

Quarterly report

VALUE EQUITY

Market tensions highlight valuation gap

The third quarter more or less resembled the prior quarter. Equity markets were unable to find a clear direction and determine if the glass is half-empty or half full. Consequently, the pendulum continued to swing between bullish and bearish markets.

There were weeks in which recession fears, political inertia and the trade war took the upper hand and other periods in which sentiment quickly improved on the back of specific actions by central banks step or when a solution to the trade war seemed closer. Although equity markets have been zig-zagging during the third quarter, the returns were reasonable. Global developed markets - as measured by MSCI World - gained about 5 percent in euro terms, although that was largely because of a strong U.S. dollar, which rose 4 percent against the euro. Meanwhile global emerging markets - as measured by MSCI EM - were flat.

In July, markets benefitted from central banks lowering interest rates and increasing liquidity in the system. A risk-off period followed in August with yield curve inversion in the U.S., and renewed U.S.-China trade tensions. The changing drivers between the various months and the subsequent volatility did not help the value factor nor our value strategies. Having said that, we generated positive returns in our developed market funds, while our emerging markets fund fell slightly. Relative returns were negative for all funds, which was to some extent related to the value factor exposure. The quarter ended on a positive note, with markets rising and a sharp rotation into value shares. We discuss below the stretched valuation gap, which has arguably left certain safe-haven sections of the market overpriced, and value stocks significantly underpriced. The market rotation in September highlights that with such a valuation background, sudden changes in sentiment can lead to swift reversals and rotations.

Leading Economic Indicators May Be Bottoming out

As most macro-economic data has been slowing for the last one and a half years, one may question if we are nearing a recession. While we acknowledge that we have come into a testing phase with mixed signals, we see some reasons not to become overly pessimistic.

Firstly, the weakening macro data is predominantly linked to the manufacturing sector, with less concern in the consumer or service sectors. This contains the slowdown for now, limiting its effect on the wider economy. Moreover, zooming in on the weakness in the manufacturing sector, there have been particularly strong headwinds in the automobile sector. With the development of electric vehicles and autonomous driving this sector is certainly going through one of its largest ever structural changes. On top of that comes demand weakness. Global car sales have declined by about 6 percent in the first half of 2019, compared to the same period last year. Most of this decline was caused by China, which saw a contraction of 12 percent. Despite the structural challenges for the industry, we see the weakness in China as temporary, as car penetration among the population is still only a quarter of developed countries. In addition, with car production falling faster than sales, it looks like the industry is going through a healthy inventory adjustment phase instead of steep decline. So, the current weakness may be followed by some recovery in autos, which are an important pillar of industrial production.

Secondly, while the leading indicator for the entire OECD-region is still falling, it is doing so at a slower pace than previously. While there is no sign of sharp improvement, this may at least imply that we are in a bottoming out phase. This can

be supportive for equity markets and cyclical industries specifically.

Thirdly, central banks have clearly responded to the nascent economic weakness by lowering interest rates and increasing liquidity in the system. They are clearly more pro-active than previously and that is supportive for financial markets.

The 'Value-engine' is not broken

As the uncertain tone in markets continues, the relative returns of different investment styles have also been somewhat volatile. While we have seen short periods of value resurgence, they have not gained longer-term traction. Indeed, since the global financial crisis, value investors have generally had a hard time performing relative to certain segments of the market. We have now written many times of how macro- and monetary conditions have led to persistent focus on certain segments of the market – such as growth stocks, quality stocks, defensive stocks, and other 'bond-proxies' such as low volatility stocks. While some segments have seen valuations rise to levels that may not seem sustainable from a long-term perspective, value stocks have experienced the opposite, with their relative valuations moving down to levels that might suggest we are in the middle of a recession. This has led some investors to argue that we are in a new era of market dynamics, in which the value factor has simply stopped working. We are happy to say that we see the underlying drivers of long-term value outperformance in place – and take comfort from the current low valuations.

GMO recently looked into this in a white paper, 'Risk and Premium, a Tale of Value'. The paper considers the relative returns of the value factor in the U.S. market during two distinct periods. From 1981 to 2005, value outperformed the broader market by 2.3 percentage points annually, but from 2006 to 2019, it no longer outperformed. GMO decompose the relative returns into four drivers: growth, income, rebalancing and valuation.

Value companies typically show lower fundamental growth than the wider market. However, this lower growth has been fairly consistent. Whether from 1981 to 2005, or from 2006 to 2019, the lower growth rates of value companies were an annualized drag on their relative returns of around 3.1 percentage points. So, value companies experiencing even lower growth relative to the wider market do not explain the lack of value outperformance in recent years.

The second return driver is income, which includes both dividends, but also net share buybacks. Value companies typically offer higher income, and this driver added 1.5 percentage points to relative returns in the earlier period, and slightly lower 1.0 percentage points in the later period.

The third return driver is a crucial one: 'Rebalancing', or the migration of value shares into growth territory, and vice versa. This dynamic is in many ways the real engine behind the value premium. Individual value stocks rise in valuation, driving returns, but eventually they leave the value cohort, while certain growth stocks get cheaper and cross into value territory. This means that value investors can benefit from the valuation increases of individual stocks, but the value universe is constantly refreshed and valuations of the value universe overall do not increase. This allows the asset class to give excess returns, without necessarily getting more expensive.

This rebalancing effect was a significant return driver from 1981 to 2005, adding 4.0 percentage points annually to the relative returns of value stocks (significantly more than the negative impact of their lower growth rates). During 2006 to 2019, the rebalancing effect weakened, but it still worked, adding 3.3 percentage points annually. The potential explanations for this effect weakening are interesting, including less reversion-to-mean than in previous periods, and fewer takeovers of cheap companies – a trend that we have also noticed within our own portfolios, which historically have experienced significant takeover activity. However, the rebalancing effect is still highly positive, and remains the largest contributor to the relative returns of value.

So, if we add together the three drivers so far (growth, income and rebalancing), we can see that from 1981 to 2005, they explain excess returns for value of 2.4 percentage points. From 2006 to 2019, they explain excess returns of 1.2 percentage points – lower, but still healthy. However, it is crucial to consider the fourth driver, valuation.

Valuation here refers to the overall valuations of the value cohort. In the period up to 2005, valuations were largely flat: Individual stocks rose and fell, but the value universe overall did not get significantly more or less expensive relative to the wider market. So, overall, the combined effect of the four drivers was that value stocks outperformed by 2.3 percentage points annually. However, from 2005 to 2019, while valuations for the overall equity market have increased significantly, those for value stocks have remained roughly flat. This has served as a significant drag on value's relative returns – to the tune of -1.1 percentage points annually. That meant that, overall, value equities failed to generate excess return. Of course, it has been frustrating to see those limited returns for value stocks. However, the analysis is encouraging. The underlying 'engine' of value investing – the migration of cheap stocks to expensive, and vice versa – remains functioning. Returns have been muted, in large part because value stocks have come cheaper on a relative basis. In recent years of low growth and low interest rates, there has been

considerable focus on certain sections of the market, such as growth, quality, defensives, and low volatility and other 'bond proxies'. This means that the valuation gap between value stocks, and their more expensive peers, has opened up to extreme levels. One may debate at length what catalysts are needed for that valuation gap to close, and when it does, the benefits for value investors could be significant. However, a crucial point is this: In order to assume reasonable excess returns for value, one does not need to assume that the valuation gap closes. One only needs to assume that the valuation gap does not continue expanding indefinitely, because if it only holds steady, the underlying value engine of migration, can generate decent returns for value.

ESG example: ArcelorMittal - CO2 certified steel a new beginning?

Meanwhile, we continually work to improve our understanding of our investment holdings and risks within the portfolio. With global warming as perhaps the biggest challenge of our generation, it is of utmost importance that we as human beings bring down our carbon footprint. For us, as investors, we have an additional and important role to play. Clearly, corporate approaches to carbon can have a significant impact on long-term corporate values. We have an opportunity to map and analyze the carbon footprint of our companies, influence management to be transparent, and encourage them to allocate capital and develop their businesses in a way that mitigates ESG risks, and exploits opportunities. We also factor those considerations into our decisions on how we allocate capital to our investments. However, the fact remains that some industries have a higher carbon intensity than others, and that we do invest in some companies with a high intensity – which bears monitoring.

For example, steel production is one of the most carbon intense industries in the world, accounting for between 4-7 percent of CO2 emissions globally. We recently met with one of our steel holdings. ArcelorMittal is the world's largest maker of quality steel products, present in all major markets and supplier to most major sectors like automotive, construction, household appliances and packaging. We were able to visit their plant in Ghent in Belgium, which is one of the cleanest steel plants of its kind in the world.

According to ArcelorMittal, steel demand will increase from 1.7 billion tons in 2018 to 2.6 billion tons in 2050, after which it is expected to level out. That demand, and the fact that steel production is such a large source of CO2, highlight how important it is to find better ways to produce steel. One trend is to increase the production of steel using recycled scrap steel. Such processes – such as electric arc furnaces – are significantly less carbon intense, but currently only 22 percent

of global steel production uses scrap steel as the raw material input. ArcelorMittal expect this to rise to around 50 percent by 2050, which will reduce the industry's carbon intensity.

However, there is currently not enough scrap steel available to allow significantly faster increase in such production, and therefore global steel demand looks set to rely heavily on entirely new 'primary' steel production for many years. Other ways to reduce the footprint are finding new sources of energy (using different kinds of waste, etc.), new technologies to produce energy more cleanly, and the concept of circular carbon. With new circular carbon technologies, carbon gases that result from steelmaking can be captured and converted into recyclable and new valuable products, and as a result, the steel sector has the potential to become much more efficient and become one of the industries with the largest improvements in terms of CO2 emission reduction.

There is also a key underlying question of the price of carbon emissions. Despite efforts to reduce emissions, the reality is that society as a whole does have need for certain outputs, which are relatively carbon intense. Carbon pricing and trading can be one part of the solution.

ArcelorMittal is also trying to contribute by participating in efforts to establish what will be called 'ResponsibleSteel'. This initiative would give certain steel products a quality certification, assuring consumers that the entire supply chain is managed responsibly. This initiative will not directly compensate steelmakers for the structurally higher costs of low-emission steelmaking, but it could lead to a customer driven demand for CO2 certified steel. Moreover, the industry could also benefit by keeping out competition from other parts of the world that are not meeting new stricter production standards.

The reality is that there is no simple solution to such issues. However, we believe that by analyzing the impacts, and engaging with our holdings, can help us to position the portfolio so that it can generate sustainable long-term returns.

Outlook

With financial markets around all-time highs, and macro-uncertainty, one might ask how much there is to gain from here. As discussed above, we think the macro situation is not entirely bleak, and there are some causes for comfort. Meanwhile, valuations overall have not increased too dramatically over the past year. From September 2018 to September 2019, the forward-looking P/E multiple for MSCI World has only increased from 16.5x to 16.7x estimated earnings. Valuations for stocks have not changed much, and arguably look more attractive now relative to bonds. More interestingly, the valuation gap between growth and value has only expanded

over this same period. This is attractive for investors like ourselves that focus on fundamentals and valuations.

To elaborate, over the past 12 months, the MSCI World Value Index has seen forward earnings expectations drop by 1.3 percent, while the MSCI World Growth Index has actually seen earnings expectations drop significantly more, by 3.5 percent. Despite this, the growth index rose by 2 percent while the value index fell by 2 percent. In other words, the value index saw its valuations largely flat - 13.4x in September 2018 and 13.3x in September 2019 - while the growth index became yet more expensive, with its multiple rising from 21.0x to 22.2x forward earnings. We not only observed this for the overall MSCI World, but it is also apparent, when focusing only on the U.S. and even more so in Europe. Looking at sectors, the valuation gap between financial stocks and IT growth stocks widened further, while health care stocks saw the largest multiple contraction.

This highlights points we have made above, and in previous letters, that the elevated valuations for growth stocks are not necessarily justified by their fundamentals. We will refrain from predicting when the valuation gap between value stocks and the wider market will contract, but we take significant comfort in knowing that the underlying engines of value

performance remain functioning, with their effect masked by the widening valuation gap. We generally like asset classes whose long-term performance drivers are intact, but whose valuations have been stretched to increasingly low levels.

It was also reassuring to see value stocks perform well during September. Although, one swallow does not make a summer, there are various reasons to be somewhat more optimistic that the value factor will work going forward. The various headwinds for value in the past few years – such as the interest rate cycle and the political and macro uncertainty – seem to be abating to some degree, which is positive. Combined with the extreme valuation gap between value and growth stocks, this could set a stage for an improving outlook for the value factor. Nevertheless, the most compelling argument for value remains the diversification benefits from value exposure, especially after a decade of herding behavior in very concentrated segments of the market.

Published November 2019

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