«The undisputable growth and success of ETFs does not mean active managers are a dying species»

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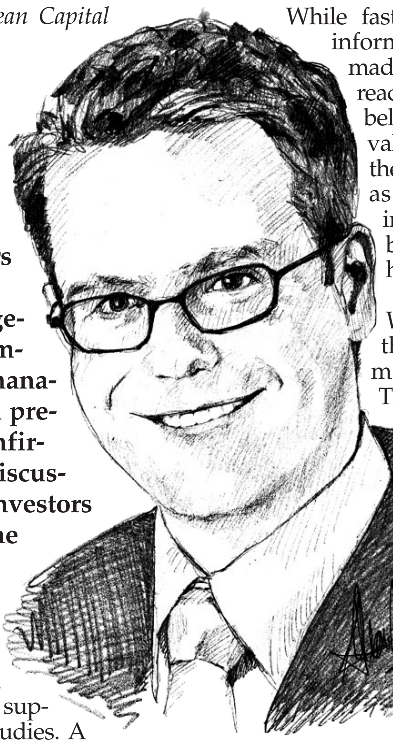

Mark Twain once said: "all rumors of my death have been greatly exaggerated". We at European Capital Partners ('ECP') believe that fits very well to active management. Many investors combine active and passive managers when deploying and preserving capital as was confirmed through our many discussions with institutional investors and family offices over the last months.

The undisputable growth and success of ETFs does not mean active managers are a dying species! This view is supported by many academic studies. A recent research on the subject paper by Martijn Cremers (University of Notre-Dame) and Ankur Pareek (Rutgers University), is again making the case: US Funds with high Active Share portfolios – whose holdings differ substantially from their benchmark – and patient investment strategies with long holding periods tend to outperform. Active management is well alive and we do believe in it at ECP.

Inside the active space, ***value investors*** appear to be particularly out of favor both in the US and in Europe. MSCI Europe Value has underperformed MSCI Europe Growth by 14% in 2015. In the US, the underperformance has been higher and going on for longer with MSCI US Value underperforming by 24% since 2011.

On the day this article is written, Warren Buffet makes it to the front page of the Financial Times as his investment vehicle Berkshire Hathaway is heading for its worst year relative to the stock market since 2009. The search term "death of value investing" currently yields more than 2 million results on Google.

So is value investing, the investment strategy with roots back to Benjamin Graham in the 30's, really dying or dead?

We strongly believe that is not the case.

There is impeccable academic evidence supporting the long-term track record of value investing. The so-called «value premium" is well documented. There is less research for the European equity market than for the US but studies clearly point towards an outperformance of value in the long run.

Even better, the outperformance of the value investment style was achieved at markedly lower volatility than the growth strategies. In other words, value investors slept better while enjoying better performance than their growth counterparts.

At ECP, we believe the main reason value has delivered superior returns in the long run to investors boils down to the limitations of the human intellect. While one can get all too excited about the future growth opportunities of a business, it is still extremely difficult to forecast them correctly as supported by analysis conducted by Sir M.G. Kendall in 1953 and P. A. Samuelson in 1965. Analysts have collectively been extremely bad at predicting future earnings growth of any business.

This is not surprising as they are heavily influenced by the past earnings growth of the companies they analyze while making their forecasts. This psychological bias, commonly called "*anchoring*" in behavioral finance, is all too human but unfortunately leads to wrong investment decisions. As "*past performance is not an indicator of future returns*", there is indeed no direct relationship between past earnings growth of a business and future earnings growth.

As value investors, we at ECP do not even try to forecast earnings growth but we focus on the current business of the company and the earnings power it can generate. If we can get growth for "free", that does not mean we will try to value it. Value investors' rigid investment framework enables them to be contrarian and stay out of the glamour stocks that may be "everybody's darling" while looking for promising opportunities.

While faster data processing in the information age have certainly made markets more efficient in reacting to new information, we believe these 2 anomalies that value investors exploit since the 30's are there to persist for as long as stock markets investors are human (or being programmed by humans).

What are then the reasons for the current underperformance of value investing? This is the direct consequence of the quantitative easing of central banks worldwide.

Over the past 10 years, there has been a 250% increase in the world's money supply: NEVER has there been a period in History during which the whole world was printing such a volume of money. Stock markets have been the major beneficiary of this policy and have been bullish for more than 6 ½ years.

European markets have more than doubled since their trough in March 2009. As central banks pumped money into the system and interest rates rock-bottomed, it is not a surprise that value is underperforming as easy money fuels companies with high hopes for future growth and helps those with weaker balance sheets… both of which value investors typically disregard.

The Fed interest rate hike in December 2015 may well be the starting point for correcting some of the overblown valuations. We therefore believe that the period of underperformance will come soon to an end and these corrections will trigger a return to value as an investment style focusing on finding shares trading for less than their intrinsic values.

By staying true to our value investment style all along, we at ECP have anticipated and are well positioned for this change. Not only because of our long and successful track record in European equities but also based on objective indicators making them attractive at this particular moment in time: low interest rates, a strengthening credit cycle, reasonable valuations, low commodity prices, a slow resolution of the Euro crisis and euro weakness provide ultimately a good hunting ground for stock pickers in European equities.

By stock picking, we mean identifying and selecting a limited number of business franchises able to generate strong earning power in the long run while trading at a 40% discount to their estimated fair value... within a universe of more than 1,500 European companies! One might say it is like looking for a needle in a haystack: we believe that patience is a key virtue of the value investor which motivates his investment decisions and drive his performance beyond the pressure of short-term horizon.

Our convictions applied to our investment style have translated into a return of almost 9% on European equities for our investors in 2015 despite a challenging market environment. We thank all our clients for their continued trust in value investing and in us.

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