

## Consensus Opinion

*“If we assume that it is the habit of the market to overvalue common stocks which have been showing excellent growth or are glamorous for some other reason, it is logical to expect that it will undervalue – relatively at least – companies that are out of favour because of unsatisfactory developments of a temporary nature. This may be set down as a fundamental law of the stock market, and it suggests an investment approach that should be both conservative and promising.”*

*Benjamin Graham, 1929*

*“Institutional money managers hire consultants who hire other consultants. They put money in venture capital, little companies, big ones, growth, value, etc. One thing that's sure is that at the end of the year, you've spent a lot on the consultants...”*

*Charlie Munger*

*Wesco Annual Meeting 2003*

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The share market is home to two camps of investing adventurers. In the first camp lie the optimists, the 'bulls', those that believe the market will go up because the outlook for the economy, earnings, investment flows or some combination of these and other factors, conspire to indicate a rosy future. In the other camp lie the 'bears'. The bears are hibernators who believe a bleak winter is just around the corner and the best approach is to position one-self to profit from a decline in prices. As the market waxes and wanes, rising and falling on a daily, weekly, monthly and even annual basis, it does so to the cheers and cries of these two camps and invariably one camp can always be heard shouting "we told you so". During extreme 'we-told-you-so' periods, obsequious dedication is aborted and campers desert 'en-masse' thereby perpetuating the majority or 'consensus' view and driving the market to overreact.

There is however a third kind of camp where another type of investor resides, who doesn't care much for the direction of the 'market'. This camp is interested in investing in businesses and buying them to take advantage of their economic performance. They understand that the share price, over the long term, will reflect the economic performance of that business. The individuals in this camp rely on the market only to the extent that it provides them - usually in periods of extreme depression - with opportunities to acquire shares in those businesses at sensible prices.

Clime is proud to be a resident of this third camp. We concern ourselves not with the wiggling of blips on a screen but in the economic performance of businesses and having identified wonderful businesses with bright prospects, waiting for the market (the other two camps) to deliver an appropriate price to pay for them.

Camping away from the two former groups of investors also provides perspective particularly during periods of extreme optimism (bullishness) or extreme pessimism (bearishness). Invariably our approach to investing, when applied this way, will present some opportunities that can only be described as 'contrarian'. When the two former camps are not equally balanced but instead are heavily betting in one direction, profitable opportunities are often presented and these are contrarian. The purchase of shares in Macquarie Bank at \$19.05 (2002), QBE at \$3.97 (2001), MAP at \$1.00 (2001) and Westpac (1999), all had the hallmarks of a contrarian investment.

A contrarian investment may broadly be described as one made at least partly due to belief or knowledge contrary to consensus opinion. There is ample evidence suggesting that consensus opinion is largely useless as a tool in the business of producing superior returns. Logically, and by definition, running with the consensus opinion should produce at best results similar to the majority of participants – average.

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But while logic suggests that following consensus will produce a result similar to the majority of participants, that majority tends to produce a result that is worse than the market averages and so those following consensus will produce returns worse than the market average. For this there is also ample evidence.

The blurb for the book *Contrarian Investment Strategy* by David Dreman reads as follows:

“In 1970, at the Institutional Investor’s Conference, two thousand of the nation’s top money managers were polled and asked to name the stock that would perform best in the coming year. The consensus choice was a high-flying market favourite. National Student Marketing, then trading at 140. It dropped to 7 within five months. In 1972, the same pros said that airlines were the industry group whose prospects looked best. The group plummeted 60 percent within a year, at which time the experts voted the airlines the industry to avoid.

Are these examples atypical or unfair? Hardly. In the decade ending 1978, 84% of the 141 largest bank trust departments and insurance companies managing \$140 billion under performed the market.”

In our own investing, we find few things more satisfying than identifying a company that has great management, wonderful prospects and has not missed a beat performance-wise, but is virtually hated by the market. While being disliked or unloved by analysts and market commentators is itself not an indication of superior future performance, such a confluence of circumstances often produces results far superior to those produced by the index and those same experts.

Mental and intestinal fortitude is required when running against the herd and Benjamin Graham’s Mr. Market allegory, repeated by Warren Buffett, may help in shoring up that resolve.

“[Ben Graham] said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his. Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market’s quotations will be anything but. For, sad

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to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.

Ben's Mr. Market allegory may seem out-of-date in today's investment world, in which most professionals and academicians talk of efficient markets, dynamic hedging and betas. Their interest in such matters is understandable, since techniques shrouded in mystery clearly have value to the purveyor of investment advice. After all, what witch doctor has ever achieved fame and fortune by simply advising, "Take two aspirins"?"

In the business of investing it is essential to insulate one's thoughts from the 'consensus wisdom' that prevails at any time. There is often very little wisdom in consensus; it is instead replete with emotion and that favourite of cognitive psychologists – 'representativeness'. Representativeness is the tendency of humans to believe that the future holds forever what the recent past has just delivered. The outlook to the experts may look bleak or rosy but that outlook is merely a reflection of recent events.

In our own efforts to achieve the required independence from consensus, it is essential that we at the very least seek a statistically significant number of observations to support our strategy – evidence. Adhering to a strategy consistently requires mental fortitude and this can only come from evidence produced from research conducted in an unbiased way. To that end we find it helpful (as well as incredibly entertaining) to watch and track the changing tides in sentiment towards individual companies.

One year a company is the market darling; the next it is in the scrap heap, and it is in the scrap heap that wonderful but unloved businesses can be found. While the business provides the return, it is the scrap heap that provides the price opportunity. One must therefore think of the scrap heap not as a final destination for companies (although it is for some) but as a recycling plant. A steady stream of companies enters the plant and, as opinion changes, a similarly steady stream leaves it. This occurs partly because there are a

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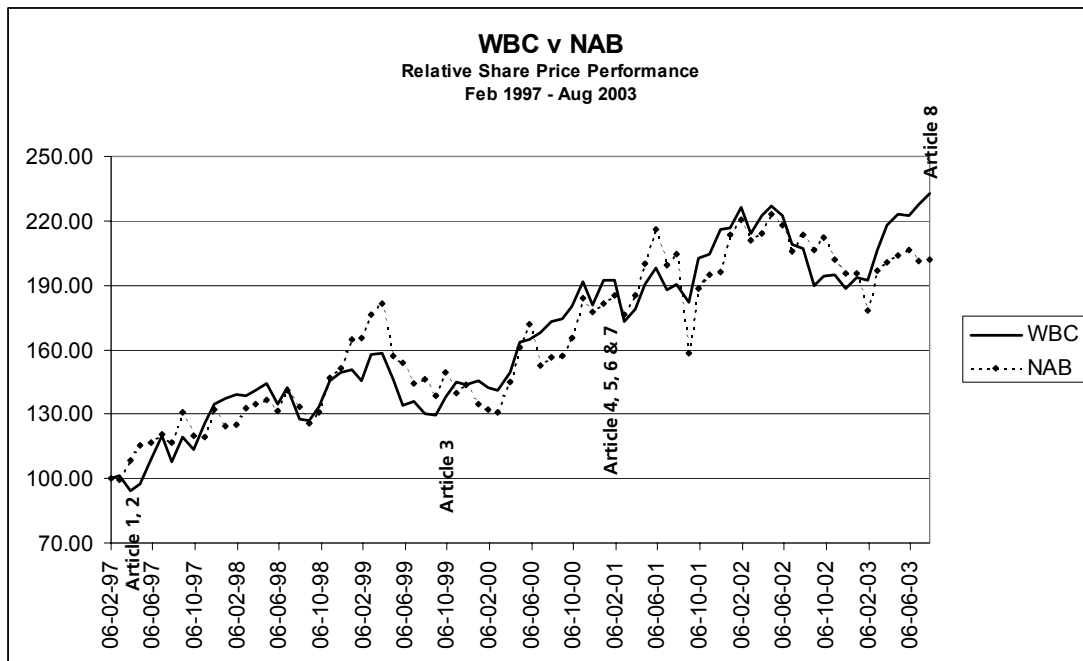
limited number of investment opportunities available in the stock market and partly because investors have overreacted in the first place: as David Dreman noted in 1979,

“One of the most obvious and predictable variables that can be harnessed into a workable investment strategy is the continuous overreaction of man himself.” *Contrarian Investment Strategy*

To begin a study into market psychology one requires a library and to help you build that library, may we suggest you start collecting articles discussing companies currently out of favour in the market and then highlight the quotes that suggest the company has virtually no future prospects whatsoever. For some companies this will be true; for a handful it will be an overreaction of man himself.

To begin your collection, take the following excerpts from articles referring to Westpac, which, at the time of writing has, as Alan Kohler remarked on the ABC, “hit \$17.00 for the first time”. Currently the market darling amongst the banks, as evidenced in Figure 1.1 it wasn't always the case. The articles below (also marked on figure 1.1) reveal the changing sentiment towards the banks, and may help fortify your resolve when investing contrary to popular opinion.

**Figure 1.1**



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## Article 1

Judging by the half-year results tabled this week, you'd swear that National Australia Bank and Westpac Banking Corporation were doing business in different countries. Or maybe different planets.

Whichever way you look at it, and no matter which acid test you submit it to, the \$1.139 billion profit (up 14 per cent) for the half year reported by National Australia Bank boss Don Argus was a good result. And perhaps, if you tend to the superlatives, it was an excellent result.

However, the story could hardly be more different a thousand kilometres to the north, where Westpac boss Bob Joss unveiled a 13 per cent lift in profits to \$638 million.

While the headline profit increase at Westpac was not dissimilar to that produced by NAB, the fine print of Westpac's announcement revealed a bank that's taking on a lot of water in the battle for banking market share. ...The risk to NAB if it doesn't treat its new customers right is it will lose \$9 billion of loans and be back where it started.

The risk to Westpac if its new Bank of Melbourne customers desert in droves after the takeover, is that it will lose \$9 billion of loans, plus it will have wiped out \$750 million of shareholders funds. ...It's unfair to lay the blame for all of Westpac's market share losses at the feet of chief executive Bob Joss. After all, he took over (in 1992) a distressed, scandal-tainted bank that was already losing market share.

Joss's strategy for dealing with that problem was to re-engineer the bank from the ground up so that operating costs came down to match a smaller balance sheet. The results of that rebuild are not yet to hand.

However, if Westpac is still losing ground 12-18 months from now, some hard questions will need to be asked. And more cost cuts will need to be made because, as this weeks statement showed, the banks cost-to-income ratio has blown out as margins have been crunched.

Aaah . . . the joys of running Westpac. Tough one day, bitch of a job the next.

**Banking ups and downs on display**

Ivor Ries *AFR* Page 80, Friday, 16 May 1997

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## Article 2

There are any number of ways you can interpret Westpac Banking Corporations \$1.4 billion takeover bid for the Bank of Melbourne. ...Westpac's bid for the Bank of Melbourne can be seen as an admission of defeat, waving the white flag in the battle for bank market share. An admission, if you like, that the name Westpac has become a consumer repellent...the statistics on banking market shares would suggest that the less flattering version is closer to the truth. That is, that Westpac has failed utterly and miserably as a retail banking franchise, not just in Victoria but indeed in most of Australia. ...Long-term, Westpac shareholders will be hoping that the BML deal is not yet another case, as the old proverb goes, of those who forget the lessons of history being bound to repeat their mistakes. ...Westpac's local branding strategy could be made to work. But, in the context of Westpac's deeply ingrained management culture, it would be a brave person that would bet their life savings on it.

### **BML bid shows up Westpac flaws**

Ivor Ries *AFR* Page 80, Friday, 4 April 1997

## Article 3

The Westpac chiefs cost-cutting regime is paying for the banks shift into e-commerce - and pressure for a takeover or price war has never been greater. ...Under the relative pricing dynamics of the big four banks, for most of the 1990s the least efficient, Westpac and ANZ, set prices that allowed the more efficient, NAB and Commonwealth, to enjoy fat margins and rising market shares. ...Westpac's shares took a hit early this year after its half-year results showed only a slight dip in its cost-to-income ratio. Since then, cost control fears have weighed heavily on the share price.

### **David Morgan, a banker at the cutting edge**

Ivor Ries *AFR* Page 28, Saturday, 16 October 1999

Our 2 cents worth; if it was cost control fears weighing heavily on the share price as Article 3 suggests, what was weighing on the "more efficient" NAB? (See Figure 1.1).

## Article 4

Domestically, Westpac Banking Corp is one company that needs to buy a large-scale fund manager because it has neither a leading position in size nor performance. It is falling behind

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Commonwealth Bank and National Australia Bank in the funds management game and, if it does not act, that gap could become unassailable.

**Maintaining Perpetual animation**

Anne Hyland *AFR* Page 28, Wed, 27 Dec 2000

**Article 5**

The other three major banks have also experienced falling share prices over the past month, though only Westpac has underperformed the wider market.

**Strypes blamed for Westpac share fall**

John Breusch, Morgan Mellish *AFR* Page 20  
Wed, 20 Dec 2000

**Article 6**

The year 2000 contained an important lesson for retail investors: the share market does not always go up in leaps and bounds....Not only did NAB acquire MLC, the Commonwealth Bank added the high- profile and solidly performing Colonial First State funds management group to its portfolio of businesses through the acquisition of Colonial Group. There is continuing speculation about how NAB and CBA will manage expansion especially NAB in the crowded and volatile United Kingdom banking sector. Westpac and ANZ have pursued a strategy of focusing on, and becoming the major players in, their existing business units.

**Stock selection, not a rising market, key to success**

Robert Guy *AFR* Page 37, Friday, 22 Dec 2000

Article 7 provides some entertainment value, if only for the comparison of WBC with AMP – AMP being superior because of its growth strategy in the UK!

**Article 7**

...Frustrated chief executives have watched Westpac slip in the past 18 months from heavy hitter status to becoming a second-tier financial services company. ...Westpac has slipped to the second tier because it has not, in the past few years, sought overseas expansion like NAB, AMP and CBA who are all operating in the UK and eyeing further growth there.

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...Moreover, Westpac did not move as quickly as its peers who took a call option on growth by buying funds management operations.

**Respect restored, but at a cost**

Anne Hyland *AFR* Page 3 Monday, 11  
December 2000

Finally, the most recent article demonstrates just how quickly investors, commentators and analysis can be firmly convinced that the opposite is true.

**Article 8**

The Bank's tightly focused strategy is paying off...Westpac Banking Corp stands out amongst the big banks for its focus on growth in the Australian and New Zealand markets... "Out of the four, it's playing the straight bat"...analyst Shawn Burns said... (and) analyst Leigh Cronin said..."It's recent track record, together with organic initiatives in place on both the cost and revenue side, appears set to ensure a continuation of recent earnings momentum and aid investor sentiment toward the stock"... "They [Westpac] look like they are more focused than the other banks," Mr Burns said. Mr Burns said if Westpac continued to deliver sound results across the entire organisation, it might be seen as premium rated.

**Westpac's plans get nod from analysts.**

Jemima Whyte *AFR* Page 25, 7 August 2003

The above articles provide evidence that, when sentiment is involved, an investor would do well to think of a swing, a merry-go-round or a recycling plant rather than a one-way train.

At Clime Asset Management we invest using a technique that would be described as 'value investing' by some and 'style neutral' by others. We however don't condone the use of these labels as they imply we are actively thinking about them when deciding what companies to invest in. For our Permanent Value portfolios we prefer the investing label "style-don't care" – we buy wonderful businesses at cheap prices and often this goal puts us, and our opinions, in an opposing corner to the consensus. Ultimately, whether investors agree or disagree makes no difference to us and their opinion neither gives us comfort nor concern. In your own investing you may also discover improved returns by standing against the tide of consensus.

Roger Montgomery  
August, 2003