Value investing

Living with the reality, waiting for the inevitable

Edison themes

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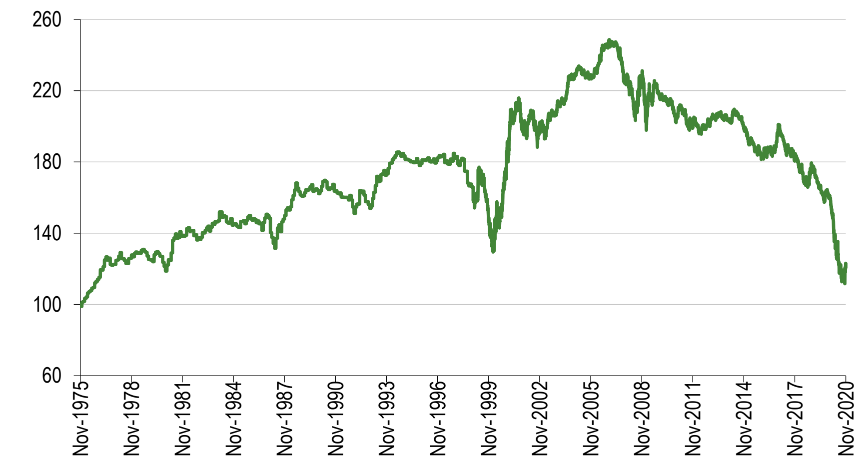
There is always value in value investing if it is done properly, and even more value at the moment given the approach's sustained underperformance. Evidence suggests that value investors agree, and while a re-rating of value may still be some way off, now could be a once-in-a-generation opportunity to benefit when value does return to favour.

There is more than usual value in value investing now

There is always value in value investing if it is done properly. Investing in businesses where the present value of the future cash flows is materially above the current market value and waiting for value to be realised over the long term, as share prices begin reflecting underlying business performance, should always be a winning strategy that delivers above market returns.

There is, arguably, even more value than usual in value investing at the moment. Value stocks have only partially recovered from the Q120 market sell-off triggered by the onset of the COVID-19 pandemic, and the extent of their underperformance against growth stocks since the start of the global financial crisis in 2007 has become even more pronounced. The current cycle of value underperformance is now both the longest in duration and the most significant in history (see below).

Exhibit 1: MSCI World Value vs MSCI World Growth over 45 years to November 2020



Source: Refinitiv, Edison Investment Research

Growth outperformance is based on fundamentals

The reason for value's underperformance is well understood. Growth indices are being driven ever higher by the extraordinary and sustained gains of a handful of US tech stocks (Exhibit 2). These gains have a sound basis. As a recent article in The Economist magazine observed, much of the recovery in these tech stocks since March 2020 is 'rooted in fundamental shifts, like policy interventions, or pandemic-prompted changes to consumer behaviour, such as online shopping, that have helped firms like Amazon'.

From the street

'Value stocks are very cheap at present after being shunned by investors for several years. In the UK market, the arrival of viable vaccines, combined with the final resolution of Brexit in coming weeks, are likely catalysts for an improvement in investor sentiment towards UK value stocks. I am very excited about the opportunities ahead. This is a very good time to invest in the value space.' - Alex Wright, manager of Fidelity Special Values

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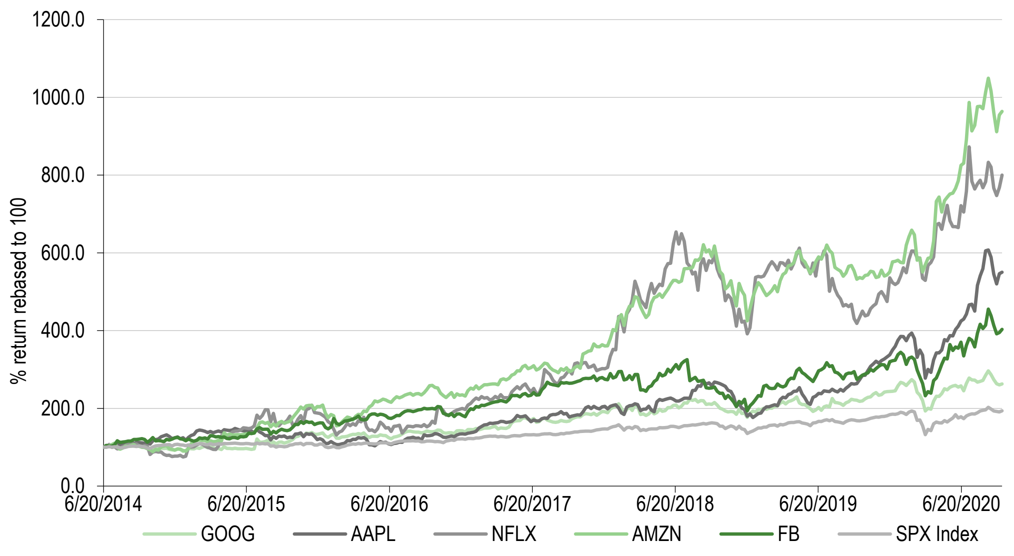
Exhibit 2: FAANG* stocks and S&P 500 since June 2014 (date of Netflix IPO)



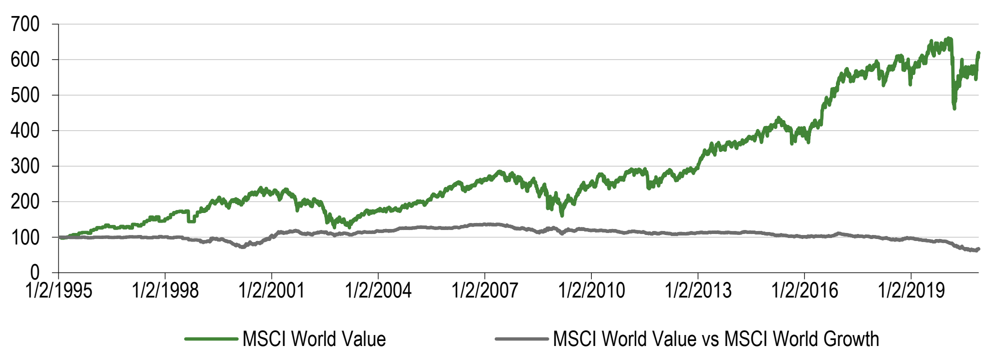
Source: Refinitiv, Edison Investment Research. Note: *FAANG stocks are Facebook, Amazon, Apple, Netflix and Alphabet (parent of Google).

Tim Woodhouse, an investment manager of JPMorgan Global Growth & Income Fund (JGGI), agrees. 'These companies have been able to take a step forward thanks to the virus,' he says. '[They] are transforming the world. They're structural winners from the crisis and will continue to thrive'. However, it is important to note that it is not just high-growth stocks that have seen significant price rises. Defensive quality names with more modest growth outlooks are also now trading at very high multiples, thanks to the impact of historically low interest rates, which have driven up their valuations.

Potential catalysts of a value re-rating – a long way off?

Even if the gains in some mega-caps are supported by fundamentals, the duration and extent of value's underperformance of growth and quality/defensive stocks have fuelled expectations that a correction is now overdue, and there is much speculation about the possible triggers for a re-rating. Some commentators point to economic recovery as the most likely catalyst. However, the links between economic recovery and an improvement in investor attitudes towards value stocks are tenuous, especially in recent times, as value's underperformance has worsened steadily since the global financial crisis, despite the subsequent recovery of the global economy (Exhibit 3).

Exhibit 3: MSCI World Value Index total returns in absolute terms and relative to MSCI World Growth index, and y-o-y global GDP % change since 1995, rebased to 100



Source: Refinitiv, International Monetary Fund, Edison Investment Research

In any case, a self-sustaining global recovery is some way off. With a vaccine unlikely to be widely available before spring 2021, partial lockdowns will continue in the meantime, robbing economic activity of forward momentum. At the same time, the wind-down of various government programmes supporting employment and businesses during the worst of the pandemic will almost certainly add to job losses and bankruptcies.

Others who are pinning their hopes of a value re-rating on a rise in interest rates, which would wind back the optimistic valuations underpinning the current rally in growth and quality/defensive stocks, have even longer to wait. The Bank of England is still in easing mode, mulling a move to negative rates, while the US Federal Reserve has indicated its intention to keep rates at their current low levels until at least 2023.

Tech stocks' recent rally looks like a bubble…

Another potential catalyst for a value reassessment may be nearer to hand. There are some alarming developments behind the recent rally in US tech stocks which suggest that while fundamentals may justify some of the price rises, derivative trades are now fuelling a speculative bubble in these mega-caps. Softbank's summer time purchases of call options on US tech names, which have the effect of accelerating the increase in the price of the underlying shares when they are rising, and amplifying share price falls, were only the most publicised instance of such activity. The Financial Times claims that Softbank purchased US$4bn worth of calls, with a notional value of around US$30bn. The total nominal value of calls traded on individual US stocks hit a record high in the last two weeks of August, averaging US$335bn a day. This is the first time average daily volumes of traded stock options have exceeded trading volumes in the underlying shares. The total volume of calls was more than triple the rolling average between 2017 and 2019.

Small traders – relatively new participants in derivative markets thanks to the advent of free retail trading platforms such as Robinhood – are a key element of this surge in derivative trading. In the second half of August and early September, retail buyers reportedly purchased US$37bn of call options, giving them a notional exposure of around US$500bn – 'a lot of clout' says The Economist, considering the combined market value of the five mega-cap US tech stocks is around US$6tn. Speculative derivative trading of such magnitude suggests the current prices of the tech mega-caps that are driving the performance of growth strategies are extremely precarious and ripe for a potentially significant correction.

While the machinations of derivatives markets may not be the constant focus of most investors, the warning signal they are clearly sounding was echoed by other recent developments. After becoming the first stock to be valued at US$2tn in August, Apple's market valuation continued to climb until it exceeded that of the entire FTSE 100, giving even the most speculative investors pause for thought about the extent of the current disconnect between market valuations and intrinsic value. In addition, veteran value investor Warren Buffett's US$6bn investment in five Japanese trading companies was interpreted by some as a signal that the ascendancy of growth and momentum strategies has reached its peak.

…but a correction could still be some time away

While it may be tempting to conclude that growth's comeuppance is near, and, that when it comes, the correction will be dramatic, it is always difficult to predict the timing of shifts in market sentiment – and those who subscribe to the principles of value investing know better than to try! A longer-term perspective may, as always, be useful, especially at the moment when the world is still less than a year into an event which will almost certainly prove to be one of the defining moments of the 21st century – not just for financial markets, but for society as a whole. The coronavirus pandemic is likely be with us for some months yet and its implications will not be fully revealed or understood for many years. So, a rush to conclusions about any related developments in financial markets or elsewhere is probably premature. As Nick Train of Lindsell Train says, ‘global and digital businesses can keep adding value well beyond the linear expectations of the 20th century, and what was considered big then, is not big now’.

Value investors should keep doing what they have always done…

So, what should value investors do while they wait for value to reassert itself? The short answer is - stay true to the principles of value investing:

- Seek solid investment returns (Benjamin Graham, the father of value investing, used the term ‘adequate return’, by which he meant an above-market return) by investing in high-quality companies, at reasonable valuations;
- Conduct careful analysis of potential investments’ balance sheets and earnings growth over the past 10 years, to ensure their quality and stability. Value investing in its truest sense is not divorced from either growth or quality considerations;
- Make a sober analysis of value. Building a margin of safety into valuations ensures there is plenty of upside price potential and, more importantly, downside protection, to minimise the risk of being wrong. The extent of recent disruption to business strategies imposed by the coronavirus pandemic suggests that this margin of safety may need to be wider than it would have been before the onset of the pandemic;
- Monitor holdings, to ensure their business franchises remain sound;
- Watch out for disruptive innovation that undermines the investment case. This is particularly important at the moment when, as Train observes, ‘digitalisation is not just creating value but, in many sectors, it is also permanently destroying value, and investors need to respond quickly to avoid or at least minimise losses’;
- Keep finding the courage to act on contrarian views and invest in deeply unfashionable companies or sectors, even in the uncomfortable glare of media scrutiny and public criticism; and, finally
- Be patient. Identify good businesses and be prepared to hold them, possibly through several market cycles.

The following table (Exhibit 4) includes a selection of more or less value-focused investment trust companies invested in UK, European or global strategies. It shows that the longer-term returns of these value strategies have been solid, with average total returns of 40.6% over five years and 120.9% over 10 years (ie c 8–12% pa). In addition, most of these funds pay investors a regular dividend, which in some cases is maintained at a high and rising level, as a matter of board policy. So, in effect, shareholders in these funds are getting paid to wait, with an average yield of 3.1%, while the funds realise capital growth.

Exhibit 4: Selected value-orientated investment companies (arranged by AIC sector)

% unless otherwise stated	Market cap (£m)	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Latest discount	Dividend yield
Global							
AVI Global Trust	864.3	12.0	21.4	90.8	121.2	(9.0)	2.0
Bankers*	1,380.6	12.7	30.8	89.9	203.2	1.2	2.0
EP Global Opportunities	108.1	(0.7)	(0.4)	41.1	108.0	(8.4)	2.2
Scottish Investment Trust*	507.8	(6.6)	(2.4)	39.5	96.0	(10.5)	3.3
Global Equity Income							
Majedie Investments	119.3	(8.3)	(6.1)	20.7	75.1	(15.4)	5.1
UK Equity Income							
Edinburgh Investment Trust[1]	907.4	(10.8)	(12.2)	(2.9)	96.1	(7.0)	4.6
Law Debenture Corporation	731.9	1.8	8.6	43.4	144.5	0.4	4.2
Lowland*	313.4	(10.7)	(13.5)	8.6	116.9	(0.4)	5.2
Murray Income Trust[1]*	943.4	(4.7)	13.0	42.1	110.2	(1.9)	4.3
Temple Bar[1]	632.6	(24.9)	(14.5)	7.2	70.4	(3.7)	4.1
Value And Income	82.0	(19.5)	(15.8)	(2.4)	54.4	(24.9)	6.7
UK All Companies							
Fidelity Special Values*	674.8	(10.9)	(4.6)	23.2	124.0	2.1	2.5
Europe							
Baillie Gifford European Growth Trust[1]	483.5	46.4	40.2	97.0	167.4	1.0	0.3
Flexible Investment							
Miton Global Opportunities	74.5	3.5	2.9	61.5	102.5	(5.2)	0.0
UK Smaller Companies							
Aberforth Smaller Companies	1,044.6	(10.9)	(8.9)	14.5	138.5	(3.8)	2.7
North American Smaller Companies							
Jupiter US Smaller Companies	131.1	(0.3)	31.7	75.8	206.3	(13.9)	0.0
Simple average (16 funds)	**562.4**	**(2.0)**	**4.4**	**40.6**	**120.9**	**(6.2)**	**3.1**
Open-ended funds	**Fund size**						
St James Place Equity Income Acc[2]	675.1	(11.9)	(3.3)	7.0	58.9		3.2

Source: Morningstar, Edison Investment Research. Note: Performance to 27 November 2020 based on ex-par NAV. TR = total return. TER = total expense ratio. Net gearing is total assets less cash and equivalents as a percentage of net assets (a number below 100 indicates a net cash position). *Edison research client. [1]Recent mandate change. [2]Representative fund used to illustrate the track record of the RWC team that has been appointed to manage Temple Bar (see discussion below).

…and not capitulate

Inevitably, not all value managers have had the luxury of waiting out the current bout of underperformance. As in any strategy, some managers will underperform the market, or their peers, or both, or fall out of favour with investors for other reasons. Taking the investment trust sector as a proxy for the broader market, over the past year, there have been four notable instances of UK and European value-orientated investment trusts opting to change their managers. While these cases differ in their reasons for change, all had underperformed the broader market and their value-focused peers and the boards of each fund faced the same question: whether to capitulate and sell out of value strategies – even at these historically low relative levels – in favour of already expensive growth stocks, or to replace a poorly performing value manager with a (hopefully) better one.

The general conclusion of these deliberations has been clear: now is not the time to abandon value. In three of the four cases, the boards of these investment trusts decided to switch to new managers pursuing more or less value strategies, and in the final case, many investors unhappy with the board's decision to shift to a growth-orientated manager voted with their feet.

Given the choice, investors are standing by value strategies

In December 2019, Edinburgh Investment Trust (EDIN) appointed Majedie Asset Management as its new manager. Majedie bills itself as having a 'pragmatic' investment style, but is generally viewed in the market as a value manager. In July 2020, Perpetual Income and Growth Investment Trust (PLI) announced its decision to merge with Murray Income Trust (MUT), ensuring PLI shareholders' continued exposure to an investment strategy focused on quality and value. In late

September 2020, the board of Temple Bar Investment Trust (TMPL) announced the results of its search for a new manager with a ‘sustainable value tilt’, after long-term manager Alastair Mundy of Ninety One (formerly Investec Asset Management) went on an extended leave of absence for health reasons.

TMPL’s board said that it had initially appointed Stanhope Consulting ‘to conduct an independent analysis of the value style both internationally and in the context of the UK equity market’. Stanhope’s analysis found that value investing ‘can be characterised by long periods of relative weakness followed by sharp periods of strong outperformance’ and on this basis, the board concluded that ‘this is not the time in the cycle of returns to abandon this value style bias’. Stanhope’s subsequent search on behalf of TMPL for a replacement manager led to the appointment of RWC Asset Management. Nick Purves and Ian Lance, RWC’s proposed fund managers of the TMPL mandate, commented: ‘In our long investing career, we have seen three occasions where dislocation in the stock market has created the most exceptional opportunities for long-term value investors: post the technology bubble of the late 1990s, coming out of the global financial crisis, and today. We look forward to harvesting these opportunities for the benefit of Temple Bar shareholders’.

In only a single instance of management change – that of European Investment Trust (EUT) – did the board make the decision to abandon value in favour of growth. In November 2019, EUT’s board appointed Baillie Gifford as its new manager, changing the trust’s name to Baillie Gifford European Growth (BGEU). This move did not require shareholder approval, so investors did not have the opportunity to express a view on the switch from value to growth prior to the change. However, the change in manager was followed by a tender offer in which BGEU offered to purchase up to 10% of the trust’s shares, giving former EUT shareholders the opportunity to sell at a narrower than market discount. More than half (53.5%) of the shareholders tendered their shares, meaning that the tender was more than 5x oversubscribed. This oversubscription may have been due in part to the fact that the offer gave shareholders the chance to sell at an attractive price, but it could also be interpreted as a sign that shareholders in EUT’s value strategy wanted to maintain their exposure to a value-style investment approach, perhaps due to an ongoing commitment to this style, or as a diversifier away from other investments in European or global growth strategies.

Conclusion: A once-in-a-generation opportunity?

These recent developments within the investment trust sector provide significant evidence attesting to investors’ ongoing belief in the merits of value investing and their confidence that there is still value in the approach. Yet we should not rely on possibly optimistic forecasts when considering the timing of a shift in market sentiment in favour of value stocks. Rather, as Benjamin Graham advised, we should look instead to history, which tells us of the inevitability of an eventual resurgence in value strategies. Meantime, with value stocks presently at long-term lows relative to growth stocks, now may be a once-in-a-generation opportunity to benefit as value returns to favour, whenever that may be.

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