Sparinvest

Letter to Shareholders

VALUE EQUITY

Brexit and Bregret

Bregret?

One word has dominated markets lately: Brexit. As the second quarter progressed, focus shifted increasingly to the UK's referendum. Opinion polls swung one way and then the other. In the last few days before the June 23 vote, markets seemed positioned for a 'remain' victory, so the actual result sent a 'risk off' shock wave through the markets. Gold rose, bond yields fell, and equities fell – with cyclical sectors underperforming defensive sectors, and value underperforming growth.

The shock has eased a little. Let us be clear: this is not a panicked market with indiscriminate selling of all assets. Global equities are roughly in line with the pre-Brexit level. Bank share prices have suffered sharply, but it does not look like a credit crisis; credit default swaps and marginal funding costs have not reacted too violently. This is reassuring, but not totally surprising: the financial sector, and indeed the corporate sector in general, are in far more robust shape than a few years ago.

However, financial markets are likely to remain volatile for some time. The US presidential election campaign rumbles on. In the UK, David Cameron immediately announced his resignation, but also that he would not trigger Article 50 – seen as the formal commitment to leaving the EU within a 2 year timeframe. Instead, he would leave this for his successor as leader of the Conservative Party and Prime Minister. This has led to much speculation about if, and when, that crucial step will actually be taken.

The political scene is in dramatic flux. The Conservative leadership contest is ongoing, but Boris Johnson, a key architect of the 'Leave' victory, saw his hopes destroyed after strong criticism by his erstwhile supporter, Michael Gove. The frontrunners are Theresa May, Andrea Leadsom, and Gove. Meanwhile, Nigel Farage has resigned as UKIP leader, and the Labour Party is in turmoil. Labour MPs are trying to dislodge their leader, Jeremy Corbyn, because they feel he is not offering effective opposition in Parliament, and because of his perceived failure to campaign strongly for 'Remain'. But Corbyn so far refuses to quit, arguing that he still has support from grassroots members of the party.

So, we do not know who will be leading the major political parties, or the UK government. We do not know what negotiating stance will be taken towards the EU, although hundreds of scenarios are being discussed. A key balance will be between access to the single market, and free movement of people. Some argue that the new government ought to call a general election, to secure a fresh democratic mandate for the complicated tasks ahead. Some argue that, once there is a rough idea of a potential settlement with the EU, a further referendum should be held. Others argue that "Brexit means Brexit" and there can be no turning back.

So, regarding Brexit, the only certainty now is that nothing is certain. For the EU, there is the dilemma that a harsh settlement benefits nobody, while a generous settlement may encourage Eurosceptic movements in other countries. In France, Marine le Pen is vociferous in her calls for a referendum. However, while there will obviously be political posturing on all sides, we imagine that negotiations will be informed by a serious pragmatism, a desire to reduce economic impact for both the UK and elsewhere.

Interest rates

The immediate risk-off reaction saw equities fall, gold rise, and bond yields compress. Some of that reaction has eased, but it's fair to say the market mood remains cautious. Bond yields and interest rate expectations clearly have a significant impact on equities and, more specifically, financial sector shares. Since the vote, bond yields have compressed in all key markets, and the likelihood of another Fed rate hike during 2016 has dropped.

Significant increases in yields seem unlikely while political uncertainty is high, but some degree of political clarity should start to emerge in the UK and US later this year. In the US, overall macro developments had been fairly encouraging, but it remains to be seen what impact the Brexit vote has. Core US inflation (PCE) had been edging up towards the Fed's 2% target, but the dollar has now strengthened, which would typically lower inflation expectations. Meanwhile, commodity prices have been mixed since the vote, but the big picture remains that they fell heavily in 2015 and bottomed out in early 2016. This means that, all other things being equal, headline inflation (which includes food and energy) could start rising later this year. While the Fed typically pays most attention to core inflation, rises in headline inflation would typically exert upward pressure on longer rates. So, while political woes are compressing rates right now, we must bear in mind that those upward pressures also exist.

Implications for Equity markets

Clearly, Brexit was a shock. But let's place this in context. Generally, equities delivered positive returns in the second quarter, even after the post-vote pain. From April to June, our global developed market funds gained around 1-2% and our global emerging market funds gained over 5%.
We've commented before on the links between interest rates, and the performance of value stocks relative to growth stocks. Value stocks outperformed growth stocks during most of the second quarter, but as bond yields fell after the vote, lost some ground. In broad terms, high beta underperformed low beta, cyclicals underperformed defensives, and cheap stocks underperformed expensive stocks. Against that background, our global developed market funds returned slightly less than the MSCI World since the result, while our global emerging market funds have performed in line with the MSCI Emerging Market index.

But we should not over simplify this. It's true that in the few days since the referendum, the market, as described above, reverted to many of the 'risk off' characteristics that have dominated in recent years. However, sector performance this year has been mixed. Energy and materials have performed strongly – as we discuss further below. Meanwhile, health care – a defensive sector – was one of the worst performers early in 2016, partly because the US presidential race has seen some hard-talk about drug pricing. We have generally found health care stocks to be expensive in recent years, but the weak performance earlier this year has left some individual names looking more compelling. Partly because of this mixed picture, we are seeing opportunities across various sectors, including some of the more defensive areas. For stock picking funds, market turmoil provides opportunity to make investments that can help drive long-term returns. So we are hunting.

In recent years, we have not found it easy to invest in biotech companies. The sector generally trades at high valuations, and while that can to some extent be justified by fundamental and structural factors, in recent years the valuations simply appeared too stretched to us. Valuations have eased somewhat lately. Moreover, when a sector's valuations do become stretched, one implication is often that any company that hits a bump in the road, gets excessively punished. We recently invested in drug company Gilead Sciences. The stock has fallen sharply since mid-2015. To some extent, it is the victim of its own success. Its ground-breaking treatments for hepatitis don't just treat patients, but effectively cure them – which is great for patients, but does reduce the addressable market. We recognise that earnings growth will be limited for the next few years, but this has pushed valuations to very low levels. We see potential for it to protect or even grow its main franchises in HIV and liver-related diseases. Meanwhile, it has very solid cash flow generation, with a double-digit free cash flow yield, and a fortress balance sheet.

Focus at the company level

Meanwhile, we note that valuations of value relative to growth look compelling from a long-term perspective. More specifically, the valuations of our fund holdings suggest healthy discounts to long-term corporate values. We are encouraged by the low earnings-based valuation metrics, but in the current yield-hungry environment, we also note that our global developed and emerging market funds offer higher dividend yields than their benchmark indices.

Moreover, at times like these, when political events dominate the market, it's important to remember that the fund is investing in the long-term value of individual companies. What is going on in the companies? What is happening to their productivity? Remember that companies have dealt with a lot of crises over the past eight years, have taken steps to strengthen their balance sheets and cost structures, and still managed to focus on developing their businesses. Of course companies are heavily affected by current political events, but at such times we often find more optimism and long-term vision in the corporate sector, than we find in financial markets as they try to digest and quantify big political risks in a short space of time.

The holdings in our funds are exposed to several different factors besides macro, politics, growth/value, regions, sectors, currency, and cyclical/defensive. Companies are also exposed to many and varied triggers that could unlock value at a more fundamental level and this, again, gives diversity to the fund.

Those triggers can be at the industry level, like price recovery in various products and commodities, new market trends or changing product replacement cycles, new regulations, and industry consolidation. Companies can also be masters of their own fate, with restructuring, break-ups, divestments, new management, changing strategies, and cost cutting for lower breakeven points. There can be earnings recoveries thanks to new products or improved product mix. We see companies with increased cash flows, changing attitudes to deploying their excess capital, in takeovers, share buybacks, and increased dividends. While short-term volatility reigns, there can be comfort in asset backing, hidden values, or simply the classic of low valuations with the potential for significant mean reversions. Certainly, companies face challenges and headwinds, but we must remember that this is a diverse set of companies; they have a massive toolbox at their disposal.

One example is Maersk, where we have seen the group CEO step down, replaced by the CEO of Maersk Line Søren Skou. The new CEO is tasked with finding a new strategy that will improve shareholder returns going forward, as the company struggles with headwinds in its core activities in shipping and oil. This has refreshed speculation about a potential break-up of the conglomerate. The potential break up of Maersk Line, Maersk Oil, Terminals, Drilling, Damco, Svitzer and Supply Services could mean listing individual parts separately, or expanding some parts and selling others. We will be watching to see what form the new strategy takes, and in the meantime, it is not impossible that consolidation and discipline could lead to more rational pricing in the container market. Above all it is encouraging to know that management recognise the issues, and are determined to deliver for shareholders.

A second example is Philips, a company that has transformed over the past decade. What was once an industrial conglomerate with its main activities in commodity-type and volatile consumer electronics businesses is changing into a more focussed healthcare and consumer lifestyle company, operating in stable growth end markets with higher added value. The final step in this process is the spinning off its lighting unit in an IPO earlier this year.

Although Philips has global market-leading positions in lighting, this business unit had become relatively small compared to the other segments, with roughly one fifth of group sales in 2015, the lowest profitability, and the highest earnings volatility. This also explains why this strategic decision can help unlock the conglomerate discount which has historically been attached to Philips. Additionally, the remaining Philips will increasingly be compared to health care equipment makers that typically trade at higher multiples, due to the more attractive end markets.

Commodities

The energy and materials sectors have performed strongly in recent months as oil and commodity prices have risen. The underlying drivers differ somewhat by commodity, but overall it looks like most commodities are bottoming out after sharp price declines in recent years. This has also led to some sharply positive share price moves, perhaps a reminder that not everything fits neatly into a 'risk on / risk off' split.

Over the second quarter, Brent oil rose from USD 41 to almost USD 50. The US Energy Information Administration recently raised its oil demand forecast due to higher expectations for GDP growth in emerging markets. At the same time, it cut its supply expectations because it now thinks North American production will decline by more than previously expected, and because of shorter term supply disruptions like social unrest in countries like Nigeria, Libya and Iraq, and wildfires in Canada. These developments are supportive for the oil price, but we acknowledge that similar things happened in early 2015, only for the supply-demand balance to weaken later in the year. Looking at global equity markets, energy stocks have been the strongest sector so far in 2016, and in the second quarter when they returned 13% in EUR terms. However, that was well below the 22% increase in oil prices, and not all energy stocks performed so well: this was not a full-on rally, and there is perhaps still a sense of wait-and-see. Nevertheless, we think that we are still in a bottoming-out process and the upcoming earnings season will be crucial to see if companies also see the light at the end of the tunnel.

The Materials sector is also showing signs of improvement, with rising prices for most industrial metals due to improving fundamentals for emerging markets. More recently, the Brexit vote triggered a rally in precious metals like gold, as a safe haven. In our developed market funds, iron ore miner, Rio Tinto, and wire maker, Bekaert, both gained 11%, while in our emerging market funds, gold and copper miner, Buenaventura, rallied 67%.

Robust Emerging Markets

We have been arguing for some time that emerging market equities are cheap, after weak returns for several years. Some of the key issues faced have been weaker currencies, declining capacity utilisation, political volatility, and declining commodity prices. As we've noted before, it's a diverse universe and many of those factors work both ways: while lower commodity prices clearly hurt countries like Brazil and Russia, they have given a dividend to net energy importing countries. While politics have been harmful in many countries (Brazil and Russia again spring to mind), they have been positive elsewhere (India's reform agenda, for example).

Overall, it now seems that some of the headwinds are starting to abate. We note that emerging market GDP growth had been shrinking, relative to developed markets, for some years, but that gap may stabilise going forward. Meanwhile, emerging market currencies had suffered partly as inflation expanded relative to developed markets, but that gap may start to ease. Moreover, many of the countries which are perceived as vulnerable to US dollar strength already suffered during 2015, as people 'bought the rumour' of Fed rate hikes. Going forward, there may be scope for emerging currencies to be more resilient against the dollar, which may be positive for profit margins. We note that from January to June 2016, global emerging markets gained about 4.5% at the index level, with our funds gaining just under 7%.

Conclusion

There's no escaping the fact that over the last couple of weeks, the general atmosphere has been one of shock and uncertainty. We think the political uncertainty will last for a while, but as noted above, there are political processes – elections, leadership contests, negotiations – which are progressing and which will ultimately lead to better visibility. In the meantime, we must remember that the markets have been behaving in a reasonably orderly manner. Equity returns in the second quarter were positive, and since the Brexit vote global equities are roughly flat. There is some volatility, and as always we will be looking for the opportunities that generates. Looking at our portfolio, we are encouraged by the valuations, the fundamental business developments, and by the diversity of triggers for improving long-term corporate value.

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