

## Quarterly report

## VALUE EQUITY

Dear investor,

Overall, the picture of equity markets performing well since early 2016 has not changed. Measured in Euros, global developed markets (MSCI World index) fell 2.5%, global emerging markets (MSCI EM) fell 0.4%, and European markets (MSCI Europe) gained 0.7% in Q2. However, bear in mind that the Euro strengthened significantly during the quarter, which is why those returns sound slightly lacklustre. In US Dollar terms, MSCI World rose over 5%, MSCI EM over 6% and MSCI Europe over 7%. Across all these regions, value indices underperformed the wider market. Our funds generally outperformed the value indices and performed more-or-less similarly to the wider market.

After the first quarter, we noted that equity markets continued to generate positive returns, but that the dynamic had changed from the previous year. From mid-2016, economic improvements, rising interest rate expectations, and then the Trump election triggered rising US bond yields and an equity market rotation, which benefited cyclical sectors, financials and low-priced value stocks, among others. In early 2017, although economic figures generally remained encouraging, the market rotation reversed. This was partly as doubts crept in over Trump's ability to deliver. US bond yields moved somewhat lower. In equity markets, the reaction was rather more severe. As investors flocked back in the short term to perceived safety, this benefitted growth stocks and defensive sectors like healthcare and consumer staples. Meanwhile IT stocks in both developed and emerging markets have been leading the market: large names such as Apple, Facebook, Tencent and Alibaba.

These trends generally continued for much of the second quarter, but it is important to note that the picture started to change again in June. During the month, macroeconomic figures in Europe continued to be encouraging, with decent retail sales and employment growth. Late in the month, ECB President Draghi gave a speech in which he acknowledged that inflation remains muted, but suggested this may be temporary: "While there are still factors that are weighing on the path of inflation, at present they are mainly temporary factors

that typically the central bank can look through". The comments were interpreted by many as a hint that the ECB might wind down quantitative easing sooner than previously expected. Long European yields rose on the back of this, and the Euro rallied further. Perhaps Draghi's comments were misinterpreted as being more hawkish than he intended, and the markets overreacted – although they do say, "there is no smoke without fire". The Bank of England also appears to be edging closer to rate hikes, as the weak British Pound stokes inflationary pressure and long US yields rose in June. As expected, value stocks started to pick up somewhat relative to the market, and financials, which had been middle-of-the-road for most of the quarter, led the market in June.

Of course, central banks face a delicate balancing act, carefully trying not to tighten too fast and derail the current economic upturn. They have also stressed the need for structural reform, in preparation for the days when monetary policy normalise. Nevertheless, it does seem that the glory days of loose monetary policy are slowly ending. As we have frequently noted, the period of ultra-low interest rates had major impacts on asset allocation, bringing flows into parts of the market perceived to offer more safety or higher yield as bond proxies. This has included many growth stocks and defensive sectors, which got progressively more expensive. Meanwhile, it was not a bright period for cheap, value stocks.

As mentioned above, the significant market rotation in late 2016 was a major tailwind for value – but this reversed early in 2017. However, we believe the general trajectory remains encouraging for value investors. The underlying, positive economic story that began around June 2016 has more or less continued – and we think still will. However, from the US election onwards, the rotation into value first accelerated on Trump enthusiasm, and then reversed as he faced problems in implementing his programme. In some ways, we think the market decoupled from the underlying macro development. The reaction seems overdone. As the global economy keeps on improving and yields drift upwards, we think this should be supportive for value investing. So, if you want to harvest

this value effect, what is the best way to do that? First, let us unpick what we actually mean by 'value' – because this is a term that gets used a tonne of different ways by different investors.

## Fundamental analysis and Qualitative Value

For us, value investing goes back to Ben Graham. Perhaps his core tenet was to distinguish between a company's share price, and its underlying intrinsic value. His focus was on carrying out fundamental analysis in order to make one's own estimate of a company's worth, and investing with a significant margin of safety: that is, when the share price is significantly discounted to your estimate of the company's value. This, then, is a qualitative definition of value investing, focused on the selection of individual stocks, evaluated on their merits and prospects. It does not define value by a rigid focus on specific numbers or metrics, and indeed Graham himself was sceptical of excessive focus on specific measures, such as price-to-book. You might call this 'qualitative value investing' or 'intrinsic value investing'. Part of the mind-set is that you think in terms of buying the underlying business, with a fairly long-term investment horizon.

## Quantitative Value

Over time, it became clear that many investors who followed a Graham-type investment approach were generating decent returns. Later in the 20th century, in the context of the Efficient Markets Hypothesis, there came attempts to measure this, what would ultimately be called the value premium. Whether Basu, Fama & French, or countless other academic studies, the unifying strand is a statistical or quantitative approach, measuring whether excess returns can be achieved by focusing on stocks with certain valuation characteristics, such as low price-to-book or price-to-earnings. This body of work points to a strong value premium over time: investing in cheaper stocks helps to outperform the market over longer time horizons. This value factor has been found to work using various metrics, and it is demonstrated to exist both at the global level, and within specific countries and sectors.

## How we define value

The quant approach picks up all stocks that share a given set of valuation characteristics. The qualitative approach is more selective, choosing only those stocks where the individual analysis suggests a decent margin of safety, avoiding securities that are cheap for a reason by assessing the company specific risks. Obviously, the two approaches do not lead to the same sets of companies, but it is fair to say there is usu-

ally a good deal of overlap. We use a qualitative stock selection process, considering each company on its own merits – but more often than not, we find ourselves interested in companies that also have low valuation metrics. To put it another way, we believe in fishing in the sea of cheap stocks, but prefer to fish with a selective line, not an indiscriminate trawler net. This means that we aim to drive long-term excess returns through exposure to the value premium, but above all through our individual stock selection.

## Value in recent market conditions

When financial markets experience a sudden shift or rotation, it often happens that entire asset classes move almost as one homogenous unit. Stock-to-stock correlations rise, meaning that in the short-term share prices are influenced more by which 'herd' a stock belongs to, than its individual characteristics. At such times, returns are heavily influenced by having exposure to the right market factors. During the turbulent past few years, there have been many such periods, and this may partly explain why quantitative style funds have gained in popularity. Meanwhile, when correlations are high, it can be difficult for selection of individual stocks to make a difference, at least in the short term.

Late 2016 was just such a period of high stock-to-stock correlations. The rapid shifts in US rate expectations and politics created a market environment in which large swathes of the financial market moved together. The value factor – quantitatively cheap stocks – were a big beneficiary, and performed strongly. We were encouraged that our funds also performed strongly, but nonetheless this was not really a period where fundamental stock selection was able to express itself.

Market conditions like late 2016 are not sustainable. As economic conditions normalise and rates move upwards, we do not expect market developments to be as dramatic as in late 2016. We think it will be a supportive environment for value stocks, but not in that extreme way. Stock-to-stock correlations will likely be lower, which leaves more room for the selection of individual stocks to influence performance. We firmly believe in a classic Benjamin Graham maxim: "In the short term, the market is a voting machine... but in the long run, the market is a weighing machine". In the long-term, the share prices of companies will reflect their underlying intrinsic value, and this is where a strong investment process for selecting individual stocks could make a difference.

## Smart Alpha?

As we hinted above, there can be a fair amount of overlap between a qualitative and quantitative approach to value investing. The quantitative approach emerged from academia:

bundling stocks together by certain quantitative characteristics, such as low price-to-book etc. This has evolved into considerable focus on quant funds and smart beta, and their ability to deliver decent excess returns. Interestingly, Kenneth Winther and Søren Steenstrup have recently argued that, while concepts like smart beta may generate better returns than purely passive market cap based investing, active management can indeed add significant value. Their research suggests that smart beta might serve as a useful benchmark, but extra performance can indeed be obtained through active management: through the individual selection and deselection of stocks. They call this concept “smart alpha”. We do not think this concept is so different to our investment approach. We believe that in the long run, having exposure to the value factor (and, to some extent, to small and mid-cap stocks) should boost returns compared to the broader market. More than this, we think our qualitative stock selection process as active managers can further enhance returns, also in markets where the value factor does not contribute much.

## Qualitative value investing and ESG

We noted that part of our mind-set is to think in terms of buying the underlying business, with a fairly long-term investment horizon. This has implications for the way we analyse companies. When building our understanding of the earnings power and asset strength of a company, of course, much of our work is focused on the traditional financial statements, including the balance sheet, income statement and cash flow statement – and all the notes attached to those. However, we seek a broad understanding of the threats and opportunities which could influence the company's worth, and clearly, that includes many things which are not reflected in traditional financial statements. One example is considering Environmental, Social, and Governance issues - or ‘ESG’ for short. We sometimes hear ESG described as a question of ‘non-financial risks’, which seems a bit odd. From our perspective, a company's approach to the environment, social issues, or corporate governance can have a very significant financial impact – both positive and negative. It is only natural that qualitative value investors should take an interest in the long-term risks and opportunities that ESG issues present.

Sekisui House has been a long-term holding in our funds. It perhaps is a useful example of the way in which ESG issues are, in reality, inseparable from classic fundamental analysis of a company. In its core business, Sekisui builds detached homes to order, mostly in Japan. It also has smaller businesses building condominiums, gets involved in urban redevelopment projects, and has been developing its overseas operations to counterbalance demographic challenges in Japan. We first invested in early summer 2008. The entire sector had been under pressure, because in 2007 the government

introduced a stricter application process for new buildings, including double-checking by designated bodies. In reality, most of Sekisui House's products were exempt from this, but the increased administrative burden for builders and inspectors caused a general slowdown. Of course, this was not a time when global sentiment on house builders was positive. Nevertheless, we saw opportunities.

Sekisui was – and still is – one of the leading house builders in the domestic market. The houses are prefabricated, but this does not imply low grade: they are built to exacting levels of quality and design. One example is earthquake resistance. It is understood that in Japan, this is an issue of massive social impact. The company has committed considerable R&D over the decades to achieving high standards, and their earthquake dampening system is highly regarded. It is a humbling experience to sit in their earthquake simulator and realise the forces these buildings must withstand. This strength is reflected in an impressive record of accomplishment of their houses withstanding major earthquakes. From a purely financial perspective, such an edge helps give confidence in the company's ability to maintain solid market share in the long run. Product quality and product safety is a classic ESG concern, with clear impacts on company's abilities to protect and nurture their business in the long run.

We were also impressed by Sekisui's approach to environmental issues. We recall one visit to their research centre, where they enthusiastically talked us through their waste disposal processes on building sites. This may sound rather dull, but it matters. Each site has multiple waste recycling buckets. Of course, one aim is simply to maintain clean building sites, reducing the impact on the local society and environment, and ensuring a solid brand image. Equally significant is that much of the waste can be recycled directly into new products, limiting materials costs.

It is also interesting that, several years ago, Sekisui House showed us new roof tiles, in which solar panels were incorporated into regular-looking roof tiles. They have taken the challenge of the “zero emission house” seriously, well aware of the long-term market potential. (We found it entertaining in early 2017 when Tesla's Elon Musk announced production of a “breakthrough” for solar power: solar roof tiles. Perhaps Sekisui House should emulate some of his showmanship.)

Of course, these examples – earthquake resistance, recycling, and solar power – are obvious issues for a house builder. As we said, we usually find that ‘ESG’ issues are in reality just a regular part of building an understanding of how a company works, and importantly, how it thinks. Often, by looking at some of the smaller issues, one can build a good under-

standing of management attitudes. Are management approaching operations from a long-term perspective, not simply thinking of ways to maximise short-term profit, but focused on building long-term value? Naturally, good corporate governance plays a huge role here – and we will save that discussion for another time.

As for Sekisui House, we built an impression of a company determined not to sit on its laurels as a market leader, but to continue innovating to ensure that it tapped into emerging areas of demand, protecting its brand image all the while. Crucially, we also felt this potential was undervalued by the market. It is now nine years since we first invested, and we remain positive. Since initial investment, Sekisui has returned around 190% in Euros, significantly ahead of both Japanese and global developed market equity returns.

Japan as a whole has been placing increasing emphasis on governance specifically and ESG in general. One example is the gigantic Government Pension Investment Fund (GPIF), the world's largest pension fund with around USD 1.3 trillion in assets. GPIF have taken various measures, but most recently adopted three ESG-focussed stock indices. GPIF will invest a proportion of its assets based on these indices, to incentivise Japanese companies to improve their "ESG evaluations and enhance enterprise values in the long-term". Each index has different criteria, but all aim to include Japanese companies that are relatively strong in ESG. And Sekisui House? It is included in all three indices.

## Conclusion

We will end this letter the same way we did last quarter by highlighting how the current robust economic development, central bank policy changes and the subsequent bond yield moves have an impact on equity valuation. Towards the end of the quarter, markets showed us how increasing bond yields could lead to lower equity valuations. Similarly, markets confirmed that higher bond yields could lead to outperformance for value stocks. If we combine this observation with our opinion that value stocks are trading at a discount to the market, we are convinced that we are in a favourable environment for value investing. We also think that today's market conditions favour an active approach to value investing. Stock markets are not as attractively priced anymore and volatility is very low, while stock-to-stock correlation is coming down from elevated levels. Such market conditions warrant careful bottom-up stock picking and well-diversified portfolios in order to avoid the riskier parts of the market. Our portfolios continue to contain an attractive mix of undervalued companies. Some are competitively advantaged and growing businesses, while others are more contrarian battered-down names in the process of normalisation. We remain very optimistic about our portfolios, and we believe they provide you with a strong risk/reward profile that can deliver good results even in the current markets.

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