Time to be Contrarian

Weekly Digest

19 February **2018**

– Andrew Hardy, CFA

Notwithstanding the recent volatility in markets, high growth stocks have continued to outperform in early 2018 as they did throughout last year. The widely referenced 'growth' and 'value' style indices are flawed but represent the trend nonetheless, while the returns of actively managed aggressive growth strategies drive the point home. On any measure the 'value' style has endured a decade of underperformance, despite a brief revival in 2016. Our portfolios have benefited from a balanced exposure across different styles, indeed our most widely held global growth manager outperformed by over 20% last year, but we are now increasingly tilting towards value stocks. Broad market level valuation multiples perhaps suggest there is limited upside left in equity markets, but a focused portfolio of value stocks presents a very different picture.

The so-called 'FANG' grouping (Facebook, Amazon, Netflix, Google) represents some of the most widely held high growth stocks in America. Since the start of 2015 Facebook and Google have returned 3-4x the global equity return of 32.4%, while Amazon and Netflix have delivered 11x and 14x that return! Similar observations could be made in other markets outside of the US, particularly in Asia where the trend has been arguably even more extreme. The bull points for these stocks are clear for all to see but as Warren Buffett famously said "you pay a very high price in the stock market for a cheery consensus".

These large but concentrated moves distort market level metrics somewhat and disguise value left in other areas. One way we analyse this is through value spreads - a measure that looks at how discounted the cheapest quintile of global stocks is compared to the long run average discount. On this measure value stocks have not been this cheap since the dot com bubble. That's not to say we believe growth stocks are close to bubble territory, unlike 20 years ago their high valuations are mostly supported by strong and growing earnings and cash flows, but rather the dispersion in valuations is evidently high.

'Value' has appeared cheap for several years, however. One potential trigger for a turnaround could come in the form of rising interest rates. High growth stocks are effectively longer duration investments, as much of their earnings potential is in the distant future, hence valuation estimates should be more vulnerable to higher discount rate assumptions. Traditional 'value' sectors such as financials would benefit directly from higher earnings as a result of rising interest rates, while more cyclical sectors (e.g. energy, materials or consumer discretionary) may benefit disproportionately in the stronger economic environment that justifies rising interest rates.

Value investing does not necessarily mean buying low quality companies; first and foremost it is about investing in businesses that are priced below their intrinsic value. It generally requires a contrarian and long-term mindset in order to capitalise on the emotional behaviour of other investors. Although sector and country tilts will be key drivers of the performance of value portfolios going forward, opportunities abound for managers that are willing to dig deeper to find specific companies that are mispriced versus their future potential. A willingness to back these ideas with conviction in a focused portfolio constructed without reference to benchmarks is a key attribute we look for among the best value managers.

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The **Marketplace**

- Brent crude was up 3.3% % to $65 a barrel
- Gold rose by 3.1% to 1353.7
- Global equity indices extend rebound, treasuries fall
- Bitcoin advances 50% since early February to nearly $11,000

Market **Focus**

US

- The Dow Jones rose 4.3% finishing the week at 25219. US stocks more broadly were up 2.5% year to date, back on the course set since mid-2017
- US 10 year treasury yields topped 2.9% last week
- The NASDAQ was up 5.6% to 6770.6
- CPI rose 0.5% in January beating estimates of 0.3%. Core PPI rose 0.4% with healthcare leading -both symptomatic of rising inflation
- The S&P index rose 4.3% to 2732.2 led by strong performances in tech and utility stocks: Its best week in five years

UK

- Signs of struggle in various sectors of the UK retail sector, particularly food and home improvement
- The FTSE finished the week up 2.9% at 7294.7
- UK house prices rose 0.8% in February from January. That is below the ten year average. The London market continued its downward trend with prices falling by 1% over the last year
- Boris Johnson attempts to extend an olive branch to Remain voters in a speech with mixed results

Europe

- Jobless rates in France fell to their lowest level in nine years, standing at 9.6%
- Signs that the upcoming Italian elections could result in the status quo as the prospective centre right coalition unravels- The current PM would then stay on
- The governor of Latvia's central bank has been detained by authorities on potential ties to North Korea. He also sits as a member of the ECB
- The Stoxx 600 index rose 3.3% to 3426.8 on the back of gains in materials and tech stocks

Asia

- The South African Rand gained on the back of Thursday's resignation of Jacob Zuma to its strongest level in three years. It rose 4.5% against the dollar on the week
- The Hang Seng had its best run in over two years finishing the week up 5.5% to 31116
- The Nikkei fell -0.8% to 21720 though Japanese trade data looks strong in value and volume of imports and exports

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 16 Feb. 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	4.4%	-3.1%	2.4%	18.0%
United Kingdom	GBP	3.2%	-2.8%	-4.7%	3.9%
Continental Europe	EUR	3.4%	-3.7%	-1.3%	7.3%
Japan	JPY	0.3%	-5.4%	-4.4%	14.4%
Asia Pacific (ex Japan)	USD	4.0%	-5.0%	1.3%	26.6%
Australia	AUD	1.4%	-1.9%	-2.4%	6.3%
Global	USD	4.3%	-3.3%	1.8%	18.6%
Emerging markets equities					
Emerging Europe	USD	5.4%	-2.7%	7.2%	24.1%
Emerging Asia	USD	4.3%	-5.4%	2.1%	32.8%
Emerging Latin America	USD	5.7%	-2.4%	10.4%	20.0%
BRICs	USD	5.7%	-5.0%	5.9%	34.7%
MENA countries	USD	1.1%	-1.3%	3.9%	1.4%
South Africa	USD	11.9%	2.9%	5.8%	33.3%
India	USD	0.1%	-6.2%	-1.4%	25.8%
Global emerging markets	USD	5.0%	-4.3%	3.7%	29.7%
Bonds					
US Treasuries	USD	-0.3%	-0.9%	-2.3%	-0.1%
US Treasuries (inflation protected)	USD	0.0%	-1.3%	-2.2%	0.3%
US Corporate (investment grade)	USD	-0.2%	-1.6%	-2.5%	3.2%
US High Yield	USD	0.8%	-1.1%	-0.5%	4.7%
UK Gilts	GBP	0.0%	-0.5%	-2.6%	-0.1%
UK Corporate (investment grade)	GBP	-0.1%	-1.4%	-2.3%	2.4%
Euro Government Bonds	EUR	0.1%	0.0%	-0.4%	1.5%
Euro Corporate (investment grade)	EUR	0.1%	-0.2%	-0.5%	2.0%
Euro High Yield	EUR	0.1%	-0.7%	-0.3%	5.0%
Japanese Government	JPY	0.2%	0.3%	0.1%	1.3%
Australian Government	AUD	-0.2%	-0.4%	-0.9%	2.5%
Global Government Bonds	USD	1.1%	0.0%	1.4%	7.8%
Global Bonds	USD	0.9%	-0.3%	0.8%	7.7%
Global Convertible Bonds	USD	2.6%	-1.1%	2.5%	9.1%
Emerging Market Bonds	USD	1.1%	-1.9%	-2.4%	2.9%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 16 Feb. 2018	Month to date	YTD 2018	12 months
Property					
US Property Securities	USD	1.4%	-5.3%	-9.3%	-7.0%
Australian Property Securities	AUD	-1.1%	-5.4%	-8.6%	-5.9%
Asia Property Securities	USD	3.3%	-6.8%	0.2%	18.8%
Global Property Securities	USD	2.6%	-5.3%	-4.2%	7.7%
Currencies					
Euro	USD	1.9%	0.2%	3.5%	16.8%
UK Pound Sterling	USD	1.9%	-1.0%	3.8%	12.6%
Japanese Yen	USD	2.2%	3.1%	6.1%	6.9%
Australian Dollar	USD	1.8%	-1.6%	1.4%	2.9%
South African Rand	USD	4.5%	2.6%	6.9%	12.4%
Swiss Franc	USD	1.5%	0.8%	5.2%	8.0%
Chinese Yuan	USD	-0.8%	-0.9%	2.6%	8.0%
Commodities & Alternatives					
Commodities	USD	2.9%	-2.0%	1.2%	4.1%
Agricultural Commodities	USD	1.3%	0.9%	2.9%	-6.3%
Oil	USD	3.3%	-6.1%	-3.0%	16.5%
Gold	USD	3.1%	1.0%	3.6%	9.3%
Hedge funds	USD	1.4%	-1.2%	1.2%	5.5%

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Important notes