Well that escalated quickly!

An update to our note 'Turning Point: Now is the Time to Switch from Growth to Value'. October 2018

The market moves of the last few days and weeks have confirmed our view that the long awaited rotation from growth to value is underway.

As we stated in our note from June 'when a regime change from growth to value occurs, the moves are sudden and violent and hence investors need to position themselves ahead of the event'. As this process now appears to have started, we believe there is even more urgency for investors who are over exposed to growth stocks to begin the process of allocating towards value. In our view, this could be one of the biggest investment opportunities for years.

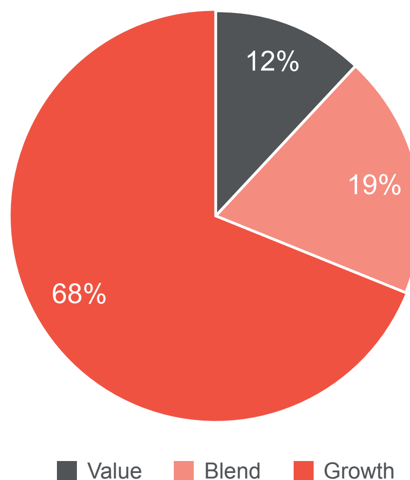
A reminder of what we were saying in June

We pointed out that growth had now outperformed value for ten years and put forward several theories for why this might have happened.

- Ten years of falling interest rates had favoured long duration assets (growth stocks) over short duration assets (value stocks).
- In a world of secular stagnation, growth becomes a rare commodity and is more highly valued hence growth stocks enjoyed a huge re-rating.
- An overwhelming belief in the disrupters (Amazon) over the disrupted (Retailers) meant the former types of stocks rose dramatically.
- A flood of money in to passive ETFs which have large exposure to the FANGMAN stocks.

We then highlighted that these trends had created a potentially dangerous imbalance in the UK fund management sector where nearly 70% of funds were being run with a growth style compared to only 12% with a value style (see chart below).

FIGURE 1
UK Equity Funds



Value Blend Growth

Source: RWC/Bloomberg

Finally, we put forward a view that this outperformance of growth over value might be about to change as the factors that had caused it started to go in to reverse. Specifically, we noted the Federal Reserve's determination to keep raising interest rates whilst simultaneously reversing quantitative easing and the fact that the ECB were also tapering their asset purchases.

It seemed likely that this could be the catalyst for a regime change that even in June, had already started to show signs of starting. Our view was that with nearly 70% of funds being managed to a growth style, there was potential for instability in the market (in the same way that all the passengers rushing from one side of a boat to another causes).

No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.

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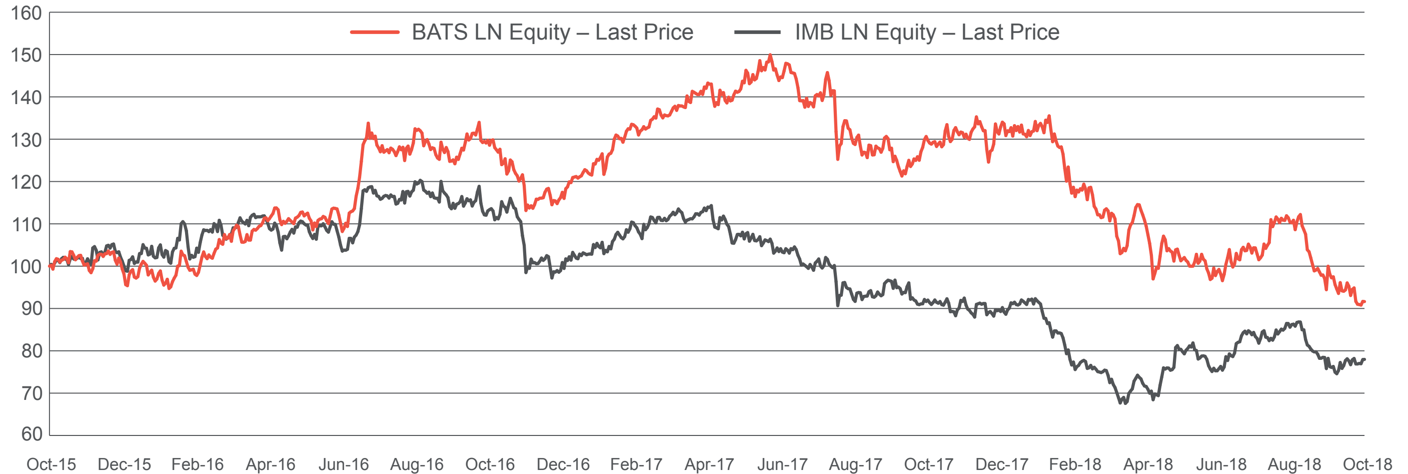
How has the market responded?

There are several fascinating/contradictory things going on at the same time.

1. **The classic bond proxies have continued to decline**
   As we highlighted in our note, many consumer staple companies had enjoyed a huge re-rating in the last few years despite deteriorating fundamentals. The market has belatedly woken up to this with stocks like BAT and Imperial Brands losing over a third of their value in the last year.

FIGURE 3
Tobacco stocks have performed poorly



Source: Bloomberg, 12 October 2015 - 11 October 2018

2. **Growth stocks started to decline**
   Secondly, the market had started to de-rate growth stocks but this process appeared to go in to overdrive in the last week. This is probably best represented by the performance of the big technology companies as shown in the table below.

Company	Price decline in last five days	Price decline from high	Price increase in last twelve months
Facebook	-7%	-30%	-12%
Amazon	-10%	-14%	+76%
Netflix	-14%	-22%	+67%
Google	-10%	-15%	+9%
Apple	-8%	-7%	+40%
Nvidia	-14%	-15%	+29%
Baidu	-10%	-32%	-25%
Alibaba	-15%	-35%	-25%
Tencent	-14%	-44%	-24%

Source: Bloomberg. All prices in USD at close on 10 October 2018

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Despite the recent price declines, it is worth noting that most technology stocks are still up substantially over the last twelve months and sporting very fancy valuations. Even after their recent declines, Netflix trades on a P/E of 122x and Amazon a P/E of 100x.

It is also worth highlighting that this is not something that is confined to US technology stocks. In the UK, some of the growth darlings that have led the market in the last few years have recently dropped like a stone. In the first ten days of October, the engineering company Halma has lost a fifth of its value (see chart below).

FIGURE 4

Halma

Source: Bloomberg, 20 September 2017 - 11 October 2018

Whilst Burberry has lost nearly 30% since the start of September.

FIGURE 5

Burberry Share Price

Source: Bloomberg, 20 September 2017 - 11 October 2018

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These are far from isolated examples as the table below shows. The market seems to be drastically reappraising the valuation that it is willing to pay for growth stocks.

Company	Five day price change
Melrose	-15%
Hargreaves Lansdown	-15%
Croda	-15%
Ashtead	-15%
Scottish Mortgage Investment Trust	-16%
Aston Martin	-20%

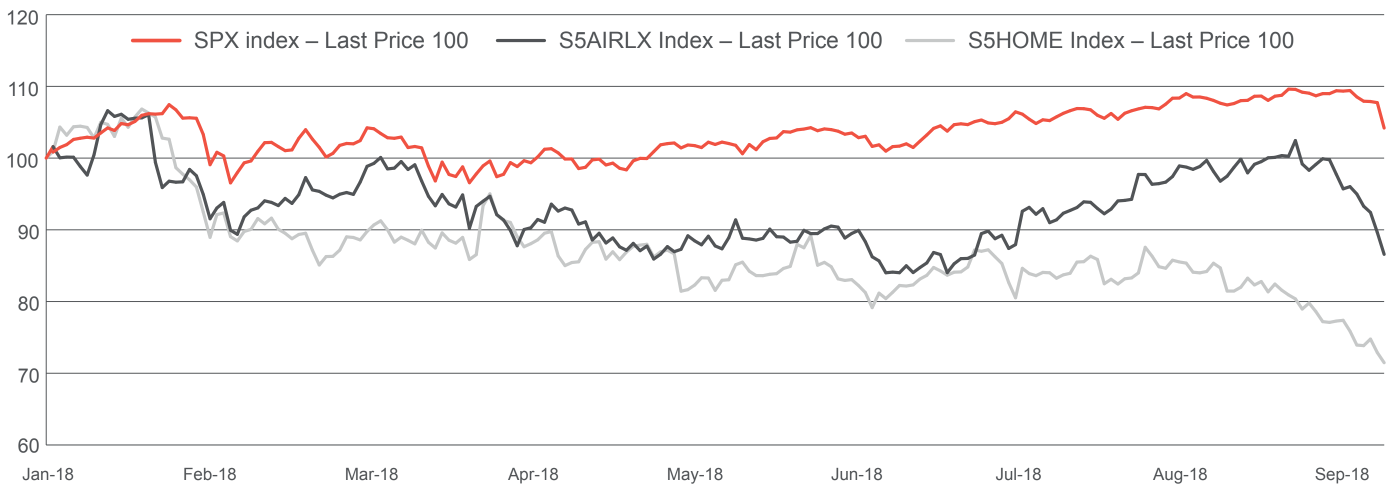
Source: Bloomberg. All prices in USD at close on 10 October 2018

After ten years of outperformance from growth stocks, we feel it is unlikely that the rotation back to value will only last five days. Indeed we think it is more likely that this is the start of a multi-year phase of significant value outperformance.

3. But at the same time cyclicals have been weak

FIGURE 6

Cyclicals have been weak



Source: Bloomberg, 29 December 2017 - 10 October 2018

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Strangely, the market seems to be simultaneously trying to price in the risk of an economic downturn. The chart above shows how weak US housebuilders and airlines have been this year. Given the rhetoric about the strength of the US economy, this seems counter intuitive until one considers the impact that rising interest rates, rising energy costs, dollar strength, weakening demand from China and the one off benefits of the tax cut starting to roll off.

This is also true in the UK where cyclical companies such as Hays have also been very weak, losing nearly a quarter of their value in the first ten days of October.

FIGURE 7

Hays share price

Source: Bloomberg, 20 September 2017 - 11 October 2018

It is also notable that housebuilders have been very weak in the UK with Barratt Developments down 20% year to date and Taylor Wimpey down 18% over the same period. For whatever reason, the market currently seems worried that an economic slowdown may not that be far away and is starting to price this in to cyclical companies.

Conversely, value as a style has notably begun to perform much better. As investors have rushed to exit growth and cyclical stocks in the last five days, they appear to have been rotating in to domestically focused value stocks judging by the share price performance.

Conclusion

As we wrote our Quarterly letter in June, we knew that value as a style had been out of favour for nearly a decade and that the valuations of growth stocks had reached levels previously only witnessed at the top of the TMT bubble. What we had no idea about, was when the rotation from growth back to value would begin nor what the catalyst would be to start it. We often feel that the best analogy in these circumstances is that of a stretched elastic band which sooner or later will snap back; it feels as if we are now past that point. Investors who have high exposure to growth should act swiftly to re-balance in order to benefit from the gains that we feel are likely to come from value investing over the next few years.

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Portfolio Managers

Ian Lance, Nick Purves and John Teahan have managed funds together for over 10 years. Their loyalty and experience is leading within the industry and has awarded them a number of accolades. Ian, Nick and John joined RWC Partners in 2010 to establish the Equity Income team and now manage c. £3 billion for their clients.

The team's approach fully integrates conviction led, value-based stock selection with a distinctive and technical approach to stablising assets, with the aim of delivering investment solutions that both grow investors' assets and protect the purchasing power of capital and income.

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