Focus

ECP European Value strategy: outlook & positioning

February 2018

Market environment & outlook

An environment driven by exceptionally low interest rates and volatility levels

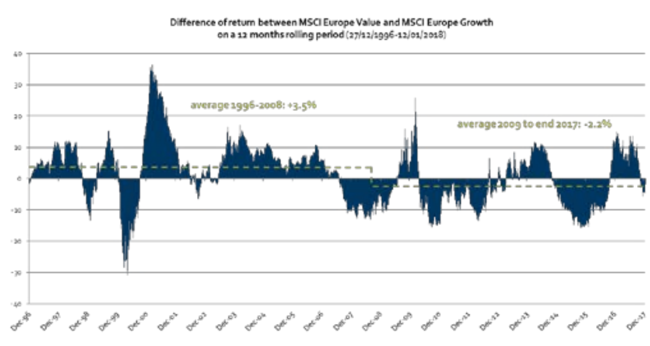
The market environment in which we are all working is exceptional in many ways.

Since nearly 20 years, interest rates have been going consistently down with the consequence that the majority of professional investors have spent their entire investing career in a low rate environment.
This trend has accelerated since 2008 as we have experienced the greatest monetary policy experiment of all-time leading interest rates at even lower levels. Hence 10-year rates of German government bonds went down from nearly 7% end of March 1989 to 3% end of December 2007 and dropped even lower with 0.43% by end of 2017.

This particular environment has a direct impact on the trends we are currently witnessing on the European stock markets:

1/ "Value" investment strategies are still out of favour.

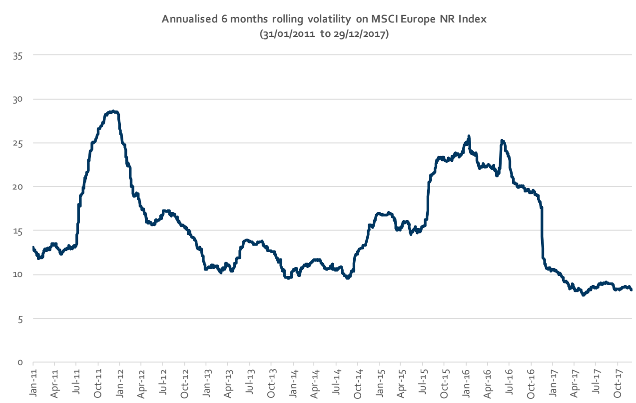
This backlash stems from the financial crisis that initiated in 2007-2008 and from the subsequent introduction by central banks of ultra-accommodative monetary policies.



Source: Bloomberg, data from 27/12/1996 to 12/01/2018. Please note that past performance is no indication for future performance.

The year 2017 did not escape the rule with a market primarily driven by growth and momentum stocks where valuation did not represent a relevant investment criterion.
This behaviour is, after all, quite logic in the sense that growth stocks are "longer duration" while value stocks are "shorter duration". And in an environment of falling interest rates *Mr. Market* has now for 10 years preferred the long duration growth stocks. This is the case in Europe as well in the US. The performance difference is clear: MSCI Europe Growth has returned 68% since 2007. MSCI Europe Value has returned only 26%.
However, in a normalising interest rate environment MSCI Europe Value may fight back.

2/ The volatility of European equity markets is low and 2017 has seen a sharp drop in volatility which is now at historically low levels.



Source: Bloomberg.

As stated rightly by Andrew Lapthorne in a recent SG note, if there is no evidence that a period of very low volatility leads to a higher likelihood of a market sell-off, prolonged periods of high asset price confidence inevitably lead to excesses due to the positive feedback integrated into many risk models that tend to favour riskier assets in time of low volatility.

Our view is that the current volatility of the European equity markets has nothing to do with the actual underlying risks related to investing in stock markets.
These low levels are therefore not sustainable and volatility should, sooner or later, increase.

Thus, the key challenge for the markets in 2018 will be to absorb even a mild increase in volatility, given expectations of changes in monetary policy.

Based on this observation, we continue to focus on the analysis of fundamentals and to seek quality companies based on the same criteria: how much sustainable cash flow / earnings power does the company have? And then how much do we have to pay to get access to this earnings power?

At the same time, as we think, volatility will somewhat come back and monetary policies will progressively tighten, **value strategies should benefit again from a more favourable environment and proved their added value.**

Economic growth, earnings outlook and valuations act as supportive factors for the European stock market

From a macroeconomic perspective, the climate in Europe seems rather favourable with a consolidation of economic growth which has (finally) resulted in an increase in companies' earnings.

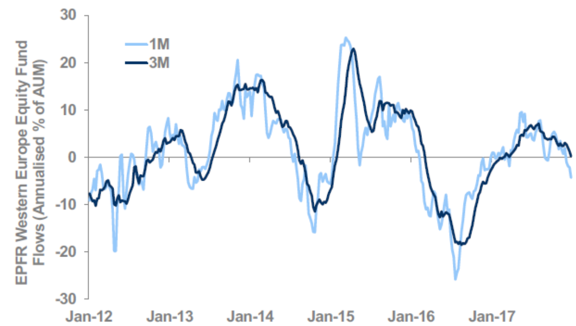
- Eurozone EPS Growth vs. GDP Growth -

Source: IBES, JP Morgan – JP Morgan report, Europe Year ahead 2018, p.10

Moreover, if they cannot be considered as particularly cheap, the valuations of European corporates remain below their historical average and above all are still more attractive than what is currently in force on the US market. 2018 P/E for European stocks is 15,5x where it is 18,4x for US companies. However, European companies are expected to have a significant higher growth rate.

Last but not least, as an asset class, European equities are still largely under owned by investors who seem to still underestimate the improvement of the European economic framework; we therefore are entitled to expect a catch-up in net flows in European equities.

Exhibit 9: By contrast, European equity funds saw an acceleration in outflows towards the end of last year



Source: EPFR, Morgan Stanley Research. Note: The EPFR data and charts displayed here must not be extracted and republished (whether internally or externally). Such use will violate the terms of Morgan Stanley's contract with EPFR which only covers named users.

Where are the risks?

The main cloud in the picture is in our opinion, the **strengthening of the euro against the US dollar** which should not abate in the coming months and **is a latent threat for European exporting companies.**

Our approach considers currency fluctuations as being part of the business operating environment. Especially, those companies enjoying real strong competitive advantage should be able to keep it despite a slightly unfavourable currency environment.

We, however, remain vigilant and carefully integrate these aspects in our fundamental analysis process. Similarly, we monitor on a permanent basis the global exposure of our portfolio to exportation. Currently, the companies included in our portfolio sell 50% more into European markets than they do into the US market.

In addition, each exporting company develops its own strategy to counter or limit the impact of exchange rates movements. One of them being to have local production and costs in local currency.
They also have the possibility to implement financial hedges to reduce their exposure to currency risk. We simply believe the companies' management do a better job in currency hedging than we can do.

Investment cases

Next is a UK based retailer offering clothing, footwear and home products. The company was founded in the early '80s as a womenswear brand and over the years menswear, home and children wear were added to the product ranges. Next is one of the biggest clothes retailers in the UK (M&S being the first one). With GBP 4.1bn in sales and GBP 668mn operating cash flow, it is a mature company in a low growth industry.

The stock has been integrated in the portfolio in June 2017 and has done quite well since then bringing positive contribution to the yearly performance.

Source: Bloomberg.

Our initial investment case was founded on different arguments: strong cash flow generation, healthy balance sheet, good positioning to benefit from the growth of online shopping and a flexible business model thanks to advantageous leasing contracts for stores.

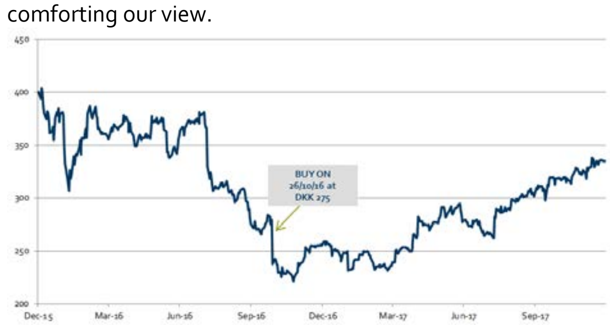
Hence, this investment case seems to be comforted by the results and guidance published. Online sales are growing both on its own and as a proportion of the total sales. On FY16/17, they were representing 41% of the sales, for FY 17/18, they are now expecting to represent 45.5%. In the meantime, more than 50% of leasing contracts for retail shops will expire in a relatively short time while the new lease agreement should be around 25% cheaper benefiting from falling leasing rates. This provides higher strategic flexibility for the company as consumers are increasingly shopping online.

During the last quarter of 2017, the stock suffered from some profit takings due to its sharp rise in the third quarter but its stock price stabilised rapidly. We remain fully confident in our investment case and in the ability of Next to maintain a sustainable high cash flow generation.

During a long time, the Danish pharmaceutical *company* ***Novo Nordisk*** has been viewed by investors as a high-growth company. When its growth rate started to slow down, investors overreacted leading the company to be priced as it was an ex-growth company without considering the still solid fundamentals.
Simultaneously, the stock suffered from some price pressures and pre-US elections fears.
This pessimistic environment created an attractive entry point in this company which is highly cash generative and has a bullet proof balance sheet.

Our initial investment case was mainly build around the key competitive advantage of Novo Nordisk which is market leader in diabetes treatment and has been able to extend its expertise in the treatment of obesity. Both diseases being considered as major public health issues of the coming years.

Since we initiated the position end of October 2016 to end of December 2017, the stock price increased by 21.64% comforting our view.



Source: Bloomberg.

Hence, if the market was still quite pessimistic end of 2016, the stock price recovered progressively when investors adjusted their models to Novo Nordisk considering that it was still able to deliver growth even if at a slower pace than before.

Moreover, the company increased its guidance for both growth and profitability underlying its strong positioning not only in the diabetes market but also on the much bigger obesity market which is heavily underpenetrated (600 million people having obesity vs. 425 million with diabetes while only 2% of obese persons are currently under treatment). While the health care sector to a large extent has not (yet) recognized obesity as a disease the global obesity challenges have not diminished. In the US alone it is estimated that 35% of adults suffer from obesity. For children the figure is 17% which is 3 times higher than just one generation ago.