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# The Future of Equity Investing

Presented by:

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# Agenda

- Investing Alongside The Government
- Unconstrained Strategies Make Sense
- Fundamentals Drive Alpha

There is no assurance that the investment process will consistently lead to successful investing.

Any portfolio risk management process discussed includes an effort to monitor and manage risk which should not be confused with and does not imply low risk or the ability to control risk.

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# Investing Alongside The Government

## Example: Healthcare Reform

- Something is likely to happen this year
  - High priority for the Obama administration
  - Congress / Industry generally in support
  
- Where the compromise likely exists
  - Potential for a “public plan trigger”
  - Medicaid entitlement expansion
  - Creation of state-based exchanges with premium assistance
  - Health underwriting reform
  
- Bottom line
  - Headlines likely to be controversial but we think the final reform bill will be better for most companies than feared
  - Key objective of “bending the cost curve” will take years in our view and could face challenges

# Investing Alongside The Government

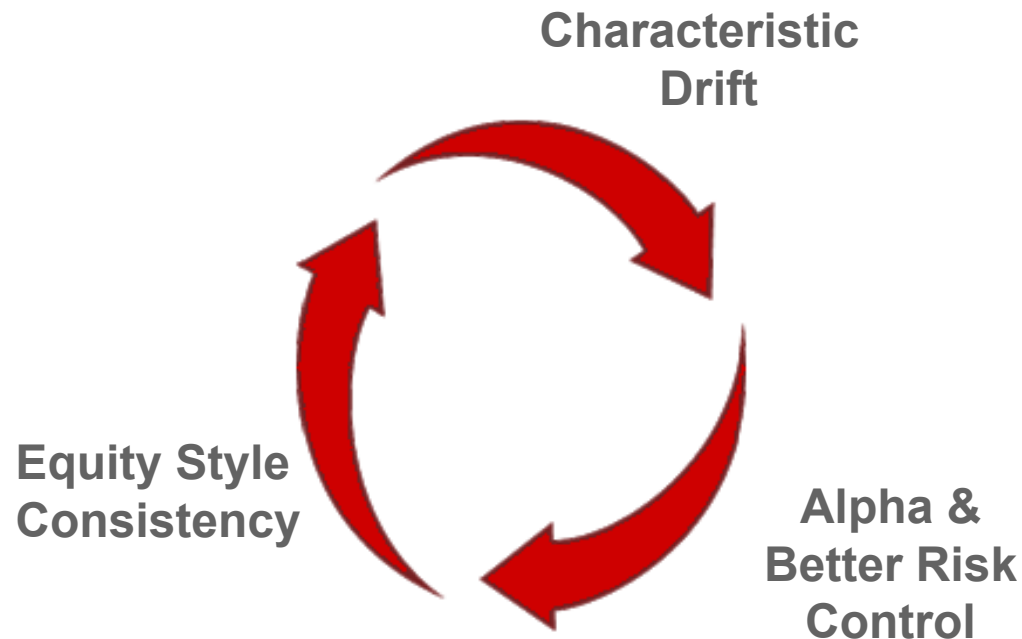
## Example: Healthcare Reform

- Who is most at risk
  - Insurance companies
    - Hits to Medicare Advantage
    - Risk of adverse selection if individual mandate lacks teeth
  - Other healthcare products / services
    - Hyper-growth areas within Medicare
  
- Who stands most to benefit
  - Generic companies
    - Increased volumes from uninsured
  - Pharmacy Benefit Managers / Distributors
    - Increased volumes
  - Pharma
    - Increased volumes, donut hole coverage
  - Biotech
    - Benefit from 12 year exclusivity and average selling price parity
  - Hospitals
    - Reduced bad debt
  
- Uncertain effects
  - Medtech
    - Proposed excise tax
    - “Super MedPac” is a priority for Senate Finance Committee

# Unconstrained Strategies

A Viable Option for Alpha

- A consistent style, without regard to the box, has historically performed the best
- Characteristic drift is part and parcel of superior performance
- Long-only, unconstrained strategies may provide viable option for plan sponsors seeking alpha through more traditional means



# Unconstrained Strategies

Defining Global

*The Coca-Cola Company*

**ORACLE®**



# Unconstrained Strategies

Active Share: Another Measure of Portfolio Risk

$$\text{Active Share} = \frac{1}{2} \sum |w_{fund,i} - w_{index,i}|$$

- Where  $w_{fund,i}$  and  $w_{index,i}$  are portfolio weights of asset  $i$  in the fund and in the index; the sum is taken over all portfolio and index positions
- Alternatively, active share is the sum total of the positive active positions in the portfolio versus the relevant benchmark

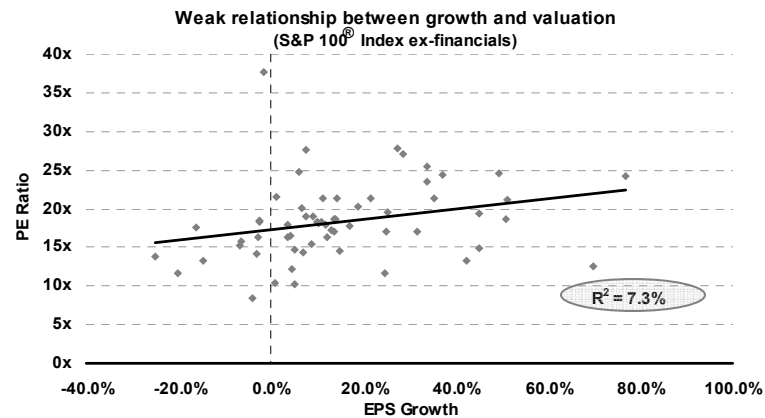
# Unconstrained Strategies

Active Share: When 4% ≠ 4%

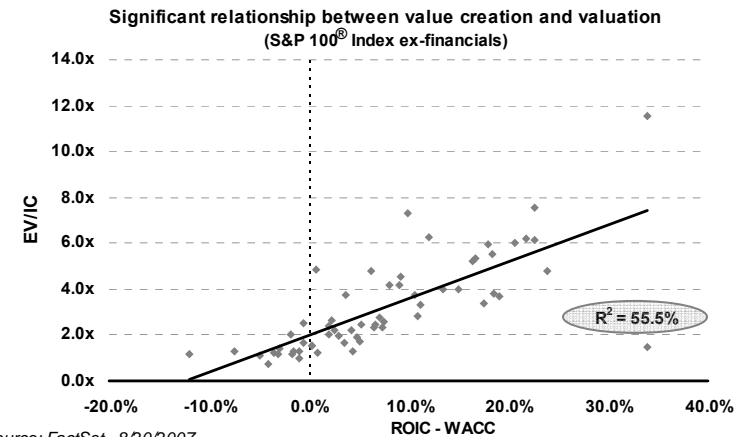
- Investment style of the portfolio manager can affect the interpretation of a single tracking error figure
  - Portfolios with significant systematic (factor) exposures, such as Sector/Industry deviations from the benchmark, will often have high tracking error
  - Diversified portfolios featuring stock-picking but with few sector tilts will often have low tracking error
  
- Empirical research (Cremer and Petajisto, 2007) suggests that funds with high active share (>80%) have generated more value-added versus the relevant benchmark than those funds with lower active share
  
- Thus, important to look beyond a single measure to ascertain portfolio riskiness or propensity for success

# Fundamentals Drive Alpha

## Significant Relationship Between ROIC and Valuation\*



Source: Bloomberg - 8/20/2007



Source: FactSet - 8/20/2007

- Statistically weak relationship between earnings growth and valuation
- Earnings growth is one of many factors that investors consider when determining what they may be willing to pay for a company
- Sustainability of earnings growth and the overall returns the business is generating may also be considered
- Stronger statistical relationship between ROIC and valuation
- Enterprise value (EV) to invested capital (IC) is a better relative valuation proxy when performing ROIC analysis
- Data suggests market assigns a premium to those firms with a greater spread between ROIC and WACC

\*We excluded financials in this analysis because ROIC is not necessarily a good representation for these companies' performance due to their capital structures and the complexity of the assets they generally have on the books. In addition, we normalized the dataset by eliminating the outliers or extreme data points.

*Past performance is no guarantee of future results.*

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# Fundamentals Drive Alpha

ROIC Defined

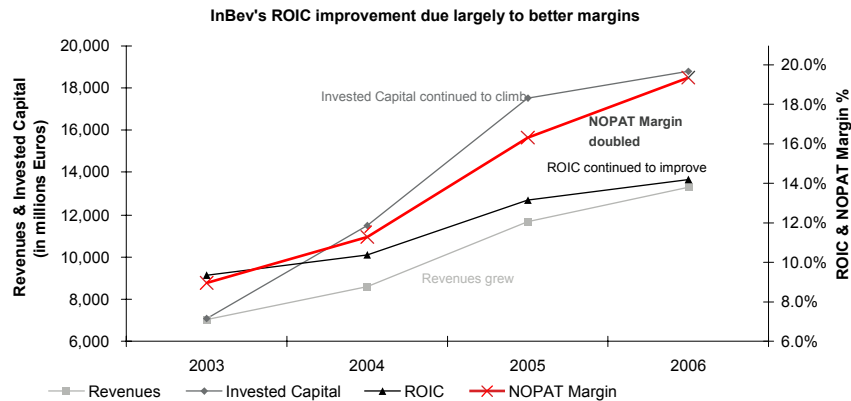
$$\text{ROIC} = \frac{\text{Net operating profit after taxes or NOPAT}}{\text{Invested capital}} \quad \begin{array}{l} \text{(after-tax earnings)} \\ \text{(operating assets)} \end{array}$$

**WACC = weighted average cost of capital, or the cost the company pays for all of its capital, including both debt & equity**

- Measures how much profit a firm is able to generate with each dollar of capital invested
- If a firm's return on invested capital exceeds the cost of that capital, value is being created
- If the firm's cost of capital exceeds its return on invested capital, value is being destroyed

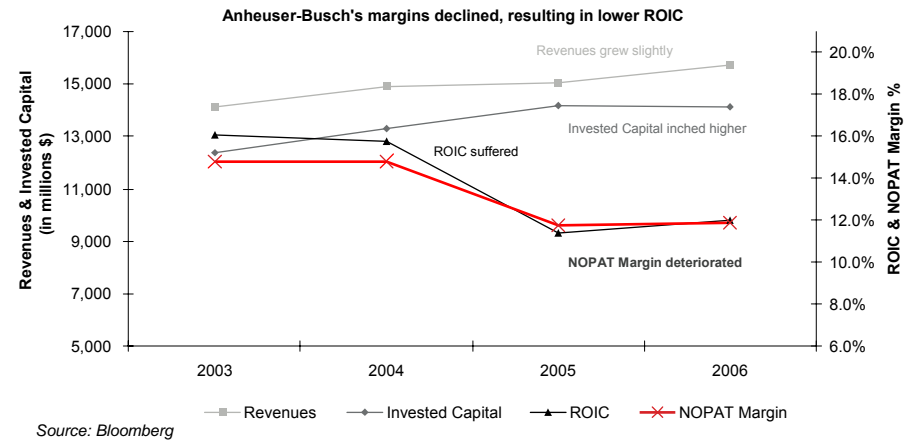
# Fundamentals Drive Alpha

## ROIC Defined: Expanding Margins



### InBev

- Focused on cost cutting & pricing power
- Margins doubled, benefiting from operating leverage
- ROIC increased about 500 basis points



### Anheuser-Busch

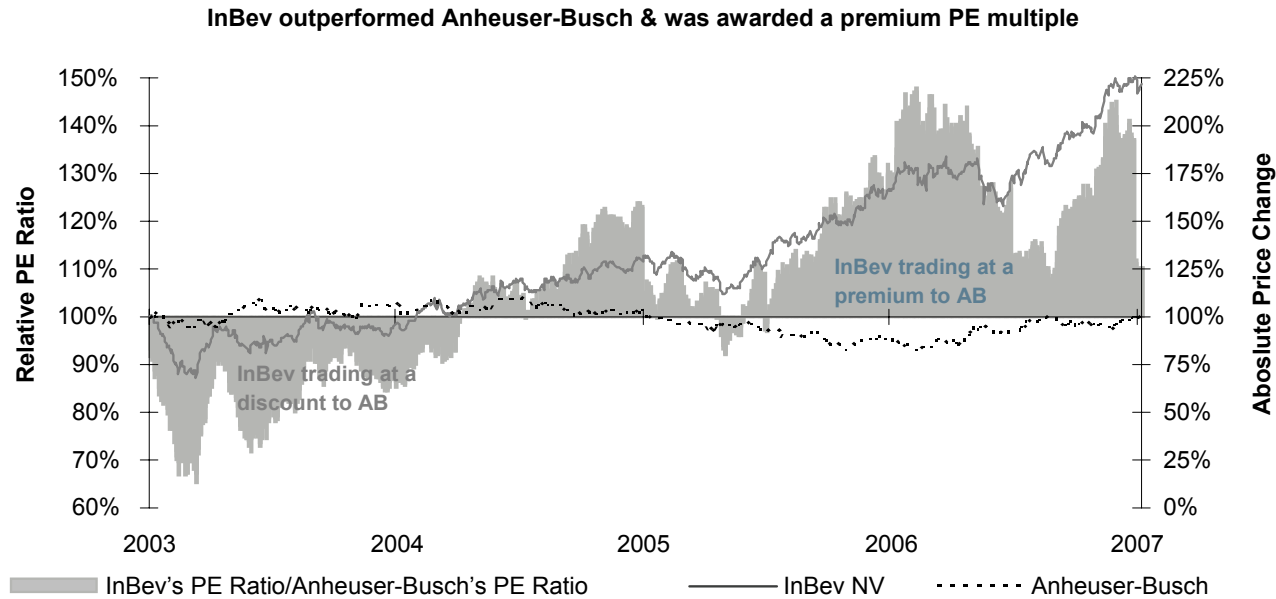
- Focused on maintaining market share through lower prices on key brands
- Margins declined nearly 300 basis points
- ROIC suffered along with the margin deterioration

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# Fundamentals Drive Alpha

ROIC Defined: Expanding Margins



Source: Bloomberg

- InBev's share price doubled from 2003 thru 2006 while Anheuser-Busch was flat
- InBev was awarded a premium multiple over Anheuser-Busch as the market recognized the firm's ability to generate high quality growth

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# Questions