



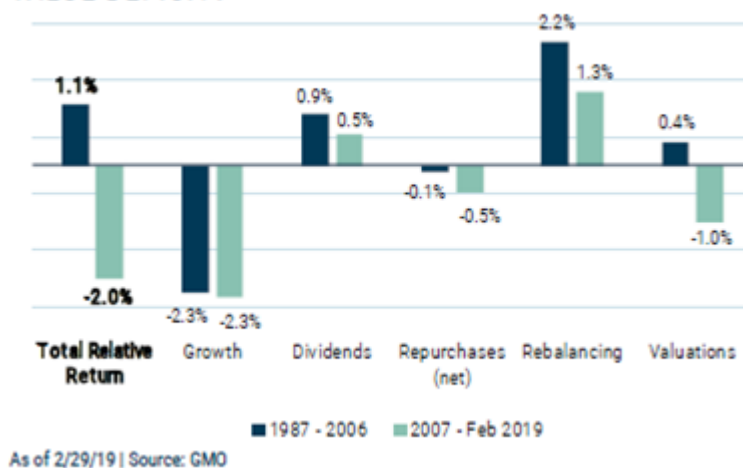
Friday Morning Coffee

Nr. 64 — Dissecting Value Underperformance

Value as an investment style continued to underperform growth/momentum strategies in the first half of 2019. European value stocks, as measured by MSCI Europe Value, have now trailed their growth peers by 3.76% per year (dividends included) since the trough in the market in March 2009 (source: Bloomberg). The value discount is now at record levels in all major developed markets comparable to those seen before the bursting Internet bubble. Much has now been written about why this time is different and why value investing will not recover its stripes. We often hear two main arguments from the perma value bears. Firstly they invoke the “winner takes it all” argument where the dominant companies disrupt and conquer their markets and leave few chances for the lowly valued second tier players to grow their earnings. Secondly the value bears claim valuations have become irrelevant in the zombie world of ultra-low interest rates where central banks have flooded financial markets with liquidity. Our reply to these glamour investors is and has been firm: we are convinced that all valuation bubbles eventually burst, we are confident that this time is no different, and we firmly believe that valuations are to investments what the law of gravity is to physics: eventually they cause stock prices to come back to earth.

In periods of doubt, we find it useful to take a long term perspective. This is exactly what GMO did in a recent study where they decomposed the drivers of the historical value premium and analyzed how these drivers performed since the financial crisis in the US market.

EXHIBIT 1: HOW DID THE VALUE PREMIUM TURN INTO A VALUE DEFICIT?



Friday Morning Coffee Nr. 64 — Dissecting Value Underperformance

In the pre-financial crisis world, value outperformed growth by 1.1% per year in the US. The main driver for that outperformance was what the authors call the “rebalancing” effect: Investors systematically underestimate the ability of companies to revert to normal profitability levels after a more difficult operating period where their fundamentals and their profitability are under pressure. Value investors exploit the opportunity created by the momentarily depressed share prices to invest as they are able to take a longer term perspective to sit things out till the company (and share prices) recover. In addition, value investors are not extrapolating historical high growth rates into the future as earnings will normalize over time. Higher dividend yields and lower valuations are the other two main positive effects playing into the hands of the patient value investor. However, these benefits are not without cost. Value investors have seen the earnings of their own investments growing at a lower rate than the earnings of growth companies.

In light green on the graph, GMO shows how the situations have changed since the financial crisis. The rebalancing effect worked less than before and value investors were actually penalized for holding lowly valued companies. Though value firms continue to pay higher dividends than growth firms, the gap between them has narrowed.

However, this study shows that the “winner takes it all” argument may be somewhat overdone. Value stocks grew their earnings annually at 2.3% less than growth companies in the past. This has not changed. Buying quality companies at a moment when they are unloved by Mr. Market, the rebalancing effect, still adds value. What has changed however is the following: buying a lowly valued stock in itself does not create outperformance. We still need to do our fundamental homework as value investors in order to avoid value traps!

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
July 5th, 2019

European Capital Partners (Luxembourg) SA (“ECP”) is responsible for the publication of this promotional document. ECP is an asset management company based in Luxembourg, registered at JF Kennedy avenue 35a, L-1855 Luxembourg (RCS Luxembourg, B 134.746) authorized as an Alternative Investment Fund Manager (“AIFM”) of the Luxembourg law of 12 July 2013 and supervised by the Commission de Surveillance du Secteur Financier (CSSF). This document is published for information purposes only and gives the opinion of the Investment team at the time of the publication. It does not constitute an offer to buy or sell financial instruments or investment advice and does not confirm any transaction unless expressly agreed otherwise. Although ECP carefully selects the data and sources used, errors or omissions cannot be excluded a priori. ECP cannot be held liable for any direct or indirect damage resulting from the use of this document. The intellectual property rights of ECP must be respected at all times; The contents of this document may not be reproduced without prior written consent. Any investment involves risks, such as the risk of loss of initial capital. Please read the Prospectus of Selected Funds, their Key Investor Information Documents (KIIDs) and financial reports before making an investment decision to understand their specific risks, costs and conditions. Those documents are available on www.ecp.lu. Past performance does not guarantee future performance. Please refer to an independent tax advisor for country tax information that can change at any time and analyze the tax impacts of any investment on your personal situation.