Quarterly report

VALUE EQUITY

Equity rebound – but how broad is the rally?

Our last letter began with a review of the first quarter, one of the most historic periods in stock market memory. World equity markets had experienced one of, if not the, fastest bear markets in history as the COVID-19 pandemic swept through Asia and into Europe. Since that last letter, we have followed as the locus of the pandemic has moved from Europe into the Americas, as well as countries in the Indian subcontinent.

Sitting in Europe, we may perhaps feel that we have now weathered the worst of the first phase of this storm, but we recognize and reflect on the suffering being caused by the pandemic in so many other countries. The headlines and statistics from many of those countries make for extremely grim reading and the absolute scale of global infection is now measured in the tens of millions.

Within Europe, despite inconsistency in the rules and their application, the reopening has certainly begun. The most significant and noticeable element is the relaxing of travel restrictions between different European countries. The concern now is of the potential for a second wave in the autumn or winter. Spirits are in turn lifted by news of potential vaccines and medical treatments, but then tempered by the sheer scale of the problem being faced. However, it is true to say, albeit with varying degrees of apprehension, that Europe is recovering.

The tentative reopening in Europe has allowed us to return gradually to the office, although the use of online meetings remains prevalent, and by now is almost normal practice for us. It is face-to-face meetings that seem strange and new.

In this letter, we will of course review the second quarter in equity markets, but also provide some nuance to the drivers of market indices, and illustrate some reflections on how markets are treating some stocks differently. We touch on the policy responses to the crisis, and why value investors may have grounds for cautious optimism. Additionally we will provide insight into the conversations we are having with the companies held in our funds during this period of heightened uncertainty. Finally, although it can be hard to look beyond headlines focused on the immediate effects of the pandemic, we highlight some themes we believe could be important in a post COVID-19 world, themes we are certainly monitoring.

What a recovery….what recovery?

The first quarter of 2020 was astonishing. Yet, as if to demonstrate the danger of ascribing too many superlatives to a single quarter, the performance of major stock market indices in the second quarter could be described as equally as historic and unprecedented. At the end of March, we were in the throes of a bear market. MSCI World fell by a third in March alone, dropping 19.2% over the first quarter, while MSCI Emerging Markets fell 21.8%.

In our last letter we noted some stabilization in the first few weeks of April. By the end of the second quarter, MSCI World had in fact rallied 16.6% and MSCI Emerging Markets 15.3%. This means that over the first half of 2020, MSCI World is down only 5.8%, and MSCI Emerging Markets down 9.8%.

So, the second quarter saw strong returns from equity markets, but this stood in direct contrast to the worsening news flow over the period. True, the quarter saw a lot of policy responses from governments and central banks, but even considering that, we find the levels of equity markets difficult to justify. Or, to be more precise, we find the levels of equity

indices difficult to justify. This distinction between equity markets, and the indices that in theory represent them, is something we return to further below.

Looking at individual regions, we again see a dichotomy between negative news flow and robust equities. In the US, the news is of a rapidly deteriorating health crisis, with states that had begun to reopen now closing again. However, the MSCI USA index is down only 3% year to date. In a preview of one of the themes of this letter, the technology concentrated NASDAQ index is actually up 12% year to date.

This contrast between news and equity performance presents a challenge to investors. Do the markets reflect the reality of our current situation? Clearly, as a discounting machine, the market looks forward beyond this year into future years. As the market digests the various policy responses from governments and central banks, may one reasonably conclude that the market response is appropriate, in direction if not in magnitude?

Although every country has tailored its policy response to its specific needs and means, they can be grouped in three broad buckets, approximately corresponding to the speed of implementation.

The first policy bucket is central bank liquidity. This response is familiar, involving large injections of liquidity into local banking systems. It happened first, primarily because it is a policy response that has been deployed most recently in response to crisis, so the basic mechanisms were understood and in place. Central banks stood by as lender of last resort, allowing banks to continue to provide credit to companies and consumers, allowing both to survive the immediate impact of lost income. The magnitude of this liquidity response is staggering. In the US the Federal Reserve balance sheet increased by USD 2.3 trillion. It surpassed in both speed and scale the measures taken during the Global Financial Crisis.

The second bucket of policy response is a short-term fiscal response to support both consumers and businesses. The US enacted an extension of unemployment benefits. In Europe individual countries have undertaken furlough programs to help companies reduce costs whilst preventing a rise in unemployment. Many emerging markets have attempted to replicate this response, but in many cases their ability to respond is constrained by the state of their finances going into the year, and of course this may have implications for the specific road to recovery that each individual country can take. These measures in Europe have been relatively successful in preventing a spike in unemployment claims, with for example unemployment in Germany rising to 6.4% in June - a rise from the 5% rate at the beginning of the year but far below the Great Depression levels that were feared early in this crisis.

The challenge for this second bucket of fiscal responses is what happens as they expire. This leads us to the final bucket of policy responses, which is long-term investment in rebuilding economies that have been damaged by the pandemic. We do not take political sides on the size and structure of the EUR 750 billion EU recovery fund, but it is evident that support is necessary for the economies hit hardest by the pandemic. It is these investments that we look to for a longer-term recovery, a topic we will revisit below.

The market is not the index

We stand as guilty as anyone of using broad market indices to summarize market action. The MSCI World index for developed markets, and the equivalent MSCI Emerging Markets index, act as useful proxies for describing market performance. However, a trend of recent years has become even more pronounced during the past six months. The broad indices have become less broad, with performance dominated by just a handful of stocks.

One way to observe this concentration of performance is to compare the performance of the indices with their equal weighted equivalents. MSCI World is a market capitalization weighted index, meaning the larger the company, the larger their weight in the index. The equal weighted version is as it sounds: each stock has the same weight in the index irrespective of their market capitalization.

During 2017, the equal weighted index slightly outperformed the normal index by a modest 0.4%. However, in 2018 and 2019 the equal weighted index underperformed significantly, by 4.2% and 4.7% respectively. In 2020, that trend accelerated: in the first half of the year alone, the equal weighted index underperformed by 6.6%. The market capitalization weighted index, dominated by a few large stocks, is outperforming the average stock.

A consequence of this growing dispersion is that when we refer to the 'market recovery', the recovery is not quite as pronounced for the average stock as it is for a handful of large stocks. The names of these stocks are well known. By end-June, Apple was up 24% year to date in Euros, its market capitalization stood at USD 1.6 trillion, and it accounted for 3.8% of the main – market cap weighted – MSCI World index. Microsoft was up 29%, also had a market capitalization near USD 1.6 trillion, and an index weight of 3.5%. Amazon was up a huge 49% and reaching a market cap close to Apple and Microsoft. The performance of these stocks, and a few other equivalents, has been very different to the average of

the rest of the market, and given their absolute size they have a very meaningful impact on the overall index.

In emerging markets, the situation is arguably even more extreme. For some years now, the main MSCI Emerging Markets index has been increasingly dominated by a handful of stocks: China internet giants Alibaba and Tencent, electronics behemoths Samsung Electronics and TSMC, and finally Naspers, which is largely a proxy for Tencent. These five companies now account for 23.4% of MSCI Emerging Markets, while roughly 1,380 companies make up the remaining 76.6%. Whether looking at the risk in the index, or its performance, the big five tend to dominate the story in any given period. In the first half of 2020, these five companies mostly performed well, on average rising 6% in Euro terms. Notably, Tencent climbed 34%. Meanwhile the MSCI Emerging Market index as a whole declined 9.8%, implying deeper average declines for the majority of emerging market stocks.

Have expectations really changed?

It is reasonable at this point to observe that the market may be completely rational in its pricing behavior of these stocks. Very few amongst us have not at least dabbled with online shopping during the pandemic, and the ability of Amazon to deliver both essentials and luxuries across the world at short notice is a masterclass in modern logistics. Surely then, is it not reasonable that this success should be reflected in the stock price of Amazon?

Let us return to the concept of the market as a discounting mechanism. Notwithstanding the current operating level of Amazon's business, the more important driver of stock price is the future earnings expectations. Looking out a couple of years, to remove the short-term gyrations of pandemic affected expectations, we review the average analyst earnings expectations for Amazon in 2022. At the beginning of this year, the average analyst expected earnings of $53 per share for Amazon in 2022. At the end of June 2020, those expectations were still $53 per share. In other words, despite the pandemic, and despite the strong share price gains, there was no change in the 2022 earnings outlook for Amazon.

Let us compare the performance of Amazon to one of our holdings, Terex. Admittedly slightly less of a household name than Amazon, Terex is a very strong player in its particular business area. Terex is an industrial company that manufactures aerial work platforms and materials processing equipment, serving diverse construction, infrastructure and recycling end markets. Without question, near term demand for the company's products is impacted by the pandemic. So then let us review the outlook for the company by using the same lens that we applied to Amazon, reviewing 2022 earnings. At the beginning of the year, the average analyst expected Terex to earn $2.20 per share. By the end of June, the average expectation for Terex in 2022 had declined to $2.06. We certainly do not dismiss a 6% drop in 2022 expected earnings as meaningless. However, we do question whether that is enough to justify the performance of the stock, which in the past six months declined 39%, while Amazon, let us remember, gained 49%.

The opportunity for value

Of course, there are many considerations in valuing a stock, and as such we recognize the simplicity of the example above. It is a comparison of two stocks with very different businesses. However, it is illustrative. The dramatic difference in share price performance of these two companies, despite relatively little difference in their outlook for forward earnings, is symptomatic of the challenge in the market.

It is easy to point to the stimulus measures detailed above and place the blame for these pricing discrepancies at the feet of the increased liquidity. However, as the example above illustrated, we are dealing with something beyond a rising tide lifting all boats. The liquidity is lifting very few boats to very high levels.

We do not believe that a market that increasingly focuses on a small number of stocks, is in any way sustainable. The valuation gap between growth and value stocks has been pushed to ever more extreme levels in 2020. We note three of the worst ever months for the value style performance, including the worst month on record, have occurred in 2020.

In our letter of the third quarter of 2019, we touched on this topic in more depth, considering the different drivers of the relative performance of value and growth. One clear conclusion was that the underlying 'engines' of value investing are still functioning, but returns for value have been muted largely because the entire asset class has got cheaper, and cheaper, and cheaper still. The implication is that in order to envisage a positive environment for the value asset class overall, one does not need to assume a dramatic closing of the valuation gap with growth stocks. One only needs to assume that the valuation gap does not continue expanding indefinitely, because if it holds steady, the underling engines can generate decent returns.

Considering what may change to end this valuation gap expansion leads us back to the economic stimulus in response to the pandemic. As the pandemic grew, interest rates fell, reflecting not only fears of recession, but also anticipating a monetary policy response. We have previously written many times of the link between interest rates and the relative valuations of growth and value stocks. So, when rates fell on

COVID-19, valuations of growth stocks rose more due to their longer duration. This move was dramatic across both developed and emerging markets. The downward move in interest rates perhaps explains the direction, but not the magnitude of the relative shift in growth and value. Arguably, desperation for yield was amplified by herding into benchmark giants.

However, very early in the coronavirus downturn, it was clear that although the magnitude of the economic challenge was as great, or greater, than the Global Financial Crisis, the cause and therefore the solution were different. The Global Financial Crisis was a financial crisis, and the appropriate solution was liquidity. The pandemic started first and foremost as a healthcare crisis, and the global banking system in large part entered the crisis with good levels of capital. Liquidity, therefore, can only be part of the solution, a fact recognized by governments around the world with the move to fiscal stimulus.

We view the longer-term stimulus, the "third bucket" described above, with some degree of scepticism but also with some degree of hope. Although the political process can lead to solutions that are far from optimal, we see the opportunity and most importantly the political will to invest in longer term infrastructure. That this infrastructure is overdue is without question, and we believe that there is the opportunity for this stimulus to benefit parts of the economy that have been overlooked for the past decade.

Due to the long-term neglect of these parts of the economy, the potential demand is much greater than the ability to supply, making this stimulus conceivably more inflationary than the initial responses, that are dealing with a collapse in demand and therefore have not yet proven inflationary. Of course, if there is a return of inflation we may be dealing with a different interest rate environment than the one we have most recently experienced. As seasoned value investors, we rarely venture beyond cautious optimism, but one can envision scenarios in which value stocks could benefit both from earnings recovery and expansion, and a modest steeping of the yield curve causing the valuation gap to cease expanding. Many of our holdings, traditional value holdings that have long been overlooked by the market, may once again have their moment.

Bear in mind that in late May to early June, coronavirus cases were dropping both in Europe, and in the US. Of course, since then, US case numbers have risen again – but during that May to June period, 10 year rates rose, and there was a period of sustained value outperformance, in which our funds participated strongly.

What does the future hold?

The first quarter naturally felt like a battle for survival, ensuring all of our portfolio holdings had adequate liquidity to survive the unknown. Whilst we don't claim that our visibility has improved by any real amount, the focus of our analysis has shifted. Our conversations with companies in the second quarter have focused on strategic considerations – how are companies managing this inherently uncertain environment.

Companies are showing a natural caution about committing to major plans: there is a sense of hope for the best, prepare for the worst. However, we do detect a growing sense of confidence amongst our portfolio holdings that they are starting to pass beyond the worst impacts. First quarter earnings did not, of course, completely reflect the lockdown in important markets such as the US, and we expect the earnings reports in the second and third quarter to be sequentially worse, despite the rising confidence within management teams.

However despite the uncertainty, we have begun to have longer ranging discussions with our portfolio holdings. When management attention is focused on survival it can seem pointless to consider longer term issues, but now is the time for us to initiate those conversations.

This is not just a matter of responding to short-term shifts in demand, although of course some companies are doing just that. One of our emerging market portfolio holdings, BYD Electronic, has responded to the pandemic by developing new face mask production lines, which seem already to be contributing meaningfully. Nor is this a question of restructuring and cutting costs, although we see all of our portfolio holdings cutting costs where possible, in order to develop a more flexible cost structure. Rather, these discussions are around the fundamental shifts in the world - what exactly does a post COVID-19 world look like?

We believe that sustainability is more relevant now for more people than ever before, and we expect this trend to accelerate. One example of the conversations we have been having over this period is that with ArcelorMittal, a portfolio holding. As one of the largest steel companies in the world, it experienced a dramatic COVID-19 related drop in demand. Our talks with the company over the past few months have not only been to make sure they have been taking the appropriate defensive steps, such as reducing investment to preserve cash flow, but also to make sure that they have not been cutting their investments in low carbon steel solutions. It was important to us to understand that the company shared our view that low carbon investments are a critical part of the company's future, and time cannot be wasted by

cutting investment in this area, even in the midst of a pandemic.

De-globalization was also a trend from before the pandemic, but it is clear that COVID-19 will have implications for the supply chains of the future. This does not necessarily have to involve local sourcing of all materials, but more diversity in supply chains is a trend to follow.

A third trend, that again predates the crisis, but that we believe has the potential to accelerate, is one that some title a 'tech cold war'. The idea is that instead of a uniform, and United States dominated, set of suppliers and solutions within technology, we may now have multiple technology platforms. China is well motivated to provide one, and countries such as India have indicated that they would like to be beholden to neither China nor the US. This 'cold war' has important implications for portfolio holdings such as Nokia, a manufacturer of telecommunications equipment for the ongoing buildout of 5G capability around the world. Based in Europe, Nokia has both opportunities and risks from this particular trend.

These trends are evolving and for most companies, the range of potential implications remains broad and dynamic. However, we anticipate returning to these topics amongst others, in our forthcoming letters.

Our holdings

It is fair to say that the style headwinds referenced above were headwinds for our funds as well over the quarter. Those headwinds notwithstanding, we did have some stocks with notable performance in the second quarter.

Microsoft was up 29% in the second quarter. Although Microsoft is certainly a beneficiary of the market concentration we bemoaned above, we have been long-term holders of Microsoft, because we saw significant potential as it transitioned from a low valued and ignored 'legacy' tech company into one of the most important cloud based solutions providers. Of course, as such companies once again become stock market darlings, the key for value investors is to recognize when the stock is not longer undervalued, and work to rotate capital into other undervalued – and perhaps currently unloved – opportunities.

Within Europe another holding, Prysmian, rose 41% in the second quarter. A more recent portfolio addition, Prysmian produces and installs the cabling necessary for the future build out of electrical and telecommunications networks. As gratified as we are by the recent performance, we see a long-term opportunity for Prysmian to develop its business in a low carbon future as the world increasingly electrifies.

Finally, in emerging markets, Kossan Rubber based in Malaysia, rose 65%. We have been long term holders of Kossan, seeing strong potential for increased global penetration of its rubber gloves, for surgical, clinical, and other uses. However, demand has exploded this year, for reasons that are self-evident, and seems set to continue at robust levels for some time, leading to questions of capacity expansion, and a sea change in the long-term outlook for the company.

As welcome as the performance of these stocks is, we also recognize that Microsoft, Prysmian and Kossan Rubber are not reflective of our portfolios in general. While the first half of 2020 has been tumultuous for all financial markets, and tough for value equities in general, we take some comfort from the extreme moves in relative valuations. This is an asset class with proven long-term ability to generate excess returns, where the underlying engines of performance remain intact, but where persistently cheaper and cheaper valuations in recent years have prevented those engines from contributing in full. When viewed against benchmark indices that are increasingly concentrated in a handful of stocks whose valuations have risen and risen, the necessity of diversification and exposure to value seems to us clearer than ever. Of course, those are arguments for the asset class. More specifically, we feel strongly that our portfolios offer potential for returns driven not only by their overall value exposure, but also by idiosyncratic stock selection. Terex, discussed above, is but one example. Our portfolios are comprised of a diversified group of companies that are significantly undervalued The potential, to us, seems significant.

Published July 2020

Sparinvest is a signatory of UN PRI and member of Eurosif and Dansif.
UN PRI is an international investor initiative sponsored by the UN and based on six principles for responsible investments.
The aim is to help investors actively to incorporate environmental, social and governance issues into their investments.

The mentioned sub-fund is part of Sparinvest SICAV, a Luxembourg-based, open-ended investment company. For further information we refer to the prospectus, the key investor information document and the current annual / semi-annual report of Sparinvest SICAV which can be obtained free of charge at the offices of Sparinvest or of appointed distributors together with the initial statutes of the funds and any subsequent changes to such statutes. Investments are only made on the basis of these documents. Past performance is no guarantee for future returns. Investors may not get back the full amount invested. Investments may be subject to foreign exchange risks. The investor bears a higher risk for invest-ments into emerging markets. The indicated performance is calculated Net Asset Value to Net Asset Value in the fund's base currency, without consideration of subscription fees. For investors in Switzerland the funds' representative and paying agent is Société Générale Zurich Branch, Talacker 50, P.O. Box 5070, CH-8021 Zurich. Published by Sparinvest S.A., 28, Boulevard Royal, L-2449 Luxembourg.