Sparinvest

Quarterly report

VALUE EQUITY

Significant price declines in the fourth quarter

Sentiment for equities reversed course in the fourth quarter of 2018. As recently as early October, MSCI World – an index of developed market equities – was at an all-time high, when measured in euros. Yet by the end of December, it had declined by over 12 percent.

There were a variety of causes. The U.S. Fed hiked rates in late September, and again in December, but the markets were probably more impacted by the Fed's rhetoric, which seemed to change on a fairly frequent basis. Although many still consider the U.S. economy to be robust, there are in reality some rising investor concerns about how long the current economic cycle can last, with – for example – GDP expectations generally coming down somewhat. This made the market somewhat sensitive to rate hikes. Meanwhile trade tensions continued to hit sentiment, and the tension was increased by other geopolitical issues, such as Brexit and relations with Saudi Arabia following the death of journalist Jamal Khashoggi.

In a clear risk off phase, all major equity markets saw significant declines, but many other asset classes showed signs of stress. For example, corporate bond spreads increased, while oil and other commodity prices fell significantly. As investors fled risk assets, traditional safe havens – such as gold – benefitted.

Looking in more detail at equity markets in the fourth quarter, confirms the risk off pattern. Both U.S. and European equities fell about 12 percent, but small caps in both regions performed significantly worse. Emerging markets did relatively better – declining only 6 percent – but one must remember that came on the back of much worse performance earlier in the year.

From a sector perspective, sectors that are more defensive outperformed, with Utilities actually rising slightly, and Telecom, Real Estate, and Consumer Staples generating only small single-digit declines. Energy was the biggest decliner – with oil prices down over USD 30 in the quarter. Information Technology was the second worst sector. IT stocks had been leading markets with extremely strong returns earlier in the year, but there was a clear shift of sentiment from October on. Memory prices had started declining in the summer, but really plummeted in the fourth quarter. Additionally, Apple's latest handset did not sell particularly well, and of course, this is a sector more susceptible than most to trade tensions.

Our funds gave mixed returns in the fourth quarter. In global developed markets, our returns slightly lagged the benchmark MSCI World. This is partly explained by our relatively high exposure to small and mid-cap stocks, which were a weak segment of the market. Meanwhile, our U.S. financial exposure saw steep declines on the back of yield curve flattening, and our exposure in the more economically sensitive sectors like Industrials, Energy and Materials also negatively affected the relative performance. Value was a bit of a mixed bag in the quarter: for example, the MSCI World Value index includes a relatively large exposure to the Utility sector, and other types of dividend play, and this helped it perform reasonably well. This was despite other types of value stock – such as those with low price-to-earnings ratios - being weaker. In our European funds, relative returns were held back by the pro-cyclical- and small cap exposure, while our Emerging Markets funds outperformed on the back of solid selection returns. This was linked to their lack of exposure to relatively expensive internet names such as Tencent and Alibaba, which performed poorly.

2018 was in some ways the mirror of the year before. Macro-developments have started to cool off slightly, with GDP expectations generally reduced, and volatility has increased. Meanwhile, although 2017 had seen concerns about several of the Trump administrations' policies, they had not had significantly negative impact on financial markets. In 2018, that changed, as the trade tensions with China escalated and started to influence both actual macro data, and especially market returns.

Having said all that, corporate earnings growth was healthy last year, and combined with lacklustre returns in the final months, this means that equity valuations contracted quite significantly. Looking at MSCI World, the price-to-earnings ratio – based on 1-year forward earnings estimates – had declined to around 14.3x at the end of December. This compares to an average of 15.2x over the last decade. Meanwhile, our global developed market funds have a price-to-earnings ratio – again, based on 1-year forward earnings estimates – of around 10.9x.

Tightening in Global Liquidity

Global liquidity conditions are getting tighter. For many years, central banks were using quantitative easing (QE) programmes to buy bonds, driving down rates and creating liquidity. As economic conditions improved, these efforts are scaled back. The U.S. Fed ended QE in 2014, and is now shrinking its balance sheet. This quantitative tightening (QT) happens through the Fed's monthly 'runoff': allowing bond holdings to mature, and not replacing them. Meanwhile, the ECB announced a halt to their QE programme in December 2018, bringing an end to asset purchases – but will continue reinvesting the cash from maturing bonds, effectively keeping its balance sheet stable. By ending QE, the Eurozone is following in the footsteps of the U.S., moving towards some normalization of interest rates.

Overall, this should be viewed as a healthy step. Having responded forcefully to the financial crisis, central banks are working to normalize policy, which also helps create the flexibility to cope with future financial difficulties if - and when - they arise.

However, these policy changes add uncertainty to financial markets, as the risk of policy mistakes increases. For example, in the U.S. the big question is whether the Fed will proceed with rate hikes, or if the recent economic data and market turbulence has stalled them. Obviously Donald Trump likes to try putting pressure on the Fed not to hike. Meanwhile in Europe, the sense has been that economic growth is more fragile than in the U.S., and has already started to weaken. Adding to the uncertainty is the fact that the current ECB chair, Mario Draghi, will be succeeded at the end of this year, which could trigger a political battle between EU nations about the future policy direction of the ECB.

Despite this increased uncertainty, the shift in monetary policies should not be seen as a negative thing. It remains a classic situation of aiming for a 'Goldilocks' scenario: not too hot and not too cold. As long as central banks are able to raise rates slowly, without stifling economic growth, it could also provide some tailwind for value stocks in general. As we have noted many times previously, the era of QE and falling - or very low - interest rates was not generally beneficial for classic value stocks, compared to growth stocks.

Trade war escalation

In our previous letter, we wrote at length about the trade war, and various scenarios - noting that in the long run, the U.S. has at least as much to lose from it as China, if not more. We questioned whether Donald Trump might dial back the rhetoric after November's mid-term elections, but we recognised that predicting his behaviour is no easy thing. So what happened?

The end of November brought the G20 Summit in Buenos Aires, and there were hopes this would offer a breakthrough for U.S.-China relations. Sadly, it did not seem to. There was an agreement to postpone additional tariff increases until 1 March 2019, but the commentaries from both nations after the summit made it seem as though they had reached different conclusions. Financial markets took this outcome negatively and concluded that political leaders were kicking the can down the road. Concern only increased on 6 December, when it emerged that the CFO of Huawei had been arrested in Canada – on the second day of the G20 summit - on suspicion of breaking trade sanctions against Iran. The fact that it was an executive from Huawei – a leading technology company - is significant, highlighting that the trade war is about intellectual property as much as about trade imbalances.

Whether it is trade tensions, or Brexit, the reality is that markets will continue to be influenced by geo-political issues in 2019. As we have often said, it is impossible to predict what will happen next. However, we do think there is now an increased sense of urgency for both China and the U.S. to reach some sort of agreement. Donald Trump seems unhappy with the recent market turmoil, which hit U.S. equities more than Chinese. There was also a sharp decline in U.S. ISM manufacturing numbers, and weak sales in China led Apple to cut its earnings expectations for the first time in 15 years. Meanwhile, China's economic data continues to deteriorate, and although this is not simply due to trade, the existing tariffs are having an impact on exports.

However, even if a deal is struck, this does not immediately solve the underlying issues. For example, if China commits to give U.S. corporates better access to its markets, and to increase protection of intellectual property rights, it does not mean that these commitments would be implemented immediately. Such commitments require structural changes in a very large economy, which can take years to implement and therefore the political situation can easily escalate again. Of course, much depends on the tone of political leadership.

Portfolio actions and news

As information technology and other cyclicals were under pressure during the quarter we decided to initiate new positions in Applied Materials and Prysmian. Applied Materials, of the U.S., is a market-leading producer of semiconductor equipment that saw its share price halve during 2018. Expectations for capital investments by memory chipmakers started to come down and the trade war discussions led to a possible ban of technology exports to China. Both fears are valid, but given the broad product portfolio and market leadership of Applied Materials, we see this more as a temporary factor.

Italian company Prysmian has a market leading position in producing underground and subsea high voltage cables, as well as exposures to telecom cables, and other specialty cables. It has a strong track record of consolidating the market and extending its leadership position. 2018 saw share price weakness because the market saw a delay in tendering for large projects, and due to minor cost overruns at the company. Besides that, a major acquisition led to temporarily higher debt levels, and of course the challenge of integrating the businesses, and we used these pressures as an opportunity to begin investing.

Necessity for improved corporate governance

In our investment work, we take environmental, social and governance issues seriously. This is because we recognise that they present companies with both risks and opportunities, which can have significant effects on corporate value. Therefore, we look at these issues when we research companies, as we monitor our investments, and when we talk to our holdings. We firmly believe that companies that are proactive in addressing these issues will help build strong corporate value over the long-term. We also believe that investors can play a role in this, and through our stewardship programme – which involves voting on our shares and engaging with companies on key issues – we aim to encourage companies to tackle the most material challenges facing them.

Nevertheless, in a diversified portfolio, the reality is that issues can emerge. Danske Bank and ING have been involved in money laundering scandals, which was very disappointing, to say the least. Large financial institutions have operations spanning various countries and business areas, and this complexity, and the nature of the business, does raise the risk of inappropriate – and illegal – behaviour in some parts. Since the financial crisis, there has been a significant increase in the amount of regulation of the financial sector, but a key challenge has also been to encourage financial institutions to improve their corporate culture. In other words, it is important to have rules, but it is equally – or perhaps even more – important to have a working culture that ensures all members of an organisation share, and support, high levels of conduct. In the case of both Danske Bank and ING, we are in dialogue with the banks – as are other investors – and in such cases, we encourage companies to improve both their governance structures for such issues, but also the corporate culture.

Of course, such problems are not limited to the financial sector. In November, like most market participants, we were shocked to hear of the arrest of Carlos Ghosn in Japan, on suspicion of financial irregularities at Nissan. We do not invest directly in Nissan, but Mr Ghosn was of course the key figure at both Nissan, and Renault – in which we do invest. He has played the leading role in bringing the two companies closer together in an alliance, along with Mitsubishi Motors - and was serving as the Chairman of Nissan, and CEO/Chairman of Renault.

Renault has a 43 percent stake in Nissan, and it had generally been understood that Ghosn was planning an actual merger between Nissan and Renault, so clearly recent events have impacted Renault's share price. For many years, our analysis has suggested that Renault shares were significantly discounted to the underlying sum-of-the-parts valuation of the company. At a very simple level, over the past 15 years, the market value of Renault's stake in Nissan has averaged around 80 percent of the total market cap of Renault.

While Nissan immediately dismissed him as board chair, Renault announced that they would retain him as board chair and CEO unless they find evidence of his wrongdoing. This was followed by an internal investigation into his behaviour at Renault, which found no wrongdoing by him at the French carmaker, at least in recent years. We will not prejudge Mr Ghosn's guilt, but, naturally, any wrongdoing at Nissan would highlight the general need for strong levels of corporate governance and oversight. This is something we focus on in our investment processes. Meanwhile, these events come in a broader context, in which some parts of the group have been more supportive of the merger, and others more opposed. The general understanding is that Nissan wanted to reduce Renault's influence on it, perhaps by making the partnership more balanced. Tensions in the alliance have now increased further. This is not an ideal situation, but on the other hand, the alliance is now at a decisive moment in its history. As of now, we do not think that this arrest will cause a break-up of the alliance, which has been in the making for almost twenty years. It is more likely that leadership will be changed or the capital tie-up amended. News reports suggest that the French government has recently asked Japan to accept a possible merger.

While Carlos Ghosn was a huge figure at both companies, their underlying value, and potential, remains. Even assuming that the capital ties were unwound – which would be a negative outcome, and seems relatively unlikely - Renault could still crystallize the significant value of its stake in Nissan, which accounts for the majority of Renault's current market cap. The implied price tag attached to Renault's automotive business – which is profitable and financially sound – is very low.

Opel and NASCAR racers

Despite a tough fourth quarter, autos – and related exposures – are not all negative for our funds. We also invest in Peugeot, which, despite a tough fourth quarter for all auto stocks, still outperformed the market over the entire year, on the successful integration of Opel. Across the Atlantic, we invest in U.S. small cap International Speedway, which also belonged to the top performance contributors in the quarter and the year. International Speedway is the owner and operator of 13 race tracks in the U.S. These tracks are the main physical assets, while the exclusive rights to organize NASCAR races and other motorsport events are the intangible part of its business model. The races in Daytona Beach are probably best known here in Europe. Spectator levels at NASCAR events have been declining in recent years, but its total revenues are still growing as more than half come from long-term television contracts. As these contracts stipulate rising TV revenues until the middle of next decade, the company has a very stable earnings outlook until then. This peculiar situation, where one has nice growing cash flows in the mid-term, but also has to reinvest to stay relevant in the long term, triggered a preliminary takeover offer for the company in early November. The deal has not been finalized yet, but the announcement led to the strong performance last year and its shares are currently trading around decade highs.

2019 Outlook

As discussed above, the trade tensions are starting to have an impact on the real economy. There are weaker trade figures between China and many of its trading partners, and the U.S. is also seeing some data points impacted. Meanwhile, Europe has also seen its economic recovery losing momentum.

So, it is easy to paint a somewhat negative picture of the current economic outlook, but there remains a big difference between an economy where growth is slowing, and an economy in outright recession. Following the scale of the financial crisis, and the volatility in the years since, there can be a tendency to assume the worst. Let us remember that 2018 started with relatively positive expectations, and while geopolitical concerns and some macro deceleration impacted markets, the reality is that corporate earnings were relatively solid. Earnings expectations have come down somewhat towards year-end, but equity price declines have been significant. Markets have certainly become cheaper and for value investors like us, it means that more ideas are popping up on our screens. Of course, a big question is whether earnings downgrades become more severe, but it does look as though current markets may offer a reasonable starting point to generate reasonable returns. In any case, the potential for markets to response well to any positive geopolitical developments is there.

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