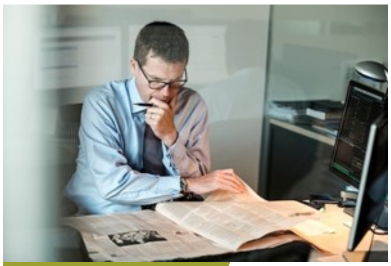

Friday Morning Coffee

Nr. 91 — From GARP to GAAP

We are scratching our heads as valuation of the so-called growth stocks has now reached what we think are unsustainable extremes while at the same time the value stocks continue to trade at affordable valuations. While Mr Market, what we value investors call the average investor, can be frenetic at times and has a tendency to go to extremes, he cannot escape the reality that the value of every company is at the end of the day the present value of its discounted cash flows. In the long run a stock price trading above its fair value will be arbitraged and see its stock price fall back towards its fair value.

This may not happen overnight or to use another quote this time from Keynes : "Markets can stay irrational longer than you can stay solvent.". However, **we believe that in the long run, valuations are to the stock market what gravity is to physics.**

<u>The graph below shows the difference in valuation as measured by forward price / earnings ratio between value and growth stocks over the last 15 years.</u>

Forward PER MSCI Europe Value vs MSCI Europe Growth

Source : Bloomberg

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Historically value stocks traded at a discount to growth, however, over the last 2 years this discount or spread reached unseen extremes. We believe the **higher this valuation spread between value and growth becomes, the more brutal the return to earth of growth stocks will become as their valuations are unsustainable considering the earnings they produce**. And it is not only the valuation of Tesla that skyrocketed: in Europe the average growth company trades currently at 21 times forward earnings. This is a 30% premium to the 15-year average historical valuation of growth stocks. **Growth at a reasonable price (GARP) has become growth at any price (GAAP) in a zero-interest world!**

On the value side however, valuations remain down to realistic. The average value stock currently trades at 11 times forward earnings, exactly in line with its long-term average.

Our European portfolio stays attractively valued with the average company trading at 36% compared to our estimated fair value. The companies we are invested in have solid balance sheets, generate solid cash flows and, for most of them, pay juicy dividends.

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
February 14[th], 2020