This article first appeared in MSN Money, reported by the Motely Fool on 1st February 2020

Ask A Fund Manager

The Motley Fool chats with fund managers so that you can get an insight into how the professionals think. In this edition, Redpoint chief executive Max Cappetta tells how quantitative investing saves choosing between growth or value.

Investment style

The Motley Fool: What's your fund's philosophy?

Max Cappetta: The name of the fund is the Generation Life Tax Aware Australian Share Fund. Redpoint, we are the underlying manager to that strategy.

It is a strategy run specifically and exclusively for **Generation Life** as part of their investment bond offering. It's a 30% tax-paid investment structure that if investors hold for up to 10 years, then the proceeds of that investment are tax-free in their hands and there's no annual distributions. So there's no taxable income events throughout the period that you're invested in the bond.

Investment bonds have been around for decades. But I think they're really finding a Renaissance at the moment with limits to superannuation and for people just looking for more tax effective ways to save for major expenditures throughout their life.

MF: What's the investment strategy?

MC: A couple of key things. Number one, we're quantitative investors – that means that we actually generally don't meet with company management, and we actually model the financial statements and a range of other metrics.

The reason we do that is because we realised that no one investment style or discipline is consistently rewarded. Styles come in and out of favour. For example, if you'd been a value-focused manager over the last few years, it's been a very tough environment. If you've been more of a growth manager, you've had a much better time.

We want to build a portfolio using insights from each company's financial statements in terms of its quality metrics, growth prospects, and valuation. And then we overlay a range of shorter horizon sentiment and momentum indicators, which give us a sort of certainty-uncertainty conviction type element to our overall stock selection.

You'll probably find that most people understand this concept and what they do is they invest in a range of different investment managers that have different styles. The fact that we quantitatively can put all of this together in one portfolio means then we have risk control across the entire portfolio.

Buying and selling

MF: What do you look at closely when considering buying a stock?

MC: We'll actually model the company's financial statements, looking at quality metrics – in particular their cash flow. We'll look at growth.

When we look at growth, we take a slightly different approach. Yes, we are interested in the company's top line growth metrics, but we're also interested in the degree to which sales are growing faster than costs. So we're looking for that incremental uplift, which for us gives us a better indication that there’s a positive surprise coming for a particular company.

When it comes to valuation, we take a range of different approaches whereby we try to model the company’s earnings from different starting points within their financial statements. We’re looking at the trend and consistency of their earnings, of their taxable income, of their free cash flow, their operating profit, their return on equity, for example. What that gives us is quite a robust metric that we can use to compare the valuation of different companies across different sectors in the marketplace.

Then, as I said, there’s a range of other sentiment, momentum, news-based metrics, which help us to have either higher certainty about those metrics. So for example, if we really do like a company, be it on quality growth or valuation, but we’re seeing that some of the shorter term metrics are quite negative or poor, then we’ll sort of ratchet back our expectations. Whereas if everything’s pointing in the same direction, then that’ll give us more confidence to actually increase our position.

MF: What triggers you to sell a share?

MC: Obviously if a company’s own metrics start to deteriorate. For example, if a company performs very well, it’s no longer attractive on valuation. And maybe we’re seeing that the kind of growth that the company is undertaking is poor quality and not leading to our expectation of increasing profitability.

But at the same time we’re looking also to see, even if a company stays still, if there’s another stock similar to it, similar industry. Because we try to keep a quite diversified portfolio that now starts to become more attractive.

Overlaid on top of all of that, we look at the individual tax parcel positions that we have in the portfolio. So that as we’re rebalancing we want to make sure that we're not just unnecessarily churning and causing tax liabilities. Because we know that risk and return forecasts are uncertain, but when you actually realise a gain, the tax implications are certain.

So we try to do that quite complex trade-off in a very automated, very disciplined way.

MF: Not many fund managers talk about capital gains tax implications, but it's an important factor, isn't it?

MC: Absolutely. One of the key things, particularly for superannuation funds, you know that a capital gain is discounted if it's held for more than 12 months. It'd be quite silly to actually sell a stock in a gain position, if you've been holding it for 11.5 months. There has to be something quite drastic to change in terms of your return expectations, to override having to pay 15% tax versus holding for two weeks and then getting a 33% reduction on that tax payment.

What's coming up?

MF: Where do you think the world is heading at the moment?

MC: I must admit, we were, and certainly I was, quite surprised at the degree to which the markets bounced back in March of 2020.

Of course they were supported by massive fiscal and monetary stimulus, which was coordinated across the entire world, and that is continuing today. So really what we've seen is the markets look through the earnings drop and out into 2022, 2023.

We see that there's a lot of positive expectation already built into share prices. There are still corners of the marketplace where there are maybe more valuation type opportunities.

But in general the market is back – and from our perspective more fully priced. So that is the challenge – I think what could derail things is maybe a slower than expected rollout of vaccines or something associated with the fact that we can't return back to pre-COVID type activity levels as soon as we'd expected.

MF: Like if the vaccines were proven to be ineffective or not last very long?

MC: That's right. Or for that matter, if there's simply a delay in being able to get that through populations, which means that countries remain locked down. While there may be domestic travel, then there's probably no international travel associated with that. So that really is the risk.

What we've seen in the pricing of equity markets to date has been this extrapolation of very low rates almost forever. And we did see that at the end of 2018, when the US Fed did start [talking] about tapering their support, that equity markets did fall.

I think there's a lot of what we might call long-duration type stocks. Stocks where profitability is expected to come, but probably in about 3 to 5 years' time. That if there are expectations of increased interest rates, even in the next 2 or 3 years, then maybe their future profitability out to 2030 will start to be discounted to quite a high degree.

So some of the high-flying stocks that really now need about a decade of plain sailing to get their financial statements to be in line with their current price. There's going to be a few risks to some of those stocks, maybe not delivering the returns that they have over the last 12 months.

Overrated and underrated shares

MF: What's your most underrated stock at the moment?

MC: One of the stocks we've had an eye on and we have a position in at the moment is **Reliance Worldwide Corporation Ltd** (ASX: RWC). They're a plumbing business essentially – rather quite boring. They're sort of behind the walls. You don't really see their product. It just sort of happens in the background.

If you look at the history of Reliance, while they've been around really for many decades, over the last 5, 10 years the company has been quite acquisitive, both in Australia and internationally. What we saw in their financial statements from last year is really a strong positioning in terms of all of those transactions that they've put together into the business – now actually starting to build momentum and causing incremental profit growth the way that we actually like to see it.

We see that it's a stock that currently is on track to probably double their earnings from 2018. And yet is still trading at 30% below the price that it traded at its highs in 2018.

We think it's also going to be supported by fiscal spending and investment into construction over the next few years. And obviously their plumbing products will be in great demand. [That] really supports their growth here in Australia, in the United States and also a growing business through Europe.

So it's one of the stocks that we think at the moment is underappreciated. They did have a very good half-year update the other day, which the market responded to quite positively. And we expect for that positive sentiment to continue in the near term.

MF: When did you start buying into Reliance?

MC: We started building up our position from October last year. We saw the outcome in the 30 June result, which was released in August, that already started to give us a positive signal. They then provided an update in October and that actually caused analysts in the marketplace to start revising up their earnings forecasts for '21 and '22... And that was when the stars aligned for our metrics to build up a position in the stock.

MF: Plumbing never goes out of fashion, does it?

MC: There's a lot of truth in what you're saying there. It does remind me a little bit of the 1999-2000 period, both here in Australia and offshore, where everybody was about clicks and order as opposed to bricks and mortar.

I think the one difference today is that maybe a lot of the old school businesses, certainly their growth profile is maybe not as strong as some of these IT and tech stocks. But if they are trading at an attractive valuation and can grow earnings meaningfully over the next 2 or 3 years, then I think they do have a part to play in people's portfolios and can deliver the good returns.

MF: What do you think is the most overrated stock at the moment?

MC: There's a stock called **Afterpay Ltd** (ASX: APT) in the buy now, pay later space. It's had a very strong run and I think it is one of those stocks that from a valuation perspective, we think it now really needs that decade of runway to be able to get its fundamentals and financials to be in line with its price expectations.

That's not to say that it can't do that, and it can remain and become a market leader. I think just the incremental return that's available to investors as the company goes down that path is probably not as strong as what we can see in other places.

I'm not necessarily talking about IT [as overrated], because there are stocks in there that we do like.

But even a company like **Nextdc Ltd** (ASX: NXT) that is running data centres, again, we see that it has probably had a re-rating because of its participation in that tech sector. We do have concerns that maybe its growth profile is not as strong.

Also, one of the things that we find very important and we look at is the metrics of stocks in terms of its environmental, social, and governance (ESG) practices and risks. One of the risks we do see for NextDC is its energy utilisation. Data centres need power, they need air conditioning – you can have solar panels on the roof, but unfortunately they don't work at night time.

So there is a bit of transition work to be done by some of those data centre companies to be more carbon efficient.

MF: For non-software tech businesses like that, it's capital-intensive to run, isn't it?

MC: Exactly right. So you do need that physical location and obviously that carries its own costs both in setup and then maintenance going forward.

Looking back

MF: Which stock are you most proud of from a past purchase?

MC: I've got a couple... The first one is actually **Fortescue Metals Group Limited** (ASX: FMG). Iron ore stock, yes, it is the market darling. It's up over 100% last year, from $10.88 through to $24 plus more than $2 if you include the tax credits on the dividend.

What we saw within our metrics, and I think the timing of it was quite important, and that is that we'd seen the cash flow generation steadily increasing. What our modeling was telling us is that the cap-ex that had been put into the business was obviously good quality capital expenditure.

Now the company was in a very strong position to be able to leverage increased prices in iron ore into direct profitability.

Sometimes companies need that price increase to justify their existence, but Fortescue put themselves in a position where price rises were just going to essentially throw off a great deal of cash, which has certainly transpired.

We did have a little bit of uncertainty with valuation going into March, but then what happened was in March there was guidance provided by the company that their activities through the COVID period they felt were going to be unchanged. And that then sparked off a range of upgrades through April and May, which then saw the price take off thereafter.

We'd already had a position. We saw that the company had very strong growth potential… Then when things got quite uncertain there in March, we essentially were increasing our position because we felt that if things remained unchanged for them, then the stock was going to deliver quite great returns.

The stock was still at $13.75 at 30 June. So it really doubled in price over the period of 6 months.

It was a great example of looking through the noise of the marketplace at the time, and looking through to the fundamentals. Looking through to the positive sentiment and expectations going forward. And it ended up being the best individual performer in the portfolio for the year.

MF: You're still holding?

MC: Yeah, we are still holding. One of the interesting things about the way we run the Tax Effective Portfolio is that when we get new cash flow from new investors into the portfolio, we actually re-optimise to determine a specific trade list for each cash flow.

And so what it's actually doing is actually reducing the active position in Fortescue in a very tax-effective way. We never have to sell a share of the stock, but new investor capital helps to downlight that active position because we don't just buy naively across the entire portfolio. We actually look at each cash flow on its merits and what we find attractive at any given point in time. We'll focus more of the [new] capital into the names which we find most attractive today, and then allow the other positions to just naturally reduce over time.

During March and April when markets fell, we actually did a lot more turnover because it was actually quite tax-efficient to reposition the portfolio – because we could realise losses, which could then offset the tax payments that would have been made on dividends.

So there's a lot of trade offs that go into the process. That's our edge as a quantitative manager, is to be able to trade off all of these different moving pieces of information, and then come up with a nicely diversified portfolio with a range of different style drivers, all acting at the same time.

MF: What's the second stock that you're proud of?

MC: The other one was a story on real estate. This was more a bit of a longer term trend. We've seen through our metrics that a lot of the retail shopping centre businesses were starting to fall off in their profit growth. And we saw this being driven by the fact that pretty much every square metre of **Westfield** shopping centre (**Scentre Group** (ASX: SCG)) was devoted to some kind of activity.

So the scope for continuing to up the revenue within that current square meterage was then starting to be reduced. We saw that the growth prospects for some of those companies weren't as strong, and we started repositioning to where we saw better opportunities in particular with stocks like **Goodman Group** (ASX: GMG).

Admittedly, the whole COVID pandemic lockdown accelerated a number of things. The lockdown within shopping centres meant that we were under-invested in those names, which was positive. Then with Goodman and their industrial portfolio picking up on delivery, and warehousing growth with **Amazon.com Inc** (NASDAQ: AMZN) here in Australia.

But more importantly, Goodman actually has a very strong global business. So in one aspect we saw the growth in Goodman and deteriorating growth in retail. Through the last 12 months that's been a positive thematic that's played out. Maybe not for the reasons that we'd expected two years ago, but COVID accelerated that repricing within those stocks.

MF: Is there a move that you regret from the past? For example, a missed opportunity or buying a stock at the wrong timing or price.

MC: I do look at Afterpay and say, "In many ways at $10 in mid-March it was a value stock". It's so easy to say now in hindsight, I must admit it's a little bit humbling when the stock that you choose in a sector, like **Xero Limited** (ASX: XRO), goes up a 100% and it's the under-performer in the sector by a factor of 10!

Having lived through and managed an Australian small caps product through 1999 and 2000, I've seen how the market can re-price some of these names. In some ways we were a little bit slow, particularly in this portfolio, to get a position. We currently do [hold Afterpay], but we are underweight – it's more there for risk purposes.

That's probably the one stock that, if we had our timing in, we might have had a little bit more invested in it in April and May, of last year.

We remain disciplined to our investment process. From a quality perspective its cash flow generation and lack of profitability is a red X for us. It's hard to obviously get a value on the stock, but even across our metrics it doesn't look like a valuation opportunity.

Growth does seem to be turning more positive of late. That's why we've taken a position over the last 6 months in the stock. Momentum has been quite strong… And the stock has responded very well or the market has responded to news and announcements from the company.

But we still see that there is a divergence across analysts in the marketplace. You know, some believing that the stock is headed to $200, others believing that it's probably more fair value at $30. No doubt, the truth is somewhere in between. Exactly which side is going to win out, we'll just have to wait and see.