

Value Vultures



John Wyn-Evans
Head of Investment Strategy

The main narratives driving markets at the moment remain unchanged. The one with the hardest deadline is the US debt ceiling negotiations. We have written in the last few weeks about the risks that these pose to markets and our view remains that an agreement will be reached, although possibly not before some sort of market-based tantrum forces the warring parties into one. And while it might be possible for short term traders to make a quick buck on the situation, longer term investors, such as we are, are best served by staying on



the sidelines and taking advantage of any potential dislocation that develops.

The jury remains out on the subject of the start of a US recession – both when it might begin and if one even happens at all. There is still a wide gap between Federal Reserve member rhetoric on inflation and interest rate expectations (“higher for longer”) and what the market is pricing in (rate cuts starting soon).

Investing in value and growth

It was refreshing to walk away from the short-term noise last week and spend a day attending the London Value Investor Conference. Eleven hours of presentations and discussions, hearing from no fewer than 16 fund managers, passed in a flash. My relationship with the concept of Value (and Growth) investing remains a difficult one. I continue to believe that the labels are too broad to be of any great use, especially in the realm of value investing, where there are multiple definitions and approaches. Growth is an easier concept to grasp, although even then it can range from the safer quality end of the spectrum to the more speculative. I certainly believe that there is a case for blending both Value and Growth elements into a portfolio, and I get frustrated with those who think that they are mutually exclusive – sometimes to the extent that their attitude takes on religious or even cultish characteristics.

Still, you can't fault the presenters for their enthusiasm and attention to detail, nor the audience of almost five hundred for their rapt attention. Some attend solely to get the fund managers' stock picks. The 2022 vintage was a bit of a mixed bag, which would have come as a disappointment to those die-hards hoping that Value's time had come. There were 18 winners and 15 losers. The total return across the stock picks was +3%, which was just ahead of the MSCI World Value Index (+2.6%), but behind the US-only S&P Value Index (+7.5%). For the record, World Growth was +13.6% and S&P Growth +6% over the same period. Could do better, as my headmaster was wont to say of my academic performance at times.

There was a wide gap between the winners and losers, which confirms my opinion that one should not have a “rifle shot” approach to Value investing. The best performer was Canadian company ATS Corporation (+62%), a custom engineer and producer of industrial automated manufacturing systems. Certainly, a company that might be in the sweet spot for “reshoring” and the search for greater productivity. Bloomberg has it on a trailing PE ratio of 38x. Even before a rise of almost two-thirds in its share price, some might have struggled with this as a Value play. I note that the successful manager's stock pick this year sports a forward PE of 21.7x to December 2023.

Bottom of the pile was Westrock (-36%), a New York-listed provider of corrugated packaging solutions. The fact that its trailing PE (to December 2022) is 6x, but that its forward PE is 10.8x tells you all you need to know about the earnings trend this year. An end to the Covid consumer boom and risks of a US recession are not being kind to it. It also appears to have fallen victim to the inventory cycle that is plaguing many goods manufacturers currently. They stacked up scarce resources just in time for demand to fall away and prices to start falling. It's an interesting lesson to apply to other goods companies, or at least to test their resilience when questioning management.

One presenter focused on the value (note the small “v”) of dividends, suggesting that they will contribute a higher percentage of total return in what he sees as a lower growth environment ahead of us (we can debate that one another time). He also highlighted the lower volatility of dividends compared to earnings, a factor that we regularly emphasise to clients. Using data for the S&P 500 Index, he showed that from 1939 to 2019 there had been 25 years in which earnings had declined, but only eight in which aggregate dividends were cut. During the five US recessions prior to Covid, the average peak-to-trough

decline in earnings was 42%, but for dividends it was 8%.

Admittedly the Great Financial Crisis saw a 24% dividend cut (mainly from Financials), but that could be set against a 92% decline in reported earnings (according to data from Robert Shiller of Princeton University). The key point for me to reiterate here is that short-term earnings (and share price) volatility does not necessarily reflect the long-term attractions of equity investing. Some other points he made that bear repeating: high returns on invested capital (which we find to be an attractive long-term investment factor) correlate well with long-term dividend growth; and high current dividend yields should be treated with some suspicion as they are more often than not unsustainable.

Two of the conference speakers (talking more on broader trends rather than offering stock picks) were the veteran Howard Marks (77) and the highly experienced, but still disconcertingly baby-faced David Einhorn (54). They both talked about how regime changes can upset investment processes. As he wrote in a recent memo, Mr Marks remains concerned about the shift in the interest rate regime away from one of falling and ultimately zero rates to one rising and higher rates which is one that the majority of today's professional investors have never experienced. He thinks that many have yet to grasp the reality of the new world we might be living in.

Mr Einhorn focused more on the structure of markets and how difficult it has become for value investors to realise returns on their investments in a world dominated by passive investing where the net dollars keep flowing to the largest and most expensive stocks. First, he had to change his value investing strategy from "long only" to "long/short". But then he had to pivot again during the "meme stock" madness of early 2021, when short positions were squeezed mercilessly. Now he has a much broader, diversified portfolio of short positions... and he doesn't disclose his positions if he doesn't have to. No point in painting a target on your own back. As for the longs, you still have to be patient. The old buyers of these would be actively managed defined benefit pension funds with consistent investment inflows. They are a rare breed now. He often has to wait for private equity or a corporate buyer to close the valuation gap. Thus, returns tend to look more like a flat line followed by a big spike up rather than a steady bottom-left to top-right diagonal.

Even so, he commented that the current market structure offers up a "wasteland of companies representing excellent value". This was a point made in a different way earlier in the day by Ben Inker of GMO (Jeremy Grantham's firm). He observed that there is a historically high valuation dispersion between the top quintile of "expensive" stocks and the bottom quintile of "cheap" stocks. We have heard this point made by other managers who use quantitative screens. And it seems to be within markets and within sectors. The inference is that there are real opportunities for stock pickers to benefit from this situation (although I can already hear the sceptics quoting Mandy Rice-Davies in the background).

I'm going to leave you first with some of David Einhorn's observations on selling discipline. His clearest rule is this: if you think you are wrong, sell it all immediately; don't wait for the market to agree with you; you've probably just come to the conclusion faster than the crowd. He also suggested selling a position when you find yourself bragging about how much you have made on it. And if you can't sell it all, at least top-slice it – that way you will feel more comfortable adding back if the shares encounter more general profit-taking or a short-term setback.

And finally, a quote offered by Howard Marks, but which originates in Ancient Greece. It comes from the statesman and orator Demosthenes and encapsulates wisdom that echoes down the millennia and pertains to man's enduring capacity for self-deception (which can be a dreadful fault in an investor): "For what every man wishes that he also believes to be true".

Away from the conference, one interesting cautionary tale that emerged last week was that of legendary investor and corporate raider Carl Icahn. In a timely reminder that not even six decades of experience can necessarily prepare you for the current investing environment, he owned up to having lost \$9 billion on betting against the rise in US equities in the last few years. Mind you, he also made \$6 billion on the long side, leaving a net loss of \$3bn, and still has ample net worth, even if it's difficult to find a reliable number on that. Forbes suggests \$10bn and Bloomberg around \$14bn.

Economic Commentary

FTSE 100 weekly winners

Sage Group plc	6.0%
Ashtead Group plc	5.5%
3i Group plc	5.5%
DCC Plc	5.4%
Rolls-Royce Holdings plc	5.2%
Melrose Industries PLC	4.9%
Scottish Mortgage Investment Trust Plc	4.3%

FTSE 100 weekly losers

Ocado Group PLC	-10.7%
International Distributions Services plc	-10.3%
Burberry Group plc	-9.0%
JD Sports Fashion Plc	-8.1%
Polymetal International Plc	-8.0%
Vodafone Group Plc	-7.5%
Croda International Plc	-7.0%

FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have position or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices which may be subject to change. The value of any tax benefits will be dependent on individual circumstances.

investecwin.co.uk

Member firm of the London Stock Exchange.
Authorised and regulated by the Financial Conduct Authority.
Investec Wealth & Investment Limited is registered in England.
Registered No. 2122340. Registered Office: 30 Gresham Street, London, EC2V 7QN.

