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VALUE INVESTING NOW BACK IN FAVOUR – WILL THIS CONTINUE?

During the 2016 December Quarter, we witnessed the value style stage a partial recovery after having underperformed for at least 2 years or so. Is this as good as it gets? Or will value continue to outperform after its initial recovery, after having been in the wilderness for some time?

At Nikko AM Australia, we believe that the conditions are set for a sustained recovery for the value style. However, post this initial bounce, only those more discerning value managers who conduct fundamental analysis on stocks are best positioned to take advantage of this over the next few years, as rudimentary ratio analysis will no longer sufficiently highlight these opportunities.

Background

In April 2016 we published a paper titled, "Value Investing Set to Snap Back?"
http://www.nikkoam.com.au/adviser/articles/2016/04/value-investing-set-to-snap-back

In that paper, we spoke about how there was a huge divergence in valuation between value stocks and expensive stocks in Australia, as well as globally.

These expensive stocks included 'bond proxies', such as REITs, infrastructure and utilities stocks, 'growth' stocks (those with higher earnings per share growth) and 'quality' stocks (those with high return on equity).

The market was in a climate of severe risk aversion and was concerned about the lack of economic growth, which was driving bond yields down. This brought these expensive stocks up to even higher levels, as they were more favoured over the heavily sold down value stocks.

The sell-down of these value stocks was dominated by those seen to be sensitive to the economic cycle, namely industrial cyclicals, financials, and arguably energy stocks, which were clearly out of favour in that environment.

This valuation divergence was at extreme levels, and was predicated on extremely low bond yields and low economic growth lasting forever. This was clearly not sustainable.

The recovery in value stocks

From around August last year, we saw the very early signs that the global economy could get out of the doldrums and, as such, bond yields started to rise on expectations that economic growth would pick up.

These signs continued to emerge and, as a result, we saw beaten down value stocks start to recover, and the very expensive stocks start to correct meaningfully. To the extent that bond yields continue to rise from arguably still below-cycle levels, the risk for these expensive stocks is continued underperformance.

Chart 1 shows how value, as an investment style, has struggled over the last two and a half years.

Even with the recovery of the value style from late 2016, the chart shows that its performance is below the trend line, and still has some catching up to do.

Chart 1: Value has outperformed growth but still has a long way to go

Source: Bloomberg

The reason this logged trend line is upward sloping is because, over the long term, the value index has outperformed the growth index. This is a well-known phenomenon in Australia and most major developed equity markets around the world. This issue was discussed in our paper titled, "Revisiting the Age-Old Debate on Value vs Growth Investing"
http://www.nikkoam.com.au/adviser/articles/2015/11/revisiting-the-age-old-debate-on-value-vs-growth-investing which was published in November 2015.

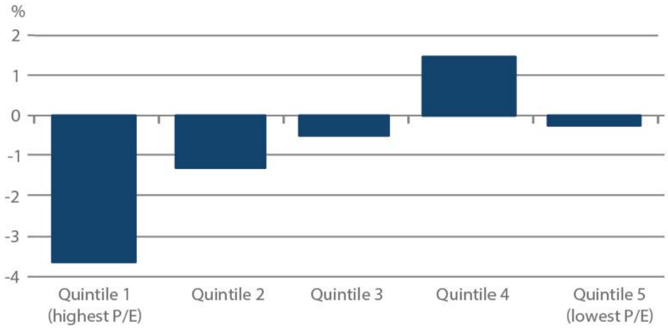
Greater visibility of earnings

During the February 2017 reporting season, the market started to adjust its earnings expectations to reflect these emerging signs of economic growth.

Not only have the very expensive stocks begun to correct in price since August, as their PE (Price to Earnings) multiples were unsustainably high, but the earnings expectations for many of these stocks were also too optimistic.

As a result, we saw negative revisions to the earnings expectations of these very expensive stocks, and very modest positive earnings revisions to value stocks starting to emerge, as shown in chart 2.

Chart 2: Growth stock pullback linked to earnings disappointment



Source: Bloomberg

After the meaningful rotation that occurred in the market during the December quarter, the PE multiple differential between expensive stocks and value stocks is arguably now within more normal levels.

However, a cycle does not last just one quarter, especially given the size and length of time the recent bond-proxy/quality/growth bubble lasted.

Any unwind or deflation of bubbles will typically be the most intense in the initial stages, as we have just witnessed, but history would suggest that this unwind will continue for some time yet.

Will this still be the case now?

The market typically has a habit of underestimating the earnings leverage that economically-sensitive stocks (such as industrial cyclicals and financials) have during economic downturns, or during subdued economic environments like we have recently experienced.

And when the economy picks up, they also underestimate the earnings leverage to the upside that these stocks exhibit. During economic upturns, the earnings improvement in the market is often led by those economically-sensitive stocks that we have already mentioned, which are currently in the value bucket.

While their prices have recovered to some extent, we are yet to see earnings materially pickup from the current below-cycle earnings levels. The PE levels of the economically sensitive stocks now arguably do not look as cheap as they did last year, however, as the economy picks up, earnings growth should provide the platform for further outperformance (see chart 3).

Chart 3: Undervalued and under earning stocks to outperform over the next phase

Source: Bloomberg

Value stocks to perform well

One way of looking at this is to consider that the new cycle in which we have just entered can be split into five phases:

Phase 1: The Bounce. We experienced this during the December quarter.

Phase 2: The Subsequent Pause and Consolidation plus Partial Retracement. As things rarely go up in a straight line, this causes people to question their conviction. We are arguably in the middle of this phase now.

Phase 3: The Earnings Recovery/Expansion. The February reporting season has shown some early signs that this may have begun, but we should see stronger evidence over the next 12 months or so.

Phase 4: Interest Rate Tightening Cycle. Cash rates and bond rates rise materially, as the RBA removes the accommodative monetary policy as the economic cycle improves.

Phase 5: The Peak and subsequent Correction. As the economy starts to overheat, the RBA pulls the handbrake through more restrictive cash rates, which moderates the outlook for the economy.

The first four phases are positive for economically-sensitive stocks, however in the latter stages of Phase 4 and the beginning of Phase 5, these stocks are seen in a more optimistic way as they extrapolate the good times.

During these latter stages, the market forgets that economically-sensitive stocks are cyclical and starts to forecast earnings growth into perpetuity.

These stocks then transition away from being value stocks and start becoming growth stocks, as their PE multiples start to expand as they get re-rated by the market, despite being at above mid-cycle earnings at that point in time. As the economy cools when the RBA pulls the handbrakes, these stocks then become vulnerable to a significant correction, as their earnings outlook starts to deteriorate.

In past cycles, the earnings recovery phase (led by the economically-sensitive stocks) will typically last for at least three years. Despite their recent bounce, we are only at the relative beginning stages of this recovery. As such, as a group, these economically-sensitive stocks, are still undervalued as their earnings are still below mid-cycle.

We believe that further value will be realised as these earnings start to emerge over the next 12 months, and continue to grow over the next few years.

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