BEWARE THE SIREN SONG OF 'VALUE'

June 2016

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The outperformance of 'growth' versus 'value' has been a persistent feature of the European equity market since the market bottomed in March 2009. This year, we have heard the argument repeated many times that 'value' has rarely, if ever, looked so cheap relative to 'growth' on a price/book basis. Value is currently trading at a circa 65% discount to growth on this metric (see Fig. 1) which is close to the bottom of its range since 2000. Indeed, some commentators observe that the points at which the relative price/book of 'value' versus 'growth' approaches one standard deviation below the median discount of circa 52% have typically prefigured periods of 'value' outperformance since 2000 (2003-7, 2009 and 2013-14).

Incidentally, this is also a convenient argument for 'value-oriented' fund managers to persuade clients to overlook the negative performance arising from poor stock selection in recent years and continue hanging on for the imminent 'style' inflection. Our analysis suggests, however, that the relative valuation gap is not unduly stretched and the fundamental justification for a 'value' rotation looks flimsy at best.

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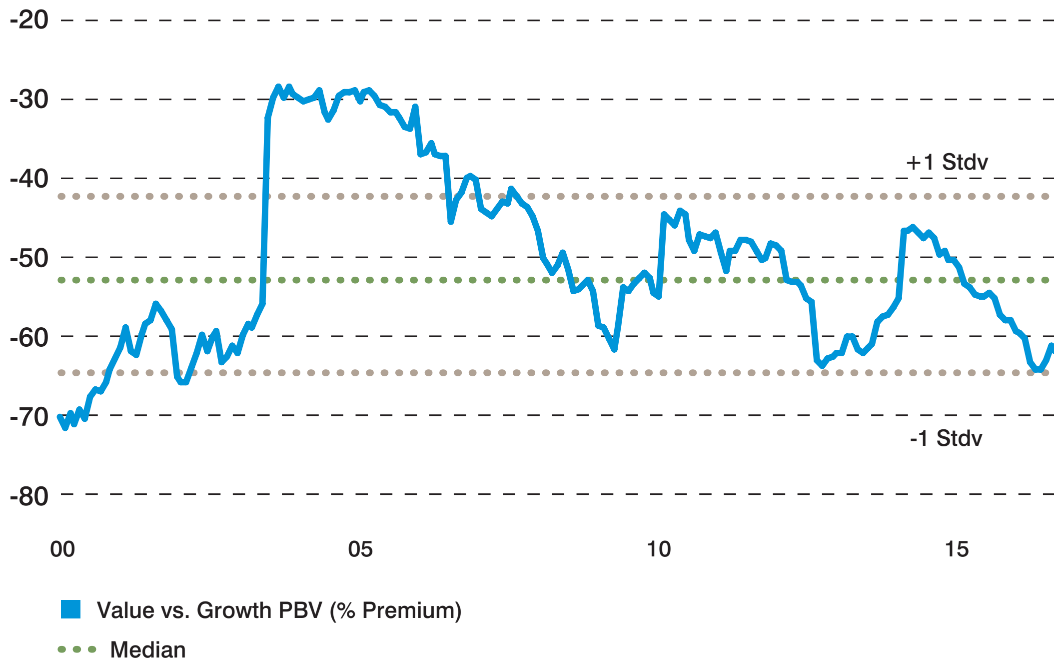
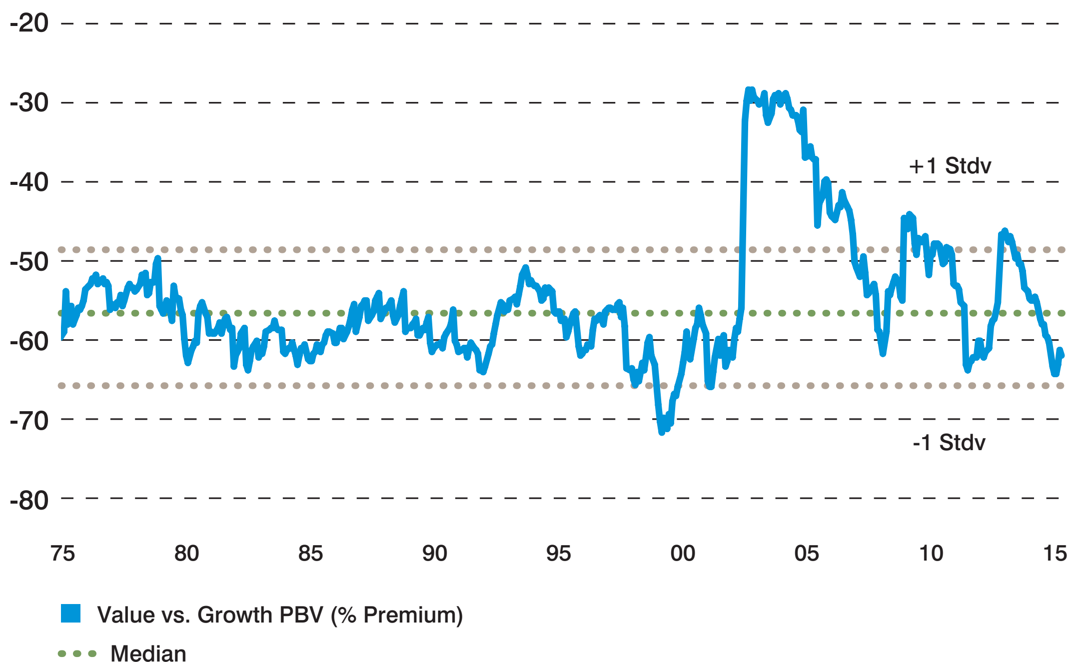
Chart 1: European Value vs Growth Price to Book Value



Source: MSCI, Morgan Stanley Research

The time frame of reference matters It is unhelpful, to say the least, only to consider the relative price/book valuation of 'value' versus 'growth' since 2000 when the MSCI data is available for Europe from 1975. The longer series provides a rather different context for the last fifteen years. Starting the relative valuation chart in 2000 deliberately distorts the picture and fails to demonstrate the extent to which the period between the TMT bubble bursting in 2001 and the Great Financial Crisis of 2007/8 was an exceptional one in terms of earnings for many 'value' sectors.

Chart 2: European Value vs Growth Price to Book Value



Source: MSCI, Morgan Stanley Research

The 'value' bubble of 2003-7 which saw the price/book discount of 'value' versus 'growth' narrow to 30% at its peak was driven by excessive leverage in the banking sector and the unprecedented boom in mining profits during the Commodity Super Cycle which came to an end in 2011. Prior to 2003, 'value' sectors never traded at less than a 50% discount to 'growth' on price/book. In this context, the current discount of 60% looks somewhat cheap but far from extreme.

2003-7: An exceptional period for 'value' sectors The 'value' universe - defined as the bottom third of the market as measured by the price/book - is overwhelmingly composed of capital intensive, low return on equity businesses, in particular, energy, commodities, utilities and financials. 2007 was the peak of a bubble in 'value' earnings which is very unlikely to be repeated. As such, 2003-7 is a very misleading reference point.

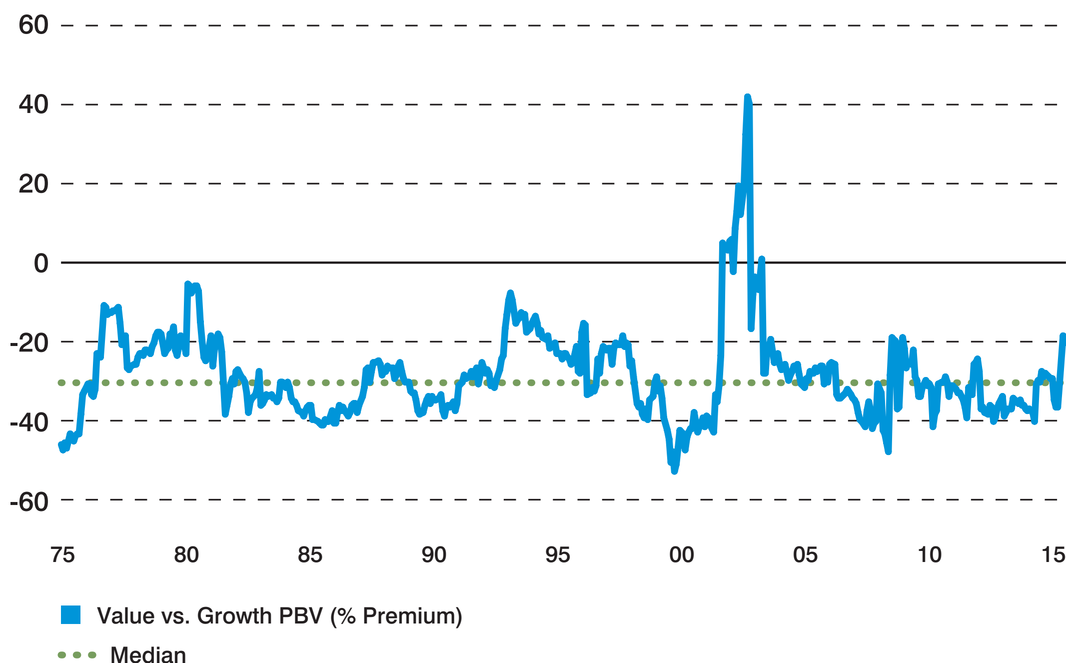
Since 2007, bank earnings have suffered from declining leverage and a shuttering of previously lucrative business areas following increased regulatory scrutiny. Given that financials accounted for around a quarter of the entire European equity market in 2006, a large portion of the underperformance of 'value' can be explained by the balance sheet recession which they have experienced and the resulting decline in the equilibrium price/book multiple linked to the structurally lower return on equity of the sector.

The earnings base of the mining sector has been decimated by the end the Commodity Super-Cycle in 2012, with prices in the underlying commodities forced lower by falling Chinese demand and increasing sources of supply commissioned earlier in the decade now coming on-stream. The energy sector has felt the pain from the collapse in the oil price since 2014 and parts of the utilities sector have struggled to adapt to lower power prices and the rapid growth of renewables.

Alternative valuation metrics tell a different story Let us not forget that the price/book is only one valuation metric. The 'book' component is subject to annual accounting revisions. When the appropriate impairments are finally taken to reflect the real market value of some energy, mining and utility investments over the last decade, 'value' sectors may be revealed to be rather less cheap than some might have imagined on price/book. Notwithstanding over EUR 100 billion of utility sector impairments since 2010, some utilities continue to carry significant goodwill. RWE, for example, at the end of 2015 had goodwill of EUR 12 billion on the asset side of the balance sheet compared to a market capitalisation of EUR 7 billion.

The long-term chart of trailing P/E tells a rather different story. We observe that 'value' sectors have traded at an average 30% discount to 'growth' since 1975 (see Fig. 3). Currently this discount is closer to 20%, suggesting if anything, that 'value' names look more expensive than cheap compared to 'growth'.

Chart 3: European Value vs Growth Trailing Price to Earnings

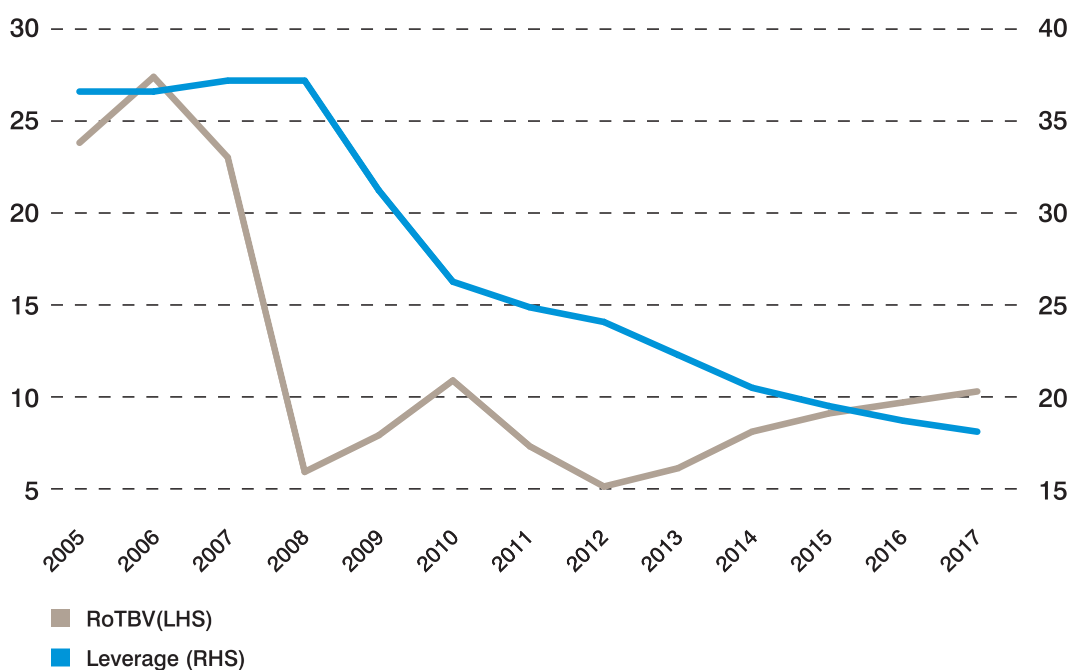


Source: MSCI, Morgan Stanley Research

Given the limited support from P/E re-rating, proponents of the 'value' argument must, therefore, fall back on earnings. The generalised outperformance of 'value' from here requires 'value' earnings to accelerate ahead of those of the 'growth' sectors. The appropriate question for investors concerned about the sustainability of 'growth' outperformance is therefore: Is there a credible case for earnings growth in any of these industries where value is said to reside? We offer our views below.

Financials When we analyse the lower return of equity of the banking sector in 2016 compared to 2006, we find that the reduction has been driven almost entirely by falling leverage. As Fig. 4 suggests, the reduction in leverage from 40x to 20x in the European banking system has produced a commensurate fall in the return on tangible equity.

Chart 4: Leverage of European Banking System and ROE



Source: Autonomous Research

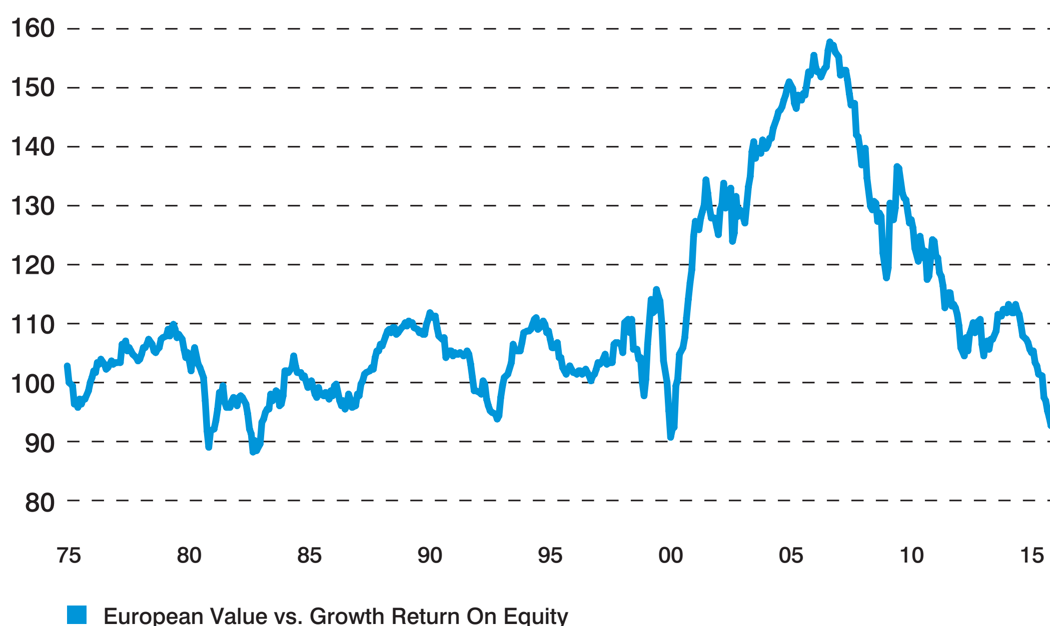
The return on assets of the European banking sector, however, as distinct from the return on equity, remains high relative to history. This indicates that a full recovery in underlying profitability has already taken place. Renewed growth in bank earnings would, therefore, require a substantial re-leverage of the sector or the discovery of new sources of earnings. In fact, we think the earnings outlook for financials looks increasingly challenged. Regulatory attitudes make releverage a very remote possibility. Banks are closing more businesses than they are opening. The compression of net interest margins arising from ECB action is now starting to bite at the same time as business model issues relating to digital banking and the retail branch network are becoming more acute. This will require substantial remedial investment in technology as well as painful new cost reduction plans. We also think that the Italian banking system remains deeply undercapitalised, and this is not being addressed in the financial engineering sleight of hand currently being conducted.

Commodities Many industrial commodities remain substantially over-supplied from a long-term perspective. While there is short-term evidence of a restock from China, we are currently struggling to form a robust view on how supply and demand will balance longer term. In our view, it is likely to balance at much lower prices. Rio Tinto and ArcelorMittal are hugely geared to rises and falls in the iron ore and steel prices respectively; for Rio Tinto a USD 5 per tonne change in iron ore prices has a 22% impact on the company's equity valuation. As such we struggle to construct a scenario under which the balance of risk-reward looks attractive. We tend to regard the shares of these companies as being more akin to warrants than equity investments.

Energy Our analysis suggests that the supply and demand of oil will return to balance in 2016/17. In January, we observed that the share price of oil and gas major Total was discounting a very low oil price into perpetuity with a positive risk/reward asymmetry, so we purchased a large position in the shares believing that it represented an excellent risk/reward trade-off. Its exposure to downstream activities, which benefit from a lower oil price, mitigated the vulnerability of its upstream portfolio. This suggests that there is some genuine upside at oil producers. We do not believe this can be generalised to the entire industry and that European oil service companies and suppliers remain broadly un-investible. Much of the project work which supported sector earnings in the USD 80-100 oil era is no longer economically justified by the current oil price. Consequently, we see a very limited possibility of a snapback in profitability for the supply chain.

Overall, we do not see a generalised case for so-called 'value' investments or a rotation from 'growth' to 'value'. Many of the major trends of the last few years remain in place, albeit with some important changes. European equities remain on the cheap side of fair value on long-term measures; the Eurozone is recovering with evidence strongest in Ireland and Spain; the European banking sector remains deeply unattractive for investors although, for the most part, it no longer poses a systemic risk to the broader recovery; the European energy sector is beginning to bottom and selective value has emerged; metals and mining stocks remain the 'tail end of the whip' and the industrial supply chain is likely to remain unattractive for some time as further 'healing' in underlying commodities requires deep and prolonged cuts to capex.

Chart 5: European Value vs Growth Price Performance



Source: Morgan Stanley

Value vs. Growth – a false distinction

Arguments about the misalignment of 'value' and 'growth' are easily distorted and should not be taken at face value. In fact, we would suggest investors would do well to set aside these labels altogether. As Warren Buffet has observed, it is difficult to point to any clear blue water between them. Investors should be wary about anyone making confident predictions about the future performance of either investment "style".

"But how, you will ask, does one decide what's "attractive"? In answering this question, most analysts feel they must choose between two approaches customarily thought to be in opposition: "value" and "growth." Indeed, many investment professionals see any mixing of the two terms as a form of intellectual cross- dressing. We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion, the two approaches are joined at the hip: Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive. In addition, we think the very term "value investing" is redundant. What is "investing" if it is not the act of seeking value at least sufficient to justify the amount paid?"

Warren Buffet, Letter to Berkshire Hathaway Shareholders, 1992

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