

Quarterly report

VALUE EQUITY

Plenty to be happy about

We are convinced that we have assembled our portfolios in such a way that they offer an interesting risk/reward ratio compared to their benchmarks, and we are comfortable with the current positioning of the funds

Over the last quarter, global equity markets and indeed our funds continued to post solid gains, when measured in US dollars. Despite continued strengthening of the Euro, most markets were up even in Euro terms. Global markets (MSCI World) were up 1.15 percent, European equities (MSCI Europe) gained 2.70 percent and Emerging Markets (MSCI EM) were even stronger with a return of 4.19 percent. Similarly, if we look at the year-to-date performance, equity investors have plenty of reasons to be happy this year. Returns have been positive, volatility is low and corporate profits have been very strong globally, which suggests that the improvement in the global economy is real. Moderate global growth has not yet fueled inflationary pressures, meaning that central banks in Europe, Japan and the US have been able to maintain relatively relaxed monetary policies. This so-called Goldilocks economy (not too hot, not too cold) has provided a solid backdrop for equities, which could remain in place for the rest of the year.

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Tailwind for emerging markets

Emerging markets have delivered the strongest returns both in the quarter and since the beginning of the year. So far in 2017, the MSCI Emerging Markets Index is up more than 14 percent in Euros – more than 10 percentage points ahead of MSCI World. Emerging markets had a difficult few years around the start of this decade, as their superior growth rates eased off relative to developed markets. This reduced their

attractiveness for many investors. Sentiment was also hurt by the ‘taper tantrum’ of 2013, in which many EM stocks suffered, but as we have pointed out before, emerging economies are today less vulnerable to rising US interest rates and a stronger dollar than they used to be. The current account deficits and foreign debt levels at some of the more vulnerable countries have been reduced. Meanwhile, since late 2015 emerging market GDP growth rates have started to accelerate again relative to developed markets, providing something of a tailwind. Corporate earnings improvements have followed. Indeed, in 2017 emerging market equity returns have been driven more by earnings growth than by repricing, when compared to developed market equities.

Within developed markets, Europe was particularly positive with deflation fears finally disappearing and the European Central Bank starting to talk about monetary policy tightening, initially through further tapering and then rate hikes at a later stage. Combined with reasonably positive political momentum, it helped power European equities during the past quarter.

However, all eyes were still on the world’s biggest economy, where President Donald Trump continued to create uncertainty. Early in the quarter, he made headlines again when he fired several important members of his administration, and intensified the sabre rattling between the U.S. and North Korea. Investors grew nervous. The threat of pulling the U.S. out of the NAFTA agreement, and the controversy that followed the violent events in Charlottesville received a lot of media attention – much more than actual policy, where investors were waiting for news about the repealing of Obamacare, infrastructure spending and taxes. During July and August, US bond yields declined and the US dollar weakened – only for September to start with Hurricane Irma landing in Florida.

Support for value

But then it all changed. Two weeks into September, after a weekend without North Korean missiles and Hurricane Irma losing momentum, markets started to turn. The markets suddenly seemed to respond to the message that central banks globally – with the exception of Japan – are starting to tighten, and government bond yields rose globally. Just as investors had got used to expecting less and less from Washington, there was renewed hope of tax reforms, which not only supported the broad market, but was particularly supportive for value and small cap stocks which soared in September. This trend was very strong in the US, less strong in Europe and much weaker in emerging markets. Finally, the Federal Reserve signaled late in September that it intends to start slowly raising interest rates, which helped reassure investors that the country is still experiencing favorable macro conditions.

The overall increased confidence in the global recovery and renewed hope of US tax reforms added fuel to the recovery of value stocks

We think that there are a few things deciding the direction of the markets. On one hand, we see good signs of a continued synchronous global upswing in economic data and we see decent earnings growth on a company level, which is positive. On the other hand, tensions with North Korea and investor uncertainty regarding reducing a decade of accommodative policies around the world are both issues that concern us. These issues not only have implications for the overall market direction, but as was confirmed in September, they have a big impact on equity factors, and the overall increased confidence in the global recovery and renewed hope of US tax reforms added fuel to the recovery of value stocks – especially in the US – that started last year.

Fund positioning

There were no material changes to the portfolios during the quarter. The inherent value exposure is still dominant, and our funds continue to have a bias – to a greater or lesser degree – towards companies in more economically sensitive sectors. This exposure suggests that the funds should benefit from the overall benign macroeconomic environment, and indeed many of the more cyclical holdings currently show good acceleration in earnings. Needless to say, the positioning of our funds is not driven by predictions of short-term market moves. Our positioning is a result of our bottom-up value

investing approach, in which investments are based on our individual analysis of each company, rather than a consideration of whether it is in the benchmark, or what weight it has. This bottom-up process can lead us to higher exposures in groups of companies that share characteristics we believe could trigger outperformance in the mid to long term.

The funds should benefit from the overall benign macroeconomic environment

Similarly, there might be other market clusters, where we have little or no exposure. One example is the recently unstoppable FAANG stocks (or any other acronym used to describe the successful IT stocks) that we have mentioned. This group of companies, or any other group, are not bad businesses and we recognize much of their attraction, but sometimes a group of companies is just not interesting enough to us from a valuation perspective, and we end up being underweight compared to the benchmark. In any case, we keep a careful overview of the risks to which we are exposed, and to which we lack exposure, to ensure that our portfolios maintain a healthy diversity of drivers.

Overweight in financials

One of the concentrations we currently have in most of the funds is an overweight in financials – in particular banks. Market sentiment has been low for a long time, and with regulatory tightening since the financial crisis, many banks have been focusing on saving costs and building capital, while facing headwinds from low or decreasing interest rates. We think many developed market banks have been under-earning compared to their earnings potential, but many are now starting to move towards more normalized levels. Earnings are accelerating and rising rates give a further tailwind going forward.

An example is Dutch bank ING, which has gone through a lot of change in recent years. We invested in ING in 2012 at a time when the deleveraging process was more or less coming to an end. Splitting up the group into its parts – a bank and an insurance company – had the potential to unlock value and leave the bank smaller, but more profitable. The first stage was the listing of the insurance arm in 2014. Since then, however, the focus has shifted to simplifying the remaining business structure further, through digitalization and targeted growth outside of the Netherlands. As a result, underlying earnings at the banking operations are significantly higher now than in 2012 and ING has a platform to grow somewhat faster than many of its European peers. With

enough capital to cover share buy backs and decent dividends providing real returns while we wait for further normalization of sector earnings and overall revaluation, we think an exposure to banks makes sense. During the quarter, the impact from this exposure was somewhat neutral, but it followed the same pattern as the value and size factor: headwinds until start September changing into tailwinds as yields started climbing towards the end of the quarter.

Good potential for recovery

In our last quarterly report, we talked about stock-to-stock correlations, which seem to be declining for the first time since the global financial crisis. If so, strategies that have played on the swings of macro-induced risk-on/risk-off in recent years will not necessarily be as profitable in the future. In a more normal environment, with lower stock-to-stock correlations, we believe that individual company characteristics will make a difference. This is very encouraging for our bottom-up investment style. Although our inherent value bias and current cyclically-tilted exposure can still have an impact on the relative performance, the funds are also full of idiosyncratic opportunities driven by factors not linked to the direction of the economy.

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True stock specific drivers are not dependent on broader themes like the changing regulation for financials, tax reforms or commodity pricing. Obviously, external drivers provide additional upside in many of our investment ideas, but many businesses we invest in are trading at discounts relative to their peers, and for some company-specific reason they are often not fulfilling their potential. Some have experienced adverse conditions or events, which had a negative impact in the shorter term, but offer good potential for recovery. Often such companies have an ability to adjust cost structures and implement self-help measures to adapt to the situation, setting themselves up for significant incremental earnings increases. If not, there is always the chance that someone external will see the unrealized potential and they become takeover targets.

We have often mentioned how our funds historically have been subject to takeovers. Several fund holdings were involved in such activities or at least increased interest from

activist shareholders during the quarter. In August, the US cosmetics giant Estée Lauder saw share price gains on rumors suggesting Unilever and other interested buyers were preparing a bid. Procter and Gamble has long been in the crosshairs of activist investor Nelson Peltz, but during the quarter the feud intensified as Peltz urged shareholders to let him obtain a seat on the board. Those are two blue-chip stocks familiar to many, but we have also seen activity in smaller, less well-known, companies.

The case for Refresco Group

One example is the recent takeover attempt of Europe's largest independent bottling company. Refresco offers bottling solutions for both private label as well as the well-known brands. Despite low growth rates in the soft drink market, the company is operating in a highly dynamic market place in terms of consolidation and innovation. Refresco has bought bottling capacity in various European countries from parties that are leaving the market, allowing Refresco to become the clear leading player, with significant scale advantage. Being predominantly, a private label bottling company gives Refresco exposure to the faster growing distribution channel of discount supermarkets like Lidl. Meanwhile, the company's branded customers are more focused on growing margins more than volume, by introducing different packaging formats and outsourcing the bottling part of the production process to parties like Refresco.

We invested in Refresco in autumn 2016, as we were attracted by its valuation and strong cash flow generation. The company had just announced its first takeover in the US, giving it a new growth platform. Refresco explicitly said it would target further US acquisitions in order to create scale.

In April 2017, Refresco received a takeover bid from the private equity firm, PAI Partners, at €17.30 per share. The board rejected the bid, deeming it too low – but also leaving the door open by commenting that it is up to the market to decide who the ultimate owner of Refresco should be. In July 2017, Refresco announced it would buy the soft drink bottling activities of Canadian company Cott, which would immediately give the company sufficient scale in the US. Although this transaction makes strategic sense, it also adds leverage to the balance sheet, and does not come as cheaply as previous transactions. PAI Partners clearly thinks the transaction makes sense, because in early October it returned with an increased bid for Refresco, of €19.75 per share. Although the transaction has not received official board support yet, the share price has already significantly increased.

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offer an interesting risk/reward ratio compared to their benchmarks

Another example: Orient Overseas

In our emerging market strategy, we own Orient Overseas, which operates in the global container shipping industry. This industry has been plagued by overcapacity and extremely low freight rates in recent years. The situation was so severe that even market leader Maersk experienced steep losses in its shipping division last year. These dire straits have triggered massive consolidation: over the past two years, the 14 largest container shipping companies have consolidated into eight companies split into three alliances. Together they control 80 percent of the market, which makes it easier to scrap older vessels and restore pricing discipline. Orient Overseas was the second largest Chinese shipping company operating in an alliance with Chinese market leader Cosco, and the potential for acquisition was part of our rationale for investing in the company. So when the company received a takeover bid in July, it did not come as a surprise. The bid, however, positively surprised in terms of the multiple offered. It sent the shares to record highs and contributed very positively to the returns in our portfolio.

These two examples illustrate that few market conditions last forever and that sound economic rationale can be a very powerful force for change. Although the outlook for both industries had not been particularly bright, it is often the case that such challenging conditions focus the minds of management, boards of directors, and shareholders – and lead to corporate actions that are designed to unlock value, trigger change within the broader industry, and often, lead to satisfying shareholder returns.

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Identifying outperformance

Steady macroeconomic growth and solid corporate earnings continue to fuel global equity markets. However, despite the positive fundamental development, investors recognize the potential for a bumpy ride as central bank stimulus starts to fade. Of course, markets have long known that sooner or later, after years of central bank liquidity injections, those stimulus measures would need to be unwound – but as we get closer to policy normalization, we expect investor nervousness to be on the rise. As always, we refrain from guessing too much about the future, but we recognize that on one hand we now have lower volatility and many good fundamental developments, and on the other hand an equity market which has already delivered some solid gains, arguably baking in some of the positives. This suggests that one should perhaps not have excessively optimistic expectations for overall gains in the equity market.

However, we reiterate that, under market conditions where equity returns are maybe not as strong as they have been recently, this should favour our active approach to value investing. Careful bottom-up stock picking can identify securities that can outperform and improve long-term returns, while well-diversified portfolios can help avoid the riskier parts of the market. We are convinced that we have assembled our portfolios in such a way that they offer an interesting risk/reward ratio compared to their benchmarks, and we are comfortable with the current positioning of the funds. Although the broader market is no longer priced at bargain valuations, we continue to look for new investment opportunities. We analyze and discuss many more names than those that actually pass our process and make it into the portfolios, and our list of ideas contains many prospects should markets provide us with a good buying opportunity.

Published October 16, 2017

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