

ADDED VALUE may be *better than* 'GROWTH'

VALUE MANAGERS ARE CAUTIOUSLY PREDICTING THAT A ROTATION OUT OF SO-CALLED GROWTH STOCKS INTO VALUE STOCKS MAY BE ON THE HORIZON.

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Value investors have had a relatively tough time of it in recent years, as equity investors around the world have generally favoured so-called “growth” stocks that offer the prospect of secure, ever-rising earnings.

But as investors begin to contemplate the possibility of interest rates increasing, albeit from historically low levels, value managers are cautiously predicting a rotation may begin, out of growth stocks and into the value stocks they hold in their portfolios.

That is not to say that value managers have not been able to find good opportunities, even against the general market headwinds. Garry Laurence, global equities portfolio manager for Perpetual Investments, says it has “gotten a bit tougher” for value investors over the past six to 12 months and his \$600 million portfolio has been “generating flat returns over the past six months”.

“But over the longer term we have still managed to deliver pretty good returns,” he says. And when Laurence cannot find quality investment opportunities, he has the flexibility under his fund’s mandate to hold a significant portion of assets in cash.

“It’s quite a high level relative to other funds in the market,” he says.

WORDS
SIMON HOYLE

“The mandate allows us to go to 25 per cent and we’re currently at 15, so we still see plenty of opportunities; it’s just we think markets will be quite volatile over the next year.”

Laurence says that a value style of investing has generally underperformed a growth-style over the past five years or so, “for probably a few reasons”.

“The market has been more comfortable in paying higher multiples and putting incremental dollars into stocks that continue to grow their earnings quickly – generally what you’d label ‘growth’ stocks,” he says.

“The market has been taking money out of particular sectors where it’s been concerned about weakness in the economy — sectors like financials and certain industrials — and so you’ve seen a rotation out of those areas into higher growing areas, especially the higher-growing tech sectors.

“And you’ve also seen people willing to pay higher multiples for defensive earnings and earnings trends that are more predictable, such as the consumer staples sector.”

OPPORTUNITIES FOR THOSE WILLING TO LOOK

But value opportunities continue to be there for investors willing to seek them out.

The technology sector, for instance, boasts a mix of different kinds of companies and within the sector, valuation multiples have come down for companies that are growing at a slower rate. Laurence says Oracle and IBM are good examples.

“Those stocks have basically gone nowhere for the past five years, while other stocks, like Amazon, which are growing their earnings at a high rate, have gone up and their multiples have gone up; so stocks trading on 30 times [earnings] have gone to 50 times, and stocks trading on 50 times have gone to 70 or 80 times. And the market has been happy to keep paying for stocks that are delivering fast earnings growth.”

Bianca Rose, equity and property portfolio manager for Morningstar, says investors’ preference for growth-orientated stocks has been driven partly by “a certainty thing”.

“Some of them tend to be safety plays, and that doesn’t tend to be value, because value tends to be value because it’s distressed,” she says.

“What we’ve seen in the past few years is what has been ‘growth’ has continued to grow, and what





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has been 'value' – in terms of being distressed – hasn't really turned around as you've seen in the past."

Rose says that classifying a fund manager's style isn't as straightforward as simply attaching a "growth" or a "value" label. Within the "value" sector there are notable style variations.

However, she says that irrespective of a manager's exact style, a value manager will typically pick a stock on the premise that it is only temporarily undervalued and that eventually the share price will rise to reflect the fundamentals of the underlying business.

"But what has happened in a lot of cases is the price has fallen and the fundamentals have followed, or continued to worsen," she says.

"Hence, some areas that may have looked expensive to some people have become further [even more] expensive, or have turned out to be all right value. It depends on what you classify as value. In a typical value style [using] price-to-book and dividend yield, yes, value has underperformed growth style. But some managers that we look at classify value differently and might say value is more Warren Buffett-style value – what you get in terms of your cashflows. Managers, generally speaking, that are a bit more, how would I describe it, 'quality value', have not fared as poorly."

THE IMPACT OF RISING INTEREST RATES

Laurence says a rotation out of growth stocks and into value stocks could be prompted by rising interest rates and the impact of applying the higher rate to calculating the discounted cashflows of businesses.

"We think that potentially, low interest rates have caused this phenomenon," he says.

"As central banks around the world have been cutting interest rates, the discount rate that people use has gone down, and generally for growth stocks people do look at discounted cashflows because they are forecasting out earnings for a long period of time to get to such a high valuation. You have to assume that earnings will grow quickly for the next 10 or 20 years.

"If you forecast that, you determine the value [today] by using a discount rate, which is based on the current level of interest rates. If you're using a low discount rate your valuation will be higher. But if interest rates do the reverse and start increasing, you should be using a higher discount rate, and there's a chance that people may reassess the multiples and valuations of higher growing businesses."

Morningstar's Rose has a more sanguine view about what might cause value management to quickly come back into favour.

"Who knows?" she says.

"Sometimes the catalyst can be something that pre-existed, but suddenly the market decides to focus on that. But if you think about earlier this year when some of the so-called 'high growth' stocks ... snapped back and they didn't do so well, and people just probably felt at that point am I paying too much as a premium for

that? And at what point do you reach that point? It's hard to say."

When a fund manager believes a rotation into value stocks might begin to pick up pace depends on when it believes interest rates will begin to rise.

Laurence says Perpetual believes "interest rates in the US will go up over the next few years – the question is the timing of it".

"Maybe one or two rate hikes this year, and a few more next year – two to four next year," he says.

THE GENERAL CASE FOR VALUE INVESTING

The general case for value investing continues to hold, he says.

"As a value investor you're saying, look, we're only willing to predict the next 10 years, rather than the next 20 or 30, and we'll buy a business that generates good free cashflow, that returns that [cash] to shareholders, and as long as that business will be around for the next 10 years, we'll do handsomely out of it," he says.

"If you're a growth investor you're assuming you can predict the earnings stream of a business for a longer period of time. It's hard."

Sometimes a stock is cheap for a reason, and the manager needs to understand the context in which it is valuing the business. In such cases the manager faces the risk that a stock it buys may remain cheap forever.

Rose says that Uber is "a classic example of a company coming in and changing the dynamics of an industry".

"Incumbents may fall in price and they may look cheap, but are they good value[?], is another question if that [company] is in decline because of new entrants or what have you," she says.

"The proof is in the pudding in the past few years, and perhaps the jury is still out, but those [value] managers who have underperformed, it's probably a case that what they have bought hasn't really turned around.

"Generally speaking, as well, value tends to be a long-term proposition. Apart from a period around the early 2000s where value seemed to have a nice long stretch, generally value has tended to [have] underperformed in stretches and then it comes in quite lumpy forms, in terms of delivery.

"If you think of the tech boom and bust, it underperformed for quite a long time and then there was a sharp reversal. The value guys will say it can flip on a coin very quickly and that underperformance can quickly change."

In the meantime, Rose says, prudent investors should maintain an exposure to different styles of managers – including different styles of value managers.

"This comes back to my point about different types of value," she says.

"It's not as simplistic as a value and a growth manager, it's just making sure they are different styles and will perform at different times." ■