

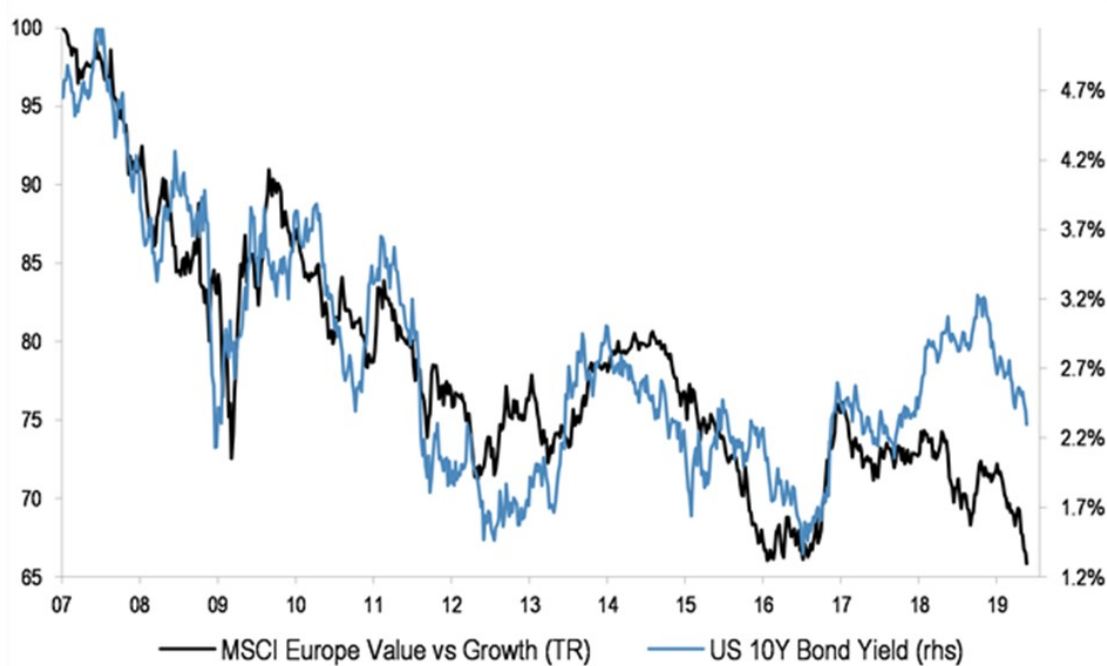


Friday Morning Coffee

Nr. 60 — Widowmakers

The investment community is known for its colourful narratives. However, we could not help but smile when we read in a recent Bloomberg article that value stocks were newly dubbed “widowmakers”. This term reminds of the paintings on the bombs mounted on fighter aircrafts before combat. Have value stocks become financial weapons of mass destruction ? The performance of value stocks in comparison to growth stocks has arguably been unimpressive since the financial crisis. However, we find the comparison largely exaggerated as it hits the headlines in the week where we celebrate the 75th anniversary of the landing of the allied troops in the Normandie, the D-Day.

Value investing, especially into European equities, has performed poorly since 2008. The performance of value is closely linked to the direction of the bond yields as shown in the graph below from JPMorgan :



Source: JPMorgan

While looking at this graph, we draw several conclusions :

- 1) As expected, growth outperforms value when interest rates are falling. With lower discount rates, growth stocks become indeed more attractive as they are long duration stocks. In addition, the value index has a higher weight in financials that suffer from the low yield environment.
- 2) Once interest rates start to increase, value makes a steep comeback. This can be clearly seen in the periods like 2009, 2013 and 2016. In Q2 and Q3 2009 for example, value outperformed growth by more than 30% in a timeframe of only 6 months !

The following note gives the opinion of the Investment team at the time of the publication. Please refer to important notice at the end of the document.



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- 3) In the latest 18 months, value has even underperformed growth more than the falling interest rates would have suggested. We do not want to read too much into this trend, but one explanation could be that growth has been an even more precious good in the stock markets in this period of economic uncertainty marked by trade tremors and political turmoil.

As the disclaimer “past performance is no guarantee for future performance” goes, we should however avoid investing for the next 4 to 5 years solely with a view into the rear mirror. The valuation gap between growth and value has now reached an extreme with European growth stocks trading at a 70% premium relative to value in terms of price-to-earnings ratio. If you believe in the concept of a reversion to the mean as we do, it is a great time to invest in value stocks. Also interest rates do not have in our opinion much leeway to continue their downward trend. At the same time, green shoots are appearing in the European economies while company earnings are growing.

Our value portfolio is not built based on traditional low P/E, low P/B multiples as the value index is. There are many companies in the value index of too low quality, so we focus instead on quality companies that actually generate solid cash flows. We buy those cash flows when they are undervalued which often happens when the business faces a temporary problem or when Mr. Market has a negative sentiment against them (which is indeed the case right now). With a median margin of safety of 38% in our portfolio the undervaluation of those cash flow streams have become quite extreme. The opportunity set currently by Mr. Market is the most interesting we have seen for many years.

Once the dust settles, value investors may well have a solid foothold on the D-Day beaches and will be ready to fight back. For our part, we own a portfolio of companies with strong balance sheets generating solid cash flows at unseen low valuations. We remain convinced that this is a better starting point and a less risky proposition for a long term investor than a portfolio of hyped growth companies with lofty valuations.

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
June 7th, 2019

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