PORTFOLIO CONSTRUCTION

Building a Better Deep Value Portfolio: Difficulties Mastered are Opportunities Won

March 24, 2017

The idea of opportunistic contrarian investing is appealing to many investors, yet in practice it has proven very challenging to implement successfully; even those who identify good opportunities can struggle with timely approvals, sizing of trades and forced exits at the worst possible times. We think deep value is best approached by pairing discretionary expertise with a quantitative framework that allows for broad screening of global opportunities and a rigorous approach to risk management. Implementing such a strategy may allow investors to successfully incorporate that elusive opportunistic element into their portfolios.

What's Inside?

This article defines “deep value” opportunities as ones in which valuation spreads are particularly wide relative to history, and discuss their causes, challenges and potential returns. We find:

- Deep value opportunities have numerous causes, often relating to behavioral biases, liquidity constraints and decisions made by investors for motives other than profit maximization.
- Opportunistic investing is challenging to implement successfully in investor portfolios in an ad hoc manner due to difficulties identifying opportunities, gaining timely approvals, sizing positions and holding on when markets move.
- A dedicated deep value strategy can potentially address the challenges of opportunistic investing by systematically screening across a broad opportunity set, sizing positions in a way that retains dry powder for periods when conditions worsen, and embedding conviction to hold positions until convergence.
- Our sample analysis indicates that such a strategy would have been profitable (even without the benefit of discretionary oversight), and in a way that could be additive to investor portfolios. In practice, such a strategy could further be improved by incorporating discretionary oversight to help differentiate great trades from value traps.

Conclusion

Many investors would like to add an opportunistic contrarian component to their portfolios, but face challenges in doing so. Pre-allocating to a dedicated “deep value” strategy which incorporates discretionary oversight in a systematic framework may be one solution that helps harness the profits from opportunistic trading in a way that diversifies existing portfolios.