Sparinvest

THE BEGINNING OF THE RETURN TO NORMAL

Looking back to a year ago, on Monday 23 March 2020, after several weeks of heavy selling pressure, the MSCI World (USD) index closed at 1,602. Complex epidemiological terms had yet to become part of everyday vernacular, but there was no shortage of dire forecasts for the immediate economic future. It is fair to say that few market participants were predicting that the same index would rise 75% over the next twelve months.

There is no question that the unprecedented situation required a monetary and fiscal response of unprecedented scale. The wholesale closure of entire segments of the global economy brought hardship on both individuals and society that without question justified the response. In country after country, actual GDP for 2020 seems to have outperformed the worst, and in some cases even more moderate, predictions. Concern is reserved for those economies without the economic capacity or governance structures to enact meaningful stimulus. Not only is the toll of suffering greater due to economic weakness, but in some, poor governance is leading to slower vaccine rollouts, more extended lockdowns and ultimately slower recoveries.

As vaccination rates rise and economies begin tentative reopening, we can once again begin to look beyond the immediate future and to the longer term. In this letter, we will address three issues that we believe will be important to understand over the coming months and years.

Firstly, we address the rotation to value that began in the last quarter of 2020. In our last letter, we discussed the reasons for the underperformance of the value style and the conditions necessary for an end to the underperformance. In this letter, we will consider the drivers of value outperformance over the long term and the potential for value into the future.

Secondly, we review the rising impediments to global trade. Globalization arguably peaked well before 2020, but the pandemic has laid bare the susceptibilities of certain industries in their global supply chains. One side effect of the pandemic may be an accelerating retreat from globalization and we discuss the potential results of this retreat.

Finally, we consider the challenges of sustainability for both companies and investors. Long-term readers will appreciate that Environmental, Social and Governance (ESG) analysis has long been an intrinsic component of our investment approach. However, there has recently been a rising volume of discussion on ESG and we take the chance to discuss some of the opportunities and pitfalls facing companies, as this critical theme becomes more widely understood.

First quarter market developments

Rollouts of vaccines were both a key theme and key differentiator in the first quarter. Countries such as the UK and U.S., benefitting from very effective vaccine strategies, achieved significant vaccination rates amongst their populations during the quarter. This higher level of vaccination allowed a tentative reopening, particularly in the U.S., with some states going as far as removing almost all restrictions. The European Union's attempt to centralize vaccine procurement backfired and the quarter saw many European countries maintain or even tighten lockdowns. Infection rates spiked in key emerging markets such as Brazil and India, demonstrating that for much of the world's population, the pandemic is far from over.

The first quarter saw the inauguration of a new president in the U.S., as well as an unexpected win for the Democratic Party in run-off senate races in Georgia that gave the Democrats control of a tightly balanced senate. President Biden wasted no time in utilizing his

control by passing a $1.9 trillion economic stimulus. This stimulus, coming just as the U.S. economy began to reopen, provoked questions as to its necessity. Bond markets responded to the fears that a stimulus of that size would be inflationary with a broad sell off. 10 year treasury yields rose from 0.92% at the beginning January to 1.74% by the end of the quarter. Yields rose in almost all major markets, although the rise in U.S. yields was one of the most pronounced.

Markets were strong in the first quarter of the year, with the MSCI World index rising 9.2% in the quarter and MSCI Emerging Markets rising by 6.5% However, those performance figures for the broad market indices fail to capture the style rotation that occurred during the quarter. The MSCI World Value index rose by 14% in the quarter, whereas the MSCI World Growth index only rose by 4%. The rotation to value was not limited to developed markets: MSCI Emerging Markets Value rose 8.4%, well ahead of the wider market.

Value for the long run

In our letter last quarter, we discussed the value rally in the last four months of 2020. Value stocks had underperformed significantly in the prior eight months and we reviewed the main drivers of that underperformance, as well as the circumstances needed for value to outperform. By way of brief review, we observed that valuation differentials between value and growth stocks had essentially never been wider. Additionally we cited research that the 'engine' of the value style, the so called migration effect, was still intact but had just been overcome by the ever widening valuation gaps. A principle driver of this expanding valuation gap – and therefore the value style underperformance – was lower and lower interest rates, which as a discounting mechanism favoured growth stocks that have most of their value associated with earnings far in the future. Our conclusion was if we reach a position where rates are no longer declining, the value engine could once again assert itself and the conditions will be in place for value style outperformance.

As proof of concept, the first quarter of 2021 works very well. As discussed above, rates rose significantly in the quarter, and as expected, growth stocks significantly underperformed value stocks. The question at hand, however, is what now? Now that rates have corrected to some degree, can we still anticipate value style outperformance? Superficially, we refer back to our conclusion from the prior letter: we do not need rates to rise for value stocks to outperform, merely for rates not to decline. We typically refrain from trying to make nuanced interest rate forecasts, but viewed through a long lens of history, rates are still at extremely low levels (and in Europe negative), so the risk surely remains to the upside. Naysayers, sceptics and committed growth investors, informed by previous value rallies that ultimately did not last for long, will point to the past decade as some structural shift that suggests value no longer works. This structural shift argument, which takes many forms, can feel powerful and so to refute it requires something more than a superficial comment.

The challenge with refuting claims of the death of value is that we do not know exactly why the value effect previously worked so well. The value premium refers to the superior risk adjusted returns of value stocks vs. growth stocks. The concept of a value premium dates back to the fathers of value investing, Graham and Dodd, in 1934. However, the first to identify and measure the value premium were the University of Chicago professors, Eugene Fama and Kenneth French, in their seminal work from 1993. Fama and French identified a premium that was persistent over time and when the analysis was further expanded, present in international equity markets. The existence of the value premium, or any other premium such as the premium on small-cap stocks, runs counter to the efficient market hypothesis (a theory also originated by Eugene Fama). Due to the violation of the efficient market hypothesis, it is important to understand why there is a value premium. There are two major schools of thought as to why the value premium exists.

The first category of research on the value premium is referred to as risk-based. Under the risk-based theory, value stocks have some inherently higher risk than growth stocks and therefore, to compensate for the higher risk, require a higher return than growth stocks. There are certainly some characteristics of value stocks that suggest there may be some higher risk, some of which can be controlled for in a portfolio context. An examination of the sector composition of value indices as compared to the broad market suggests that stocks with high exposure to the economic cycle often fall into the value category. Exposure to the economic cycle brings an inherent risk during times of economic distress, and according to the risk based theory, the risk of distress requires compensation through excess return. Other sources of purported risk in value stocks include greater financial leverage and higher levels of fixed assets that cannot easily be converted to cash at times of need. The academic research is notably mixed on the risk-based approach, but it seems reasonable that as a group value stocks have characteristics that differentiate them from growth stocks and ultimately offer higher reward as

compensation for at least some of those characteristics.

The second grouping of research contains a range of concepts that we would refer to as behavioural based. Incorporating concepts from behavioural finance, this group attempts to explain the value premium as a result of the irrational actions of investors. There are a number of sub-theories utilized by this class, but one of the most conceptually compelling is referred to as the overreaction theory. Under the overreaction theory, investors are pessimistic about the prospects of value stocks but optimistic for the prospects of growth stocks. The theory posits that the degree of pessimism is greater than the subsequent reality – i.e. the businesses underlying value stocks actually perform better than expected. Equally, the degree of optimism for growth stocks is excessive – i.e. the businesses behind growth stocks in aggregate tend not to perform as well as expected. The process of expectations meeting reality is the driver of the value premium in this theory. Again, the research is inconclusive, however the idea that investors can be at times excessively pessimistic or optimistic is one that is easy to recognize.

As value investors, one may expect us to have hardened views on which theory is correct. However, possibly due our long tenure as value investors through various market conditions, when pressed on which view we take, our answer is typically 'all of the above and more'. We recognize situations where the market seems overly focused on the economic cycle and discounts value stocks for perceived risk. We also can recall many occasions where pessimism for value stocks and optimism for growth stocks seemed excessive, and we recognize that in financial markets, human behaviours and biases can play more of a role than participants would like to admit. Ultimately, the risk-based and the behavioural schools of thought do not contain contradictory intuitions, and it is likely to us that both theories have validity, with one sometimes more dominant than the other, depending on the phase of the market cycle.

Irrespective of which theory you subscribe to, the most important conclusion is, however, that nothing has changed. Both theories are as valid today as they were in 1993 at the time of the Fama and French paper. If anything, 2020 has provided a current day reinforcement of the factors underlying the theories. For risk-based adherents, a global pandemic has surely brought to the fore the risks associated with economically cyclical stocks. For subscribers to the behavioural theory, the exuberance associated with a handful of, particularly technology, stocks during the year, many of which have subsequently sold off, should be a reminder that individual investors are no more rational than they were eighty years ago when Benjamin Graham first wrote of the importance of performing fundamental analysis.

So, the two major underlying concepts that can explain a long-term value premium still exist: whether behavioural, or risk based, certain assets do become excessively cheap. Typically, they will revert to valuations that are more appropriate at some point. This reversion happens to individual companies all the time, in the process we have referred to as migration – and that has been largely intact for the past decade. However, that effect was hidden, because the valuations of the entire asset class of value stocks as a whole were pushed further and further down relative to growth stocks. This was closely linked to interest rate developments – but nonetheless, we have heard many arguments suggesting that in fact, value investing was broken.

We have been told that the rise of the intangible company – companies that no longer hold physical assets such as factories – render our analysis obsolete. We remind such persons that companies have held intangible assets for a long time, and as value investors performing in depth fundamental analysis we are able, as we always have been, to determine a value for intangible assets. We are not opposed to buying companies with lots of intangible assets, we are just opposed to over paying for the intangibles.

We have been told that value investing in emerging markets misses the inherent growth within those markets. In fact, when investing in emerging markets with a portfolio of economically sensitive value stocks, we capture very well the underlying growth rates of those economies. Indeed, there is much to suggest that the more one subscribes to expectations of superior GDP growth in emerging markets, the more this points to a value investment strategy. We are not averse to buying companies that are growing, we are just averse to over paying for the growth.

We have been told that value investors improperly account for externalities, leading us to corners of the market that will struggle to adjust to long-term trends such as climate change. We relish that argument as an opportunity to demonstrate that ESG analysis was integrated into our investment approach long before it became fashionable amongst peers. We also discuss how we utilize stewardship and active

ownership to engage with our portfolio holdings to ensure they are investing behind these themes to effect meaningful change. We are not against buying companies that have a strong ESG profile, we are just opposed to over paying for them. We also believe that there can be a more meaningful benefit to society from supporting a company, which is improving, rather than just buying the same handful of feel good stocks as everyone else.

Hubris is foolhardy when making forecasts, and we certainly do not claim that there will not be periods of time when value underperforms again. In particular, the path of interest rates could yield shocks in the short term that again drive wider valuation disparities with growth stocks. However, we are reassured that the value 'engine' still works and the theories underpinning the value premium remain valid. As long as the cycle of an ever-expanding valuation gap between growth and value stocks is halted, value stocks can benefit from that underlying engine, and the value premium can demonstrate that it is, in fact, very much alive.

Localizing supply

It is hard to discern the precise moment that globalization peaked in its most recent cycle, but it is becoming very clear that globalization has peaked for the time being. Cycles of globalization and localization have occurred for centuries, the losers of one phase forcing a reconsideration and realignment. The cycles are measured in decades and so it is no surprise that the precise moment the cycle turned is difficult to identify. The global financial crisis is certainly a candidate, a moment when the interconnectedness of global financial systems stopped being a strength and became a critical flaw. The election, in November 2016, of a trade sceptic president in the U.S. is a further candidate. However, arguably the pandemic has shone a light on supply chains and the dependence on a limited number of supplier countries as never before. Exports of medical equipment, pharmaceutical knowledge and most recently vaccines have become politically weaponized. The decline of globalization will have important consequences for economies and societies but also the operations of companies and the performance of markets.

President Biden may be spending much of his early time in office reversing the executive actions of his predecessor, but one area where change is not apparent is the approach to global trade. The multi-trillion dollar jobs and infrastructure package currently being negotiated between the executive and congressional leadership contains extensive 'Made in America' provisions that, notwithstanding the practical and cost considerations, are now apparently the political price of entry for U.S. industrial policy. Bringing production back onshore is possibly one of the only subjects that receives bipartisan support in the U.S.

Within Europe, trade is taking a step back, most obviously with the aftermath of BREXIT. The post transition deal negotiated between the EU and UK is the most bare-boned of deals, designed to limit the immediate damage to critical supply chains that would have compounded the impact of the pandemic. The deal, excluding services, which account for a large portion of trade flows, is no platform for growth. The relationship between the UK and EU is currently at a low ebb, despite the fact that based on geography alone they are natural trading partners.

China is also entering a transition in its relation to trade. Supporters of globalization will present global trade growth as 'win-win', with all sides benefitting. One of the keys to President Trump's success in 2016 was his reframing this view of global trade as 'they win-we lose'. The 'they' in this case was most identifiably China, although many countries suffered collateral damage from U.S. trade enforcement actions. Building a global export base was undeniably a success for China, with the growth of the economy and development of a middle class an achievement that played out over several decades. After the global financial crisis, however, much was made of the realignment that China needed to make, away from an industrial economy and towards a consumer led economy. A new realignment in China is now underway, known as 'dual circulation'. The internal circulation half of dual circulation refers to the domestic production, distribution and consumption of goods. This internal circulation strategy was reinforced in the latest five-year plan, announced in March, which included increased investment in areas such as research and development.

Notwithstanding the political rhetoric, not every country can do everything. The U.S. and China may say they want to onshore large parts of the supply chain, but practically there are limits even to powerful economies such as these. There are, however, some key areas that are being identified, one of which is semiconductors.

The U.S. has long had a technological edge in the design of semiconductors. A small number of companies dominate the cutting edge of the global semiconductor manufacturing industry. Chinese semiconductor

companies are technologically behind U.S. competitors, but with large investment and the support of the government, they are making a credible attempt to catch up. The U.S., not content with ownership of intellectual property, is trying to encourage actual semiconductor manufacturing back to the U.S. from countries such as Taiwan. The U.S. government has classified semiconductor production as a matter of national security, and companies such as Intel are developing U.S. based manufacturing capacity. The focus on semiconductors is in part because they have crept into almost every corner of the economy. The reality is that without a reliable supply of semiconductors large portions of the economy will slowly stop. This reality is compounded by the realization that the semiconductor supply chain is more fragile than once imagined.

The automotive industry is currently suffering from that supply chain fragility. As an early response to the pandemic, global automotive manufacturers cut expectations for demand and consequently cut their orders for parts, including for semiconductors. During the year, the U.S. began to ban sales of the more advanced semiconductors to certain companies in China, which led to stockpiling by those companies. Finally, an extreme weather event in Texas caused a production shutdown at a semiconductor foundry. These events have conspired to cause a shortage in semiconductors that is impacting the ability of the automotive industry to produce cars. Supply constraints are also visible in other sectors such as consumer electronics but the automotive industry is bearing the brunt; this may be because amid a shortage, the suppliers are not prioritizing customers that cut orders more dramatically a few months earlier.

Semiconductors are but one example of a supply chain that will become localized and replicated in several markets. There are many other examples cutting across sectors as varied as industrial products, basic materials, technology and health care. Replicated supply chains, sub-optimal manufacturing and higher inventory levels all bring higher costs, and at least some of these will be ultimately borne by the end customer. The impact will be especially felt by companies that have successfully outsourced their cost structures, which includes many of the, until recently, high-flying technology stocks. Markets are currently focused on the inflationary impact of stimulus programs. However, just as the trend of globalization has contributed to a multi-decade benign global inflationary environment, so could a move to local supply chains contribute to rising inflationary pressures. Inflation remains at low levels in much of the world, however if it were to rise central banks would need to respond with tighter monetary policy and higher interest rates, with consequences for equity markets overall as well as the relative valuations of growth and value stocks.

The challenge of sustainability

The pandemic has demonstrated our reliance on, and susceptibility to, the natural world. As such, it is a natural consequence of the pandemic that there is a renewed focus from investors on sustainability and ESG topics in general. Readers of our letters over the past decade will know that we need no convincing of the importance of ESG to fundamental investing. However precisely due to our long involvement with ESG, we also understand some of the constraints that investors and companies operate under and some of the potential pitfalls that await new arrivals in the ESG universe.

'Greenwashing' is an accusation that is thrown with increasing frequency. Generally, the term refers to the presentation of an environmentally friendly public image, which does not match the underlying reality. That specifically refers to the Environmental part of ESG, and there are analogous attempts at disinformation on both the Social and Governance components. Investors are often accused of running funds that are engaged in greenwashing. The investment industry has seen a recent wave of existing funds suddenly becoming 'ESG funds'. There are many valid approaches to incorporating ESG considerations into investment funds, and not all of them are simple or obvious. However, if a fund is merely rebranded as "ESG" without any meaningful change in investment process or disclosures, then there could possibly be a greenwashing case to answer. Transparency is the enemy of greenwashing. Our Sustainable Investment Policy includes the standards we commit to, our approach to stewardship and voting, as well as our exclusionary criteria. Disclosure of such policies increases transparency and is one tool to help distinguish between those managers who are striving to integrate ESG as a genuine part of the underlying investment work, and those who view it more as a convenient label.

Companies also run the risk of accusations of failing their ESG obligations. It would be very easy for a fund to limit its investments to those companies that already handle ESG considerations very well, so that the fund subsequently screens very well on ESG metrics. However, the more investors that follow such an approach, the greater the risk of bubble formation, which ultimately does not serve society, or investors, well. In any case, we believe there is a role to play for investors, through stewardship, to help companies improve. If companies have room for improvement on

one or more ESG areas, then pressure from investors through active engagement can drive incremental ESG improvements at these companies. This has potential to benefit both society – and investment returns – considerably. Of course, not every company is able to improve, and one of the benefits of integrating ESG into an active investment process, is that both the ability and willingness of the company to improve can be evaluated as part of the investment decision. These improvements could be environmental concerns such as reducing carbon emissions, social issues such as improving labor conditions for workers, or governance considerations such as improving the rights of minority shareholders.

As noted above, we are happy to invest in companies that are already strong in their handling of ESG risks and opportunities, but we prefer not to pay too high a price for them. Besides, we tend to believe that there is no such thing as a "perfect" company. Indeed, we think some of the strongest opportunities to contribute to real change can be found in investing in some companies which are less than perfect, with a view to using both voting and engagement to support improvements on ESG issues and other fundamental issues.

Companies must also increasingly account for their ESG profile with other constituencies. Employees can be a vocal force for change. Within traditional manufacturing, labour unions have long been strong voices for improvements in working conditions and safety. More recently, topics such as diversity at Silicon Valley technology companies are examples of areas where companies are having to incorporate views of the employee base into business practices. The customer, however, is possibly the most powerful constituency of all, with more impact than investors or employees. Boycotts of consumer products date back decades, but the recent amplifying impact of social media has increased the risks for companies that misstep, with little room to compromise.

Companies can find themselves struggling to navigate the often-competing currents of social media driven consumer concerns and geopolitical considerations, in which there is not always one "right answer". Navigating these currents requires companies to have well thought out, transparent, ESG policies. Development and support for these policies is an area where long-term investors with a strong ESG focus can contribute and support.

As one example of this, we have been in discussions for several years with one of our holdings, a U.S. industrial company, about including ESG metrics in their executive compensation program, indeed this company has introduced both environmental, and safety targets into their most recent compensation program. However, this company desires to go further. Despite operating in a very traditional field, diversity has become a focus area for them. The company, with the full backing of the board of directors, is now making a concerted effort to improve its diversity, with thorough training for Executives to ensure awareness and understanding of unconscious bias to drive improvement and to create a supportive environment. We see these changes as both beneficial to society as well as the company itself and support the process through our engagements.

Our holdings

In such a period where the value style is so strongly in favour, we have the fortune that many holdings perform well. Several sectors performed extremely well, however even within those sectors performance was not distributed equally and there was an opportunity to add value through active selection, above and beyond the returns explained by either sector or value exposure.

Retail is one such sector that experienced strong returns in the quarter, and our funds also participated in this. In the U.S., we invest in two apparel retailers, American Eagle and The Gap. During the lockdowns of 2020, these two companies went for long periods unable to open their stores. Although both companies have meaningful online businesses, the online could not compensate for the lack of in store sales. As the U.S. vaccination program accelerated through the first quarter of 2021, and the time at which stores could open came closer, the stocks began to anticipate the reopening with strong performance.

Brazilian retailer CBD also performed very well in the quarter, although this was less related to lockdown reopening and more reflective of the underlying intrinsic value of the business. A collection of different food and non-food retailers, our assessment has long been that CBD has a value based on the parts of its underlying business that exceeded the market value of the overall company. At the beginning of March, the company spun off its wholesale business. This helped to highlight the underlying value for the remaining businesses, and the stock responded accordingly.

Unlike the retailers, Nvent Electric is a possibly less familiar name. This company, a spin-off from a larger conglomerate, produces an eclectic set of products centred on electricity infrastructure. During work

from home, needless to say, there was a reduced demand for refitting the electrics of buildings such as offices, and this decline negatively impacted the stock. However, the company has a good exposure to growing markets such as data processing centres and power utilities, and the stock had strong performance in the quarter as other investors discovered the company and the market began to recognize its value.

The short-term gyrations of markets, interest rates and investment styles are hard to predict. However, whether or not the value style is assisted by rising rates driven by stimulus or the rising cost of supply chains, we will remain focused on applying our investment process, as always. We do see good potential for value equities overall, but our stock selection process means that our portfolios aim to offer not only exposure to value, but exposure to individual equities with the potential to deliver idiosyncratic outperformance.

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