Quarterly report

VALUE EQUITY

The pendulum swung back and forth between fear and optimism

During the last quarter, global developed markets gained a satisfactory 7.6% when measured in Euros – and that currency impact is significant. The US Dollar gained more than 5% against the Euro, so once we strip out that effect, equity market gains were much more moderate. Global equity markets zig-zagged through the quarter. The pendulum rapidly swung from signs of relief, good corporate earnings and general optimism to fears for an escalating trade conflict and increasing political tensions.

In March, markets had been spooked by US announcements of trade tariffs, and there was some relief in early April, with markets recovering some of the lost ground. This was followed by a good corporate results season, which led to increased earnings expectations, especially in the US and Japan. However, from mid-May the escalating trade conflict and the rising US dollar started to have notably different effects on equity markets, with countries outside the US starting to underperform. Looking at MSCI indexes as a guide to market returns, the US rose by 9.0% during the quarter, while Europe and Japan gained only 4.3% and 2.4%, respectively.

Meanwhile, global emerging markets declined by 2.8%. To some extent, global emerging markets continue to be perceived as a proxy for global trade, and particularly with US-China trade tensions increasing, the asset class was hit relatively hard. There was also some currency pain. The Argentinian peso plummeted, losing 26% against the EUR over the quarter, with runaway inflation, significant twin deficits, and a bad drought hitting production of agricultural commodities. So, the Argentinian woes (to which our funds are not directly exposed) were mainly due to country specific concerns, but looking across the wider emerging market universe, the strong US dollar did lead to some capital outflows. During the three months, no major emerging market currencies made gains against the US dollar, and some were notably weak, with the South African Rand, Turkish Lira and Brazilian Real all losing around 14-15% versus the dollar.

On a positive note, although emerging markets overall have performed weakly so far this year, that is mainly explained by a decline in valuation metrics, while underlying earnings growth has actually remained quite positive. Naturally, it's a turbulent political and trade environment, so we will be monitoring macro and earnings developments, but we continue to think that emerging markets offer attractive long-term return potential on the back of GDP expansion. As value investors, when we see valuations come down in an asset class that we find fundamentally attractive for the medium- to long-term, that usually makes us start looking for opportunities, and indeed, our emerging market funds have recently made some new investments.

Value stocks continue to underperform growth stocks, both in developed and emerging markets. This is especially notable in the US, where MSCI US Growth gained almost 11% and MSCI US Value rose only 6%. Against this backdrop, all our value strategies lagged their benchmarks (MSCI World, MSCI Europe, and MSCI Emerging Markets) during the quarter. In our developed market funds, the pain was explained as much by some of the stocks we don't own (such as the FAANG stocks which performed strongly), as by some of the stocks we do own (such as Renault, Yamaha Motor and Whirlpool, which were hurt by escalation of trade rhetoric). Our financial exposure had a negative impact on relative performance. In emerging markets, the weakness of value stocks overall was compounded by weak performance of small and mid-cap stocks. As we have noted many times before, volatility in the markets often spells opportunity, so we are focused on reviewing our existing holdings, ensuring that their medium- to long-term investment cases remain intact, and exploring new investment opportunities.

Politics and Global Macro

So, although developed market equities posted positive returns in the second quarter, there are various concerns affecting the markets. Europe has plenty of political uncertainty: on top of the continuing Brexit saga, political turbulence in Italy has also raised concerns about European unity. Looking to the US, in addition to the escalating US trade tensions with China and Europe, and unpredictable US foreign policy. It often feels like Trump is running US foreign policy a bit like a Twitter campaign. Whether the US-North Korea summit or the G7 meeting, there is first lots of focus and headline-grabbing proclamations, and then two weeks later very little attention on the same subject. Of course, this is partly just the nature of diplomacy: there is always more focus on summits, and less on the quiet, detailed work that goes on before and after. But with Trump, it is not always obvious that there is continuity between the quiet, detailed work of his diplomats, and what he chooses to say at summits. He has made it clear that he views this unpredictable style of diplomacy as brilliant disruption, the key to the art of the deal – and in some cases, he may succeed, but it introduces considerable volatility, which is not typically conducive to political stability.

All of this is taking place as central banks continue to normalise policy. The European Central Bank announced its intention to end its QE program by year-end and expects to keep interest rates on hold at least through the summer of 2019. In the US, with a strong economy and unemployment at an 18 year low, the Fed raised rates in June by 25 basis points to 2.00%, in the second hike this year.

Looking at the overall state of the global economy it still remains robust but with some signs of a softening trend in the past months, as manufacturing activity and trade activity softens. Euro zone PMIs have topped out and started a falling trend in the first half of 2018. Global credit tightens, oil trades way higher than expected one year ago, and finally inflation is starting to pick up from low levels.

Increased tariffs: globalisation in reverse?

So investors have plenty to think about at present. The potential trade war is probably the single biggest driver of market sentiment right now, and for good reason: in the past two decades global trade as part of world GDP has roughly doubled, from 15% to 30%. Many factors have driven this development, from container shipping, to outsourcing trends, to the spread of the internet, which has made the world a smaller place in so many ways. In 2001, China joined the WTO, and China was often described as the 'factory to the world', with vast quantities of cheap goods being shipped out around the world. In Europe, Germany is the big exporter, with autos the dominant sector.

Of course, some big trade imbalances have developed. Although the US trade deficit was even higher a decade ago, at about USD 760 billion, it remains significant at USD 500 billion (2016 data). The largest single country imbalance is with China at USD 347 billion. Looking at WTO data on the average tariffs set by various countries, the US does come in at the low end, at 3.48%, compared to Europe at 5.16% and China at 9.92%. Of course, a lot depends on how you do the calculations, but generally speaking, it is fair to say that the US sets among the lowest tariffs. Obviously, this imbalance gets a lot of attention from the Trump administration, with complaints ranging from import-related job losses, to alleged Chinese failure to respect intellectual property rights, to concern that the deficit leaves the US too reliant on foreign funding. We should remember that the US moves to increase tariffs are about more than just the trade deficit – they can also be a simple way to address complicated issues such as respect for intellectual property rights.

There may be some validity in some of these complaints, but overall we believe that globalisation is generally good for the US, and in any case, a trade war is a fairly risky way to address them. So far, the actual impact is limited, but that can change if both sides escalate. Bear in mind that interest rates generally are heading up, and we find this fairly positive in that it is driven mainly by improving economic growth – but if trade wars trigger inflation, and that drives further US rate hikes, we would see that as a more negative scenario. We will not pretend to know how this will develop: tough rhetoric from both sides is likely to continue, but negotiations will take place, and we would never estimate Trump's love of making a deal.

Unlocking Value

So, there are reasons for volatility in the markets, but there is still plenty of positive activity going on – both at the broad economic level, but also in terms of individual companies. We have discussed the importance of corporate actions as drivers of portfolio returns on various occasions in the past. Whether merger and acquisitions, company splits or asset divestitures, all these sorts of corporate activities can crystallize value for shareholders, and significantly boost returns. It looks like 2018 is becoming the busiest year on record for mergers and acquisitions. Despite talks about sometimes lofty valuations, corporate managers seems to be in a clear "risk-on" mode. The latest increase in M&A is driven by the corporate tax cut in the US, which give companies clarity on capital allocation and additional firepower to do large scale transactions. Additionally, because interest rates are still low, but have started to rise, companies feel a sense of urgency to act now before they miss the opportunity. In the first half of 2018, there was no lack of corporate transaction news in our portfolio.

From pharmaceuticals…

In early May, it was announced that the board of Shire, a major pharmaceutical company in which we invest, would recommend the proposed takeover by Takeda, of Japan. Over the previous months of negotiation, the proposed bid had been raised several times, and another potential buyer had withdrawn. With a transaction value of about USD 80 billion, it is not only one of the largest corporate deals announced in 2018, but also stands out because the buyer, Takeda, is smaller than the target, Shire. Takeda will increase financial leverage significantly to finance the transaction, which clearly is a reflection of their risk appetite and how vital they consider the move to be. The announcement was especially satisfactory for us, as it came so soon after we had made our initial investment at the end of 2017. When we invested in Shire we saw a company that was trading at single digit price-earnings multiples, and nominally looked about 40% cheaper than its peers. The heavy discount was caused by Shire having higher leverage, and the fact that competitor Roche had seen positive testing results for a rival haemophilia medicine. We thought this discount was unjustified. Shire's very strong cash flow generation reassured us about their debt burden, while we felt their haemophilia franchise was well protected by its diversity, and the fact that stability is important for haemophilia patients, so there is limited incentive for them to swap treatments. Besides, Shire had a much broader product portfolio than haemophilia alone, and considering the value we saw in those other products, our analysis suggested the share price at that point basically assumed zero value for the haemophilia franchise. Of course, we did not anticipate that Takeda would knock at the door so soon, but we were confident that sooner or later, either the stock market or a corporate buyer would recognize that Shire's discounted valuation was simply too low to fairly reflect its long-term value. Like many investment cases that went well, with hindsight it seems simple: if traditional, conservative valuation work suggests a major discount, sooner or later the market will reward you.

…to groceries…

More significant for the portfolio return however, was the announcement of a merger in UK supermarkets, in which Sainsbury's would buy Asda from Walmart. We see the merger of the second and third largest players in the English grocery market as a defensive move to create scale and generate significant synergies. It is in response to the more challenging environment in the UK in recent years, from somewhat weak consumption, increased competition from Lidl and Aldi and an emerging online threat from Amazon. The combined company will be the market leader, creating significant purchasing benefits. Perhaps more important than this, it opens a way for Sainsbury to roll out its successful online Argos platform. Argos is one of the most visited retail websites in the UK, with pick-up locations in Sainsbury's supermarkets. Through this acquisition, it will now get a nationwide network, which is a major competitive advantage for the online business. Finally, we like the structure of this transaction. Asda is merged into the new company at attractive multiples, while Walmart shares the benefits by becoming the largest shareholder in Sainsbury's. By doing so, Sainsbury's can also benefit from best practices of Walmart and it might even open global opportunities for the Argos online model. Sainsbury's shares have responded well to this transaction and gained 36% during the quarter making it one of the largest contributors to overall performance.

… to memory chips

We invested in Micron Technology, a US based maker of memory chips, in the spring of 2015. The company was almost debt free and traded at an EV/EBITDA multiple of 5.4x and a Price-Earnings multiple of 8.9x. The company came at low valuations, partly because the industry has a history of tough competition and vicious business cycles – but at this point, the industry had consolidated significantly. We saw similarities with Western Digital that we had held between 2011 and 2014, where consolidation of the hard disk industry had led to significantly improved earnings power for Western Digital, and attractive investment returns.

In the case of Micron, we thought that days of overinvestment and weak pricing discipline for the industry would be over as the global financial crisis had forced the industry to consolidate into three remaining players: Samsung, SK Hynix and Micron. This struck us a significant development, and in fact, across our value strategies, we have had investments in all three companies. Micron had played a crucial role in this consolidation wave by acquiring memory chip operations out of bankruptcy, from Europe-based Infineon and Japan-based Elpida. In fact, as the only non-Korean player, it was often favored to buy these assets at highly attractive conditions. Soon after we invested our thesis was tested somewhat, as short term earnings worsened on the back of lower memory prices. This time, however, it was only a few quarters of oversupply and the downturn was not as severe as previous cycles. As a result, it did not result in huge losses or balance sheet stress. Micron's response was the same as before: it acquired Inotera from Taiwan, helping to reduce industry capacity and restore selling prices. Also, its competitors refrained from large capital investment programs, and prices for memory chips started to improve from the end of 2016 onwards.

During 2017, this resulted in a continuous stream of positive earnings revisions for Micron. In December 2016, earningsper-share expectations had been about USD 2. By April 2018, they had increased to USD 11. It will not surprise you to hear that Micron shares appreciated significantly. The dramatic increase in earnings expectations also shows how difficult it is to predict earnings in this industry. Only a slight change in the supply-demand balance can be the tipping point for very significant changes in short term earnings expectations. In early 2018, we started to see the first price declines for NAND memory chips and given Micron's relatively high exposure to this segment, we decided to re-evaluate our investment case. At the moment of writing the earnings outlook for Micron is still very strong. Consensus earnings for the next two or three years are expected to stay flat at a very high level. Although the earnings cyclicality in this industry has been significantly reduced, we think the current consensus of earnings estimates may be a little too optimistic. Therefore, we decided to take profits and reinvest the proceeds in some less cyclical IT companies, like Oracle and IBM.

Long-term investments, long-term thinking

One clear trend in the industry is an increasing focus on investing responsibly, and the ways in which investors approach environmental, social, and governance (ESG) issues in their work. This suits us well. We make long-term investments, which goes hand-in-hand with long-term thinking. When we analyse companies, it is important for us understand the business model, its sensitivities, and how it evolves over the years and across changing operating landscapes: we need to consider its sustainability. Obviously many environmental, social and governance issues can be short-term in nature, but the longer your investment horizon, the more potential for them to seriously impact corporate value and investment returns. This thinking is reflected throughout our investment process: from where we screen for value in the markets, to how we shortlist companies for detailed analysis, to the topics we consider in that analysis. We factor ESG considerations into our assumptions in corporate valuations, our internal discussions of investment ideas, our portfolio construction, and our communication with our holdings. However, as with any aspect of our investment strategy, we strive to keep refining our processes and building our knowledge.

One area which we think is of increasing importance is cybersecurity. Companies face an ever-growing threat level, and cybersecurity breaches can lead to financial losses, and significant damage both to corporate reputation and long-term value. They need to have robust systems and processes to mitigate these risks. As investors, this is clearly something we need to consider in our analysis of the companies in which we invest. At Sparinvest, as part of our efforts, we are participating in a collaborative engagement project, spearheaded by the Principles for Responsible Investment. Roughly fifty institutional investors are combining resources to address cybersecurity risk in sixty companies in industries where it is of crucial importance: financials, IT and health care. Such engagements are always a two-way process. On one hand, as investors we aim to help listed companies understand investor expectations, and improve both their governance structures and disclosure for cyber risk. On the other hand, this is an evolving area, so it is a useful opportunity for participating investors to build expertise by exchanging knowledge both with each other and the listed companies involved. Sparinvest's role is to lead the engagement with a financial company held in our portfolios, and discussions with their senior management have commenced. The project is in its early stages, but we look forward to elaborating on its overall findings at a later date.

Outlook

At times when there is so much political noise, it can sometimes be difficult to retain focus, but we think it is at such times that it is particularly important to do so: stay concentrated on understanding the value of your holdings, and how they could react to both short-term issues, but also to long-term developments.

In the short-term, there can naturally be frustration that this year, again, growth stocks have outperformed value stocks. However, we should not forget that it was as recently as 2016 that we saw strong value outperformance, against a backdrop of decent economic figures combined with expectations for rising interest rates. While trade disputes clearly bring some uncertainty now, the underlying picture is not so dramatically different: the global economic outlook remains on a positive note, and mild uplift in inflationary pressures could be a net positive for value. Moreover, value stocks trade at a significant discount to growth stocks, some of which are extremely expensive now. Many investors have been willing to pay up for faster growing companies, in a slow growth, low interest rate economy. Many growth stocks are currently trading at an earnings yield of 2%, compared to a 10-year Treasury yield of 2,9%. While there is political uncertainty, investors can find such stocks tempting, but from a medium-to long-term perspective, we find it difficult to see those numbers as attractive.

One should remember that things can change quickly, and value exposure is a prudent form of diversification in portfolios. It is hard to say that markets will turn to value now, but we are coming out of a special period of quantitative easing and low rates, and entering some form of normalization. If the growth in the global economy will stay clear of major setbacks caused by tariffs on international trade, and there will be some kind of "spam filter" on the political messages sent by Trump, we could see better conditions for value investing and stock picking in the coming years.

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The aim is to help investors actively to incorporate environmental, social and governance issues into their investments.

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