Recovery after a tough start

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Most equity markets around the world had a tough start to 2016. The main culprits were concerns over China's growth and slumping oil prices – two topics that are inherently linked. The market tumult was given an extra twist by a technical factor: new circuit breakers in Chinese stock exchanges – which actually just served to increase volatility. However, as we wrote in our last letter, in mid-January, it's important not to overreact at such times. We've often argued against a herding mentality; investing based on newspaper headlines can be harmful to your financial health!

Indeed, in mid-February a V-shaped recovery started. Oil prices moved up, the governor of the Chinese central bank spoke supportively of the economy and the currency, and in Europe, ECB chief Draghi reiterated his willingness to act. Equity markets rebounded, alongside commodity prices. In fact, by the end of the first quarter, oil and iron ore prices ended up gaining 6% and 23% respectively. Similarly, the Chinese currency regained lost ground against the USD.

Newspaper headlines can be harmful to your financial health!

Of course, as we noted in our last letter, you have to be careful not to extrapolate recent trends too far. Perhaps the overarching point is that the last few months have been volatile. This made it a difficult investment climate, and many fund managers saw disappointing results. During the quarter, our **global developed market funds** declined around 4% in Euro terms, but this was slightly better than the 5% loss in the MSCI World index. We never like losing money in absolute terms, but considering the negative sentiment in the market at the start of the year, we are generally satisfied with the results. Meanwhile, our **global emerging market funds** rose about 1.5% in the quarter, slightly better than the MSCI Emerging Market index. In early April, we have seen both sets of funds performing well.

Encouraging rally and M&A activity

It's been a volatile start to the year. Many questions remain, and such periods of uncertainty are never relaxing. The world is still working to find a foothold for growth and inflation. We are encouraged by the rally in February and March, and by the increased levels of M&A activity that our holdings have experienced lately. More importantly, as we commented in our last letter, we think that an environment of slow-to-moderate growth, with spikes of volatility, can be favourable for bottom-up stock selectors.

Our focus remains on our fundamental work. Long-term investors like us exploit the volatility in stock markets to look for mispriced businesses. We put all our effort into analysing and determining intrinsic values and to buy good businesses, when they are undervalued. By focusing on this, rather than trying to guess what will happen in the next quarter, we believe we will generate healthy returns over time for those who entrust us their funds for investment.

Selection – the main driver of performance

It's reassuring to see that the main driver of performance over the quarter was our selection of individual stocks. In global developed markets, Europe gave fairly weak returns – at the index level – compared to the US, so our funds' relatively high exposure to Europe was theoretically negative. But in practice, our European holdings significantly outperformed, and this was the single biggest explanation for the fund's relative outperformance. Among the larger contributors was the Swiss company, **Kuoni**, subject to a takeover bid, which we discuss further below. We also saw strong selection returns within our materials exposure, particularly from Australian steel producer **BlueScope**. This is a company in which we have been invested for many years and one where we have had close conversations with management as they have navigated tricky cyclical conditions, with some heavy restructuring over the years. We continue to be impressed with their fundamental developments.

In our **emerging market funds** too, it was individual stock selection that drove our strong relative performance. One key contributor was Arcelik, a Turkish maker of white goods such as refrigerators and washing machines. Weaker commodity prices should have a positive effect on their profitability, but most encouraging is the solid increase in market share in Europe, through brands such as **Beko** and **Grundig**. Management have also been taking steps to bolster balance sheet efficiency.

Some tailwind to value stocks in coming years?

We also note that, during the quarter, **value stocks** marginally outperformed growth stocks at a global level. We would hesitate to label this a clear trend yet, but as we have previously commented, we do see some potential for the value style to have some tailwinds in coming years. In the nearer term, some of the themes mentioned above are expected to continue to drive the pendulum between optimism and pessimism, with high volatility continuing. The state of Chinese economic growth and central bank actions will probably continue to dominate news headlines in the near future.

> *Value stocks marginally outperformed growth stocks at a global level*

Meanwhile, the UK's '**Brexit**' referendum will clearly influence markets. We've seen some impact already, particularly on the British Pound and, obviously, focus will increase as we move closer to the end of June. Meanwhile, the high correlation between stock markets and crude oil price leaves oil supply and demand to be one of the more important themes to follow as well. Against that backdrop, our primary focus will remain on the individual selection of stocks, understanding their fundamental characteristics and sensitivities to external factors – and exploiting volatility in markets to make discounted investments in solid value companies. These aims are at the back our minds as we discuss the below topics.

The adjustment phase for oil in closer to the end

As mentioned above, one of the main narratives weighing on risk sentiment early in the quarter was the decline in crude oil prices. Intuitively, one might expect that lower oil prices should be bad for oil companies, but good for the rest of us. But it's important to ask if it's a supply shock, or a demand shock. This time, the concern is that it's both – which explains why, when oil falls, equity markets also fall. On the supply side, the multi-year increase in US oil production has met with determination from OPEC not to reduce production. On the demand side, many observers worry that falling commodities prices simply reveal the underlying weakness of the Chinese economy – which has knock-on effects for the global economy, across sectors. Of course, the picture is not all bad. In emerging markets, for example, energy exporters like Brazil and Russia have been hurt, but there are also plenty of EM countries that benefit from a cheap oil dividend, which, for example, allows governments to reduce fuel bill subsidies, paving the way for healthier long-term public finances.

> *Therefore, we do not expect to see a new peak in US oil production before 2020. This could potentially bode well for a more sustainable oil price recovery*

Regarding China, our last letter touched on the ongoing economic transition: necessary, but volatile. We've generally felt that a hard landing would be avoided in China, and more recently, there have been signs that economic activity may have bottomed out: see the March 2016 Monthly Report by our strategist, here.

Turning back to oil, halfway through the quarter, prices started moving upward, partly due to talk that – dependent on others doing the same – some OPEC producers were considering freezing or reducing production. In fact, energy and commodity-related companies and regions ended up being some of the best performers of the quarter, reversing some of the losses from last year. This reiterates the point that simple extrapolation of current conditions and trends is risky. Of course, some trends are structural and longer term, while others are cyclical and shorter term, but we always try to bear in mind the potential for things to revert.

This quarter we visited the United States to meet directly with some of our holdings and other major energy-related companies. There was no lack of negative news during this trip, and companies were generally hesitant to say much about future expectations. However, one of our key findings was that capital spending is currently so severely cut, that US oil production will likely fall more than currently expected. More importantly, when US oil production does eventually recover, the scale of that recovery it is likely to be restrained by a lack of cheap financing and an exodus of skilled labour from the industry.

Therefore, we do not expect to see a new peak in US oil production before 2020. This could potentially bode well for a more sustainable oil price recovery. Although, it certainly has not become a base case scenario for most energy companies yet, one should not exclude the possibility that oil price assumptions will be revised up more strongly in future. Another interesting finding is the fact that, due to the crisis but also thanks to technological advances, breakeven rates for new projects have dropped significantly. As a result, satisfying returns on capital can probably be achieved at a USD 60-70 oil price instead of more than USD 100 a few years ago. Although the sector is clearly not out of the woods yet, we think it is much closer to the end of the adjustment phase.

Positive impact from M&A activity

M&A news continued to impact positively on our portfolios in the recent quarter. After months of speculation, we saw a bid for Switzerland-based **Kuoni Reisen** from a Swedish private equity investor. Kuoni Reisen combines traditional hotel booking and group travel services with newer visa services. While the traditional businesses have seen technological and distribution challenges in recent years, the visa services business has been growing rapidly with high profitability. Recent group earnings were somewhat dragged down by restructuring costs and by weak earnings in the traditional group travel services. The weaker part of the business thus dragged down the valuation multiples for the entire group. Therefore, it likely that the new owners will either fix or sell off the underperforming business, while they continue to grow the visa services business organically. We also think that this takeover is a good example of an investment case where it makes sense to look at the sum of the parts, rather than the simple whole-of-group earnings power, which was held back temporarily by one unit. The deal has not officially closed yet, but we expect to receive our money in the next few weeks. Due to the bid announcement, we have seen a strong re-rating of the shares in 2016, which drove the stock selection returns in Europe.

We have regularly mentioned the overseas takeover offers by Japanese companies. By growing overseas, they try to mitigate the impact of low domestic growth. Over the past year or two, we have also noted increased activity by Chinese companies in other countries. While their strategic motivations might not always be the same as their Japanese counterparts', they have become a force to reckon with. In our portfolios, we have recently seen two examples of this. **Ingram Micro**, a US-based distributor of electronics has recently received a takeover offer by **Tianjin Tianhai**. For the Chinese company this deal offers diversification of revenue sources, while Ingram Micro accepted the bid because it offers increased growth opportunities in China. The all-cash offer valued the company's shares at over 30% higher than they had been the day before the announcement and sent shares to an all-time high.

Another US-based company, construction machinery maker **Terex**, is currently discussing a proposal from China's **Zoomlion**. The rationale behind this is clearly driven by the weak outlook for capital equipment in China, acquisition of technology and complementary distribution platforms. While the Ingram Micro deal seems set to go through, the Terex deal might actually fail to clear some regulatory hurdles. Therefore, the shares have not yet fully re-rated to reflect the offer price but remain, nevertheless, among the better performing shares in our fund this year.

Spotlight on risk after Panama

In the last week or so, revelations from the **Panama-papers** have dominated headlines. There is huge scrutiny into offshore structures, which in many cases are legal, but don't live up to people's expectations of what is fair and right when it comes to paying taxes. The Panama case is dramatic, but the theme isn't new. In recent years, various companies – including some of the world's largest – have come under pressure to pay fair taxes. Until early April, drug giant **Pfizer** was planning a massive $160 billion merger with **Allergan**. The resulting 'tax inversion' structure would have moved Pfizer's headquarters to Ireland, cutting their tax bill. That deal has now been cancelled, partly in the face of new US regulations that would make it less profitable. It was interesting to see that when the deal was cancelled, Pfizer's shares rallied sharply.

There is a need to build a corporate culture focused on doing what is right

Increasingly, people are demanding that companies don't just do what they are allowed to do legally, but that they do what is right. One example is banking. Since the global financial crisis, banks have been forced to become better capitalised, and there are myriad new regulations designed to prevent the same problems hitting again. But a crucial element here is corporate culture. It's not enough for a bank – or any company for that matter – just to comply with the law. There is a need to build a corporate culture focused on doing what is right: learning to operate in a sustainable way. Often, it can seem more profitable in the short run to operate in a way that is legal, even if it's not 'right' – but that approach potentially builds risks that could hurt corporate value in the medium to long-term. New regulations could be introduced to stop that specific behaviour, or perhaps clients might react against the perceived bad practices by the company.

When we invest in companies, we try to understand whether they have a strong company culture for addressing such risks. This applies across the board, from balance sheets to environmental, social, and governance issues: whether we're looking at a company's solvency and financial health, board structures, its relations with labour unions, or its pollutant emissions. Of course, this doesn't mean every company we invest in is perfect. Every equity investment carries risk, and our aim is to understand the key issues (and opportunities) that each company faces, and to gauge whether it is aware of, and managing, those risks sensibly – with an eye on a long-term corporate sustainability and value. We also enter dialogue with our investments, attempting to flag significant issues and encourage change. Examples are working with companies in the oil, gas and mining industries to encourage stronger policies to protect human rights, encouraging strong anti-corruption policies, and addressing the issue of carbon emissions.

Evidently, we attach great importance to the active ownership of our holdings – indeed we consider it a fundamental element of active fund management. With that in mind, we note that the fund rating company, Morningstar, has just introduced a new ESG rating system, giving funds a **"Morningstar Sustainability Rating".** In general, we welcome more attention on ESG, which we have long believed is a vital part of financial analysis. Our concern, however, is that this 'Sustainability Rating' doesn't paint a full picture, because it is based on the ESG scores of the underlying fund holdings – and fails to consider the processes of the investment manager. What do we mean by this? Our active equity funds generally have a Morningstar Sustainability Rating of 'average', 'above average', or 'high', which tells you that our underlying holdings perform reasonably well on environmental, social, and governance criteria. But those scores don't tell you anything about our efforts to encourage our holdings to adopt higher ESG standards – which we do through our voting and engagement programmes. From an investment perspective, change is often one of the most important factors, and when considering ESG, we think it's important that fund managers should be working to bring about positive change in their holdings, and investors should be aware that the new ratings from Morningstar do not currently reflect this.

Published April 26 2016

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