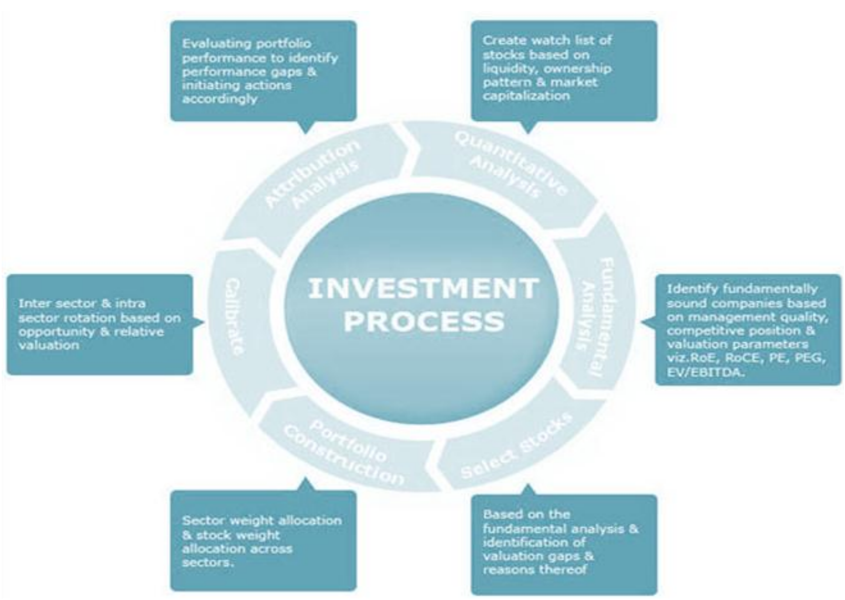
Stock Picking Strategies for the Colombo bourse

Markets have their own way of surprising investors and the Sri Lanka bourse is by no means an exception. Bucking the downward trend observed in many global markets, Sri Lankan equities enjoyed a spectacular rise over the last couple of years fueled by increased liquidity and positive investor sentiment on the back of strong macro-economic and corporate fundamentals aided by a stable political environment. As is the case with anyother emerging market, such gains are not constant and rarely replicated. The peculiar nature of the bourse appears to be the only aspect that is likely to be constant and the need for investors to adopt a highly active and 'out of the box' investment management style may become the trend for the future. This will pave way to maximize returns while minimizing investment risks in order to capitalize on investment opportunities in this post consolidation era of our country & economy.

With regard to market trajectory, it can be said that the Sri Lanka bourse is well on course to achieve double digit gains supported by strong fundamentals both on the macro-economic and corporate front. Significant home-grown liquidity will provide the necessary impetus for a market re-rating while Global Emerging Markets (GEMs) flows should also underpin growth in the medium to longer term.

Focus on Active Management

The buzz word nowadays for investment management is **Active**. Investors should focus on an active investment management style when constructing a portfolio in order to be able to generate above market returns at below market risk. This strategy involves combining a rigorous bottom up stock selection process with a firm top down investment process to identify companies with strong intrinsic values that are likely to out perform in a complete market cycle – in a market upturn and as well as in a downturn.



Source : L&T Mutual Fund

Seek alpha not beta

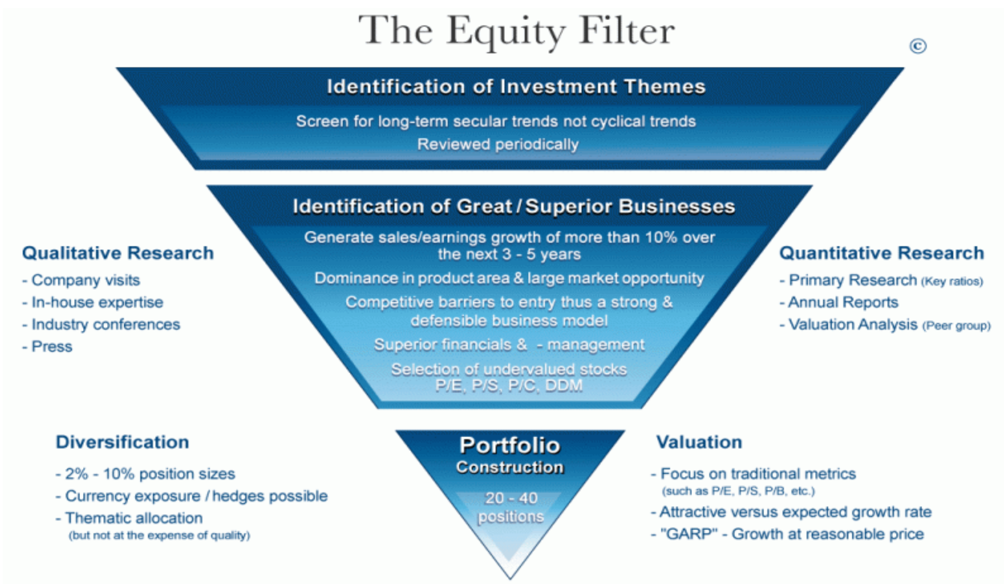
As a prudent investor in the Colombo Stock Exchange, it is important to be able to generate consistent and stable returns rather than focusing on short-term supernormal profits that can greatly increase investment risks. This can be achieved through efficient asset allocation, style rotation and a careful stock selection process which should help investors to generate significant **alpha** and outperform the benchmark on a consistent basis.

Consistent performance should also be a key factor when selecting fund managers (investment advisors) to manage your portfolio as emphasis should be placed on their ability to generate stable and healthy returns over a period of time.

Invest in what you know and stay focused: What you don't know can hurt you!

The current semi-strong form efficiency of the Sri Lankan bourse provides an excellent opportunity to generate alpha compared to most other GEMs, but investors will need to do their homework. Invest in what you know & stay focused.What you don't know can hurt you! In this respect, it is advisable for investors to,

- Bottom fish for stocks with strong intrinsic values and growth momentum.
- Accumulate quality, but avoid value traps. A low PE does not necessarily indicate an attractive investment. Consider other valuation yardsticks such as PEG in conjunction with PE valuations
- Carefully monitor liquidity flows between sectors, sub-sectors and stocks - they can be an excellent indicator of stock direction and sentiment
- Be conscious of market sentiment - diversions from value can only occur in the short term
- Do not be afraid to be market contrarian



Source : Wydler Asset Management AG

Be ‘stylish’ … do not be married to one investment style

The key to generating alpha is active management using a dynamic multi strategy approach. Be ‘stylish’ and avoid the temptation of being married to one investment style, rather shift strategies to take advantage of market opportunities to generate a sustainable and superior risk adjusted rate of return. In this respect, investors are encouraged to adopt a multi-investment strategy comprising of Value, Growth or Trading. By maintaining a diversified exposure to multiple strategies, an investor may consequently achieve more consistent returns over a complete market cycle.

Diversification

As a rule of thumb, investing in a wider universe of stocks reduces the overall risk of investment and allows for capital preservation and avoids concentration risk. Equally important however is to resist the temptation to over-diversify which runs the danger of limiting investment gains. In this respect, it is advisable to,

- Maintain a healthy mix of growth, defensive and trading positions
- Select sectors and sub-sectors that are both growing and resilient
- Select stocks that are monopolistic, inelastic with strong brand loyalty
- Select stocks that will provide sufficient capital preservation during a market downturn
- Use multiple strategies to arrive at ‘strategic best fit’ and rotate investment styles to suit the various stages of the market cycle

Volatility…welcome it not fear it

Market volatility is definitely a healthy component of the investing process, provided that investors are equipped with the right strategies to take advantage of volatility. By electing a core portfolio of stocks which are fundamentally strong with relatively low beta (targeting a medium to longer term investment horizon) combined with a dynamic allocation of stocks with relatively higher beta and liquidity will create a hybrid portfolio that can efficiently capitalize on market volatility. While the Sri Lanka bourse is expected to re-rate to higher levels, its upward trajectory is likely to be characterized by a series of rallies and pullbacks which will provide investors a significant opportunity to take advantage of market volatility by incorporating a buy-on-weakness, sell-into strength trading strategy.

Cherry pick fund managers with a consistent track record

For a high net worth or institutional investor seeking professional fund management, selecting a manager with an investment style and objective that closely matches your requirements may determine how successful you will be with your investment decisions. There are many parameters investors use when selecting a fund manager. Some prefer to use a popular brand name while others consider ratings and staff credentials. One criterion investors often overlook, but one that is critical when cherry picking a fund manager, is consistency of returns.

Consistency of performance is primarily achieved through an active investment style as opposed to a passive style where the investments of a fund are structured according to a benchmark. Using an active investment strategy, fund managers have the ability to generate more stable returns thereby avoiding strong swings in performance that is generally accompanies a passive approach.

Quality of Earnings is Key in fundamental analysis

It is vitally important to look at the quality and source of earnings figures rather than just headline numbers. In this respect, sustainability of top line revenue growth is the key parameter when selecting a stock using fundamental analysis. Some companies may report improved earnings growth while experiencing flat or declining revenues from their core businessesas a result of cost cutting or investment gains. Your concern for such companies should be on the line as to whether the source of such earnings is sustainable and to what extent they hide the weakness in the company's operating performance. While cost containment is a positive move, a sharp cost reduction can impact productivity and profits. Similarly, it is important to be wary of capital gains which can provide a temporary boost to earnings while concealing a decline in top revenues.Consequently, investors can concentrate on the following attributes to mitigate this risk,

- ✓ Strong business models
- ✓ Quality Management
- ✓ Firm top line growth
- ✓ Sustainable earnings growth
- ✓ Long term competitive advantage

Market Dynamics

Looking beyond the fundamentals, the main market driver of the Sri Lankan bourse will be liquidity. With an expansionary credit policy in place, money supply has been on the rise in Sri Lanka. Looking through a 'fundamental' lense, not all stocks can justify their valuations, so selecting the right stocks will be essential in generating sustainable returns. From a technical point of view, liquidity will continue to push the markets higher, however with the risk that some stocks could rise to unjustifiably high levels. Knowing which stocks to buy at what price levels holds the key for generating strong and consistent risk adjusted returns.

(Source: DNH Financial (Pvt) Limited.)