9 Questions on Value Investing

RWC Equity Income
Value Opportunities Today

Q: Why has value done so badly for the last few years?
We can only hazard a guess but I suspect a large part of the answer is the environment that we have been in of falling interest rates and quantitative easing. From a mathematical point of view this favours long duration assets (growth stocks) over short duration assets (value stocks). It has also encouraged risk-on or speculative behaviour because there is a belief in the central bank put (that any decline in markets will be backstopped by central bank intervention). If this is the case and the market will only go up, it is logical to own the highest beta stocks to benefit (of course we don’t subscribe to this view). Finally, the sluggish economic recovery has meant that many stocks have struggled to show any growth and those that have been able to grow, have become higher rated.

Q: Won’t value do badly in a downturn? Surely I am better to sit in my quality growth stocks and wait for the market to hit bottom at which point, I will switch in to beaten up value stocks?
The assumption about value stocks doing worse in a downturn is not necessarily correct as we have always outperformed a market decline. It may be right to say deep value/recovery funds tend to fall faster in a market decline but then rise more during the recovery, but that is certainly not the case historically for us. Finally, it is not a given that so called ‘quality’ stocks will do better in a down turn as their start point is being hideously over-valued. Tobacco stocks were the classic ‘quality compounders’ but last year many of them halved because they were over-earning, over-valued and over leveraged. We expect to see more examples of these types of quality defensives failing to live up to expectations in the future.

Q: What will be the catalyst to turn this cycle particularly now it looks like interest rates have peaked?
The honest answer to this is that we don’t know and often there is no particular catalyst. In 2000, there was no defining event that caused the NASDAQ to roll over, it was just a case of valuations becoming so ridiculous that eventually you run out of new buyers and suddenly sellers exceed buyers. At this point, lots of holders of the stocks know the prices are not supported by fundamentals and decide to panic out. They then discover there are no buyers on the other side/lack of liquidity and prices start to spiral down leading to more selling pressure. I am not predicting that this is about to happen but merely pointing out that the conditions existing today are similar to those that existed in 2000 in terms of valuations.

Q: So when should I switch from quality in to value?
We would really encourage investors to stop thinking about ‘quality’ being a subset of shares (consumer staples, technology) and value being another (banks, retailers and miners). As we continuously say, quality is the attribute of the business you are buying, value is the price you are paying. There have been times when consumer staple stocks were cheap and we bought them (Unilever on a P/E of 13x five years ago) and there are times when banks are expensive (Barclays, RBS, Lloyds in 2006-2007). What we do is migrate to where good value is in the market as historically that produces the greater returns. What most fund managers are doing today is only looking at perceived quality and ignoring price. Just recently this has worked but historically it hasn’t. To a certain extent, this is a matter of common sense – do you think that buying the same stocks that everyone else loves is going to generate a decent return in the long run.

No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.
Q: Does technological disruption mean that value investing is dead?

It is worth re-stating that value investing is the process by which you buy something for less than its worth, whether it’s a share, a house, a painting or something else. That is never going to die.

What we can say, however, is that historically, a naïve value strategy of just buying a load of beaten up companies and waiting for the forces of mean reversion to get to work was quite effective. Globalisation and technological disruption have meant that in some cases, mean reversion does not happen e.g. the number of retailers that have gone bust in part because of the entry of Amazon into the market. We spoke about this at the London Value Investing Conference and how we have adapted our process over time to put more focus on researching whether the company’s business model was still robust and not in structural decline as well as ensuring they had a strong enough balance sheet to make it through any downturn. I think this partly explains why our value funds have done so much better than the value index in recent years.

Q: Aren’t there some businesses which are just so dominant that valuation is almost irrelevant?

Whilst there are some businesses that look expensive in their early years this does not stop the share price increasing as the profits grow (Amazon for instance), they tend to be the exception rather than the rule. There are few, if any, investors who can identify these types of businesses in advance and history is littered with examples of companies which failed to live up to their potential e.g. the Nifty Fifty stocks or the Fortune list of stocks to own forever in 2000 which included companies like Enron. In addition, a good business is not always a good investment. Microsoft in 2000 was an incredible business and its earnings per share grew by over 170% in the next decade. If you bought the shares in 2000, however, you had to wait for fourteen years to get your money back – simply because the starting valuation was way too high. We believe that certain investors are making this mistake today and locking in a poor return from what might be good businesses by over-paying for them.

Q: The Federal Reserve look like they are about to cut rates, that should be good for growth stocks shouldn’t it?

As mentioned earlier, mathematically it can be demonstrated that growth stocks should benefit from a reduction in the discount rate as they are long duration assets. In practice, however, things are rarely this simple. Cuts in interest rates are frequently associated with an economic downturn which is rarely good for equities. The Fed were cutting interest rates aggressively in 2001 when NASDAQ lost two thirds of its value and again in 2008-2009 when the US stock market halved. Reasonable quality but lowly valued businesses often fare better in this environment and much of our outperformance has come during these periods. Conversely, stocks where valuation had become disconnected from fundamentals can fall the hardest as momentum investors try to get out of them at the same time.

Q: Do you think the dispersion between growth and value is as wide as it was back in 1999?

It certainly feels like it and there are lots of things we observe today that are very reminiscent of 1999. Just like then, there are certain stocks which are so loved by the market that it seems no valuation is too high and others that are so hated that no valuation is too low. One example of the former is Diageo where, incredibly, the share price has increased by more than the NASDAQ index in the last three years (which itself has been no slouch). As the chart below shows, this stock traded on an average price to sales multiple through the two decades from 1990-2010 of 2.6x but now trades on 6.2x and still rising.

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Conversely an example of a stock so hated that no valuation is too low is Standard Chartered Bank. This is a stock that as recently as 2010 traded at 3x its tangible book value although had previously had traded much higher (see chart below). Today at a little over half its tangible book, no-one want to know.

This bifurcation is repeated right across the market and has led to a similar spread between the valuation of growth stocks and value stocks as existed in 1999 as the chart below demonstrates. Just like 1999, virtually nobody seems to care about this spread judging by the huge flows of money going in to growth funds right now. This point is worth stressing, in a market with the widest spread between value and growth stocks for nearly fifty years, investors are selling the cheap ones to buy the expensive ones.

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Q: So should I switch all of my growth exposure to value right now?

No. Firstly, that’s your decision but secondly, I am merely highlighting the fact that some incredible value opportunities are currently available and that investors should try to capture them. It feels to us like the average investor may be over-exposed to growth, in many cases because of the style drift of their fund manager. A prudent strategy could well be to re-balance back towards value, particularly given where relative valuations are today.

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