OUT OF THE ORDINARY

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Value is in the eye of the beholder

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It makes a pleasant change to look back on a week when global equities actually rose for the first time since the beginning of April. Searching for a specific catalyst has proved to be a fruitless task. As likely a candidate as any is the fact that sentiment was close to rock bottom, with Bank of America's proprietary Bull & Bear Indicator sinking into what it described as "unambiguous contrarian buy" territory. There will also have been some fund rebalancing demand for equities as we headed towards the end of the month.

Another potential factor was a positive reaction to results from a handful of US retail names including department store Macy's and the "dollar stores". This helped sentiment following the previous week's warnings from Walmart and Target, but perhaps only served to illustrate that careful analysis of company-specific factors is going to be vital in assessing corporate wellbeing. The transition of consumer demand from predominantly goods more to services is one of the "tricky transitions" that we have highlighted in recent presentations, and a misreading of that shift can leave retailers holding uncomfortably large inventories of the wrong stuff.

Our UK Asset Allocation Committee met last week but could find no consensus to turn more positive in our risk stance. While valuations are lower and sentiment is, as mentioned already, poor, we still face the headwind of tightening monetary policy, which this week will be strengthened when the US Federal Reserve begins to reduce the size of its balance sheet by selling Treasury and Mortgage bonds. We also remain concerned that the speed of change in, for example, mortgage rates, energy prices and other input costs has not yet been fully reflected either in consumers' behaviour or in corporate margins. It was noted that companies with a January year-end (and therefore speaking with an extra month of experience) were more downbeat about prospects.

None of this precludes a further rally. Indeed, it has often been noted that some of the biggest one-day rallies in stock markets have been during bear markets. Short positions can be aggressively squeezed. Goldman Sachs constructs many different custom baskets to reflect certain tradeable themes. The biggest winner last week was Retail Net Bought Since 2019, containing (US) companies that have been the favourites of retail investors for the last three years, with a rise of 10.55% (but still -27.9% year-to-date). Liquid Most Shorted was next best, +9.6% (still -31.3% YTD). On a more positive note, its Go Outside basket was up 8.92%, reflecting enthusiasm about a return to more normal behaviour as the Covid-19 tide continues to ebb.

In recognition of the greater value on offer, we did recommend increasing holdings in Investment Grade Credit (IG), the corporate bonds issued by companies with the safest financial positions. The combination of rising government bond yields and wider credit spreads (the premium over government bonds demanded by investors for the extra risk) means that the yield on UK IG Credit is now around 3.6%, a decent premium to what is available on other safe assets and close to the top of the range over the last few years. The IG segment has an extremely good historical default record, and we therefore evaluate the risk from a potential recession as minimal.

One feature of 2022 has been the outperformance of the Value factor versus Growth. I have written a lot in the past about how I would prefer to label these factors as "short duration" and "long duration", because they are drastically affected by investors' investment horizon and by the movements in discount rates. This year's rapid rise in bond yields has been a major factor in reducing the current valuation of companies whose worth is held more in its future prospects than in what it produces today. Meanwhile Value indices are chock full of Resource companies that have been beneficiaries of geopolitical strife.

Bearing all of this in mind, I attended the London Value Investor Conference a couple of weeks ago. I had previously attended in 2019, the last "live" event before Covid intervened. One of the features of the conference is that the presenters (and there were presentations from seventeen fund managers this year) are asked to name their top stock pick. Indeed, I believe that some people pay the entry fee purely on the basis that they can put all the stock picks into their portfolio for the next 12 months. The report card for the class of 2019 was more interesting than usual because it covered a period of events which I can assure you from looking at my notes was not even vaguely forecast – no pandemic; no military invasions, for example.

The average equal-weighted capital performance of the nineteen shares in the 2019 "conference portfolio" over the last three years was +37%, which compared favourably with the S&P 500 (+38%), the Dow Jones Industrial Average (+27%) and the FTSE 100 (+4%). But the dispersion of returns was enormous, ranging from +110% for United Health (US-listed owner and manager of health systems and health insurance) to -77% for Capita (UK-listed public and private sector outsourced services provider). The names in between included an investment bank, a chemical company, an auto manufacturer, a tobacco company and even one of the poster children of growth investing, Amazon (+23%)! When one considers these were the top picks of managers carefully invited to represent their industry, it shows the benefits of diversification.

Value is in the eye of the beholder, and there are a number of ways of approaching the subject. Historically, the value discipline was based more on looking for companies trading at a discount to some form of tangible net asset value, and this was a more rewarding approach in the past when investment research was less developed, information was less accessible, and the economy was generally more asset and capital intensive. Low Price/Earnings ratios, low Price/Book ratios and high dividend yields were the lures. This was despite the fact that the acknowledged father of value investing, Benjamin Graham, clearly asserted that a discount to intrinsic value was the driving force. Thus, companies with apparently high current valuations may yet be "cheap" if future prospects were sufficiently attractive.

Our preference as equity investors remains tilted towards companies whose net present value is derived as much from their future as their present cash flow. Within this group we find "value compounders", and it was good to see one of the presenters making the case in their favour. One of the slides illustrated the concept of "form is temporary, but class is permanent" that I alluded to last week. It showed that companies in the top quartile in terms of Return on Invested Capital (ROIC) who stay in the top quartile compound returns well above the market averages over rolling five-year periods. And the better news is that there is persistence to these returns, with more than half of the starting constituents remaining in place – indeed, that's the highest "persistence factor" of any of the quartiles, suggesting that strong, profitable companies do have some sort of enduring competitive advantage.

At the other end of the scale, many of the worst companies in terms of ROIC are doomed to remain there, with a "persistence factor" of exactly 50%. They also provide very poor relative investment returns, unsurprisingly. However, the worst relative returns are delivered by what one might describe as "fallen angels", those companies who fall from the first to last quartile of ROIC. Here we would expect to see a vicious combination of valuation de-rating and lower growth expectations at work. Thankfully the cohorts representing falls from top quartile ROIC to third and fourth quartile are the two smallest, but they still represent an exclusive club of which nobody would aspire to be a member.

The best returns of all are provided by companies that improve their ROIC quartiles, which the presenter described as a "quality transition". These do not quite qualify as "hen's teeth" in terms of rarity, but neither are they abundant. But it's certainly a category that we scan for, as improving returns tend to attract a higher valuation which makes for a rewarding re-rating.

The other presentations ranged through varied detailed investment philosophies and methodologies, with each presenter no doubt convinced theirs was the best. The bargain basement contained a UK retailer with a market capitalisation of just ten percent of its revenues, but, frustratingly, no mention of its returns on capital. There was also a Hong-Kong-based retailer with an apparently sustainable dividend yield of 12%. At the upper end of the valuation scale was a Canadian food processor on a historical Price/Earnings ratio of 31x, which had a few attendees gasping in disbelief.

One of the more offbeat presentations was from a fund manager who "raises red flags through machine intelligence". To you and me, that means he runs company accounts through his computers looking for shifts in lines such as contract assets, client receivables, provision releases and capital expenditure. His assertion is that company managers have never been so financially motivated as they are now to be creative with the numbers owing to the nature of compensation packages. He is particularly worried that a lot of currently reported high growth is overstated and certainly unsustainable. Weaker economic periods tend to reveal the culprits. He is also concerned that too many investors buy into narratives rather than doing the donkey work of analysing the accounts. Maybe that's not entirely surprising, as the average UK-listed company's annual report expanded from seventy pages in 2000 to one hundred and seventy-five in 2020.

Finally, a couple of general comments that I highlighted in my notes. The first, from a well-regarded UK hedge fund founder/manager, noted that "Growth investors sometimes care too little about valuations, but Value investor sometimes don't appreciate business risks" Simple, but true, I think.

The second is from a very quirky and amusing veteran US manager. He noted that a discounted cashflow model is a bit like the Hubble Telescope – great for zooming in on a distant star, but if you're just a bit off you could be looking in the wrong galaxy. By which he reminded us that when distantly projected cash flows are being discounted back to the present, the compounding effect of even small changes in the discount rate or expectations for growth or returns can have an enormous effect on the next present value. There are a lot of investors in speculative technology and disruptive companies who have learnt that truth the hard way recently.

Economic Commentary

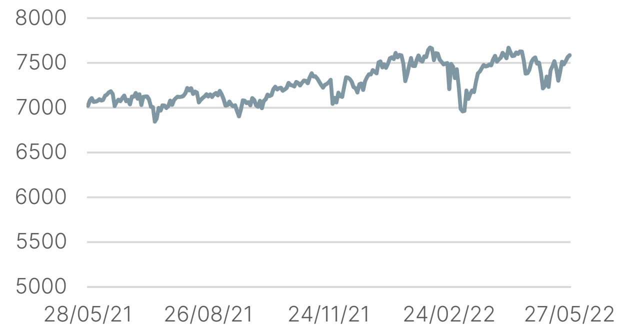
FTSE 100 weekly winners

Ocado Group PLC	19.4%
Intermediate Capital Group plc	14.3%
Barclays PLC	11.6%
Melrose Industries PLC	9.2%
HSBC Holdings Plc	8.5%
NatWest Group Plc	8.0%
Anglo American plc	7.9%

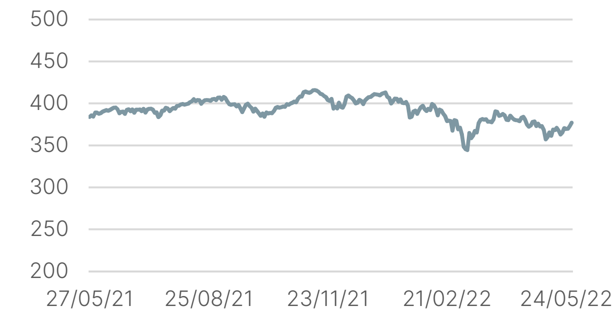
FTSE 100 weekly losers

Johnson Matthey Plc	-10.5%
SSE plc	-8.4%
United Utilities Group PLC	-7.6%
Severn Trent Plc	-5.6%
Intertek Group plc	-4.6%
Polymetal International Plc	-4.1%
National Grid plc	-3.8%

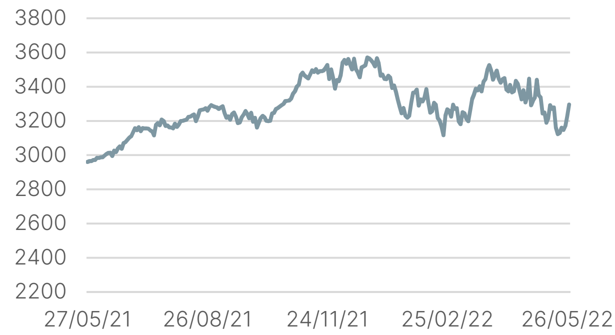
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



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