BELLWETHER

-n. one that takes the lead or initiative

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Alan Kohler interviews Bruce Bell

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Bruce Bell, the managing director of Bellwether Group Ltd, has a unique system for deciding which companies to invest in, and since he achieved a 46.88% gross return over the 12 months to September 30, I thought I should ask him how it works - in line with our policy at Eureka Report of passing on good ideas to our subscribers.

What I learnt is that it's perhaps not a system for everybody and certainly not for small investors because it involves subscribing to an expensive feed of data from broking houses and running a computer program that scores company boards on a variety of qualities.

But in the end it's neither complicated nor magical: Bruce assesses share price momentum by watching for minute changes in broker earnings per share (EPS) forecasts and then rates the people who run the companies. And he never owns more than 30 stocks; he believes that's all the diversification you need. It's as simple, and as complex, as that.

Here it is, in Bruce Bell's own words ...

Alan Kohler: What's the first thing you do to filter stocks, Bruce?

Bruce Bell: I've been in the industry for a long while, and I've worked as an analyst and I've had a lot of analysts work for me, so I know that you often have large analyst teams working continuously, living within their models, gathering information wherever it's possible, all those sort of things, and making adjustments and fine tuning to the models and therefore changing the bottom line EPS figures on a very regular basis. But not all of that actually reaches light of day, not because there's some conspiracy at work or anything like that, it's just that it's not high enough impact for it to matter in the sense of an organisation that has to sell ideas for a living, which a broking house has to do. But those adjustments do occur. What our computer program does is identify those changes, sometimes even small ones.

We're finding that there are significant insights to be had from broking analyst data and it has helped us both to make a decision that a stock which possibly has been performing well for us, needs to be looked at carefully and may in fact not qualify for the portfolio or if it's a "torpedo", or alternatively is a turnaround situation.

So your program basically works by pulling together broker research. Is that right?

Yes, but we take the raw data, remember.

The raw data of their models?

Yes, from the IBESS system.

So if a bunch of brokers start to have small changes to their EPS forecasts for a particular company then you'll think the tide is turning for that company and it's time to get out. Is that kind of ...

Yes. That's basically what it is. And you know because of your background, Alan, that the people who work in the broking offices as analysts work incredibly hard. They devote their lives to trying to understand the companies that are within their remit as well as possible, and we're not going to try to replicate that. You have to honour the work that these people do. But we can't have dialogue with every analyst in Australia. We can't get access to every model in Australia and we're only really interested in adjustments at the margin.

What does IBESS cost?

I think we pay about $120,000 for the licenses that we have.

And it gives you all the data you need from broking analysts?

All the data we need, that's right. But you know, all sorts of groups subscribe to the IBESS service and they use it in all sorts of different ways. It's a terrific amount of information in there. We would say that the value that we've been able to generate for our unit holders has been because of our ability to take that data and hunt through it for the information that can actually impact value.

How do you find buys as opposed to sells?

It works for both sides. The turnaround signals indicate stocks that are coming out of the basement as well. The other thing I should say is that we do not hold more than 30 stocks at any time, and we believe very strongly, very strongly indeed, that the only way to deliver our performance over any period of time is to keep a cap on the portfolio — otherwise you're wasting your time ... forget everything else you do. Unless you have the discipline, which is forced upon you by capping the number of stocks, then you're kidding yourself and everyone else.

Modern portfolio theory says you need at least 60 stocks to minimise risk. You obviously disagree with that.

Well I wouldn't say it's bunk because it may come back and hurt me at some point in the future, but we don't think it's true. In fact, we'd say that the additional value of diversification drops away in the early 20s.

You think you can get sufficient diversification with 20 stocks?

Yes. But you know, there is a consequence of it. If you're going to have an Australian portfolio there's nowhere to hide. You will have things happen, you know, and you are going to have to play the other side of that game, which is make sure that you have got intense focus upon those stocks at all times and you effectively continue ... have continuous scrutiny upon those stocks.

How often do you trade them?

Oh, not very often. Our turnover has been dropping away consistently since we established the fund, which is what we intended to happen. We run the system only once a month because we don't want all the noise along the way, so we revisit the portfolio at the end of the month and have a close look at it and make any changes that we think may be required. We aren't spooked by negative price action in the stock if we believe that the fundamentals, as disclosed by our system and by our qualitative analysis as well, are still in place; we'll stay with it.

You have a second level of analysis you call qualitative. How does that work?

With qualitative, it took us a little while — I'll be quite open about this — to stop tampering with the results coming through, and initially we put a lot of time into thinking about what we needed to disclose in the qualitative part of the process. Now we've got a highly structured process, which essentially involves looking at risks.

And how do you determine those?

Well it's basically subjective analysis of material. We have accumulated an enormous database on companies, which we've perfected over about two-and-a-half years, but we look at four major categories. We look at the market dynamics, which we break up into five sections. We look at strategy. We look at vision within strategy, whether there is a clear and articulated vision. We look at whether it's articulated, and we also look to see whether there's a focus upon innovation and activity within the sector. Next, we look at management: the track record of management. We look at board quality and stability, and we look at track record. And we look at a series of risks: earnings risk, cash flow risk, product specific risk, etc. And we drop this down through quite a structured document. It produces a score. And that's what we then debate around. It is highly subjective, but that's again what you're really looking for at the qualitative stage of the game.

What else do you look for?

We're very interested in personality dominance within a board or within a company.

In the sense of wanting to avoid it?

In the sense of recognising it as a risk. We know that some of the best-performing stocks in the market have dominant personalities. What we feel — and we continue to work on this — is that the market sometimes doesn't fully recognise what the adverse consequences can be of a personality dominance. There are risks.

So does that mean you avoid the companies that are dominated by an individual or not?

Under our system, if there is a dominant individual in there, particularly if the board surrounding that individual seems to be soft, it would hurt the rating.

What does your back testing tell you about that?

I don't want to go too far in this because we need to do a lot more work, but our back testing suggests that there is a startling correlation between performance and the rating.

And how do you determine the rating of the board? Apart from personality dominance, what else?

We have a score for each director.

According to what?

According to utility.

How do you work that out?

We're still working on this and it's only one part of a very broad process. A lot of this quest is to come up with insights that may be overlooked because people are covering the vast amounts of information and that's one of the areas that we intend to do more work. That's all I'm going to say about that.

So your qualitative work basically allows you to delete stocks from the list, is that correct?

That's overwhelmingly the case. It brings it down to a manageable list — something you can actually work on.

Alan Kohler is one of Australia's most experienced commentators and journalists. Former editor of the Australian Financial Review and The Age, former business and economics editor of the 7.30 Report, former Chanticleer columnist for the Financial Review and currently columnist for The Age and the Sydney Morning Herald, finance presenter on ABC news and host of Inside Business on ABC TV each Sunday.