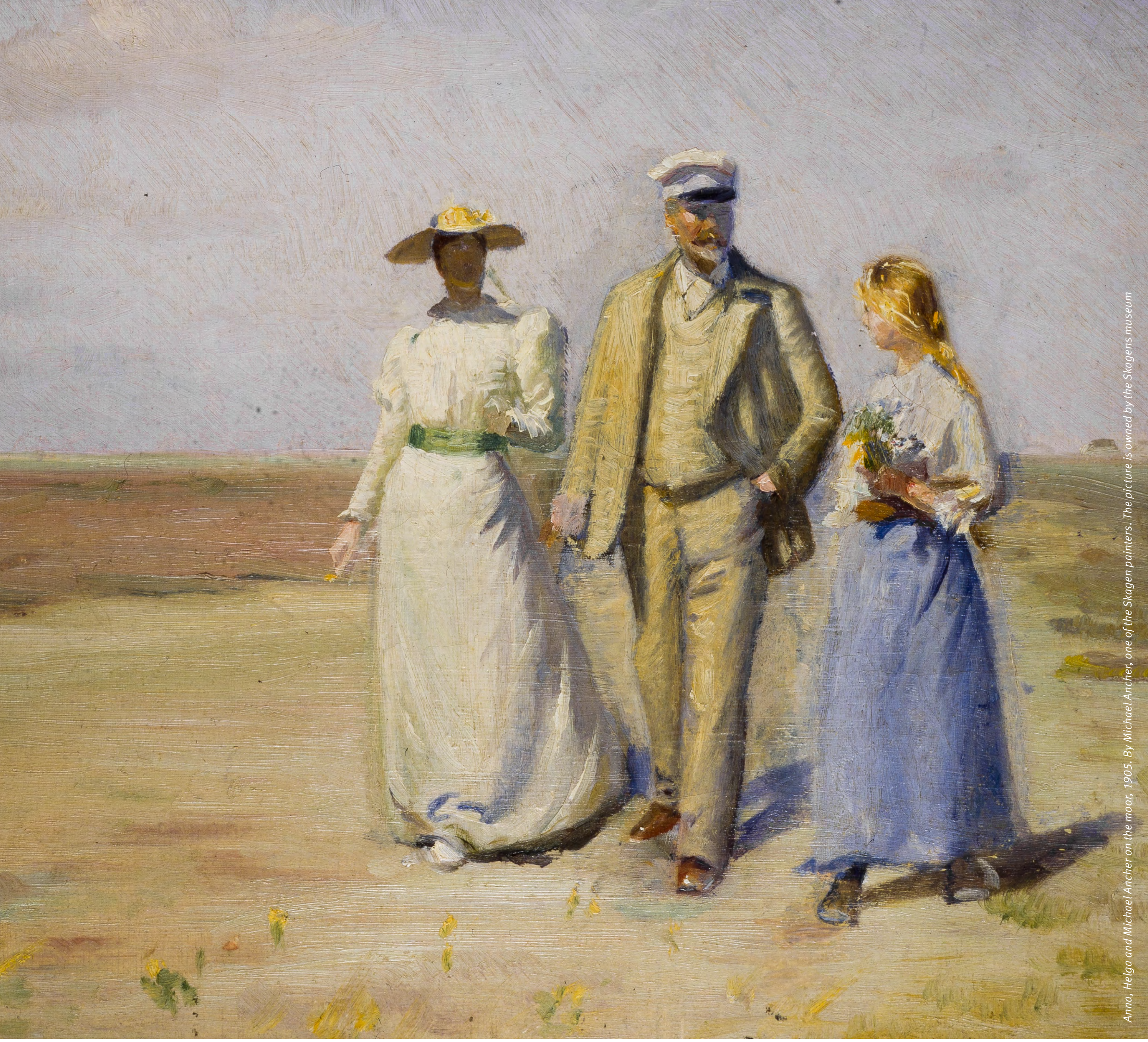


Anna, Helga and Michael Ancher on the moor, 1905. By Michael Ancher, one of the Skagen painters. The picture is owned by the Skagens museum

SKAGEN Funds
A Guide to Value Investing

The art of common sense

SKAGEN funds

Introduction to Value Investing

The idea of value investing was established by Benjamin Graham in the early 1930's. Graham worked as an investment manager and lecturer at Columbia University, and authored the two books that form the foundation of value investing theory; Security Analysis (with David Dodd) and The Intelligent Investor. One of Graham's students was Warren Buffet, who is perhaps the best-known value investor.

The concept is a simple one: By focusing on fundamental company analysis, investors can outperform the stock market by identifying and investing in companies that trade at a discount to their intrinsic value, typically measured in terms of their earnings potential, the value of their assets or ability to generate dividend income.

Contrarian thinking

Value investors don't believe in the efficient-market hypothesis, which states that share prices already include all information about a company. Instead, value investors believe that companies are sometimes under or over-priced. Not only do they reject the efficient-market hypothesis, but they are often contrarians. When everyone is buying, value investors are often selling or standing back and when everyone is selling, they're typically buying or holding shares.

Value investing is a long-term strategy and it can take several years before investments reach their intrinsic value. As with most investment strategies, proponents must have the patience and diligence to stick with their investment philosophy even though they will occasionally lose money. Also, sometimes value investors may identify a particular company they want to invest in but will have to wait for its share price to fall before investing.

Ultimately, value investors care most about a company's intrinsic value and they want to own companies that they know have sound fundamentals and financials, regardless of what other investors are saying or doing. The discount between a company's share price and the higher intrinsic value is what

Graham called the ‘margin of safety’. As another famous value investor, Seth Klarman, explains: “A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck or extreme volatility.”

The importance of downside protection:

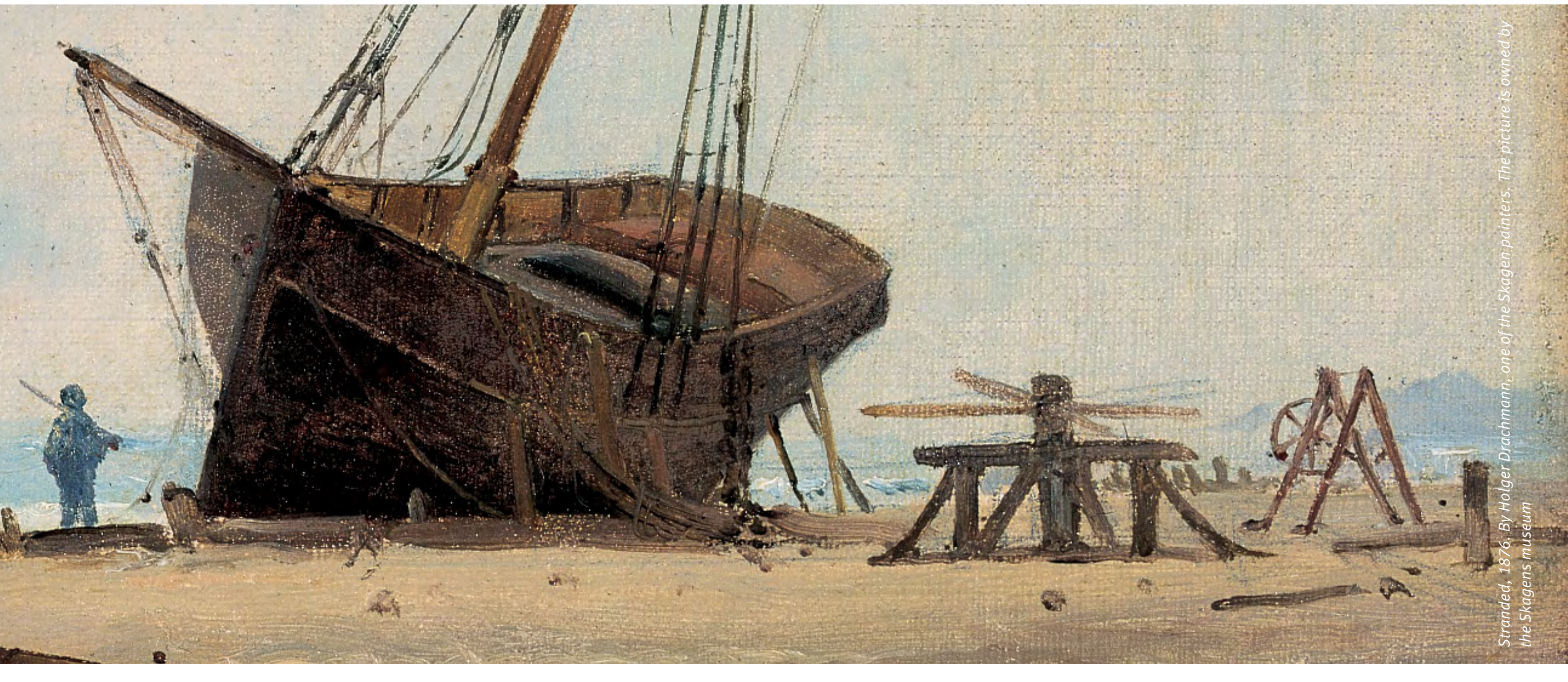
Initial Loss	Return required to break-even
20%	25%
33%	50%
50%	100%

Value versus Growth

While value investing typically involves the hunt for ‘diamonds in the rough’, growth funds in contrast focus on companies expected to experience faster than average growth in the form of revenues, profits or cash flow. While growth funds are expected to offer the potential for higher shareholder returns, they also generally represent higher risk than value funds.

Generally speaking, growth funds tend to outperform the market when share prices are rising and underperform when equity prices fall. As a result, investing in growth funds may require a slightly higher tolerance for risk, as well as a longer time horizon. In comparing value and growth funds, many studies* show that value funds typically outperform over the long-term, provided sufficient portfolio rebalancing is carried out.

* Fama and French - Value Versus Growth: The International Evidence (1997); Ibbotson Associates - A Comprehensive Set of Growth and Value Data (2003); The Brandes Institute - Value vs. Glamour: A Global Phenomenon (2008)



Stranded, 1876. By Holger Drachmann, one of the Skagen painters. The picture is owned by the Skagens museum

Five Commandments for Value Investors

In order to succeed as a value investor, it is not enough to just find companies that have low valuation based on earnings and book value.

The challenge for value investors is that it is based on static valuation metrics which often fail to take into account the fact that companies are constantly growing and changing. For a long-term investor with a three to five year horizon, these changes often have a significant effect on a company's fundamental value.

The key to long-term success lies in a combination of buying companies cheaply and being aware of what will influence them over time. With this in mind, what are the five central success criteria for an active, value-based equity investor like SKAGEN?

First commandment:

Avoid losses

If you wish to earn money, a good starting point is to avoid losing it. From the perspective of a long-term value investor, it is important to differentiate between temporary and permanent loss of capital.

A temporary loss occurs when a stock falls in price even though there has been no change in the company's intrinsic value whereas a permanent loss happens when a company's fundamental value changes because the future potential to earn money weakens.

Historically, there have been two main causes of permanent loss for value-based investors. The first, and most important, is debt. Companies that take on a lot of leverage in order to earn money should be treated with scepticism because debt reduces the operational margin of safety and manoeuvrability. A poor business year, regardless of whether it is due to a weak real economy or other unforeseen circumstances, can easily result in a company being forced to raise new capital, or in the worst case going into liquidation. Both outcomes cause irreparable damage to shareholders.

A more silent predator is creative destruction; the inherent capitalist process whereby new and expensive products are replaced by better and/or cheaper ones, which causes a company's competitive awdvantage and profit to erode over time. As consumers, we continuously get cheaper and better mobile phones and televisions while non-competitive manufacturers perish. To illustrate this, of the 30 original constituents in the US Dow Jones Index only two still exist in their original form; capitalism is a capitalist's worst enemy.

Second commandment:

Growth is our friend, when it is cheap

There is often an artificial divide between growth and value stocks. The fundamental value of a company is a function of future

cash flow. The size of the cash flow is tied to the expected growth in earnings. As growth is a component in the valuation of a company, the two are inseparable – both in practice and in theory.

History tells us that many investors are willing to pay an irrationally high price for expectations of future high growth. That is why we always treat expectations of future growth with a healthy dose of caution. Our willingness to pay for growth is dependent on the price of the company, and to what extent we can be sure that the future earnings growth can be estimated.

Despite our inherent scepticism, over time we have seen that growth in companies' earnings has been one of the most important drivers for returns in some of SKAGEN's biggest and best investments.

Third commandment:

Return on equity is a long-term investor's best friend

From a value investor's perspective, the twin brother of growth is the return a company achieves on its equity. Growth requires capital, and the return on this determines to what extent growth creates or destroys value.

It is difficult for a company to create value for owners – both with and without growth, if it cannot demonstrate solid return on equity. That is why in the long run it is almost impossible to attain a higher return on stocks than the return a company attains on its own equity.

One reason that we prefer Korean companies to their Japanese counterparts is that Koreans are considerably better at using return on equity to create growth.

Fourth commandment:

Good management is key

The ability and willingness of management to create value is often decisive in whether a company's intrinsic value is realised or is left to rust. Naturally we appreciate managers who take care of shareholders' money in the best possible way by being focused on and good at operational management. Competent, financially-oriented managers, who share value creation with shareholders by means of dividends, share buybacks and structural financial measures are also desirable.

We will not necessarily rule out investing in a company if its management has a poor history, or continues to struggle with a frayed reputation. If we can see management changes on the horizon, which could act as a trigger for the share price, we may take an interest. This is also true if the intrinsic value is of such high quality that even catastrophic management would be hard pushed to destroy it.

Fifth commandment:

Dividends – yes please

Most empirical data shows that in the long-run companies' dividends account for around 50 percent of investor returns from the stock market so choosing companies that provide a solid income stream takes us halfway to our goal of beating the market.

As the benefit of dividends is more apparent over the long-term than the short-term, they are often undervalued by short-term investors, which goes part of the way to explaining why studies show that stocks with high dividends yield higher returns than stocks with low or no dividends over time.

Beyond purely financial benefits, a robust, deeply-rooted dividend policy is often a good indication of a company's long-term health and of management's willingness to create shareholder value. Moreover, studies show that dividends are a far better tool for rewarding shareholders than share repurchase programs. This is due to the fact that on the whole companies are not good at investing in their own shares.

Five Pitfalls for Value Investors

So you think stock markets are inefficient and are there to be beaten? Unfortunately it's not quite that simple.

You've looked at different investment styles and decided that value is the way to achieve the greatest returns or alpha. So what are the common hazards that can trip up an active manager pursuing a value-based philosophy and what can be done to avoid them?

Pitfall one:

Beware the value trap

Value traps occur when the hidden value that investors think they can see in a company fails to materialise. The effects can be very damaging – either skewering shareholders quickly or inflicting a slow and painful death and these financial mirages come in many guises.

By definition, they can appear out of nowhere. Very few investors asked firms about their debt covenants in 2005-2007 but in 2008 banks reduced their credit lines and many companies with seemingly cheap valuations suddenly became a lot cheaper as default risk increased, often in a very short space of time.

Although the threat may originate from a wide variety of sources, some causes are common and there is usually a human element at play. In most cases value traps are due to poor management, low return on company assets or default risk. While these three components clearly interact, the people running the business are usually the most obvious single reason for value traps.

It is often important to look across a company's business model and capital structure. Combining information on financial solidity from the corporate bond market with our own assessment of valuation in the stock market can provide clues warning of potential value traps. Unfortunately the rating agencies seldom shed any light on the quality of company management per se. When assessing potential investments SKAGEN therefore adopts a healthy suspicion of company executives, often preferring the relative safety of Annual Reports checked by auditors rather than the glossy equity story found in many presentations to gauge whether management does what it says it will do.

Pitfall two:

The perils of the P/E ratio

The Price / Earnings ratio is one of the most popular valuation measures in use, partly thanks to its simplicity. But buying a stock just because it has a low P/E is no guarantee of a good return. The low P/E could be a result of low growth prospects or (temporarily) low tax charges and could mask high levels of debt and earnings manipulation. Following Worldcom and Enron, cash flow statements and analysis of off-balance sheet commitments have become more important; if they're not in harmony with the income statement and balance sheet one needs to be very alert.

One solution is to use a variety of different valuation tools and to be particularly vigilant during periods of expansion. When a business doesn't generate enough cash from internal sources to fund its growth one needs to be very cautious; Enterprise Value/EBITDA or Enterprise Value/EBIT can provide some indication of the leverage-adjusted valuation but net cash earnings are a far better measurement for checking the health and performance of a company.

Pitfall three:

Selling too soon

Unfortunately not all investments are like the long-held SKAGEN investments Samsung Electronics or Great Wall Motor, which can be bought, held and continually deliver good growth while remaining attractively valued. Most investments have to be sold at some stage and selling winners too soon – or the disposition effect as it is called in behavioural finance – is a psychological phenomenon.

Like most investors, SKAGEN has sometimes been guilty of failing to suppress an itchy trigger finger and has done considerable work internally to address this. Company price targets are discussed and revised regularly in response to new information. When the sell decision is made – either because the target price is realised, the company develops unexpectedly or we find better investments elsewhere – holdings are typically reduced gradually to minimise any opportunity cost.

In SKAGEN we are very focused on business evaluation i.e. earnings growth and volatility, key business drivers and balance sheet items. A quarterly review of business performance gives a good idea of direction, speed and potential troubles ahead. Our fundamental valuation work is ongoing and usually the key deciding factor for both buying and selling a business.

Pitfall four:

Overpaying

Paying too much for a company is a risk for all shareholders but particularly for value investors, given that they tend to be more sensitive to capital preservation, and it is especially acute for those who, unlike SKAGEN, focus on relative, rather than absolute value.

To mitigate this risk and identify potential bubbles forming, it is important to look at valuations relative to historic averages, as well as other companies or sectors, and to understand the intrinsic value of a company and the possibilities on the downside as well as the upside. As Investors should avoid unrewarded risk and only take risks that are fully understood; even the best insurance underwriters occasionally make mistakes, but on average they make a lot of money because they understand the risk.

Pitfall five:

Mental hazards

The final danger comes from within and requires having the courage to trust your analysis and instincts. You need to be prepared to stick your neck out and go against the market as well as face potential criticism from colleagues and clients. That said, this doesn't mean having blind faith in a company and it's equally important to be able to admit when you're wrong. If assumptions for a revaluation of the company do not materialise i.e. operating cash flow does not improve as expected, investors should get out.

Of course, many of these pitfalls are interlinked and side-stepping one may land you in another. Ideally at SKAGEN we're looking for net cash generators with modest debt and a sustainable business model which consistently creates value year after year. Then it's mainly a question of identifying good entry points.

Put like that it sounds easy but of course it's much harder to do it than to explain it. Being able to do it consistently is the real art – the art of common sense.

SKAGEN Funds
A specialist in global stock picking

Why choose SKAGEN?

- Clients come first
- World class performance
- Investment-led
- Truly active long-term value manager
- Contrarian approach

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Except otherwise stated, the source of all information is SKAGEN AS as at 29 February 2016.

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