



## Understanding Style

Nick Pashias, Deputy Head of Equities, explains how through its bottom-up approach to stock analysis, Aviva Investors is unconstrained by particular definitions of investment style.

Many investors, advisers and consultants like to pigeon hole fund managers into different groups of fund managers depending on their investment style. Some of the more common groups include value, growth, quant, or sector neutral. Investors however, often have difficulty categorising our bottom-up stock selection approach, which can span both growth and value.

As a fund manager, Aviva Investors is unconstrained by either “value” or “growth” investment styles. Instead, we employ a bottom-up approach to stock analysis and any portfolio bias or outcome is purely a result of our aggregate bottom-up stock picking process.

When doing our research we take a long term view, generally over several years and having due consideration for mean reversion. This can also be described as contrarian investing.

Contrarians simply attempt to be fearful when others are greedy, and to be greedy only when others are fearful because we know that the current mood will eventually turn.

### So what do “contrarian investors” look for?

Before we answer this we need to understand the earnings life cycle of a company. The “Earnings Expectations Life Cycle”, first developed by Richard Bernstein, is a simple way of explaining this cycle. We will use this life cycle to illustrate what contrarian investors look for, and how this fits in with the conventional “value” and “growth” investment styles.

The Earnings Expectations Life Cycle, shown below, defines the various stages of investors’ expectations.

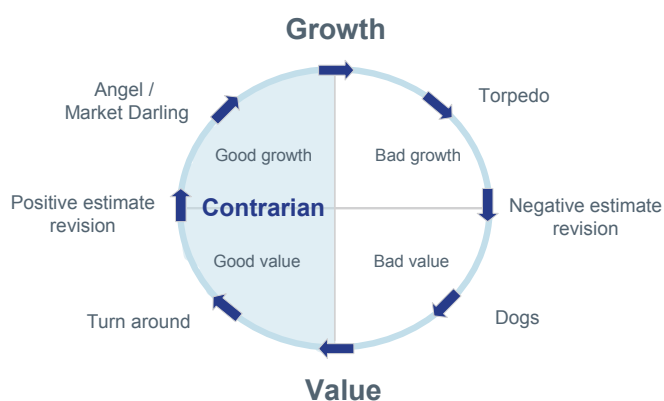


Figure 1: Earnings Expectations Life Cycle  
Source: Richard Bernstein

To explain, we will start with growth stocks. These stocks have generally enjoyed good growth for a period of time and have performed well from a share price perspective. Generally, sell side analysts have buy recommendations on these stocks, they are a core part of everyone’s portfolio, and management are viewed as gurus. These stocks are considered indisputably superior, and are often termed “market darlings”. Earnings expectations are very, very high.

From here, the stock “torpedoes”, affected by unexpected problems. This results in the stock losing some love, and it fails to perform on good news and starts to mildly underperform. Sell side analysts start to wind back recommendations and earnings expectations. Many believe the problems are temporary and there is nothing to worry about.

As problems persist, these torpedoing stocks turn to “dog” stocks. Everyone is universally negative towards these stocks, and the problems are thought to be permanent. The share price is sold down on good news, bad news, any news. Management are viewed as incompetent, analysts forecast bottom of the cycle earnings forever, and multi-year underperformance often leads to the stock being neglected. Now expectations are very, very low.

Eventually the stock price stops falling on bad news and starts to perform on good news. More people start doing more research and discover that things aren’t as bad as first thought. Sell recommendations moderate to hold. Price and earnings actually start to perform better, and earnings begin to be upgraded. Before long the stock again becomes a market darling and the cycle is completed.

An example of the Earnings Expectation Life Cycle for the Australian market is Telstra. Back in 1999 to 2000, Telstra was part of the new economy. These companies were going to revolutionise the way business was done and the way consumers bought and sold goods and how they interacted with one another, leading to new found revenue streams and profits. Telstra was a market darling. This was reflected in very high earnings expectations, and also a very high multiple being paid for those earnings, leading to a very strong share price. As illustrated in Figure 2 (Telstra share price in blue and expected earnings per share in grey), both were moving up at the turn of the millennium.



Figure 2: Telstra Corporation share price vs. expected earnings  
Source: Factset

Unfortunately that did not eventuate as quickly as some had hoped and earnings were gradually wound back and the share price fell for many years. To add to the pain for shareholders the risk of regulation began to plague Telstra, as did the threat of further competition. Over the last few years this has led to earnings expectations falling further and further, and the share price falling to very low levels as the stock moved through the “Torpedo” and “Dog” phases of the cycle. Earnings and the share price began to bottom in 2006. However, Telstra has recently delivered results that have been in line to slightly better than those lowered expectations, and now expectations have actually increased. Consequently, Telstra has performed relatively well over the last year or so, and I believe it is still in the turnaround phase of its earnings life cycle.

It should be noted that not all stocks track the cycle at the same speed and can often do “mini” cycles where they actually go backwards before they go forward.

With the Earnings Expectations Life Cycle in mind, we will now explain the traditional investment styles of value and growth investing, and then provide an indication of what contrarian investors try to do.

## What do typical growth and value managers try to do?

Good growth managers are generally in the top left quadrant of the life cycle, often trying to buy stocks with above average growth, and are not overly concerned with the price they pay in terms of multiple. Good growth managers enjoy the sweet spot of the earnings revision cycle.

The risk for growth managers is that they hold on for too long and are torpedoed by an earnings downgrade, which results in not only lower earnings but a lower multiple, and the stock underperforms.

Good value managers on the other hand try to buy stocks that appear cheap on multiples, and are about to turn around or have just recently turned around.

Unfortunately, turnarounds seldom do just that, and stocks can remain “dogs” for a long, long time. The risk for value managers here is that they buy into a stock too early and the stock continues to underperform.

## So what do contrarian investors try to do?

Contrarians ideally try to operate in the left hand hemisphere, waiting for stocks to be totally out of fashion, waiting for all the bad news to be in the price and then holding on for the mean reversion. Even when the stocks turn, contrarians hold on.

As mentioned earlier, Aviva Investors are not constrained by strict definitions of value or growth, so remain comfortable holding onto stocks with high growth rates and perceived high valuations so long as we think the upgrade cycle will continue for some time and long term value exists.

## Market Review

Fears that the world was headed for Great Depression 2 earlier this year saw enormous dislocation in all asset classes. Equities and commodities prices fell heavily, currencies swung wildly, credit related securities were trashed and bond markets enjoyed an aggressive “flight to safety” rally down to levels once thought impossible. Thankfully the arrival of better economic numbers appeared throughout the second quarter allowing some of the extreme financial market pricing which had become so dislocated earlier this year to unwind to a large extent as a result.

After ending the first quarter of 2009 on a positive note, global equity markets continued their momentum through the second quarter. The Australian equity market broke a six quarter run of quarterly declines in the June quarter, with the S&P/ASX 200 Accumulation Index posting a gain of 11.3%.

Cyclical stocks reversed the trend of previous quarters outperforming defensives, and the Consumer Discretionary sector returned 17.4% for the quarter. Resources (up 11.0%) again performed well as commodity prices continued to make gains, while Banks (up 8.4%) underperformed the broader market as earnings reports disappointed and further capital raisings were completed. This notion of strengthening balance sheets continued beyond the banks, with big names such as Rio Tinto, BlueScope Steel and Asciano Group all issuing equity.

The Reserve Bank of Australia (RBA) continued to ease monetary policy during the quarter, with the official cash rate lowered by a further 0.25% following the Bank’s April Board meeting. Following the last couple of months where rates have been put on hold, the official cash rate now sits at 3%, the lowest level since the early 1960’s.

## Below are short commentaries on each Aviva Investors fund, outlining their gross performance and the main contributors to performance.#

**Australian Equities Fund** - The fund returned 12.8% for the June quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 11.3% by 1.5%. The main contributors to performance for the portfolio over the quarter were overweight positions in CSR and OneSteel. Not owning Macquarie Group and Orica detracted from performance.

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**Australian Resources Fund** - The fund delivered a return of 12.2% for the quarter, outperforming the benchmark S&P/ASX 300 Resources Accumulation Index of 11.3% by 0.9%. Positively contributing to performance during the quarter were overweight positions in Minara Resources and Equinox Minerals. Main detractors from performance were not owning Sims Metal Management and having an overweight position in Rio Tinto.

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**Dividend Builder** - The fund delivered a return of 13.1% for the quarter, outperforming the benchmark S&P/ASX 200 Industrials Accumulation Index of 11.4% by 1.7%. Overweight positions in CSR and Wesfarmers positively contributed to performance. Not owning Macquarie Group and Orica detracted from performance.

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**Elite Opportunities Fund** - The fund returned 12.2% for the quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 11.3% by 0.9%. The main contributors to performance for the portfolio were overweight positions in Asciano Group and BlueScope Steel. Main detractors from performance over the quarter were not owning Commonwealth Bank and an overweight position in CSL.

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**High Growth Shares Fund** - The fund returned 11.1% for the quarter, underperforming the benchmark S&P/ASX 200 Accumulation Index of 11.3% by 0.2%. The main stocks to contribute to performance during the June quarter were an overweight position in Asciano Group and BlueScope Steel. Main detractors from performance were an overweight position in Newcrest Mining and an underweight position in Orica.

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**Long/Short Equity Fund** - The fund delivered a return of 9.0% for the quarter, outperforming the combined benchmark S&P/ASX 200 Accumulation Index (75%) and UBS Bank Bill Index (25%) of 8.6% by 0.4%. Positively contributing to performance during the quarter were overweight positions in Asciano Group and BlueScope Steel. Stocks detracting from performance were an underweight position in Orica and an overweight position in Newcrest Mining.

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**Small Companies Fund** - The fund delivered a return of 22.1% for the quarter, underperforming the benchmark S&P/ASX Small Ordinaries Accumulation Index of 25.7% by 3.6%. The main contributors to performance for the portfolio were overweight positions in Oakton and not owning St Barbara. Stocks detracting from performance were an overweight position in Salmat and not owning Karoon Gas Australia.

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**Sustainable Investment Fund** - The fund returned 10.2% for the quarter, underperforming the benchmark S&P/ASX 200 Accumulation Index of -11.3% by 1.1%. The main contributors to performance for the portfolio during the June quarter were overweight positions in Asciano Group and Suncorp-Metway. Stocks detracting from performance were an overweight position in CSL and an underweight position in Macquarie Group.

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**Australian Shares Fund\*** - The fund delivered a return of 12.8% for the quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index of 11.3% by 1.5%. The main contributors to performance for the portfolio over the quarter were having overweight positions in CSR and OneSteel. Not owning Macquarie Group and Orica detracted from performance.

\*Closed to new investments

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**Listed Property Fund** - The fund delivered a return of 12.3% for the quarter, underperforming the benchmark S&P/ASX 200 A-REIT Accumulation Index of 15.2% by 2.9%. Positively contributing to performance during the quarter were underweight positions in Commonwealth Property Office Fund and GPT Group. Stocks detracting from performance were an underweight position in Stockland and not owning Macquarie Countrywide Trust.

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**Premier Fixed Income Fund** - For the quarter the fund delivered a gross negative return of 1.0%. The return of the fund was below its benchmark<sup>1</sup> of negative 0.5%. Factors that had a negative impact on performance were our overweight exposure to the Australian fixed income market versus overseas bonds as well as a long duration strategy that was put in place at the total fund level. On the positive side was the overweight exposure to the high yield market which delivered strong positive returns, and also an overweight exposure to semi-government bonds and both government and non-government guaranteed major bank paper.

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**High Yield Fund** - The fund delivered a return of 7.6% for the quarter, outperforming its benchmark<sup>2</sup> by 7.6% over the quarter. A pleasing number of ASX listed hybrid securities began to find favour with investors over the June quarter off the back of the equity market rebounding off the lows reached during the March '09 quarter. In particular the Orica SPS, IAG Finance (NZ) Notes, Australand Assets and Myer Group Notes were strong contributors to the fund's performance. Despite these encouraging signs of recovery, the failure of the Timbercorp and Great Southern MIS schemes were negative contributors to performance over the quarter.

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**Income Plus Growth Fund** - The fund returned 6.4% for the quarter, outperforming the benchmark<sup>3</sup> by 1.9%. The fund's outperformance was a result of both the Australian equities and fixed income portfolios within the fund outperforming their respective sector benchmarks over the quarter.

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Please note continued volatility in financial markets has impacted a number of credit related securities within the portfolio. Due to the impact these securities have had on the fund, we believe the fund is likely to only achieve a below benchmark return going forward, resulting in investors receiving a low monthly income. As a result, in the best interests of unitholders, the decision was made to terminate the fund effective 3rd July 2009.

To effectively manage the fund wind-up process, we have begun a programme to sell down the portfolio. The liquid portion of the portfolio will be redeemed first, and the proceeds returned to unitholders in late July. The remaining investments in the fund will be managed to maximise returns to unitholders. A second instalment will be paid to unitholders once this process is complete.

# All returns are gross of fees. Please refer to page 4 of the Quarterly Review for a summary returns which are net of fees.

<sup>1</sup> Benchmark is 75% UBS Australia Composite Bond Index and 25% Barclays Capital Global Aggregate Bond Index (hedged into A\$)

<sup>2</sup> Benchmark is UBS Australia Composite 0-5 Year Index

<sup>3</sup> Benchmark is 40% S&P/ASX 200 Industrials Accumulation Index and 60% UBS Australia Composite 0-5 Year Index

# Aviva Investors Investment Returns

Performance to 30 June 2009

		3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	Since Inception % p.a.
<b>Australian Equities</b>						
<b>Australian Equities Fund</b> Inception date: 03/07/1995	Gross Return	12.8	-13.0	-1.1	8.4	10.6
	Benchmark Return	11.3	-20.1	-3.8	6.9	9.2
	Excess Return	1.5	7.1	2.7	1.5	1.4
	Net Return	12.6	-13.8	-2.0	7.5	9.6
<b>Australian Resources Fund</b> Inception date: 03/03/08	Gross Return	12.2	-26.9	-	-	1.2
	Benchmark Return	11.3	-30.4	-	-	-17.1
	Excess Return	0.9	3.5	-	-	-15.9
	Net Return	11.8	-27.8	-	-	-
<b>Dividend Builder</b> Inception date: 06/09/2005	Gross Return	13.1	-9.3	-3.5	-	-0.3
	Benchmark Return	11.4	-14.3	-6.5	-	-2.0
	Excess Return	1.7	5.0	3.0	-	1.7
	Net Return	12.9	-9.8	-4.1	-	-0.9
<b>Elite Opportunities Fund</b> Inception date: 18/11/2002	Gross Return	12.2	-12.6	0.2	10.1	13.0
	Benchmark Return	11.3	-20.1	-3.8	6.9	8.9
	Excess Return	0.9	7.5	4.0	3.2	4.1
	Net Return	12.0	-13.2	-0.4	9.3	12.1
<b>High Growth Shares Fund</b> Inception date: 07/12/1999	Gross Return	11.1	-13.8	1.2	10.1	13.5
	Benchmark Return	11.3	-20.1	-3.8	6.9	6.8
	Excess Return	-0.2	6.3	5.0	3.2	6.7
	Net Return	11.1	-14.6	-0.1	8.8	11.6
<b>Long/Short Equity Fund</b> Inception date: 27/08/2004	Gross Return	9.0	-7.3	5.0	-	13.8
	Benchmark Return	8.6	-13.9	0.1	-	9.5
	Excess Return	0.4	6.6	4.9	-	4.3
	Net Return	8.8	-8.4	3.6	-	12.6
<b>Small Companies Fund</b> Inception date: 19/11/1999	Gross Return	22.1	-27.2	1.0	11.8	11.1
	Benchmark Return	25.7	-28.6	-6.4	5.6	4.2
	Excess Return	-3.6	1.4	7.4	6.2	6.9
	Net Return	21.8	-27.9	0.0	10.7	10.0
<b>Sustainable Investment Fund</b> Inception date: 16/02/2006	Gross Return	10.2	-16.7	-1.0	-	0.2
	Benchmark Return	11.3	-20.4	-3.9	-	-1.4
	Excess Return	-1.1	3.7	2.9	-	1.6
	Net Return	9.9	-17.4	-1.9	-	-0.7
<b>Listed Property</b>						
<b>Listed Property Fund</b> Inception date: 28/02/1994	Gross Return	12.3	-32.9	-16.3	-3.5	6.5
	Benchmark Return	15.2	-42.3	-22.7	-8.4	4.6
	Excess Return	-2.9	9.4	6.4	4.9	1.9
	Net Return	12.1	-33.4	-16.9	-4.2	5.7
<b>Fixed Income</b>						
<b>Premier Fixed Income Fund</b> Inception date: 31/05/2000	Gross Return	-1.0	8.4	6.0	6.2	6.7
	Benchmark Return	-0.5	10.9	6.9	6.4	6.7
	Excess Return	-0.5	-2.5	-0.9	-0.2	0.0
	Net Return	-1.1	8.0	5.6	5.8	6.3
<b>High Yield Fund</b> Inception date: 21/01/2004	Gross Return	7.6	-1.6	0.1	2.9	3.2
	Benchmark Return	0.0	10.8	6.8	6.2	6.2
	Excess Return	7.6	-12.4	-6.7	-3.3	-3.0
	Net Return	7.4	-2.2	-0.5	-	2.6
<b>Income Plus Growth Fund</b> Inception date: 31/03/1998	Gross Return	6.4	-1.7	0.7	4.3	6.4
	Benchmark Return	4.5	0.6	1.7	5.3	6.3
	Excess Return	1.9	-2.3	-1.0	-1.0	0.1
	Net Return	6.2	-2.5	-0.1	3.5	5.5

Disclaimer: All net returns are based on exit to exit unit prices for Professional Selection units, are net of fees and assume the reinvestment of income. Past performance is not a guide to or indication of future performance. At Aviva Investors' discretion, the management and/or performance fee may be partly rebated to professional, sophisticated or wholesale investors. The above information is of a general nature and has been prepared without taking account of your individual investment objectives, financial situation or particular investment needs. It is not intended as financial advice to retail clients. Before making an investment decision, you should consider the appropriateness of the information, having regard to your objectives, financial situation and needs. We recommend you consult with your financial adviser, who can help you determine how best to achieve your financial goals and whether investing in a fund is appropriate for you. Investment in the Aviva Investors Investment Funds will only be made upon receipt of a completed application form from the current PDS, a copy of which can be obtained from Aviva Investors. Aviva Investors Australia Limited ABN 85 066 081 114. AFS Licence No 234483. Level 28 Freshwater Place, 2 Southbank Boulevard, Southbank VIC 3006 GPO Box 2007s, Melbourne 3001 Telephone: (03) 9220 0300 Facsimile: (03) 9220 0333 Email: investorservices.au@avivainvestors.com Website: www.avivainvestors.com.au Part of the international Aviva plc group.