A Reluctant Rally

Early 2019 saw a strong rebound in equity markets. In the final quarter of 2018, the Fed's rhetoric on rate hikes, concerns about global growth, and fears over the U.S.-China trade dispute sent most major asset classes down, but in the first quarter of 2019, a reversal took place as the same concerns faded. The Fed pointed to global economic risks and muted inflation pressure, as it shifted back to a more accommodative tone. The ECB and China were also more dovish, with China rolling out stimulus measures. Together with optimism on trade talks, these shifts in tone seemed to outweigh concerns over weaker economic data and continued challenges for earnings growth, and equities moved sharply higher.

Other asset classes also performed well. Bonds and commodities were also up in the quarter, but interestingly, even the gold price increased. In late 2018, when everything else tumbled, the rise in gold prices was to be expected; but normally investors lose interest in this classic defensive asset in periods where stocks perform well. Meanwhile, despite substantial stock market gains, we did not really witness the reversal of underlying style factors and sectors that one would expect in a typical rally. From a style perspective, sturdy quality stocks – in MSCI index definitions, those with high profitability, low debt and low earnings variability - outperformed, which may suggest investors are still nervous. It is true that cyclical sectors did outperform defensives, but the gains for cyclicals were to a large degree driven by IT stocks. That may signal that investors were looking for secular growth stories in a low growth environment.

So, although near-term recession fears seem to have moderated, the market reaction in recent months suggests that optimism is somewhat muted. We feel that the year-to-date gains were driven mainly by the Fed's dovish flip, and trade optimism: markets enjoyed a 'reluctant rally' in which investors are not optimistic about the future, but merely find relief in further central bank support.

The big picture is that, on the one hand, the markets are gradually being weaned off the period of quantitative easing and ultra-low rates, with central bank balance sheets likely to shrink over coming years. On the other hand, recent economic and earnings data has not been so encouraging. These two conflicting pressures can leave markets highly sensitive to political news and shifts in central bank tone.

So, the Fed's dovish turn in early 2019 triggered short-term market moves, which echoed the longer-term trends seen during the recent years of quantitative easing, in terms of both the overall market direction, and the underlying style and sector performance. This also means it was not a supportive environment for a value investment style. All our funds had a strong first quarter in absolute terms and rebounded from the nosedive of late 2018. However, relative returns were disappointing. The underperformance was to a large degree due to our consistent value style exposure. Value stocks continued to trail the markets and we were not able to compensate for the style headwinds with our security selection. The phenomenon of weak performance for the value equity style has lasted for many years now – actually, throughout the entire current bull market.

Long-term value perspective

The first quarter echoed the tone of the recent years of quantitative easing. It also marks 10 years since the global equity bull market began – and we think it makes sense to reflect on what has happened during that decade. Since the market bottomed out in March 2009 in the midst of the global financial crisis, investors who pursued a long-term "buy and hold" strategy were handsomely rewarded. Since then, global equities (MSCI World) have returned 325 percent – or 15.5 percent annually – in euro terms.

While value equities as an asset class also saw strong absolute gains, they performed poorly compared to the wider market. Whether in global developed markets, U.S., Europe, Japan or Emerging markets, MSCI's value indexes – which are one broad way of measuring value performance - underperformed the main index by more than 1 percent annually. Prior to the bull market, value strategies had significantly outperformed, so what happened in the last decade?

A quick look at the drivers of historical returns gives some insight. In a very simple way, we can split historical returns into fundamental drivers - dividends and earnings growth – and a more intangible driver – changes in the price-earnings multiple that investors were willing to pay. Using MSCI data, and taking the MSCI World Value index as an example of a global value strategy, it saw earnings growth of about 8.2 percent annually over the decade. That was slightly less than the overall equity market, which saw earnings growth of 8.7 percent. However, the value index had a slightly higher contribution from dividends over the same period, so overall, both value stocks and the wider equity market got a very similar return contribution from fundamental drivers over the decade.

The big difference in total returns was due to the changes in price-earnings multiples. The value index did see its valuation multiples rise, but not as much as the overall equity market. From end March 2009 to end March 2019, the MSCI World Value index saw its forward price-earnings multiple rise by 19 percent, from 9.8x to 11.7x. For the MSCI World index, the same multiple increased by 34 percent, from 10.7x to 14.3x.

We are sometimes asked if we still believe in value investing. The above numbers seem to suggest that value stocks have been generating value in the form of dividends and earnings growth equal to the wider market, which comforts us. It also implies that 10 years of value underperformance has been driven by investors becoming increasing willing to pay relatively more for other stocks than value stocks. It is important to consider why.

Interest rates matter

An interesting angle, which we have touched on many times in recent years – is the relationship with interest rates. There are various plausible explanations to why value stocks outperform over time, and one is known as the 'duration-based explanation' of the value premium. It is born out of fixed-income theory, where duration shows the sensitivity in price to a change in interest rates. The theory argues that value stocks, with lower valuations, have a shorter maturity of cash flow: their cash flows are more 'front-loaded' to the years right in front of us. Meanwhile, growth stocks, with higher valuations, are more 'back-loaded', with a relatively larger portion of their cash flows expected to come further in the future. This implies that growth stocks have higher duration than value stocks and therefore growth stocks are more sensitive to the changes in the interest rate. This can be fairly easily demonstrated in a discounted cash flow valuation model: adjusting the discount rate has a significantly bigger impact on the implied price of companies with more of their projected cash flows further in the future.

During the bull market there seems to have been a noticeable relationship between long-term interest rates and the relative performance of value and growth. The decline in long-term interest rates lifted the implied fair price for equities across the board, but significantly more for growth stocks with their longer duration. This explains, at least in part, why investors became increasingly willing to pay more for growth stocks, and value stocks underperformed.

However, it is important to remember that although a valuation gap has expanded between growth and value stocks over the past decade, it is unlikely to continue expanding indefinitely. If the valuation gap were to hold at current levels, let alone shrink, this could be very encouraging for value equity returns. Generally, as the period of ultra-low rates and excess liquidity winds down, one might expect this to be a tailwind for value stocks. We will refrain from predicting when value stocks will begin to outperform again, since we cannot predict where interest rates are going, at least in the short term. We humbly observe that we are at a historically large disparity between value and growth stocks (or between value and the wider equity market), and we reiterate that many investors seem to overlook the inherent interest rate risk in exposure to more expensive, growth stocks. Although it has been frustrating to see the long duration of this cycle of value underperformance, we are convinced that the long-term history is accurate, and that value investing will prevail.

Sector exposures and the internet

Of course, the past decade has not only been about interest rates. One of the other key dynamics has been at the level of industry sectors. As value investors, we do not have pre-conceptions about which industries should be more attractive. Of course, sometimes certain sectors are more popular in the markets, and tend to trade at higher valuations, while other sectors can fall out-of-favour for various reasons, and trade at lower prices. We think that it is possible to find decent, bottom-up individual investments in both areas, but of course, there can be tendency for value investors to have more exposure to out-of-favour sectors, and less exposure to pricier sectors.

This has been relevant over the past 10 years, when one sector – Information Technology – has dramatically outperformed all others. From March 2009 to March 2019, the MSCI World's IT sector rose 511 percent in euro terms, easily outstripping other top-performing sectors. For style-consistent value investors, this has been a headwind, because they typically missed out on some extremely strong returns from high-priced, fast-growing IT names. Over the years, our funds have seen their returns relative to the overall market have been held back by not owning certain of these stocks. In Emerging Markets and in the U.S. market, there is a handful of large IT-related stocks that are dominant in terms of index weights that they become substantial risk and return contributors. Most prominent are the FAANG (Facebook, Amazon, Apple, Netflix and Alphabet (Google) and BAT-stocks (Baidu, Alibaba and Tencent). Tencent, for example, has a bigger weight in the MSCI Emerging Markets index than Russia or Mexico, or than the index's 12 smallest countries added together. (Incidentally, some FAANG and BAT-stocks are not technically included in the IT sector. For example, internet retailers Amazon and Alibaba are classified under Consumer Discretionary, and Alphabet (Google), Facebook and Tencent now fall under Communication Services.)

During the QE years, certain pockets of the market like FAANG- and BAT-stocks became very popular and valuation multiples increased to a level where we found it difficult to justify buying them. As they continued to perform strongly, we were sometimes left behind in terms of relative performance – although often we managed to offset this through strong stock selection. Indeed, some of our own, cheaper, IT picks, performed extremely well. Admittedly, the high valuations of the FAANG and BAT stocks were largely driven by expectations that structural changes in the economy would drive much faster earnings growth than the rest of the market and those expectations have proved to be more-or-less justified. However, those high valuations were clearly exacerbated by the effect of low interest rates and QE. Indeed, the performance of FAANG stocks relative to the S&P 500 looks highly correlated to the combined size of the balance sheets at G4 central banks.

Moreover, such great secular growth stories are rare. Certainly, there are secular megatrends that will be key drivers of revenue and earnings growth in many companies and industries going forward and lead to solid share price performance as well. Sadly, the stocks exposed to such trends are often overcrowded and very expensive. However, although we are value investors and invest in lower priced stocks, our funds also have exposure to such secular trends. We have exposure to e-commerce, cloud computing, electric vehicles and so on, but instead of looking for the companies with the highest expected growth rates – and paying extremely high multiples for them - we typically look elsewhere. This can mean investing in established names with proven business models and track records in long-standing business areas, who are pivoting into new areas, and stand to benefit from increasing exposure to the abovementioned themes. For example, instead of buying fast-growing and much-hyped Tesla, we own other automotive companies that are transitioning into electric vehicles. Similarly, we invested in IT mega-cap Microsoft early in its transition from the PC era into cloud computing, buying it at low multiples, and benefitting over recent years as it rerated to today's more elevated valuation levels.

Cyclicals and Defensives

One way to split the equity market is into 'value' and 'growth' stocks – or cheap, and expensive. Another is to look at cyclical sectors versus defensive sectors. Defensive companies are generally perceived to benefit from more stable revenues and earnings, and consequently more stable share prices – and this tends to mean that defensives trade at a premium, commanding higher multiples than cyclicals. Typically, you would expect defensives to outperform during periods of economic contraction, and underperform during periods of economic expansion, particularly in the early phases. Indeed, over the past 10 years of post-crisis economic recovery, global cyclical sectors (IT, Consumer Discretionary, Industrials, Materials, Energy, Financials) outperformed global defensive sectors (Real Estate, Consumer Staples, Utilities, Health care and Telecom). However, if we exclude the very large contribution from the IT sector, cyclicals and defensives performed almost in line.

If we repeat the exercise from above, looking at return drivers, the past decade of economic recovery saw higher earnings growth in cyclical sectors (whether you include IT or not) than in defensive sectors. What is surprising is the fact that price-earnings multiples for cyclical sectors (again, with or without IT) rose by only about 15 percent on average, while defensives saw their multiples rise by more than 50 percent on average. What drove investors to pay increasingly high prices for defensives? Of course, there have been times over the past 10 years where investors' love of defensive stocks was driven at least in part by concern over the sustainability of the aging economic cycle. However, it is hard to escape the conclusion that low interest rates played the leading role in determining the price investors were willing to pay for defensives.

This perhaps highlights the strangeness of the past decade: on one hand, a clear trajectory of economic recovery, driving earnings at the cyclicals. On the other, persistently low rates and excess liquidity, driving multiples at the defensives and growth stocks. Finally, a lot of political turmoil thrown into the mix, which at times favoured defensive stocks, and at times, cyclicals.

Of course, there is a danger in generalisations and over simplification. As we noted above, we think a diligent bottom-up stock selection process should be able to unearth decent individual investments in many parts of the market. Being value investors does not mean we dislike defensive stocks, or indeed, that we dislike growth. We like earnings growth, and are more than happy to invest in it – but we do not like to pay too much for it. Microsoft was one example, and another is Estee Lauder.

Estee Lauder

We first invested in U.S. company Estee Lauder in October 2015. We saw a dominant player in the field of so-called 'prestige beauty', producing and selling skincare, makeup, fragrance and haircare products. It offered a range of brands across price points, ranging from more classic brands such as Clinique, Bobbi Brown and Estee Lauder, to more progressive brands such as MAC, Le Labo and Tom Ford Beauty. Its products sell globally - although we saw decent potential for continued expansion in emerging markets. Estee Lauder sells via various channels, with U.S. and international department stores remaining the largest, but with fast growth in specialty retails, freestanding stores, e-commerce, and travel retail – including at airports, an area, which has expanded significantly.

Within the Consumer Staples sector, we saw prestige beauty as a particularly compelling category: one that offered high gross margins and high returns on capital. It also offered superior earnings growth compared to other categories such as mass beauty, personal care, and household products, with continued potential for consumers to migrate upwards to prestige products. Within this attractive space, Estee Lauder had a track record of delivering sales growth above the overall industry level. There was a stable earnings history, with the exception of 2009, when the impact of a global slump in consumer spending was made worse by retailers destocking and shifting to tighter inventory management. This had hit both sales and margins, but Estee Lauder responded robustly. Their clear strategy focused on product categories with wide margins and decent global growth potential, while they worked to gain efficiency by reducing inventory days, and to restructure significantly to reduce costs. Their track record in delivering on this strategy in subsequent years gave us confidence in management's ability to handle a crisis, in case anything should threaten what looked to us like a strong and stable outlook.

From the above, it is perhaps noticeable that this was not a troubled company. In a relatively stable sector, this was a company with a strong record of delivering growth, in a product category with relatively superior growth characteristics. So what was the attraction for value investors? At the risk of repeating ourselves, we are more than happy to invest in growth – we just do not want to pay too high a price for it. In August 2015, the company had released earnings results, and adjusted their medium-term guidance. The results themselves were not particularly worrying. They confirmed that it had been a year of challenges, with lower growth in China, and the travel sales channel hurt by the MERS virus and a drop-off in high-spending emerging market travelers. The operating margin suffered somewhat. However, e-commerce sales growth had accelerated. Growth in skin-care had slowed, but makeup and fragrance accelerated. In other words, it struck us as a good example of the benefit of the company's diversity in product range, brands, and sales channels.

However, the medium-term targets were adjusted; with the operating margin target reduced, and pushed back a year. This was simply to reflect the challenges of the previous fiscal year, but management remained committed to delivering on their strategy, and we saw no major need to adjust our medium and long-term assumptions. However, the market took the change negatively, and the shares slumped from over USD 90 to around USD 76. Estee Lauder's valuations looked discounted to a peer group of similar companies, such as L'Oreal, Kao, Beiersdorf and Shiseido, and this market overreaction struck us as a clear entry opportunity.

In the years since, the company has broadly delivered on our expectations – and we continue to see strong potential. Emerging markets still represent only 18 percent of revenues, with significant expansion in coming years from the expanding EM middle class. The U.S. business is large, but has suffered due to headwinds in the department store sector overall, and lacks profitability - with good potential for a turnaround. Estee Lauder offers solid, consistent cash flow generation, creating good opportunities for value creation, whether through brand acquisitions, or returns to shareholders.

However, the share price has also performed strongly, rising from the low USD 80s at initial investment in October 2015, to over USD 160 now. The valuation has expanded significantly. We initially invested at a price-earnings ratio of 21x 2-year forward earnings, and that ratio has now risen to 30x. We recognize that companies in a stable industry with strong growth prospects do command relatively high multiples. Indeed, the 21x multiple which we initially paid was on the higher end within our portfolios, but notably discounted both within the sector and relative to Estee Lauder's own valuation history. However, at 30x price-earnings now, the downside risk has increased significantly, and notably, the company is no longer discounted to peers such as L'Oreal. We therefore chose to divest our position in Estee Lauder in March 2019. In euro terms, from our initial investment to the recent sale, Estee Lauder generated total returns of over 105 percent, compared to MSCI U.S.'s 51 percent, and MSCI World's 39 percent.

Outlook

In our last quarterly report, in early January 2019, we noted that, despite some economic concerns, after the price declines of late 2018, the markets perhaps offered a reasonable starting point to generate returns, and that there was potential for a positive market response to any positive geopolitical developments. This neutral stance meant we were perhaps slightly more optimistic than many at the time. Now, some months later, markets have responded positively to the Fed's shift, and to some encouraging signs on U.S.-China trade tensions. However, we retain a fairly neutral view. The economic uncertainties remain. Considering that the first quarter's 'reluctant rally' was rooted in rising valuation multiples driven by the Fed and perceived trade progress, we are aware that future Fed meetings or U.S.-China trade meetings quickly drive them back down. At its heart, the delicate balance remains: the positive scenario remains one in which economic growth does not falter, but is not so strong or matched by inflation such that the Fed changes to a more bullish tune.

As always, we refrain from making short-term predictions. We stick with our long-term investment horizon and our research-driven approach to value investing. With a portfolio of mispriced stocks, decades of value outperformance history on our side and a wide valuation disparity between value stocks and the market, we are confident that the fund is well positioned for the future.

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