20% per year in the same period.

In conclusion, we believe that a long-term horizon is needed to invest in publicly traded equities, even longer for less liquid or researched universe such as small cap companies.

We constantly update our valuation model based on discounted cash flow to determine if our companies are undervalued and we have a very well diversified portfolio of 56 companies in 13 countries and 35 industries, knowing that the market likes to rotate between sectors and industries.

Have a good week.

The Global Alpha team

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