ABERFORTH PARTNERS

Aberforth's Investment Philosophy and putting it into practice

The philosophy

Aberforth's purpose is to deliver superior long-term investment returns for its clients and, by extension, for the ultimate beneficiaries of its clients' portfolios. The definition of "superior returns" varies by client, but a common investment philosophy underpins how Aberforth manages its clients' capital. The following beliefs form that philosophy.

- Consistent application of a value investment style enhances investment returns. Within the Numis Smaller Companies Index (excluding investment companies) [NSCI (XIC)], which defines Aberforth's investment universe, value stocks have out-performed growth stocks by 3.3% per annum between the index's inception in June 1955 and December 2022.
- Investors are rewarded for investing in smaller companies, which are generally less liquid and more volatile than their larger peers. Small companies are also less efficiently priced by the stockmarket, which creates more opportunity for the value investor. Since 1955, small UK quoted companies have out-performed larger UK companies by 1.4% per annum.
- Over and above the value and size premiums, fundamental analysis helps understand the important influences, internal and external, on the value of individual companies and allows the identification of valuation opportunities that arise through inefficient stockmarket pricing.
- Stock selection and portfolio management are best conducted collegiately, by reducing the reliance on the whims of an individual and by emphasising the consistency of process that can endure through time.
- An investment outcome can be improved by regular engagement with the board of an investee company and by efforts to effect change should such change seem likely to maintain or enhance the company's value.
- A company's system of governance is crucial to how its environmental and social policies are designed and implemented.
- Investments should be made on the assumption that the company will be a long-term holding, but the stockmarket often presents opportunities for "value roll", by re-pricing a stock and allowing value to be realised and reinvested in a more attractively valued situation.
- Dividends play a crucial role in long-term equity returns and impose an additional discipline on boards when making capital allocation decisions. Accordingly, companies should pay dividends or, if near-term circumstances prevent this, their boards should articulate how future dividend payments will be possible.

And the practice

Aberforth have an experienced and well-resourced investment team, whose interests are aligned with those of their clients through meaningful personal holdings in the funds that they manage. The team's efforts are concentrated on stock selection and the moulding of stocks into a portfolio. The process underlying these activities has been consistently applied over the life of the firm. There are three main aspects to the process.

1. Company analysis is facilitated by splitting the small cap universe by sector: each investment manager looks after a handful of sectors and is charged with identifying opportunities within these. With six experienced investment managers in recent years and around 350 companies in total to analyse, the level of resource directed at the investment universe is very high. The investment manager seeks to understand how a company makes its money, its barriers to entry, its vulnerabilities, any significant ESG factors, the motivation of its executives and the oversight provided by the chair and non-executive directors. Scrutiny of historical results and regular contact with management are important features of the analytical effort. Using the output of the analysis, the investment manager determines a valuation for the company in question. A variety of methodologies and metrics – most commonly the ratio of enterprise value to earnings before interest tax and amortisation – are utilised, all with the aim of calculating a target price for each stock.

2. While analysis is conducted by the individual investment managers within their allocated sectors, buy and sell decisions and portfolio management are a collegiate effort. For a value investor, this part of the process is at one level very straightforward: the aim is to move capital from companies whose share prices are close to their targets into those at a wide discount. Aberforth refers to this circulation of capital as the "value roll", which can be a powerful contributor to the investment returns generated by a value manager. For this to work, it is important that the valuation determined for each company is close to being correct, more often than not. This is the focus of scrutiny and debate when investment managers gather for investment meetings.

3. The third noteworthy aspect of the process is engagement with the chair and other directors of investee companies, through face-to-face meetings and voting in general meetings, something that the firm has done throughout its history. The value of regular engagement becomes especially clear when investment cases go awry. All companies disappoint their investors' expectations at some point. The reaction of the stockmarket to such events can be harsh and, in the firms' experience, is usually over-done in the short-term. The investment managers are therefore often inclined to view a profit warning as an opportunity to own more of a company at a better price. Additional purchases are not, however, undertaken blindly: the investment manager will engage with directors if poor governance or capital allocation have contributed to the company's misstep. The odds of effecting change are improved if Aberforth's funds collectively own a significant stake – up to 25% in some limited cases – in a company's issued share capital. While Aberforth actively seeks to improve investment outcomes through our engagement, it always does so discreetly. More information about our Engagement Policy can be found HERE.

These three features of how Aberforth invests have been applied consistently throughout the life of the business. Underpinning the ability to remain true to a process that has proved itself over that time is the ownership structure of the firm: the business is entirely owned by partners working at the firm. There are no outside shareholders who might encourage a dilution of the value investment style, through exploration of other equity markets or pursuit of an asset-gathering strategy. This would risk being against the interest of investors in existing funds managed by Aberforth. Indeed, the firm remains committed to a ceiling on the business's assets under management, specifically 1.5% of the total market capitalisation of the NSCI (XIC) index.

ESG Framework

Aberforth's methodology for ESG analysis is set out HERE. Aberforth's approach is to integrate ESG factors into the investment process: anything that affects the value of an investee company is relevant and, depending on the significance of its impact, may be the subject of engagement with the company's board. Whereas Aberforth's engagement record on governance matters is long and deep, its list of environmentally and socially motived engagements is shorter. This is changing as the threats from climate change intensify and as the interest of the broad investor base in environmental and social issues develops, which would imply that the valuations of companies with poor performance on these fronts will be penalised. Aberforth believes that a company's system of governance is crucial to how its environmental and social policies are designed and implemented. It is therefore important that boards describe their approach to managing these issues and companies' financial reporting include relevant data. There is evidence that investment returns can be enhanced by investment in and engagement with companies that face ESG challenges and are already seeking to address them or can be encouraged to do so. Except when requested by clients, Aberforth does not exclude investments from portfolios on the basis of ESG matters alone and will invest in any constituent of its investment universe as long as the risks affecting it, ESG or otherwise, are reflected in its stockmarket valuation together with an adequate margin of safety.

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