Crest Value Strategy
Conceptual Framework

Executive Summary

- ❑ Value investing is a cornerstone of active security selection and traces its roots to Benjamin Graham who associated value with a margin of safety, which enables the investment to withstand adverse business developments.

- ❑ Value investing is a proven approach which has historically generated returns above the market average. This superior performance of value stocks over the long term has been termed the “value premium”.

- ❑ According to behavioral finance, value strategies might work because they are contrarian to naïve strategies followed by other investors. These naïve strategies might range from extrapolating past earnings growth too far into the future, to assuming a trend in stock prices, to overreacting to good or bad news, or to simply equating a good investment with a well-run company irrespective of price. Investors’ systematic errors in predicting future earnings growth of value stocks, and investors’ excessive pessimism about these stocks causes the superior performance of value stocks relative to growth stocks.

- ❑ We believe that a focus on free cash flow (FCF) can help in reducing investment risk and avoiding value traps. FCF is a more comprehensive measure of profitability than earnings and is more difficult to manipulate.

- ❑ Companies with strong cash flow can capitalize on market opportunities and can also better ride out economic storms than a firm with weaker cash flow. Companies with large cash flow may also be able to better finance growth and reward shareholders through dividends and share repurchases.

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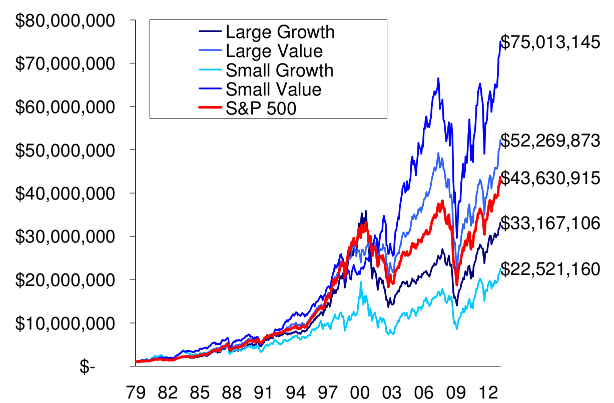
What is Value Investing?

Value investors seeks to buy stocks of companies that they believe the market has undervalued. Commonly, value investors select stocks with lower-than-average price-to-earnings or price-to-book ratios or higher dividend yields. Despite the different approaches, value investors focus on "cheapness": stocks are selected based on the ratio between market prices and some measure of fundamental value such as earnings or assets.

Value investing is a cornerstone of active security selection and traces its roots to Benjamin Graham who associated value with a margin of safety, which enables the investment to withstand adverse business developments. More importantly, value investing is a proven approach which has historically generated returns above the market average. This superior performance of value stocks over the long term has been termed the "value premium".

Chart 1. Growth of $1M Invested (1/1979-3/2013)



Source: Morningstar, Russell, Crest Investment Partners

Chart 1 illustrates the value premium using the Russell indexes. Over this period the large cap value stocks had an annualized return of 12.2% outperforming the large cap growth stocks by 150bps per annum and the S&P 500 by 60bps per annum. The small cap value stocks generated a return of 13.4% outperforming the small cap growth stocks by 390bps per annum and the S&P 500 by 180bps. Over the same period, $1M invested in the large cap value stocks grew to $52M, to $33M in large cap growth stocks, to $75M in small cap value stocks and to $22M in small cap growth stocks.

Chart 2. Average Total Returns by Decade

Decade	Large Value minus S&P 500	Large Growth minus S&P 500	Small Value minus S&P 500	Small Growth minus S&P 500
1930s	-5.5%	1.6%	-0.2%	7.4%
1940s	8.0%	-1.8%	11.8%	2.5%
1950s	2.8%	-1.8%	0.6%	-1.7%
1960s	2.9%	0.1%	7.6%	2.9%
1970s	6.4%	-2.4%	9.1%	-0.1%
1980s	2.7%	-1.8%	3.6%	-6.7%
1990s	-4.3%	1.7%	-3.7%	-3.2%
2000s	1.3%	-0.9%	11.5%	-0.1%
Average	1.8%	-0.7%	5.0%	0.1%

Source: Fama-French data through Morningstar

The table above reports that the value premium has averaged 1.8% per annum for large cap value stocks and 5.0% for small cap value stocks over the last 8 decades. These significant and quite consistent excess returns earned by value stocks stand in contrast to the efficient market hypothesis which states that investors cannot consistently achieve returns in excess of average market returns on a risk-adjusted basis, given the information available at the time the investment is made.

Some academics and practitioners contend that the value premium is a compensation for investors bearing distress risk. Some others - including us - embrace a behavioral explanation: value strategies might work because they are contrarian to naïve strategies followed by other investors. These naïve strategies might range from extrapolating past earnings growth too far into the future, to assuming a trend in stock prices, to overreacting to good or bad news, or to simply equating a good investment with a well-run company irrespective of price.[1] Regardless of the reason, some investors tend naturally to feel more comfortable with and invest in growth companies with high growth rates thus bidding up their prices and market multiples above their intrinsic value. Conversely, they overreact to stocks that have recently done poorly, pushing down their prices and compressing their multiples below their intrinsic value. Investors' systematic errors in predicting future earnings growth of value stocks, and investors' excessive pessimism about these stocks causes the superior performance of value stocks relative to growth stocks.

[1] Contrarian Investment, Extrapolation, and Risk, J. Lakonishok, A. Shleifer, R. Vishny (1993), NBER Working Paper Series

Designing a Value Strategy

Value investors earn excess returns by taking a contrarian view of stocks trading at low market valuations due to investors' unwarranted pessimism on their growth prospects. In practice though, value investing presents two major challenges: a) avoiding value traps; b) ability to withstand short-term volatility.

While the risk to investors in growth stocks is *price risk* (risk to overpay), the risk with value stocks is *business risk*. In fact, low market multiples are often a result of negative business trends reflected in low growth rates and deterioration of profitability. Thus a value trap is a stock that appears attractive on a valuation basis but whose business performance never improves.

Investors who employ traditional valuation metrics such as price-to-earnings and price-to-book ratios are more likely to fall in a value trap than investors who focus on cash flows. Specifically, we believe that a focus on free cash flow (FCF) can help reducing investment risk and avoiding value traps. FCF - defined as operating cash flow minus capital expenditure – is a more comprehensive measure of profitability than earnings as it includes working capital necessary to run the business and capital expenditures needed to maintain and expand operations. FCF is also more difficult to manipulate as it removes the discretionary accounting component of accruals that can distort earnings.

Companies with strong cash flow can capitalize on market opportunities and can also better ride out economic storms than a firm with weaker cash flow. Companies with large cash flow may also be able to better finance growth and reward shareholders through dividends and share repurchases.

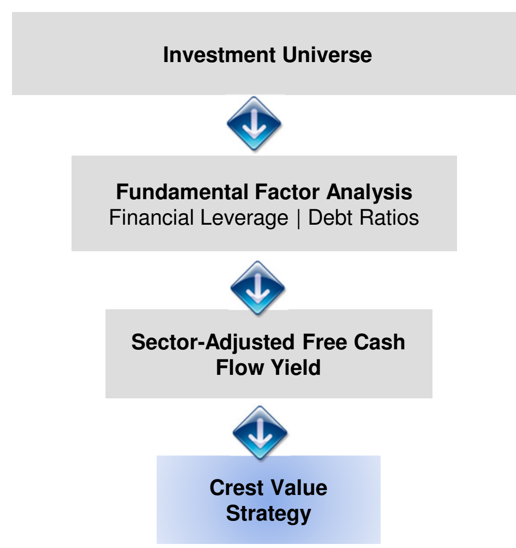
Cash flow generating power needs to be assessed in conjunction with debt leverage in order to adjust the FCF-based valuation multiple to reflect the overall enterprise value. This methodology penalizes companies that are over-leveraged and rewards companies with an attractive combination of large free cash flow , low debt and high cash balances.

Due to their weak fundamentals and recent earnings disappointments, high uncertainty surrounds the prospects of value stocks. This business uncertainty results in high price volatility. Due to the emotional nature of investing and the potential to over-react to market fluctuations, we believe that a structured, disciplined investment process is key to successful value investing.

Chart 4 illustrates the investment process flow that leads to the final portfolio selection. The sequence reflects our fundamental thinking:

1) Select companies with low financial leverage and high liquidity
2) Select stocks with attractive leverage-adjusted Free Cash Flow Yield

Chart 4. Investment Process Flow



Source: Crest Investment Partners

As a result of our process that combines cash flow with debt leverage analysis, the Crest Value Strategy is intended to display a significantly higher free cash flow yield and lower debt ratios than the market.

Our portfolio construction methodology is designed to result in a well-diversified portfolio across sectors and industries to reduce portfolio volatility and provide enhanced diversification.

Portfolio Management Massimo Santicchia is a Co-Founder and Chief Investment Officer of Crest Investment Partners. He directs all aspects of the investment strategy as well as develops and manages quantitative equity portfolios. Santicchia has 16 years of investment experience including: S&P Investment Advisory Services LLC, as creator and portfolio manager of the JNL/S&P 4 funds and co-manager of the JNL/S&P Managed and Disciplined funds.

Important Notes

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