Institutional Investor's alpha

Why Fundamentally-Focused Managers Are Struggling

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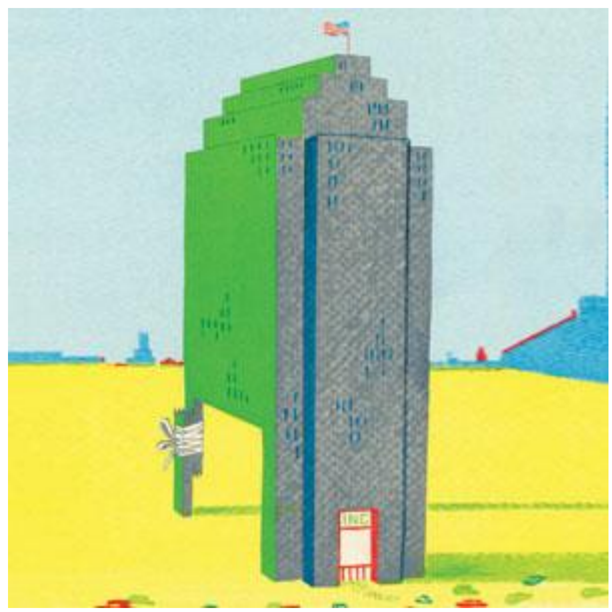
Managers who rely on this kind of analysis say the Federal Reserve is propping up the stock market and making it harder than ever for them to ply their trade.



When Daniel Niles, senior portfolio manager at West Conshohocken, Pennsylvania-based AlphaOne Capital Partners, applied the principles of fundamental analysis to Amazon.com last year, he came up short - literally.

To Niles, whose firm manages $400 million in two long-short equity hedge funds and an equity mutual fund, the online retailer showed signs of earnings weakness. His research indicated a slowdown in Amazon's revenue growth as its market share began to mature and concluded that the trend was about to affect profit growth. If Niles was right, Amazon would miss its earnings targets, and then the sky-high stock price - it was trading at 85 times earnings - would surely come down. Niles shorted the stock and waited for the company to disappoint Wall Street. His analysis was correct: Amazon missed a series of earnings targets. But instead of falling, the stock steadily rose. Niles got slammed.

"It was a painful experience," he says. "The past two years have been the most challenging in my career, at least by using fundamental analysis to drive returns. Particularly on the short side, it has been brutal."

That observation about the shortcomings of fundamental analysis might be dismissed as the grumbling of a portfolio manager who was stung after getting some bets backwards. But Niles is hardly alone. Managers across a variety of hedge fund strategies who rely on some form of fundamental analysis are reporting similar difficulties. Their refrain is that central bank stimulus by the U.S. and other developed nations has distorted markets, driving some interest rates down near zero, prompting a flood of money into equities that has pushed up prices relentlessly and creating situations in which things move in unpredictable ways - or at least in ways that defy fundamental analysis.

The situation has left many managers who depend on fundamental analysis scrambling to find other ways of conducting research and placing bets that can respond to recent market issues. Some adherents to fundamental analysis have sought to adapt by modifying their approaches: getting out of short positions quicker, forgoing new long positions until prices come down or adding a second or third layer of analysis to the mix to supplement fundamentals. Some equity-based managers who rely on fundamental analysis are borrowing from technical analysis of such things as daily volume and price movements to help guide their trades. The environment has left investors wondering why so many heralded and high-priced managers are unable to keep up. Fundamentally based managers, meanwhile, find themselves forced to employ comparatively unfamiliar techniques to try to improve their results.

"Fundamental analysis still matters," Niles says. "It does have some impact. Does it have a lot less impact when governments are shoving trillions into the system? Yes. It has been very challenging managing money because you are at the mercy of central bankers."

But for skilled practitioners, fundamental analysis is widely used because it tends to work. It is a particularly important tool in long-short equity strategies, which often revolve around a bottom-up approach involving research into a company's fundamentals. An equity manager using fundamental analysis will delve deeply into a company's balance sheet and its various corporate filings, and review debt levels and operating margins. Managers also focus on metrics such as free cash flow, revenue and earnings, and price-to-earnings and price-to-book ratios. Some equity managers insist on visiting companies and meeting with management; others eschew direct contact and rely strictly on data-crunching. Many say they try to ignore market gyrations and central bank actions, and concentrate solely on company fundamentals in making their selections. Ultimately, the goal is to uncover something about a company that is not widely recognized and that points to business success or trouble and thus provides a reason to buy or sell.

But when asset prices are unusually high and interest rates unusually low, fundamentals can lose their effectiveness as a gauge. The conclusions drawn from fundamental analysis may be on target and still result in losing bets - as, for example, with Amazon, when a company's ability to produce earnings in line with expectations falters but its stock price still rises.

For fundamental investment managers trying to be selective, the markets are confounding and often seem to defy reason. Some managers say the level of mispricing in the markets today is off the charts as a result of government stimulus. Paul Singer observed in a recent letter to investors in his hedge fund firm, Elliott Management Corp., that both bond and stock prices had gone "completely awry because governments are pulling the strings to a degree never before seen in the free enterprise systems."

David Einhorn, founder of New York-based hedge fund firm Greenlight Capital and an avid practitioner of fundamental analysis, lamented in a recent conference call to his investors that he had trouble finding any new investments worth pursuing in the second quarter of 2014. In an earlier letter to his investors, Einhorn observed that dirt-cheap debt financing had spawned a wave of corporate takeovers that in more-normal markets probably would never have occurred. But now buyers are willing to pay premium prices for companies with fundamental problems, he wrote, and the market not only has accepted the practice but has rewarded such questionable decisions by bidding up the acquirer's stock as well. That is not a good situation for long-short managers, who can find themselves with short positions in companies that they are convinced have fundamental problems but that end up being taken out at premium prices. Einhorn noted in his letter that the heightened takeover activity had "infected" a number of his short positions.

The situation also has tested the analytical skills of some of the so-called Tiger Cubs, the heirs to the stock-picking legacy of Tiger Management Corp. founder Julian Robertson Jr. Philippe Laffont's Coatue Management reportedly posted a 7.4 percent decline in its flagship fund in the first quarter of this year, after short positions lost money and long positions in the expensive and frothy technology, biotechnology and media sectors lagged. The fund had reportedly narrowed its loss to 4.5 percent through June. Lee Ainslie's Dallas-based Maverick Capital was up a scant 1.13 percent through June. Tiger Cub Jonathan Auerbach's Hound Partners gained less than 1 percent through June.

Managers who have historically relied on fundamental analysis to drive their decision making have several options in the current environment. One way to adjust is to try to use technical analysis to help guide trades. Fundamental analysis might suggest a stock is a good long or short investment, but technical analysis, which might involve charting past price movements or moving averages, could suggest that a stock is poised to move in ways that are not in line with the fundamentals. The trick is interpreting and interweaving the two data sets in a way that gives a clearer and more accurate picture of an investment's prospects.

Thomas Kreitler, who leads the hedge fund and liquid strategies fundraising team at Rowayton, Connecticut-based fund placement firm Eaton Partners, contends that managers need to stay abreast of analytical methods besides fundamentals. His firm continues to seek managers who have solid credentials in fundamental analysis but looks for those who are able to incorporate other metrics and borrow from other strategies, as the situation dictates. Kreitler says equity managers using fundamental analysis need to add three extra layers of analysis: a macro overlay, an event-driven perspective and technical analysis.

"We are still strong believers in fundamental analysis as an alpha driver," he explains. "We rarely work with a manager that isn't fundamentally based. Having said that, it is really important for managers to incorporate other elements into a strategy. Just fundamentals without any sense of timing is a loser."

Some managers have continued to do well by tweaking their research methods to respond to changing markets. Barry Gill, senior portfolio manager at O'Connor, the $5.5 billion multistrategy hedge fund unit of Swiss banking giant UBS, says that for his firm fundamental analysis remains a key tool in applying its investment strategies. But he adds that it needs to be used along with other analytical methods if it is to be effective, particularly in markets that are not behaving as might be expected. "Most of the people in our organization have fundamental training," Gill says. "We are applying it every single day. It is yielding returns. Is it the be-all-end-all of identifying alpha? No. There is always return available. The trick is not to get dogmatic in what you do."

Niles is among those making adjustments. "We are looking a lot more at what the dividend yield is on a company," says the onetime All-America Research Team-ranked technology analyst, who joined AlphaOne in 2009 after managing money for Neuberger Berman. "What is the likelihood it will get acquired? How does the stock look technically? We are being a lot more cognizant of those kinds of things, especially in the short book. We are trying to stay with our longs longer and trying to cover shorts more quickly."

Paul Karos, senior portfolio manager at Minneapolis-based Whitebox Advisors, says his firm uses both quantitative models and fundamental analysis. He explains: "The bottom line is, the disciplined use of quantitative models can help an investor stay nonemotional and objective during a variety of market environments, but fundamental analysis can often see or uncover things that a model could miss or not possibly process - think an activist investor or other public event. We believe the most effective approach is to marry the two disciplines."

For others who depend on traditional fundamental analysis, the key to surviving in the current environment is to stay on the sidelines until things return to a more normal state - either going to cash or calling it quits. Indeed, one well-known manager, Steven Eisman, shut down his long-short fund, Emrys Partners, this spring, just two years after its launch, laying the blame partly on a breakdown in fundamental analysis. Eisman was one of the winners in the subprime-mortgage-backed-securities short a few years ago, making him a major character in Michael Lewis's book *The Big Short*. But he found himself unable to impress investors in his newer long-short equity fund. According to the *Wall Street Journal*, Emrys offered an explanation for its difficulties in one of its latest regulatory filings: "Making investment decisions by looking solely at the fundamentals of individual companies is no longer a viable investment philosophy. While individual company analysis will always be important, the health, or change in health, of the financial system is the starting point of all analysis."

One example of where Emrys got it wrong by relying on fundamental analysis: Toronto bank Home Capital Group. At the May 2013 Sohn Investment Conference, an annual gathering in New York where hedge fund managers pitch their best ideas to raise money for charity, Eisman singled out Home Capital, a provider of credit products including home mortgages, as a company primed for a fall, based on its heavy participation in the lower end of the Canadian home mortgage market, which he saw as shaky. But the doomsday scenario for Home Capital that Eisman's fundamental analysis predicted has yet to materialize. Home prices have continued to rise in Canada, as have buyer debt levels, but there has been no corresponding increase in mortgage defaults that would have torpedoed Home Capital's bottom line. From the time of Eisman's presentation in May 2013 through this July, Home Capital's stock doubled in value.

For some managers the wait for markets to become more responsive to fundamental analysis is simply taking too long. Eisman is not the only manager to close shop and comment on the difficulties for fundamentally based firms. Among the fallen are some others with solid pedigrees. Citadel veteran Michael Pascutti shuttered New York-based Eagle River Asset Management at the end of last year, saying it was simply too difficult to effectively run a relative-value credit hedge fund at a time when interest rates were near zero and stock prices were soaring. Short-biased, New York-based hedge fund firm Axial Capital Management - launched in 2002 with the backing of Tiger patriarch Robertson - decided to call it quits late last year after seeing its short positions get repeatedly crushed by rising equity markets despite its crew's solid grounding in fundamentals.

Jay Warner, chief investment officer at Boston-based Balter Capital Management, a $1.2 billion, opportunistic boutique hedge fund shop that operates a long-short strategy, says part of the problem for equity managers in the recent markets is simply that values have risen to levels that make it difficult to construct sound trades. Fundamentals may point an equity manager to a company that has good business prospects, but that doesn't mean a long position in its stock is a particularly good bet.

"Say you have a company you would like to buy at 10 times earnings, but you have to pay 12 to 13 times," Warner says. "That is not the greatest way to invest based on fundamentals."

Recently, stock pickers using fundamental analysis have frequently found themselves operating in the shadow of index funds, which have been able to generate hefty returns simply by tracking the bull market. Emrys, for example, reportedly was up 10.8 percent in 2013 and 3.6 percent in 2012, while the S&P 500 returned about 32 percent and 16 percent, respectively.

Ironically, at the same time some managers are shutting down in exasperation, a notable number of new funds are being launched, and two of the most popular emerging manager strategies are long-short equity and long-only funds - the very types of strategies that tend to rely heavily on fundamental analysis. Robert Leonard, global head of capital services at Credit Suisse in New York, says he sees no letup in new equity hedge fund start-ups. Leonard says that investors, instead of seeing a market getting overheated, may detect a near future that offers additional equity investment opportunities that require more-nuanced stock selection. In a market like that, fundamental analysis would become far more valuable.

"Investors are saying they think this is going to be much more of a stock picker's environment going forward, and they want to be well positioned to profit from it," Leonard explains.

Emerging managers may be in a favorable position to benefit from such a changing market environment. By virtue of being start-ups, these managers may have an advantage over some existing managers whose portfolios might be burdened with legacy picks made at less opportune moments.

While new managers are streaming into the market to test their fundamental chops, some established investors are taking a break by moving more into cash. Boston-based Baupost Group, the $27 billion hedge fund firm run by highly regarded stock picker Seth Klarman, has been stockpiling cash. Warren Buffett is doing the same thing. His Berkshire Hathaway was sitting on an estimated $55.5 billion in cash as of the second quarter, a record for the company, as the legendary investor stepped away from equity markets.

Both Klarman and Buffett are practitioners of an investment style that is linked particularly closely to fundamental analysis: value investing. It revolves around a buy-and-hold strategy and depends heavily on fundamental analysis for its selections. If recent markets present a challenge for fundamental analysis, value investors especially should be feeling the pinch. "For some value investors it is a difficult proposition for them to stay invested," Balter's Warner says.

Yet some value investors have managed to do just that. Andrew Wellington, co-founder and chief investment officer at New York-based Lyrical Asset Management, says his firm remains fully invested despite adding just one long position, in multinational property/casualty insurance company AmTrust Financial Services, in 2014. Lyrical manages $2.5 billion across several equity-based offerings, including a long-only fund, a long-short hedge fund, mutual funds and an alternative mutual fund. It uses pure fundamental analysis tied to a value investment strategy that relies on buying good companies cheap and holding until the market drives up the price; this can take as long as six years.

So far, Wellington has not had to sacrifice returns. His largest fund, the Lyrical U.S. Value Equity Fund, was up 9.9 percent net through June of this year, about 2 percentage points above the S&P 500. In 2013 the Lyrical funds produced returns in excess of 50 percent, beating the S&P by about 20 percentage points.

Wellington believes that rational markets will eventually win out, allowing him to continue investing as he has always done, based on fundamentals. "We don't know when the market will recognize the value in an investment," he says. "We just trust that the laws of economics - the invisible hand - will eventually lead a stock to its proper valuation."

For many managers who see wackiness in current markets, the catalyst that will return the investment landscape to a more rational state is the withdrawal of central bank stimulus. That has already begun with the Fed, albeit very modestly. The big question is, What will happen when stimulus is significantly reduced? The markets have become so wedded to stimulus that its withdrawal will be akin to an addict going cold turkey, observers say - not a pretty picture.

If things do get as chaotic as some predict, the rational approach embodied in fundamental analysis may not be much help.

"At some point, when that punch bowl is taken away, it is going to get ugly quickly," AlphaOne's Niles says. "Unfortunately, at that point fundamentals probably won't matter either."