Quarterly report

VALUE EQUITY

The Green Shoots of a Value Recovery?

The turn of the year is a natural time for reflection and contemplation. Perhaps as no other year in living memory, 2020 deserves its share of reflection. For many of us, life has become an endless repetition of home working, home schooling and home vacationing. However, we must also take a moment to recognize that despite the dreary monotony, those who have been able to transition to this existence must count themselves as amongst the lucky ones. Our thoughts go to anyone who has experienced, either directly or through family members, the effects of COVID-19, and we also feel a debt of gratitude to those who do not have the option of working from home: medical and health care workers, and first responders, who remained at their posts despite the risks to personal health; teachers supporting children in schools; food supply-chain workers; and so many others who have kept working to allow society to function. As the first vaccine rollout offers the possibility of an end to this pandemic, we can all join in the hope that 2021 is truly a very different year to 2020.

In this letter we both reflect, and look forward. We focus on three dynamics observed in 2020, that we believe may be significant developments for 2021 and beyond. Firstly, we dissect the rally that value stocks experienced in the second half of 2020, accelerating into the final quarter. As pleasing as the outperformance of the value style in the fourth quarter was, we discuss the opportunity for the value style in 2021.

Secondly, we discuss a specific sub-sector of the market that has experienced significant volatility and dispersion of returns. The auto sector has long been mostly within value investment territory, and we will examine the movements within the sector lately - how market focus has shifted, and the degree to which we, as value investors, can benefit from some of the trends.

Finally we return to the theme of value investing, but take a longer term perspective and review some of the broader macroeconomic themes that could not only extend the value rally seen in the fourth quarter, but result in a longer-lived return to the performance of value as observed over the longer term of the market.

Fourth quarter market developments

In a year with no shortage of newsworthy events, the fourth quarter of the year managed to contribute its share of excitement. The U.S. presidential election dominated the news cycle in October and early November. The election was quickly followed by the initial COVID-19 vaccine trial results that showed efficacy far in excess of expectations. As the year reached its close, the UK and EU managed to reach a deal on trade after the end of the BREXIT transition period, which in turn ended on the last day of the year. Finally, in the last couple of weeks of the year new COVID-19 mutations were identified, with potentially significantly greater levels of transmissibility. These new mutations resulted in the New Year being rung in across Europe with new lockdown restrictions in place.

The markets had a strong finish to the year. The MSCI World index rose by 9.2% in the quarter and the MSCI Emerging Markets index rose by 14.7%. Whilst October was the weakest month for equities, with the MSCI World declining and MSCI Emerging markets rising only modestly, November showed extremely strong returns, with MSCI World rising 9.8% and MSCI Emerging Markets rising 6.4%. In fact, for both indices, in Euro terms, November was the second strongest performance for the year, surpassed only by April when markets were rebounding from the sharp March sell-off.

For the first eight months of 2020, growth stocks had been significantly outperforming value stocks, a topic discussed at length in our prior letters. However, the fourth quarter experienced a strong reversal with significant outperformance by MSCI World Value against MSCI World Growth.

The dual catalysts for both the November rally and value outperformance were the U.S. election and vaccine announcements. Markets initially responded positively to the U.S. election result, as it became apparent, at least to most, that Democratic candidate Joe Biden had beaten the incumbent and Republican candidate Donald Trump. The election was followed by the announcement on November 9 of the COVID-19 vaccine trial results from Pfizer, with efficacy rates above 90%. The positive market response to the vaccine news is intuitive, but we examine more closely the news driving outperformance in value stocks below.

The value rally

In our letter from the third quarter, we observed that September was the first month of 2020 where value outperformed growth. We can now extend this observation, the fourth quarter was the first, and by definition only, quarter in 2020 where value outperformed growth. In the last letter, we were hesitant to extrapolate too much from a single month, and equally we should now resist the temptation to draw conclusions from a single quarter of value outperformance. However, when analyzing the catalysts for the value outperformance we are able to develop a cautiously optimistic near term outlook for value.

We recognize that value underperformance is more than a 2020 phenomenon. With some variations by geography, value as a style has underperformed since the end of the global financial crisis. There have been short periods of value outperformance during that time-period, and sceptics may see the most recent quarter as just another of those. In response to those sceptics, we identify two elements that support our, admittedly cautious, optimism.

Firstly, we point to the differential in valuations between value and growth stocks. Growth stocks should by definition have a higher valuation than value stocks. The market is ultimately a discounting machine, and the stock of a company with fast growing earnings should reasonably justify a higher multiple of current earnings than the stock of a company with slower earnings growth. However, the gap between the valuation of growth stocks and value stocks has reached extreme levels. There are many ways to determine valuation, but for the purpose of demonstrating the change in the valuation gap we will use the consensus one-year-forward price-to-earnings ratio, FY1 P/E. Applied to an index, it is the ratio of the value of an index to the average expected earnings of its members, over the coming year. We recognize the limitations of any single metric, but FY1 P/E has the benefits of simplicity and consistency and so will suffice for purpose of illustration.

Ten years ago, during the first quarter of 2011, the MSCI World Value had a FY1 P/E of 11.5x, while for the MSCI World Growth the equivalent measure was 14.9x. Therefore, the market was willing to pay almost 30% more for the current earnings of a growth stock relative to a value stock, to allow for the higher future growth rates. Performing the same analysis at the beginning of January this year, the MSCI World Value has a FY1 P/E of 15.5x. However, the MSCI World Growth has a FY1 P/E of 33x. The market premium for growth stocks has moved from 30% ten years ago to a little over 100%. Within emerging markets, the valuation dispersion has been even more pronounced. Ten years ago, the MSCI Emerging Markets Growth index was valued at a 24% premium to the MSCI Emerging Markets Value index, but now the growth stocks are valued at a 110% premium. The valuation of an index over time can be impacted by changes in its geographic and sector composition, however these changes do not account for this dramatic change in relative valuation.

We elaborate on the drivers of this valuation dispersion further below, and this supports our long-term view on the prospects for value. However, for our near term expectations it is perhaps enough to note that based on this admittedly simple metric, the premium applied to growth stock multiples has only been higher one time in the records available to us. That was in the second quarter of 2000, at the moment the dotcom boom began its great unwind.

The second element of our optimism relates to the persistency of a concept we refer to as the migration effect. In our letter of the third quarter 2019, we referenced some research performed by GMO to understand the value underperformance since the global financial crisis. The GMO paper decomposed relative return into four drivers: growth, income, ‘rebalancing’ and valuation and then compared two periods, from 1981 to 2005 and from 2006 to 2019. During the first period, value equities outperformed. During the second, they underperformed.

As discussed above, value companies typically show lower fundamental growth than the wider market. However, the difference in growth rates has been fairly consistent across time periods, with an average drag on the relative returns of value stocks of around 3.1 percentage points. The second return driver is income, which includes both dividends, but also net share buybacks. Value companies typically offer higher income, and this driver added 1.5 percentage points to relative returns in the earlier period, and a slightly lower 1.0 percentage points in the later period, a significant decline but not large enough to explain why value stocks underperformed in this period.

The third return driver is a crucial one: ‘Rebalancing’, or the migration of value shares into growth territory, and vice versa. This dynamic is in many ways the real engine behind the value premium. Individual value stocks rise in valuation, driving returns, but eventually they leave the value cohort, while certain growth stocks get cheaper and cross into value territory. This means that value investors can benefit from the valuation increases of individual stocks, but the value universe is constantly refreshed and valuations of the value universe overall do not increase. This allows the asset class to give excess returns, without necessarily getting more expensive. This rebalancing effect was a significant return driver from 1981 to 2005, adding 4.0 percentage points annually to the relative returns of value stocks (significantly more than the negative impact of their lower growth rates). During 2006 to 2019, the rebalancing effect weakened, but it still worked, adding 3.3 percentage points annually. The potential explanations for this effect weakening are interesting, and worthy of discussion in their own right, but for the purpose of discussing the outperformance of value, it is enough to conclude that the first three drivers of style returns identified by GMO – growth, incoming, migration - remain largely intact.

The fourth driver, valuation, refers to the overall valuations of the value cohort. The GMO paper reports that in the period up to 2005, the relative valuations of growth and value stocks were largely flat. Individual stocks rose and fell, but the value universe overall did not get significantly more or less expensive relative to the wider market. However, from 2005 to 2019, while valuations for the overall equity market have increased significantly, those for value stocks have increased by far less. As the valuation gap expanded, this has served as a significant drag on value's relative returns – to the tune of -1.1 percentage points annually. Indeed, this was the crucial driver meaning that – in the later period - value equities failed to generate excess return.

The valuation effect is confirmed by our simple comparisons of multiples above. The conclusion we draw from this is that the underlying components of long-term value outperformance, most critically the migration effect, remain intact. The value underperformance of recent years has been driven by ever widening valuations. We will address some potential causes of this valuation dispersion below. However, our optimism comes from the belief that valuations will not continue to disconnect forever, and any reversal will lead to strong value outperformance. More significantly, we do not even need the relative valuation gap to shrink back to historical levels: if the gap merely stops expanding, it can stop having a negative effect on the relative returns of value equities, and allows the other drivers, such as migration, to come to the fore and lead to value outperformance.

The "new" auto industry

The automotive sector has long been a sector that typically falls more into value territory. The sector includes more than the manufacturers of automobiles with names familiar to the consumer. There are also a myriad of equipment suppliers, whose names are not so familiar. These companies provide parts to the auto assemblers, parts ranging from simple to complex systems containing large amounts of technology.

The auto industry has a long history of struggling to address major sector shifts, such as lower cost manufacturers, trade restrictions and geographic shifts in demand. The most recent shift has been electrification. The poster child for the industry's move to electrification is clear: Tesla. Tesla was only founded in 2003 (as compared to 1937 for Toyota, 1916 for BMW and 1903 for Ford) and since founding has been a constant at the vanguard of the electric vehicle industry. An early investor was Elon Musk and after he took control of the company, and subsequently took the company public in 2010, he has been probably the best-known evangelist for the electrification of transportation. Partly due to the occasionally erratic external persona of Elon Musk, and his eye-watering remuneration scheme, it has at times felt easy to raise an eyebrow at Tesla. However, Musk's achievements cannot be denied: he has built, essentially from nothing, an entirely electric car company, that last year manufactured almost 500,000 vehicles, and has begun to generate a significant profit by doing so.

It is also fair to say that the market has recognized Tesla's achievements, quite often well in advance of those achievements actually being realized. Tesla stock performance has been extraordinary, culminating in 2020 with a rise of 675%, leaving Tesla with a market capitalization of $800 billion, almost the same level as the total capitalization of the next ten largest manufacturers. While Tesla's close to 500,000-production run-rate in 2020 was impressive, the next largest company, Toyota (market capitalization a mere $240 billion) produced approximately 8 million vehicles.

Long appreciated by our growth-investing peers, it has been difficult for value investors ever to justify considering Tesla. So, does that mean that value investors cannot participate in industry shifts, like electrification? The answer, happily, is that we can participate. However, as value investors we must explore a little further beyond the headlines and invest in companies where there is an opportunity to participate in this shift at a lower valuation, while possibly managing through other issues or businesses.

Korean auto company Hyundai, a portfolio holding, has long been at the forefront of technology investments into new forms of fuel for transport, including not only electricity but also for example hydrogen. In conjunction with the company's strategy related to premiumization of its portfolio, the market at the end of the year began to recognize the opportunity, resulting in very strong stock performance. Even more impressive stock performance was achieved by auto parts supplier Mando. Mando, a long-term holding, is a major supplier to Hyundai and is benefitting from the general upscaling in overall content by Hyundai, increasing use of advanced driver assist systems, as well as the electrification plans of Hyundai. It also worth noting that Mando continues to develop strong sales to customers other than Hyundai – and is, indeed, a supplier to Tesla.

Finally, also we draw attention to LG Electronics, also a portfolio holding. LG Electronics is a diversified Korean electronics company with many businesses. One part of the business that we have been monitoring is its business focused on parts for electric vehicles. This business had perhaps been overlooked by the market, however the company recently announced it would place this business in a joint venture with Canadian company Magna. This joint venture announcement allowed the market to more easily identify the value of the underlying business and the stock responded very quickly to reflect that identification. More recently, LG Electronics has highlighted that it may finally consider taking more drastic steps to address the losses in its long-standing mobile phones business, an area we have discussed with the company over the years. This announcement further bolstered the share price, as the market increasingly sees the potential for corporate transformation.

A feature of all three of these companies was that they had exposure to electrification of vehicles, but the market failed to recognize it sufficiently. As the market began to recognize the value, the stock prices responded and the company's began their valuation migration, to use the parlance from the section above. As the migration occurs we respond as value investors by reducing our exposure, and indeed in the case of Mando, fully exiting our position. We then recycle the capital from these migrating stories into new value opportunities where we see the market is failing to appreciate the long-term opportunity.

We equally we have other holdings within the auto sector, and many of them have strong offerings within the electrification of transport opportunity. One example is portfolio holding Renault. It may surprise that Renault has the largest selling electric vehicle model in Europe (with Tesla second and Hyundai third). The market may take its time to recognize the value, and at times it can seem unfair that companies such as Tesla get all the attention, however we are reassured by our holdings with their lower valuations, strong existing businesses and new areas of opportunity, and we await market recognition for these companies to begin their valuation migration.

The long-term opportunity for value

In the section above, we identified an ever-growing gap in valuation between value and growth stocks as the primary source of the underperformance of value stocks since the global financial crisis. The conclusion we reached was that we only need the valuation gap to stop expanding, for value stocks to have far greater potential to outperform. However, to increase our confidence in the long-term prospects for reversal we need to better understand the reason for the rise of this valuation gap.

It is no coincidence that the rise of growth stocks has been in lockstep with the decline in bond yields. The nature of growth stocks is that they have a greater share of their earnings to be realized at some distant point in the future. To paraphrase from earlier in this letter, if the market is a discounting machine, then the lower the discount rate the higher the value of far-off cash flows.

At the beginning of 2010, the yield on the 10-year U.S. treasury was 3.9%. Twelve months ago, before the onset of the COVID-19 pandemic, the yield had dropped to 1.9%. At the beginning of 2021, the yield was 0.9%. The discount rate applied to future earnings has declined markedly. Within Europe, the decline has been even more dramatic. German 10 year Bunds yielded 3.4% at the beginning of 2010. After briefly breaching the unknown of negative yields in 2016, Bunds have been firmly ensconced in negative rates since mid-2019. The German government can now borrow for 10 years at the rate of -0.5%. If low rates distort the discount rates on the future earnings of companies, negative rates surely play havoc.

Faced with the monetary response from central banks to the global financial crisis, the market expected – feared - inflation. However due to a range of reasons including excess economic capacity, demographic challenges and globalization, inflation did not appear. Since the financial crisis, inflation in the US peaked at 3.9% and began 2020 at 2.5%. Within the Eurozone, inflation barely reached 3% and began 2020 at 1.4%. The response from central banks to COVID-19 has surpassed even the response to the global financial crisis, but can we really expect a different inflationary outcome and associated interest rate response?

We do see some reason to believe that the stimulus supporting the global economic recovery from the pandemic could lead to tighter economic conditions and therefore inflation. Firstly, we may have passed, at least for the time being, peak globalization, and the economic trend is now one of localization. Secondly, although central banks provided an initial monetary response to the pandemic, central bankers have been increasingly clear that they are at the limit of their powers. A fiscal response is needed, and as discussed in our letter in the third quarter, whether through President Biden's stimulus plan, or the unprecedented mutually funded EU recovery fund, fiscal stimulus is coming. The headlines may focus on important and worthwhile ambitions such as transitioning to green energy; however, the details of even a green transition require investment in areas such as infrastructure, areas that are the traditional domain of value investors. Due to long-term underinvestment in these areas, economic capacity can be used up quickly, setting conditions for potential inflation.

Some assets are showing signs of inflation. Many countries have experienced surge in house prices in 2020. Although this may be explained away through demand shifts related to the lockdown-related desire of apartment dwellers wishing to move to larger properties, rising house prices do not exactly correspond to the deteriorating economic conditions caused by the pandemic. Within commodity, markets there have also been significant price rises. Metals price rises that began with precious metals soon moved onto industrial metals. The ultimate economic bellwether, copper, has risen from a low of $2.20 / lb. in March of 2020 to end the year at $3.52 / lb, a level not seen since mid-2013. Agricultural commodities such as corn, soy and wheat have all reached multi-year highs in recent months.

Importantly however, bond markets do not expect higher rates. Market expectations are for low rates in the U.S., and within the Eurozone a prolonged period of negative rates. This lack of expectation of higher rates is also factored into the higher valuations of growth equities. As we often remind ourselves, the definition of a surprise is something that was not expected. Bond markets and growth equities are priced for no surprises.

The observation from above is worth reiterating: as value investors we do not need the valuation gap to decline, we just need it to stop expanding. In other words, we do not need the discount rate on future earnings to increase; we just need the discount rate to stop declining. Therefore, a return to inflation and higher rates is not a necessary condition for value stocks to outperform, but the assistance given from an end to ever-lower rates could provide strong support to the value style.

Our holdings

As discussed at length above, our automotive sector holdings provided some of the strongest returns in the quarter. However, we also benefitted from strong performance in the quarter from many different companies ranging across all the different sectors of the global economy.

Alcoa is a U.S. based aluminum smelter, which is vertically integrated into bauxite, the raw material for aluminum. Demand for aluminum, a metal used across a range of industrial and consumer including light-weighting vehicles to improve fuel efficiency, dropped during the first pandemic lockdowns, as production lines for end-products stopped. As demand has recovered in the second half of the year, so has the price of aluminum itself and the stock of Alcoa responded to this recovery with very strong returns of 102% in the fourth quarter.

Terex was most recently discussed in our letter from the second quarter of 2020. At that point, we drew an admittedly simple comparison between the treatments by the market of Terex, an industrial company that produces aerial work platforms amongst other products, with Amazon. Terex had underperformed significantly, despite no changes to the long-term earnings outlook of the company. Since the time of writing that letter, Terex has risen by 96%, and in the fourth quarter alone, it rose 71%, reflecting the discounted valuation and stable long-term outlook.

Discover Financial Services is a U.S. credit card company. Early in the pandemic there were justifiable concerns related to economic decline impacting the ability of consumers to repay loans. By virtue of the support provided by extended benefits and economic stimulus, the distress felt by consumers has not been as sharp as feared. Discover Financial Services reacted to that improved outlook by rising 54% in the quarter.

Globalwafers is a Taiwanese silicon wafer manufacturer that rose 83% in the quarter. The company announced a plan to acquire a major competitor that would consolidate a previously fragmented industry. Whilst we more typically benefit from owning the target, rather than the buyer of an acquisition, in this case the potential for a more rational and disciplined industry structure benefits Globalwafers and the stock rose accordingly.

The impact on value returns from the migration effect, as described above, can sound a little like an abstract concept. The reality is that the migration for an individual company will always contain idiosyncrasies specific to that company. As demonstrated by the examples from this quarter, some may be cyclical recovery, some may require acquisitions and some may require patience for the market to pay more attention to underlying business transformations. However, irrespective of the exact nature of the migration, we are reassured not only by the academic evidence of the persistence of the migration effect but also by the real examples of the migration still occurring. We believe the potential for value equities is solid, and the risks of underexposure to value are very real. We remain focused identifying new investment opportunities, to replace ideas that migrate upwards and out of the value universe.

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