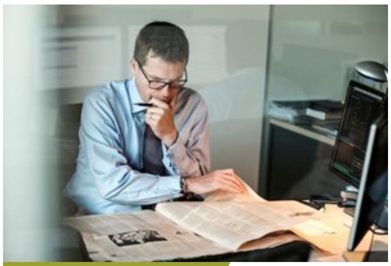

European Capital Partners

Friday Morning Coffee

Nr. 61 — Diamonds are Forever

Value Investing makes again the headlines and not only in Europe. We indeed saw an increased number of publications lately on the imminent death of value investing. For example, in a detailed research piece titled "The Value Conundrum – Past, Present, Future" that appeared on June 7th, the quant team from JPMorgan gives an update on the current state of the nation in Value-land, analyses the structural headwinds value investing currently faces and suggests what conditions are needed for Value to make a sustained comeback.

Their analysis shows that in the US, value is trading at the largest discount ever to the market. In terms of forward P/E, the 1% cheapest stocks of the S&P 500 trade a 7 times discount to the market overall. This is the highest level seen over the last 30 years, even higher discount that during the 2000 TMT bubble. The authors claim that the situation would be even worse in Europe. This is hardly surprising to us as we have commented on the valuation gap between growth and value on many occasions. Also some of the explanations given for the recent disappointing performance of value as an investment style have been discussed before, like the rise of passive investing and the easy access to cheap capital globally.

What we find however much more interesting is the last part of the study on preconditions of a sustained comeback in value investing. The first precondition we would have brought forward would be a rise in interest rates. Here the authors take a radically different route. Condition number 1 for them is regulations that foster competition. In many industries like large financials, internet retail, diversified telecoms, computers, sales concentration amongst a few players has risen dramatically over the last 10 to 15 years. As the authors write it became a "winner take all" cycle while the smaller, often lowly valued companies were marginalized. We agree with this argumentation, at least partly.

The market leaders of today in technology, media and telco for example are the successful disruptors of yesterday who managed to build market share over time as they matured. We should however remember that many of the leaders of today will not be the leaders of tomorrow as new disruptors enter. The whole point of value investing is to avoid these type of businesses that are glamor now and trading at lofty valuation but can be disrupted easily. Regulation can accelerate the dismantling of the winners. This has happened before in different sectors like financials and technology. However we also believe that innovation and competitive forces will also contribute to a large extent.

The second argument brought forward for a return of value investing is the saturation of passive investment vehicles (ETFs in particular) and private equity as well as a stabilization of active equity AUM. The emergence of passive investment strategies has been impressive, especially in the US as shown in the following graph :

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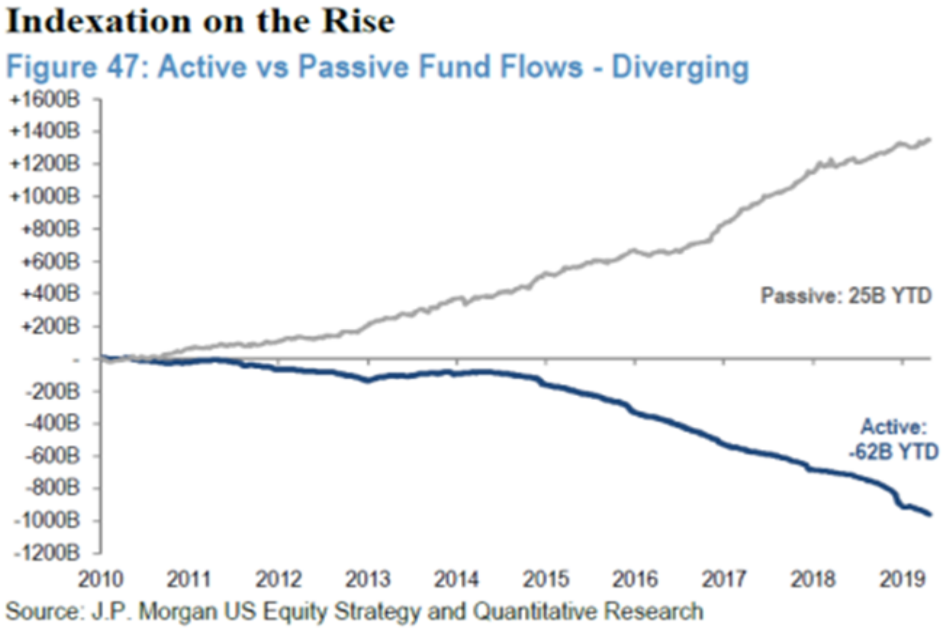

We note the success of passive investment strategies. However we do not see how a saturation in passive strategies can occur without better performance of active strategies. To put it in plain language, investors prefer ETFs for as long as their performance (net of fees) is higher than the one of active managers. The moment active managers beat the market, money will flow back. So the trigger of saturation in passive is in our opinion a return of active stock-picking in general and value investing in particular. This sounds to us as a circular argument.

In conclusion, with a record high undervaluation of value stocks compared to their growth peers, it is likely that we will have sharp Value snapbacks where the style outperforms dramatically. What will be the trigger of value investing coming back into the spotlight is impossible to tell. Two items we have on top of our minds is the historic high valuation gap between growth/value stocks or higher interest rates. As we are still not expecting an economic Ice Age, interest rates will increase at one stage or like Vitaliy Katsenelson put it "Just remember, low interest rates, unlike diamonds, are not forever". While the timing is uncertain, the return of value is a certainty.

I wish you a great weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
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