If rates go up it can benefit small and overlooked stocks

The market rotation in the recent quarter suggests that investors are starting to recognize and fear the interest-rate risk in certain parts of the market. As always, we think it is important to take a long-term view when investing and it is important to stress that we are not hostile towards companies that pay dividends or stable companies that grow earnings over time. Such companies can make for solid long-term investments. We just think that the current pricing of certain large-cap dividend stocks and perceived defensive growth stocks are currently priced at a premium, because of their liquidity and bond-proxy nature. There are perhaps better ways of earning a good yield right now.

If rates are starting to point upward, and money continues to leave the bond-proxies and the market cap-weighted indices, it will likely go into stocks that are smaller, or more overlooked, and attractively priced. We are well-positioned to take advantage of renewed investor interest in those kind of stocks.

Hard Brexit more likely

Our last quarterly report came in early July, shortly after the Brexit referendum. We noted that the initial shock had eased a little, but that financial markets would likely remain volatile for some time. The reality was that during August the markets were relatively quiet. Regarding Brexit, there was a slightly surreal atmosphere: the referendum result was clear, but nobody had any idea what this would actually mean, and all the UK government had to say was "Brexit means Brexit". Meanwhile, the Conservative party conference in late September started to give some insights into what kind of Brexit the government wants. Prime Minister May made it clear she will formally trigger the Brexit process in early 2017, and her comments appeared to prioritize limits to immigration over access to the single market, leading to growing expectations of a "Hard Brexit". In late June, immediately after the referendum, the pound had dropped about 11% versus the US dollar, but had then remained roughly flat until late September. But in the two weeks to October 11th, it has dropped almost 6% more as the markets digested the Conservative conference.

> *Looking at our funds, the impact of Brexit on performance relative to benchmarks thus far has been fairly muted.*

From a fundamental perspective, it remains hard to calculate the longer-term impact on companies operating in the UK. Clearly, major UK exporters – including our holding AstraZeneca – have rallied strongly in the short term, thanks to the falling pound. Meanwhile many small-cap UK stocks, which are often more domestic in their operations, have suffered. But the ultimate impact is more nuanced. We met recently with a major UK industrial exporter whose shares have risen dramatically on the back of the falling pound, and they appeared to feel that the market was perhaps overestimating the benefit of the weak currency, while the longer-term fundamental impact of Brexit on the business remains unclear, given the early stage of negotiations. Looking at our funds, the impact of Brexit on performance relative to benchmarks thus far has been fairly muted.

Clearly, over the coming months, and indeed years, there will be moments where concrete news flow related to Brexit negotiations emerges, triggering volatility as the market attempts to price it in. As we noted previously, for the EU the dilemma is that a harsh settlement benefits nobody, while a generous settlement may encourage Eurosceptic movements in other countries. Within the UK, while the government appears to be leaning towards a hard Brexit, there are plenty - even within the Conservative Party - who are arguing for something softer, and calling for a parliamentary vote on the negotiations, or the deal that emerges. We will be monitoring developments at the political level, and in our own holdings both in the UK and Europe, aiming for a prudent balance of risk and willingness to exploit any opportunities that the volatility might generate.

US Reality TV

Meanwhile, the US will soon have a new president. In many ways this election cycle has been a disappointing experience, and the recent second presidential debate did nothing to raise the tone. It was surreal to watch the two candidates acting like guests in some kind of 'roast' TV –show, where the aim is to say as many nasty things about each other inside two minutes, over and over again. It is hard mentally to grasp that this process is about selecting the future 'leader of the free world', as they would humbly put it. The rest of the world is watching on the side line with disbelief, trying to second guess the potential political and economic impact of this bizarre reality show. Clearly we think Clinton would be a safer pair of hands, and, from that perspective, recent polls are encouraging. We also note that, even in the case of a Trump victory, campaign rhetoric is one thing, and the reality of stepping into the Oval Office, and dealing with Congress, is another. So we are at least cautiously optimistic that the worst-case economic scenarios can be avoided – but clearly there is going to be some stock market noise as the presidential election looms closer. Volatility in September was markedly higher than August.

> *Clearly we think Clinton would be a safer pair of hands.*

Markets defy concerns

Obviously there are other stock market drivers than Brexit and the US election. During the quarter, the state of Europe's banks was once again up for debate. Worries grew about the solvency of the age-old Banca Monte dei Paschi and the entire Italian banking system, and in September concerns arose over Deutsche Bank, following the US Department of Justice fine. Finally, central bank actions continue to be on top of the agenda - from the Fed's potential hike, through the ECB, to the Bank of Japan's latest policy shift.

In spite of somewhat lacklustre economic growth and the abovementioned stories, global equities performed well during the quarter and developed stock markets advanced 3.7%. We note that emerging market equities continued their strong performance in the third quarter, with MSCI Emerging Markets gaining 7.8%. At the broadest level, we note that, for some years, emerging market equities underperformed those in developed markets, as the overall GDP growth rates of emerging markets declined relative to developed markets. There are now growing expectations – from the IMF among others – that emerging market growth rates could start to pick up again relative to developed market peers. This is likely one key factor leading to money flows back into emerging markets. We also see fair potential for value as a strategy within emerging markets, as we touched on in a recent video available from the News area of our website:
(http://www.sparinvest.lu/international news.aspx?newsid=B2EC8444ABC940CCB961DE56DC3632C0#B2EC8444ABC940CCB961DE56DC3632C0).

> *We also see fair potential for value as a strategy within emerging markets.*

Within developed markets, Japanese stocks outperformed during the quarter. Economic growth is still not satisfying, but a convincing win for Prime Minister Abe in the Upper House elections in July paved the way for further stimulus measures, as well as longer-term reforms. In September, the Bank of Japan announced an overhaul of its policy with more focus on yield-curve control going forward. Both events increased investor appetite for Japan, but there are also other factors at play. Over the last couple of years, we've touched on the changing environment in corporate Japan, as the new Corporate Governance Code and Stewardship Code push listed companies towards improving governance standards and stronger dialogue with investors. One aspect is capital structure. Corporate Japan has long had a reputation of being cash rich: healthy balance sheets which give comfort for a rainy day, but which were fairly inefficient as the capital wasn't generating returns. Over the past decade, many investors – including ourselves - addressed this topic with our holdings in Japan. We saw gradual changes, but this has accelerated recently under Abenomics, with companies investing in overseas expansion, and also bolstering returns to shareholders.

Sompo – positive news

Specifically within the Japanese insurance sector, two key challenges have been as follows. Firstly, the domestic insurance market had relatively low growth rates and high disaster risk. Secondly, many insurers had significant capital tied up in relatively inefficient 'cross-holdings' in shares of their major customers. For us, the rationale for investing in this sector rested on the potential for change. We saw potential for some improvements in the domestic insurance market, but also a likelihood that the insurers would find ways to reduce cross-holdings and instead put that capital to more productive use, including overseas expansion.

Over the years we've been encouraged by developments. The latest step came last week, when portfolio company Sompo Holdings – one of Japan's largest insurance companies – announced that it would spend around USD 6.3 billion to acquire Endurance Specialty Holdings. This US firm offers insurance, including crop protection, liability, property and casualty, and some reinsurance, but relatively low exposure to catastrophe reinsurance. Sompo is paying a premium of around 40% over Endurance's recent share price, a level which seems reasonable relative to Endurance's assets, and perhaps a little pricey relative to their current earnings. But we view the news positively. Strategically, it provides Sompo with a more diversified business profile. The share of profits from outside Japan looks likely to increase from around 10% currently, to around 30% in a couple of years. It looks likely to boost Sompo's ROE (return-on-equity), and, ultimately, could well lead to higher shareholder returns. Clearly, such deals are all about the long-term, but it's reassuring to see that Sompo's share price has responded positively to the news, rising over 12% in just a few days.

Autoneum – reduced position

Another holding which has enjoyed solid performance recently is Autoneum. In 2011, the company was spun off from the small Swiss industrial conglomerate, Rieter, a long-term holding of ours. As one of the largest shareholders, we have been in regular contact with management of both companies over the years, and also supported the split of the group. Historically, Rieter was a global market leader in textile spinning equipment. That business is cyclical, so in the 1980s it decided to find a counterweight by diversifying into the automotive industry, which at that point was enjoying structural growth. Over the next few decades, it successfully grew the automotive segment into a global leader in noise and thermal management technologies for vehicles, supplying the majority of the major car brands. Both businesses co-existed well under one holding company, but, as often happens with such structures, the shares usually seemed to be valued at a discount to the sum-of-the-parts.

Automotive had been a structural growth story, but the harsh reality was that when the global financial crisis hit, both sides of the business were hurt badly. Group revenues more than halved between 2007 and 2009. The textile machinery business had dealt with such pain many times before. Rieter was able to fall back on its strong market position, maintaining its pricing power and a strong contribution from spare parts and services. Meanwhile emerging market economies had a relatively bright outlook compared to the rest of the world, and it was clear that in the medium term, the wear and tear of textile machines would inherently trigger replacement demand. In 2009, the business started to recover.

However, the problems in the automotive business were of a different magnitude. As a smaller supplier to car assemblers, Rieter had built a global network of around fifty facilities near car plants. As sales fell, almost all these facilities became underutilized. To make matters worse, its customers were also suffering, and decided to move production to lower-cost countries – leaving Rieter little choice but to follow them, and build new plants themselves. So just as revenues fell sharply, the automotive division faced high restructuring expenses and increasing capital expenditures. This led to heavy losses in 2008 and 2009, and of course, also diverted management attention and resources away from the recovering textile business.

As the situation stabilized in 2010 we, among others, discussed the possibility for strategic action. This led to the 2011 split up of Rieter, in which existing shareholders also received shares in the newly created Autoneum. We kept our shares, waiting for the benefits of the recent restructuring and a global car sales recovery. By the end of 2016, it looks likely that Autoneum will have seen sales growth of 6% and operating profit growth of 40% per annum, since 2011. Its operating margin has quadrupled to nearly 9%. The share price has almost tripled since April 2011, and valuation multiples have increased. We remain positive on the company, but take the view that it is no longer heavily discounted compared to other car suppliers, and have been reducing our position.

Bekaert – solid price gains

In our last letter we mentioned signs of improvement in the materials sector. Belgian holding Bekaert, which makes steel cord for tire reinforcement, is a clear example of this. Looking back a few years, the company was able to avoid the worst of the global financial crisis due to its strong foothold in China. Not only did Chinese demand for tire cords keep growing, but in 2009 to 2010, Bekaert saw an explosion in demand for its sawing wire, used to cut silicon in the production of solar panels. This was after the Chinese government decided to become a global powerhouse in the production of solar panels. While many industrial companies were still struggling with the aftermath of the global financial crisis, Bekaert reported very strong earnings in 2010 and became a darling of the stock market.

By 2012, however, the Chinese stimulus programmes had led to massive industry overcapacity, especially in sawing wire. Meanwhile the tire cord business suffered as Chinese sales growth of cars and trucks disappointed. Bekaert's fortunes reversed and the stock market darling turned into a dog. We decided to buy shares of Bekaert in the spring of 2012, as we thought that the market was too pessimistic about the short-term pain, and the time it would take to recover. We took comfort from the fact that the tire cord business was basically a duopoly. In any case, the company struck us as excessively cheap.

It turned out that we were half right in our assumptions. After we invested, it became clear that the recovery in the tire cord business would take longer than anticipated. However, since 2015, the Chinese government seems less willing to support unprofitable companies, which ultimately means excess supply is falling out of the market. With the demand-supply situation improving in China, particularly in tire cords, we have seen selling prices and earnings recover sharply at Bekaert. The company has a medium-term plan for profit growth, and is currently about a year ahead of its own targets. This has obviously led to solid share price gains, and we have taken profit from the shares. Although, we were not completely right in our initial thesis, we bought at low valuation multiples when the stock had a high margin of safety, and this is what allowed for healthy double-digit annualized returns over the holding period.

Interest rates drives the sector rotation

The three above-mentioned companies have their individual drivers, but they also represent industry sectors (financials, materials and consumer discretionary) that are sensitive both to economic conditions and more specifically interest rate expectations. Those three sectors, along with industrials and IT stocks, were the strongest performing sectors in almost all regions during the quarter. At the same time, exposure to value stocks and small-cap stocks served as tailwinds in many markets, and our strategies generally outperformed in Q3.

Although it was, in general, an encouraging reporting season for many economically-sensitive companies, it seems that expectations that the FED will raise interest rates before the end of the year are driving the sector rotation. We have often discussed that over recent years, low bond yields and low growth expectations have sent investors in the same direction. In the hunt for yield, investors have turned to equity dividends to provide income streams similar to bonds. In order to reduce risk, they targeted the so-called bond proxies like utility stocks, consumer staples and liquid high-dividend blue-chip names. At the same time, the low interest-rate environment helped attract investors into growth stocks, because their expected cash flows are longer duration, and therefore valuation of those cash flows is more sensitive to interest rates.

We have previously warned about this herding effect, which may have caused stretched valuations in certain parts of the market, and we have stressed that those parts carry lots of interest-rate risk. Furthermore, the herding has been magnified by the massive increase in passively-managed, low-cost index funds, where the exposure of well-performing bond proxies has been on the rise.

> *We think that a mild increase in rates could actually prove positive.*

The obvious problem for many investors is what happens if, or when, interest rates rise. We know that many investors still think rate hikes are unlikely as the world has become too indebted and hooked on low interest following the loose monetary policy since the financial crises. But the latest rhetoric from the FED has put it back at the top of the agenda. Obviously a slight rate hike would possibly encourage a further sector and style rotation, as seen already, but we also do not think it is something to be too scared of from a macro perspective. From the consumer perspective, we think that a mild increase in rates could actually prove positive. In theory, of course, low rates encourage people to spend, but the problem is when you feel you are getting no returns on your savings and pensions, the future can feel fairly bleak. It is a kind of negative wealth effect. If rates start to point just slightly upwards, that can have a positive impact, and it could prove to be a benign investment environment.

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