One-step forward, two steps back and one-step forward again

The second quarter of 2019 turned out to be a volatile one. It ended with moderate gains for developed market equities, and marginal losses in emerging markets but this was after something of a rollercoaster during the three months.

April saw a good start to the quarter, with global markets showing a continuation of the widespread risk willingness from the first quarter. However, the mood turned sharply risk-off in May, with developed markets falling around 4 percent, and emerging markets dropping around 8 percent. This was primarily due to concern over the breakdown in U.S.-China trade negotiations. President Trump added Chinese tech giant Huawei to a trade blacklist, and increased tariffs, and combined with fear of Chinese retaliations, investors feared an impact on global economic fundamentals and consequently sought refuge in safe haven assets. Other significant political events added to the uncertainty, although ultimately the European Parliament elections had no immediate impact on markets (populist and euro-sceptic parties gained fewer seats than anticipated) and Prime Minister May's resignation did not seem to move markets much.

Market sentiment recovered in June, largely driven by softer central bank rhetoric. The US Fed indicated probable rate cuts later in 2019, and US 10-year bonds fell under 2 percent for the first time since November 2016. The ECB's Mario Draghi also suggested the ECB was ready to lower interest rates again if need be. Sentiment on US-China tensions also improved, as President Trump backed off slightly, deciding not to impose – yet – tariffs on certain tranches of Chinese imports. He also eased – to some degree – controls on Huawei at the end of June.

By quarter end, developed market equities had returned roughly 3 percent in Euro terms, while emerging market equities had marginally negative returns. Our value strategies – in global developed markets, European markets, and global emerging markets – trailed their respective benchmarks by between 1 and 2.5 percent over the quarter.

The second quarter's ups and downs meant it was rather mixed from a style perspective, but it generally was not favourable for value investors, and this was a significant driver of the relative returns of our funds. In the worsening sentiment of May, there was a fairly typical market reaction: cyclical sectors suffered most, and defensive sectors like real estate, utilities, health care and consumer staples outperformed. IT stocks fell sharply due to their sensitivity to US-China relations – only to recover strongly in June.

We have seen weakening momentum in the global economy in the first half of 2019, especially in developed market economies, where Europe sticks out. We do not see a recession coming yet, given reasonable consumer sentiment, low unemployment and high real wage growth, but the global economic outlook has become more uncertain - mainly caused by the Trump administration and its quest against global trade patterns. The current focus is on US-China relations, but there are continuing issues with other of its key trading partners such as the EU, Mexico and Japan.

Extreme Valuation Gap

In our last letter, we looked back at a decade of the global bull market. We touched on the duration-based explanation of the value premium, noting that the relative weakness of value stocks over this period was inherently linked with it being a period of falling, or ultra-low, interest rates, and quantitative easing. That rate environment triggered significant flows into growth stocks, and also exacerbated certain distortions in the market, such as the extreme outperformance of the FAANG and BAT stocks.

There is, of course, always a valuation gap between growth stocks (more expensive) and value stocks (less expensive), but that valuation gap has expanded dramatically over recent years. In the US, for example, the dispersion between the cheapest and most expensive stocks on price-to-earnings is now at a historical extreme. There have been plenty of times in the past when some have proclaimed the death of value investing, only for it to rise again dramatically. We have discussed many times the various potential triggers – including a period of moderate economic expansion, with interest rates moving upward.

Alpha Generation

Certainly, such triggers could lead to a shrinking of the valuation gap – and significant outperformance for value. However, it is perhaps reassuring to consider that even if one just assumes the valuation gap stops expanding, and holds at its now record wide levels, that alone could be a positive driver for value returns. This is because the long-term value premium is not explained by value stocks as an asset class getting more expensive. Rather, it is explained by individual stocks migrating between cheap and expensive: at a simplistic level, as an individual value stock performs well and rises in valuation, it ceases to be a value stock. Meanwhile, an expensive growth stock may underperform, become cheaper – and thereby become a value stock, thus replenishing the pool of value stocks at low valuations. This means that the asset class of value stocks is able to outperform – without necessarily getting more expensive.

To recap, there is now a massive valuation gap between value and growth stocks. Reassuringly, for the value premium to kick in, we do not even need to assume a shrinking in that valuation gap. In addition to this, remember that while we do aim to exploit the value premium over the long-term, we are also stock pickers: we aim to generate additional alpha though our selection of individual stocks. In doing so, we believe that our disciplined process and the knowledge and experience of our team, help give us an edge.

Our core skill lies in selecting individual stocks based on discount to intrinsic value. We implement this through an investment process which we have developed over more than 20 years, and which we apply with discipline. We continue to see value in the original conceptions of Benjamin Graham: that each company has an intrinsic value, and a market price; that these two may well diverge; and that the investor is general best served by focusing on the intrinsic value, and not daily fluctuations in the market price. We have an investment horizon of 3-5 years, often holding companies longer, and we believe this focus on the longer-term allows us to exploit opportunities overlooked by many market participants. Of course, this approach takes patience and thick skin – and we think we are helped in that by our team’s long experience running the value strategy through various market conditions.

Millennium & Copthorne

During the quarter we received a bid on Millennium & Copthorne Hotels. This hotel chain, which we have owned for more than a decade, consists of 139 properties and more than 40,000 hotel rooms. About half of its hotels are directly owned by the company, many of which are at key tourist destinations like Times Square in New York, Knightsbridge in London, Boulevard Haussmann in Paris and near Marina Bay in Singapore.

At first investment, we saw an interesting asset case. The company had owned these hotels long before we initially invested, and they periodically re-valued them to reflect current market values. The shares were trading at a discount to the underlying market value of the real estate assets, but we also saw potential for the asset values to rise over time, given the super-prime locations. Additionally, hotel-REITs had just started to become more popular, so we saw potential to crystallize the underlying value of these assets.

However, Millennium & Copthorne was indirectly control by a family, which can raise corporate governance concerns – and also meant that the family would ultimately be the decisive factor in any potential asset crystallization. On the other hand, the family – the Kwek family of Singapore - had also shown themselves to be very experienced managers of hotels, with an ability to thrive in different economic environments. They had recovered strongly from the Asia-crisis.

The initial years after our investment were difficult. The global financial crisis had a severe impact on room rates, and there was also the concern that the market value of the hotel portfolio would be impacted. As the economy started to recover, so did the operations, while the asset value of the hotel portfolio continued to expand. In recent years, however, the operations have been somewhat under pressure again as hotel rates weakened and some of its larger hotels needed refurbishment. As a result, the share price had weakened again to well below the market value of the assets.

During the autumn of 2017, the Kwek family – via its property company City Developments - notified the markets that it intended to buy all outstanding shares of Millennium & Copthorne at 552 pence per share. This was a premium of about 25-30% to the share price of Millennium & Copthorne at that time, but a substantial discount to the NAV of its hotel portfolio. Investors, including ourselves, were very dissatisfied with the bid. As a result, City Development increased the bid to 620 pence in December 2017, which we again rejected. During 2018, Millennium & Copthorne replaced its CEO, and reached out to investors like ourselves. We explained our rationale for not tendering our shares in December 2017. We felt the price offered did not adequately compensate shareholders for the core asset values of the company, and noted that those values could, perhaps, be more fully reflected via other routes, such as asset crystallization. We pointed to recent examples like that of Accor, which had just divested a majority stake in its hotel portfolio and returned some of the proceeds to shareholders. In June 2019, City Development came back with a new cash bid of 680 pence per share. As this better reflects the underlying asset values of the hotel portfolio and the share price has returned to pre-financial crisis highs, we consider to tender our shares.

Outlook

Although it has been frustrating to see the long duration of this cycle of value underperformance, we are convinced that the long-term history is accurate, and that value investing will prevail. The era of "easy" money which has contributed to the significant divergence between value and growth stocks, seems currently to be prolonged. However, we reiterate that many investors seem to overlook the inherent interest rate risk in exposure to more expensive, growth stocks. Purely from a diversification perspective, the arguments for value exposure are in some ways stronger than ever.

As always, we refrain from making short-term predictions. We stick with our long-term investment horizon and our research-driven approach to value investing. With a portfolio of mispriced stocks, decades of value outperformance history on our side and a wide valuation disparity between value stocks and the market, we are confident that our funds are well positioned for the future.

Published July 2019