Aviance Capital Partners

FOCUSED ASSET MANAGEMENT

Commentary on the Disciplined Value strategy
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Finding Winners: A Look at Fundamental Factors of Return

The Aviance Disciplined Value strategy focuses on high-quality businesses that are trading at significant discounts to their fair value. While finding bargains is the first priority, we also require that companies grow at least as fast as the economy and pay dividends. For investors who are willing to take a conservative business-like approach to portfolio management, the Disciplined Value strategy looks for companies with higher than normal expected returns based on Fundamental Factor Return projections (among other forms of analysis). With this commentary, we go into a little more detail into how this plays out from a research perspective.

Fundamental Factors of Return

To understand how this approach can be used to identifying opportunities, we first examine how the concept works. The performance of any stock can be broken down into these three pieces: 1) growth, 2) valuation adjustment, and 3) dividends.

For illustration purposes, let's have a look at the performance of a company over a specific time period. While we could conduct a similar analysis for any stock over any time period, let's look at Microsoft's (MSFT) performance from June 1999, to June 2012. Before we explore the three Fundamental Factors of Return for Microsoft, let's simply consider the total return as experienced by an investor. Microsoft's June 1999 price stood at $45.14 per share. On June 30, 2012, it was $30.59. Based on the share price, it has lost -32%. In 1999, the company paid no dividend, however, began paying a dividend in 2004. When you include the dividends, the actual total return an investor would have experienced over this period is a loss of -13%. This translates into -1.1% annually.

In looking at past performance, the goal of studying the Fundamental Factors of Return is to understand (or explain) what drove results. In Microsoft's case, most investors who have held the stock since 1999 are a justifiably frustrated lot. It would not be uncommon for an investor to describe the company as a laggard ~ from an investment perspective. On the other hand, when we look at the factors, it tells an interesting story.

If Microsoft's total return was -1.1% annually, what are its Fundamental Factors of Return?

Factor 1: Growth Factor

To start, consider that revenue changed from $1.93/share in 1999 to $8.79/share today. This represents *growth of +355% or +12.4% annually.*

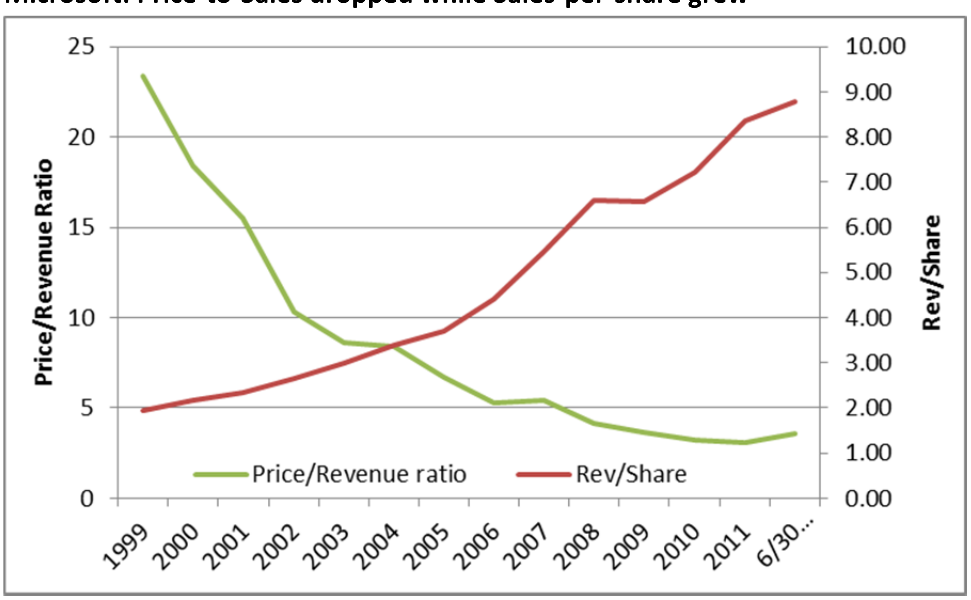
Factor 2: Valuation Adjustment Factor

Next consider a firm's valuation. Since we are considering "Revenue" growth above, we need to look at price-to-sales. At the end of 1999, prices-to-sales stood at 23.4 times. Today, the same metric is 3.6 times. (Note: We could easily consider "growth" and "value adjustment" on an earnings basis and get similar results. For examples, EPS grew from $0.76/share to $2.00/share, while the P/E shrank from 59 times to 15 times trailing EPS.) Price-to-sales shrank a very costly -85% or -13.8% annually. *This represents a valuation adjustment of -13.8%*.

Factor 3: Dividend Factor

Finally, consider that Microsoft didn't pay dividends until the middle of this measuring period. If the company paid a dividend in 1999, and maintained a similar payout policy, we could simply consider its 1999 dividend yield. Instead, consider that the company's average yield was approximately 2.1% over the period. *As a result, we use 2.1% to estimate our dividend factor.*

Microsoft: Price-to-Sales dropped while Sales-per-share grew



Microsoft's Fundamental Factor Return ("FFR") Calculation (June 1999 to June 2012):

An investor's actual total return can be explained by the FFR

FFR = (1 + Growth Factor) * (1 + Valuation Adjustment) * (1+ Dividend Factor) -1
= (1 + 12.4%) * (1 + -13.8%) * (1 + 2.1%) -1
= 1.124 * 0.862 * 1.021 -1
= -1.1%

In Microsoft's case, a long-term investor's performance has been buoyed by growth and dividend income. Had the company not been trading at such a lofty price (as measured by price-to-sales or price-to-earnings or on any measure), the total return would have been rather respectable given the growth and income. Instead the negative impact from the valuation adjustment overshadowed investor experience.

Why is understanding Fundamental Factor Returns important?

If an investor could conduct a reasonable *projection* of a company's factor returns, then it's possible to identify good investment opportunities. Once again, let's consider Microsoft (note: we do hold this stock, however this analysis does not represent an investment recommendation).

Today, the company pays a dividend yield of 2.7%. If you conclude that this dividend is sustainable, 2.7% represents a reasonable dividend factor. Over the past 13 years, as we've seen, the company grew by about 12% per year. A conservative growth estimate might be one-half that rate; say 6% as a growth factor. Finally, consider valuation. It currently trades at a price-to-earnings of 10 times (next year's estimated earnings). This is about 40% lower than the industry average of 17 times, and about 25% lower than the market average of 13 times. On the other hand, one might conclude that its business deserves this low multiple. As a result, let's give Microsoft a conservative valuation adjustment factor of 0% (implying the Price-to-earnings will stay low).

When we apply the appropriate math, Microsoft's projected Fundamental Factor Return stands at 8.9% based on these conservative estimates. Another analyst might assign different factor values. An extended analysis might also include a range of estimates to describe a base case, aggressive case, and conservative case.

This analysis of Microsoft might not impress many ~ the prospect of an 8.9% estimated annual return. On the other hand, 8.9% is arguably a conservative guestimate, whereas a base case for the company could be higher. In our analysis, we come across many businesses that well-exceed these estimates, and focus time on exploring those opportunities.

How does the Disciplined Value strategy employ this approach?

For investors who are willing to take a conservative business-like approach to portfolio management, the Disciplined Value strategy looks for companies with higher than normal expected returns based on

Fundamental Factor Return projections (among other forms of analysis). We prioritize on the valuation-adjustment, and look for dividend payers with reasonable growth prospects. However, it is a strong combination of these factors that counts; giving us reason to believe that continued long-run market out-performance is a reasonable probability for the strategy.

While predicting a company's future results can test logic, a conservative approach increases the likelihood of pleasant surprises. It is in this spirit, as has been so eloquently described by the late great Benjamin Graham, where a "margin of safety" can be built into an analyst's estimates.

The Aviance Disciplined Value strategy employs a variety of valuation and quality tests. However, upon investment, we ensure that a stock has a satisfactory Fundamental Factor Return estimate. In aggregate, the portfolio consists of 40+ companies that have passed this examination process.
