Quarterly report

VALUE AKTIER

Strong quarter for value

The last quarter of 2016 saw a strong end to the year for equity markets. This was also reflected in our funds, which generated solid returns in the quarter, and over the full year.

In our global developed market funds, the US exposure was a major contributor to the fund performance. Our US value stocks performed very well this year, while Europe and Japan lagged. Having said that, our European Value Fund significantly outperformed its benchmark. Meanwhile, our emerging market funds were the best performers in our fund range, with returns in excess of 20%.

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It was certainly an eventful year. Looking back to the start of 2016, it did not take long before there was much uncertainty and little optimism. January started with falling commodity prices and concerns over Chinese growth. Amid the uncertainty, interest rate expectations slumped. These concerns eased, until the Brexit vote brought more pessimism and another slump in rates. But ultimately, underlying economic developments were encouraging and, as the third quarter progressed, interest rate expectations in the US rose. We have discussed many times in recent years how such a rise in rate expectations had the potential to trigger a major rotation in equity markets, and that is what we saw. Investors shifted from defensive sectors and 'bond proxy' stocks into more cyclical areas, and from expensive stocks into cheaper stocks. Value outperformed growth.
Of course, the biggest upset to expectations was Trump's victory in November. The equity market rallied strongly, bond yields increased strongly, and the rotation within equity markets accelerated. Toward year end, the Fed hiked rates and sent more hawkish signals. This rotation was clearly positive for our strategies, and 2016 ended up being a great year for all our value funds in both absolute and relative terms.

Angry voters

The Trump victory was a 'game changer' in many ways. Firstly, the Trump and Brexit surprises stemmed from a general phenomenon in the developed world today, where huge numbers of angry working class/middle-income people feel like casualties in the whole globalization trend we have seen evolving in the past two decades. They have felt their relative wealth decrease over those two decades, so they feel angry, forgotten, and wanting to protest against the established society that has left them behind.

Secondly, it highlights the sheer disruption going in the media. The results of both the Brexit referendum and the US election made a mockery of much of the preceding media coverage and opinion polls which, for the most part, had suggested that both outcomes were fairly unlikely. On election night, many expert commentators and journalists – and of course, many billions of people around the world - were left shocked and speechless as the US map gradually turned red. One aspect is that most commentators in the quality media did not anticipate the Trump victory, perhaps taken by surprise at the pace with which populist and anti-establishment politics have gained ground. But it is also clear that balanced, quality media coverage is one of the most significant victims of disruption, and this clearly played a part in the election campaign. Unwillingness to pay for news is becoming a big problem for this industry. For many, the name of the game is headlines over substance. This focus on click bait is a lot like Trump's election campaign: he dominated the news cycle, again and again, by standing up and making one or two outrageous comments. The media is perhaps an extreme example of disruption in the digital age, but many industries are under pressure.

Obviously, there is much more to the recent political developments, and these are topics that are going to be discussed and analyzed endlessly in the coming years. But enough about 'angry people' and disruption and low quality polls – let's focus more on what this means for the underlying economy, financial markets, and our funds.

A Trump Rally?

There is no doubt that Trump's victory and his likely aggressive fiscal policies helped push markets up in the last quarter. But the reality is that the markets had already started shifting before the election. The US economy had been improving, and from the middle of the year, bond yields had been rising, indicating growing expectations that the Fed would raise interest rates – which they ultimately did in December. All in all, the US economy and to some extent the global economy are not doing as badly as had been feared earlier in 2016, and that was a key driver for the optimistic note toward year end. China is reasonably stable, the ECB has signaled that it will not be buying up bonds forever, and the FED has indicated more interest rate hikes this year.

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So, Trump's victory and imminent inauguration come in the context of an already improving environment. He is of course planning various changes and reforms – many of which are expected to impact the US stock market in a positive way. Fiscal expansion and corporate tax cuts are generally beneficial, at least in the short-to-medium-term, while his agenda of prioritizing American jobs over international trade may be beneficial for small- and mid-cap companies, which tend to be more domestically focused. There are, of course, potential implications elsewhere. There is the question of how potential USD strength and rhetoric about trade tariffs might impact emerging markets. It is a complex question, but here we will simply note that 'emerging markets' are not one homogenous group of countries, but a diverse group of economies with varying challenges and opportunities. We see plenty of potential for bottom-up investors to generate returns, even if Trump takes a tougher line against certain countries.

Moreover, these are still early days: it is difficult to predict how many of his campaign promises Trump intends to carry out, or will be able to deliver. True, the republicans now hold the majority in both chambers, the Senate and the House of Representatives, which implies easier passage of bills – but that does not necessarily mean Trump is in for an easy ride. Only time can tell: at this point it is very difficult to identify what Trump's actual politics will be and the potential impact that they will have.

Value investing has come back from the dead

After several years during which the value investment style has generally been underperforming, we finally saw a strong comeback of the style in 2016. While value was out of favour, we frequently mentioned the potential that, ultimately, improving economic sentiment and rising interest rates could trigger a rotation back towards value. Of course, we never knew exactly when this might happen – and in fact not long ago we put a picture in our presentations from Aesop's fable of 'The Boy Who Cried Wolf'. But, regardless of this, we have always remained confident that value eventually would come into vogue again.

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So, in the second half of 2016 it was reassuring to see that the rise in rate expectations did indeed trigger a rotation. Investors shifted from relatively high-priced stocks into relatively cheaper stocks, and value outperformed. Investors moved from defensive sectors into more cyclical areas, and areas like financials, energy, industrials and materials performed well. Of course, it was satisfying to see our funds responding well to these changing market dynamics, with decent returns across our value fund range. We aim for our funds to have more than one potential driver for returns: for example, at the broadest level, this means our bottom-up selection of individual stocks, our exposure to value, and exposure to mid- and small-cap stocks. In 2015, the overall value exposure did not pay off, but our individual stock selection generally helped drive returns ahead of the wider market. In 2016, stock selection was beneficial in places – particularly in our emerging market funds – but overall it was our value exposure that pushed returns in the second half of the year.

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Since the financial crisis around ten years ago, there has sometimes been an atmosphere in the financial industry in which it has seemed like only certain kinds of investing made sense any more. Within equities, there has been a huge increase in passive investing, and large numbers of investors focused on certain parts of the market – for example, the more defensive, low volatility sectors like health care and consumer staples, which have behaved like bond proxies for some years.

We have nothing against those sectors, and there will be times in the economic cycle where we find compelling value cases there. But we have been somewhat cautious of an atmosphere in which many investors associate 'low risk' with simply investing in funds which mirror a benchmark – despite the fact that these benchmarks are often skewed towards certain mega-cap 'darling' stocks – or in certain defensive sectors. Having said that, the fact that many investors crowded into certain parts of the market did lead to wide valuation gaps, with other parts looking very cheap – and we were happy to exploit that. Perhaps the rotation seen in 2016 is a reminder that the global economy, and the equity market, offers a wide and diverse universe of potential investments, and that the highest and lowest 'risk' is not always parked in the same place over time. Looking at that wider universe, and taking contrarian positions, can still help to drive solid long-term returns. In any case, we think it demonstrates that bottom-up, active value fund managers have the potential to deliver index-beating investment returns.

Positive outlook for the financial sector

It is still early days, but the arrow is pointing upwards for interest rates. Broadly speaking, rising rates indicate an improving economy. This is good news for banks in particular. A positive economic environment tends to bring more optimism and increasing investment activity in the corporate sector. Borrowers are better able to make loan payments, and banks have fewer non-performing assets. They can also earn more from the simple spread between deposit rates and lending rates. Falling bad-debt costs and improving credit ratings can mean less money set aside in loan loss reserves, and balance sheets have more leeway for expanding the loan book (at least, until the cycle reaches a peak). This dynamic is certainly something we are keen to exploit, and we discuss one of our bank holdings below.

Insurance companies also gain from this environment. Increased economic activity and spending – on new homes, cars, equipment, etc. – means increased writing of new policies. Meanwhile higher rates mean increased yields from the underlying investments which back the insurance policies. There are, of course, other sectors which are also relatively sensitive to improved economic sentiment: consumer discretionary and industrials are two obvious ones. All these industries have been performing well in recent months, but it's encouraging that we have found and still find attractive value investment ideas in these sectors.

Positive effects on our stocks

Within our global developed market funds, the most direct beneficiaries of the rising rate expectations and market rotation were our US financial holdings. Over the last two to three years we have gradually increased our holdings there, initially by buying positions in Regions Financial and Citigroup in 2014 and early 2015. When we saw compelling valuations, against a backdrop of all-time-low interest rates in the fourth quarter of 2015, we decided to substantially overweight our US financial holdings. During those months we initiated new buys in JP Morgan, Discover Financial, Leucadia and Metlife.

As rates continued to decline in the first quarter of 2016, our bet did not pay off immediately, but as the year progressed, it started to become a very lucrative decision. Especially, rate-sensitive names like Regions Financial, Discover, Citigroup and Mitsubishi UFJ have done very well in recent months. The funds benefitted significantly both from the overweight position, and above-benchmark returns from our stocks in the sector.

One of our largest holdings is Regions Financial, the largest US regional bank. We initiated a position in the summer of 2014. We saw a plain vanilla business model, with one of the sector's highest interest-rate sensitivities, which could also benefit from increased lending activity. We also liked that it had an overcapitalized balance sheet, giving potential for an increase in shareholder returns, and one of the highest cost-to-income ratios, which it had started to improve on. To us, this showed that it clearly had potential to increase its earnings power and payouts. This, combined with low absolute and relative valuation, made it attractive to us.

The financial sector has obviously been one of the major beneficiaries of the market rotation mentioned above. After the recent rally we have decided to reduce the position somewhat, but still see further potential as the company still has not fully benefitted from higher lending activity, and higher rates, against a lower cost base.

Terex takeover

In the second half of 2015, construction machinery maker Terex announced a "stock merger of equals" with Finnish material handling equipment maker KoneCranes. Early in 2016, this was followed by full cash takeover offer by a Chinese competitor, for USD 30 per share. Although this cash bid seemed somewhat more attractive, it always seemed rather unlikely to succeed due to regulatory hurdles. However, it clearly brought the strategic value of some of Terex' assets to investors' attention, and improved Terex' bargaining power versus KoneCranes. As a result, Terex and KoneCranes decided to amend their initial "merger of equals" so that it became a divestment of the materials handlings unit of Terex to KoneCranes. The amended transaction results in a better-focused company with ample liquidity on an outstanding balance sheet and more leeway to improve its operational efficiencies. Investors clearly welcomed this newest deal and Terex shares started to perform well in the third quarter. The icing on the cake came with the election of Trump and his promise to increase infrastructure spending. As a major provider of construction equipment in the US, Terex is expected to be a major beneficiary of this. During the "Trump rally" its shares have also performed much more strongly than one of the industry bellwethers, Caterpillar.

We have a genuinely positive view of the potential of our investments in the future

Outlook

As we wrote at the start of this letter, 2016 was certainly an eventful year. On the one hand, it has been a year of political surprises and there is a strong sense of the unknown, particularly in many Western countries. Yet, the world is not falling apart. The general economy seems to be reasonably robust, and equity returns have been favourable.

After several years in equity markets where many behaved as if there was a new paradigm, perhaps 2016 was also a reminder that some things stay the same. We have long suggested that value investing offers strong long-term returns; that it does go through headwinds from time to time; and that even when those headwinds last for longer periods, they will ultimately abate – and turn into tailwinds. We have suggested that when the valuation gaps between different parts of the equity market become stretched, those gaps can last for a while, but ultimately, they will revert. Arguably, 2016 offered some vindication to those views. The rotation in styles and sectors was significant in the past two quarters, and as ever, we are not going to make predictions for the short term – but we do think that there continue to be valuations gaps in the market, and we will continue our work to exploit them. We see a large number of significantly undervalued companies in our portfolios, and will continue to search for new candidates. We have a genuinely positive view of the potential of our investments in the future.

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