VALUE EQUITY

Healthy markets and decent performance

Global equity markets extended their gains in the last quarter of 2017. Over the entire year, developed markets posted healthy returns, with MSCI World up almost eight percent and European markets up even more. However, emerging markets stood out, rising over 20 percent on the back of robust growth in corporate earnings.

In the last quarter and over the entire year, our funds generally delivered strong results in both absolute and relative terms. This was despite 2017 being a year where value stocks overall did not perform particularly well. In global developed markets, value stocks were over nine percentage points behind growth stocks (as measured by MSCI indexes). In emerging markets, the gap was even wider, with value stocks over 16 percentage points behind growth. Those are the widest value-growth performance gaps in many years. Despite those headwinds, our value funds gave encouraging returns. The global developed market funds were more or less in line with MSCI World, the European fund was above benchmark, and the emerging market fund lagged MSCI EM slightly, but significantly outpaced MSCI EM Value. If we look at the year-to-date performance in 2018, equity investors have plenty of reasons to be happy. Returns have been positive, volatility is low and corporate profits are strong globally. The solid stock market returns came on the back of solid global economic growth. Consumer and business confidence is generally strong, while industrial activity and even capital investments have picked up. Economists now expect global growth to be around 3.5 percent for 2018. Europe stands out as a positive story: growth surpassed expectations in 2017, consumer and corporate optimism is at the highest level in 10 years, and unemployment is at the lowest level in the same period. In addition, this flow of strong macro-data led to upward revisions in corporate earnings over the course of 2017. Emerging markets are also enjoying the tailwind of superior economic growth: expectations are that GDP grew around five percent in 2017, with similar growth expected in 2018. This is feeding through to emerging market corporate earnings, which likely grew by over 20 percent in 2017.

While the economic data is generally encouraging, the political situation is more mixed. The president of the United States still manages to cause widespread controversies with his daily tweets, while tensions with North Korea, increased nationalism around the world, and the ongoing Brexit discussions are all reasons for concern. In emerging markets, 2018 brings various elections, including presidential elections in Russia, Brazil and Mexico. We would not overstate the political risk, and indeed, financial markets lately seem perhaps slightly less sensitive to political noise than they have at other times, perhaps thanks to the supportive economic environment.

'This time it's different'. But how different?

As described above, 2017 was a year where growth stocks outperformed other styles significantly. More specifically, IT stocks dominated. The IT sector rose 20 percent in developed markets, and almost 40 percent in emerging markets. In both markets, a handful of the biggest tech stocks were major drivers of the indexes' total returns. Of MSCI World's total gain in 2017, about one-fifth is explained by Facebook, Apple, Amazon, Microsoft and Google. In emerging markets, it was more extreme: five companies explain 40 percent of the index rise. They are Samsung Electronics, Tencent, Alibaba, Naspers and TSMC – more on those later.

So, is this kind of market new? Clearly not. In the late 1990s, we witnessed the dot-com era, when financial markets were wild with excitement about the internet. The hot names, besides all the internet IPOs, were a small number of tech stocks known as the 'Four Horsemen': Microsoft, Intel, Cisco, and Dell. These stocks drove equity markets up. These days, it is again a very short list of tech stocks that dominates.

People love to question whether 'this time is different', but situations are never that black and white. We are by no means Luddites, and there is no doubt that promising new technologies emerge in rapid succession today. These offer new opportunities to do business and optimize old business practices, in ways that will benefit the economy in the long term, and generate significant value. Looking back at the history of financial markets, they have an impressive history of being very quick to assess and price in the value of new technologies in the short term, and bubbles have of course been formed on the back of this. Clearly, the dot-com bubble burst, but the underlying technological shift has been undeniable – and in fairness, while it is easy to mock the dot-com excesses, long-term investors in the Four Horsemen would in fact now have been well rewarded, so long as they didn't buy them at the absolute peak.

So, we are not arguing there is a tech bubble in the stock markets right now. Many of these tech companies have extremely dominant market positions, benefit from structural shifts in the economy, and are already generating impressive amounts of cash flows. That is very different to the situation twenty years ago, and incidentally, is very different to the situation now unfolding in crypto currencies, where the euphoric herding into the asset class is not based on any underlying earnings or cash flows.

Cluster Risk

Nonetheless, it is undeniable that many of the big IT names trade at lofty valuations that make it difficult to consider them as 'value'. We also see significant cluster risk in market cap weighted benchmarks. From 2007 to now, the weight of the IT sector in MSCI World has increased from 11 percent to 17 percent, and the FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) are over six percent of the index. In emerging markets, it is even more extreme. In a few years, the IT sector weight has rocketed from around 10 percent to almost 30 percent. Samsung Electronics, semiconductor player TSMC, and internet names Tencent, Alibaba, Naspers, and Baidu now make up almost 23 percent of the index. To put this in context, MSCI EM includes 26 diverse countries, but if Samsung, Tencent, Alibaba and TSMC were countries, each would be a Top 10 nation by index weight. Combined, the Big 6 Tech stocks weigh more in the index than all 20 smallest countries added together – and that's a list which includes heavyweights like Mexico and Russia.

This has very pronounced effects on performance. MSCI EM Growth, which now has 43 percent in the IT sector, returned 29 percent in 2017. This compares to MSCI EM Value, with only 12 percent IT weight that returned 13 percent. After such a period, for investors who are heavily exposed to emerging market growth stocks with significant concentrations in mega cap tech stocks, it may be prudent to consider diversification into value stocks. As we have commented before, value stocks offer an asset class where relative valuations have grown steadily cheaper in recent years, where supportive macro tailwinds may lie ahead, and where active, stock-picking investors find fertile grounds for generating alpha – as our Ethical Emerging Markets Value fund has demonstrated over the past five years. For a closer look at the issue of IT concentration in stock indexes, see our recent commentary here.

Commodities recovered during 2017

We have had some very turbulent years since the oil price crashed mid-2014. At the beginning of 2018, however, oil trades at the highest level in three years. It started to recover from June 2017 when continued OPEC production cuts started to have an impact on supply. Meanwhile, global oil demand is forecasted by the EIA to increase by 1.7 million barrels a day during 2018, up from 1.4 million barrels in 2017. Brent is now at around USD 69, in sharp contrast to the headlines not too long time ago that were calling for declines to USD 20. Although we think that calling the oil price is extremely difficult, we are of the view that at current valuations, the risk-reward balance for oil-related companies has improved. We recognize the need for alternative energy sources to grow, and think this can be an interesting opportunity, both for existing energy companies and for new entrants. That said, there does seem likely to be structural demand for oil for the next few decades, even as alternative energy sources expand. We think that attractive returns can be achieved in the sector, but we remain selective and always seriously consider environmental, social and governance issues when screening for potential energy investments. We also favor current cash flows above future production, particularly for fossil fuel based energy.

2017 was generally supportive of commodities. China is, of course, a major factor. The government has pushed to reduce capacity in industries traditionally plagued with excess capacity, which leads to oversupply, weak pricing power, and weak corporate earnings. The steel industry is a classic example. The closing of lower grade, excess capacity has improved profit margins, cash flows, and credit metrics, which has also helped boost confidence on the loan book quality at Chinese financial stocks. Chinese equities were among the strongest performers of the year. Meanwhile, the improved fundamental situation has fed through to commodity prices. For example, iron ore experienced a lot of volatility in 2017. Prices fell from over USD 80 per ton at the beginning of the year to as low as USD 50 by mid-year, before rallying back to USD 75 by year-end. However, a focus on the headline prices misses an increasingly important distinction in the market. As capacity was reduced through closure of lower grade steel mills, so higher-grade mills saw their utilization rates rise, pushing them to seek ways to boost production – and one way is to use higher grade iron ore, which has a higher ferrous content. Meanwhile, increasing enforcement of environmental standards also led to a significant premium being attached to that higher-grade iron ore. This means that lower quality iron ore is now being heavily discounted by the market, while higher grades are priced up. This bifurcation in the market benefits iron ore producers such as Rio Tinto and Vale, two of our holdings, as their iron ore assets are tilted toward the higher end. In the second half of 2017, some of our strongest performing holdings were in the energy and materials sectors, and commodity prices rebounded.

Improving fundamentals

Clearly, this was not simply a year for commodity related companies. The accelerating global economy is also increasingly having an impact on other sectors. As GDP growth exceeded expectations in many areas, so corporate earnings expectations were predominantly upgraded during the year and this served as an additional catalyst for share price performance.

Our portfolios also enjoyed strong earnings upgrades. The earnings outlook in energy and materials improved on the back of higher commodity prices. More surprisingly, however, is that we saw broad-based earnings upgrades in our financial holdings. The sector appears to be returning, finally, to something closer to a more normal operating environment in which it is no longer excessively impacted by large regulatory, restructuring and legal pressures: they can focus on normal business operations. In consumer discretionary, we saw increased earnings expectations thanks to both lower costs, and final demand in excess of expectations. Finally, some of our IT companies witnessed very strong earnings upgrades as semiconductor and component prices continued to rise during 2017 due to market tightness.

One illustration is Sony. It is widely known that, over the last 10-15 years, the once mighty Japanese consumer electronics giant has seen an erosion of its previously dominant market positions in TVs, audio and mobile phones. Sony struggled with seemingly never ending restructuring charges. This long and painful process has now ended. Sony has adjusted its production footprint, has outsourced large parts of its production and has significantly lowered its cost base. In short, the traditional home electronics business has stopped bleeding cash, and has started to become a small earnings contributor. Investors clearly underestimated the magnitude of these underlying improvements. The background for the earnings upgrades at Sony in 2017, however, is much broader. During these restructuring years, Sony continued to invest in businesses in which it has a competitive edge. For example, it expanded capacity in image sensors as its sees high volume growth from increased applications in smart phones and in autonomous driving. These new applications drive selling prices up, and importantly have also led to market share gains for Sony. The current PlayStation4 platform is seeing stronger demand than any of its predecessors, and this in turn leads to higher software sales and subscriptions. Sony has also found better ways to monetize its vast music and film library.

The underlying improvements in Sony's earnings structure had been widely underestimated, and earnings estimates saw rather large upgrades in 2017. In the financial year ending March 2018, Sony is expected to see the best earnings in almost 3 decades. That improvement is increasingly reflected in the share price performance (+55 percent in 2017), its shares are still trading well below the peak of 2007 and early 2000. In fact, based on forward-looking earnings estimates, Sony actually got cheaper last year – because the estimates increased faster than its share price. This contrasts with some of the largest US IT companies, where the strong share price performance was driven mainly by multiple expansion – getting more expensive – rather than earnings growth.

Recent activity

There were no big changes in our portfolios during the final quarter of 2017. The value exposure is still intact, and most of 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 an acceleration in earnings.

We recently completed the sale of Conzetta, a Swiss holding company, which we have held for many years. Conzetta owns companies with a wide range of activities spanning metal processing, glass, foam materials and graphic materials. Surprisingly, it also owns the mountain sport wear brand Mammut. The holding company structure means that transparency is sometimes not ideal, and of course it can be difficult to compare such a diverse group of business units. Nonetheless, the company has a strong track record of generating high and stable margins and has shown remarkably good earnings visibility. However, Conzetta is a small company, off the radar of many investors, so during times without any significant news, its share price can be range bound for long periods. Having said that, the stock market certainly pays attention when significant change comes.

For example, in 2014-15, Conzetta paid out significant special dividends from its net cash balance sheet, and reduced complexity by spinning off its real estate division. This was well rewarded by the stock market and its share price almost doubled. Still, with only about CHF 1.2 bn in total revenues, Conzetta remains too diversified and its sportswear activities are too small to compete with global brands. In early 2017, Conzetta saw its topline growth accelerate on the back of buoyant end markets, and rumors appeared that it was preparing its sportswear business for a potential divestment. Again, this drove the share price substantially higher. In the second half of 2017, we decided to use this momentum to sell our shares and to lock in the gains that we have seen in recent years. Over the 10-year period December 2007-17, the shares in Conzetta returned 14.5 percent per annum in EUR, compared to 7.7 percent for the MSCI World.

Outlook

At the beginning of 2018, the world is a mixed bag of somewhat concerning politics, and the best economic conditions in the past decade. Macroeconomic growth and solid corporate earnings continue to fuel global equity markets. A big question is what the unwinding of central bank stimulus will mean for the investment climate in 2018. Valuations look lofty in U.S. equities, but the economy looks strong and we should see positive effects from tax cuts in the coming year. In other developed markets – particularly Europe and Japan - valuations look more attractive, which could support decent equity performance, particularly if coupled with positive macro developments. In emerging markets, 2018 seems likely to be another year of decent economic growth supporting solid corporate earnings, which should drive equities.

We will try not to guess too much about the future, but we recognize that on the one hand we now have lower volatility and good fundamental developments, while on the other hand we have equity markets that have already delivered solid gains. Arguably, many positives are already baked into share prices. This suggests that one should perhaps not have excessively optimistic expectations for overall equity market gains. At least, we recognize that 2017 was a particularly good year. Careful bottom-up stock picking can identify securities that can outperform and improve long-term returns, while well-constructed 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 profile, and we are comfortable with the current positioning of the funds. Although the broader market no longer is 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. We remain convinced of the strength and long-term potential of our investments. We are confident that their balance-sheet strength and robust business models will provide them with a competitive edge in future markets.

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