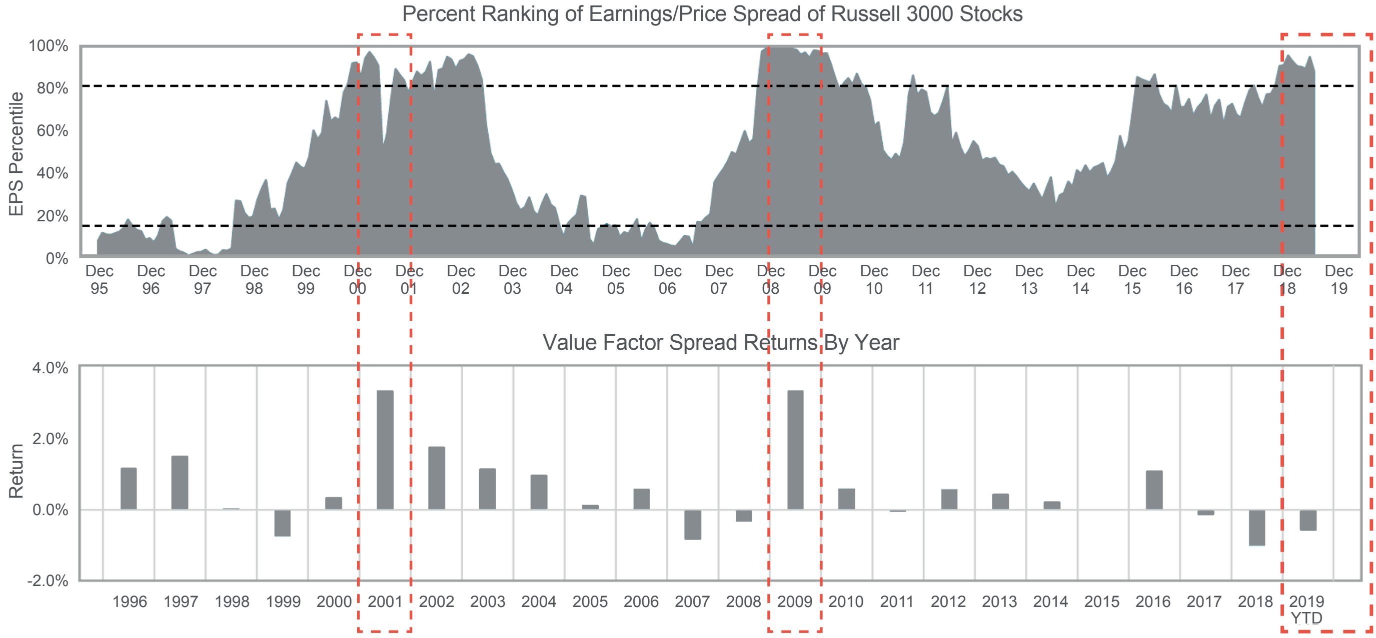
For Professional Investors and Advisers Only

RWC Equity Income

Introduction

In thirty years of running money, I have witnessed two occasions in which a popular narrative has caused investors to favour one group of companies over another to such a degree that the valuation spread between the loved and unloved companies presented contrarian investors with the opportunity to lock in returns for the several years that followed. The first was the hysteria that swept through markets during the Technology Media Telecoms (TMT) boom of the late nineties, the second was the real estate and commodity boom that preceded the Great Financial Crisis in 2008. I believe that we are now witnessing the third such opportunity as a fear of a global economic downturn and a view that central bankers will be able to continue to supress interest rates for an extended period has driven investors in to quality growth companies and out of financials and cyclicals. The valuation spread this has created between these two groups now matches that witnessed in 2000 and 2008 (top chart of figure 1) which set up periods of fantastic returns for value stocks (bottom chart figure 1).

FIGURE 1: PERCENT RANKING OF EARNINGS/PRICE SPREADS & VALUE FACTOR SPREADS



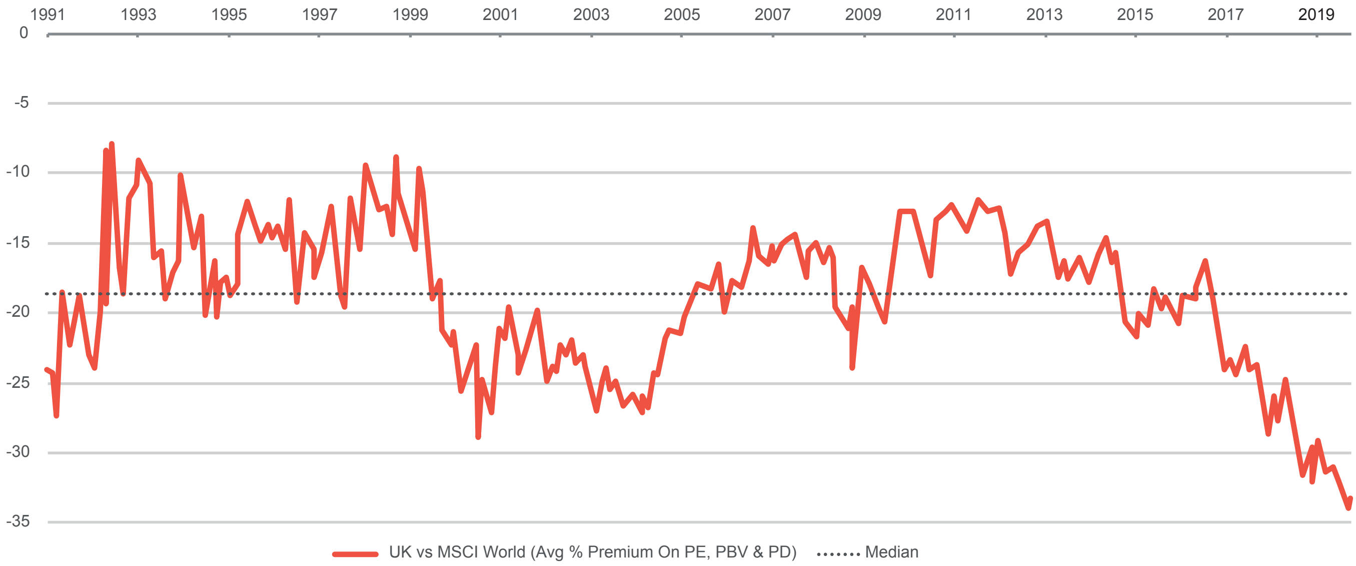
Source: QMA, FTSE Russell. Data from 12/31/1995-6/30/2019
From: Value versus Growth: The New Bubble September 2019

No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.

In a desert of over-valued assets, UK equities could represent an oasis of opportunity

Central bank policy for the last ten years has promoted risk taking in all asset classes that has produced what some have referred to as 'The Everything Bubble'. While we would agree that most asset classes look expensive, there are still a few areas which we believe are cheap relative to their history and to other asset classes; UK equities is one area that stands out. Global investors have been allocating away from UK equities for several years possibly over fears about the negative economic implications of a No-deal Brexit on an index which is heavily weighted towards financials and cyclicals and under weight growth sectors such as Technology. Irrespective of the reason, this constant selling pressure has left UK equities at the biggest discount to World equities for twenty eight years (Figure 2). If you still believe that low starting valuations tend to be correlated with high future returns, you should see this as an opportunity not a threat.

FIGURE 2: UK VS MSCI WORLD AVERAGE VALUATION PREMIUMS



Sources: Morgan Stanley, 02 September 2019

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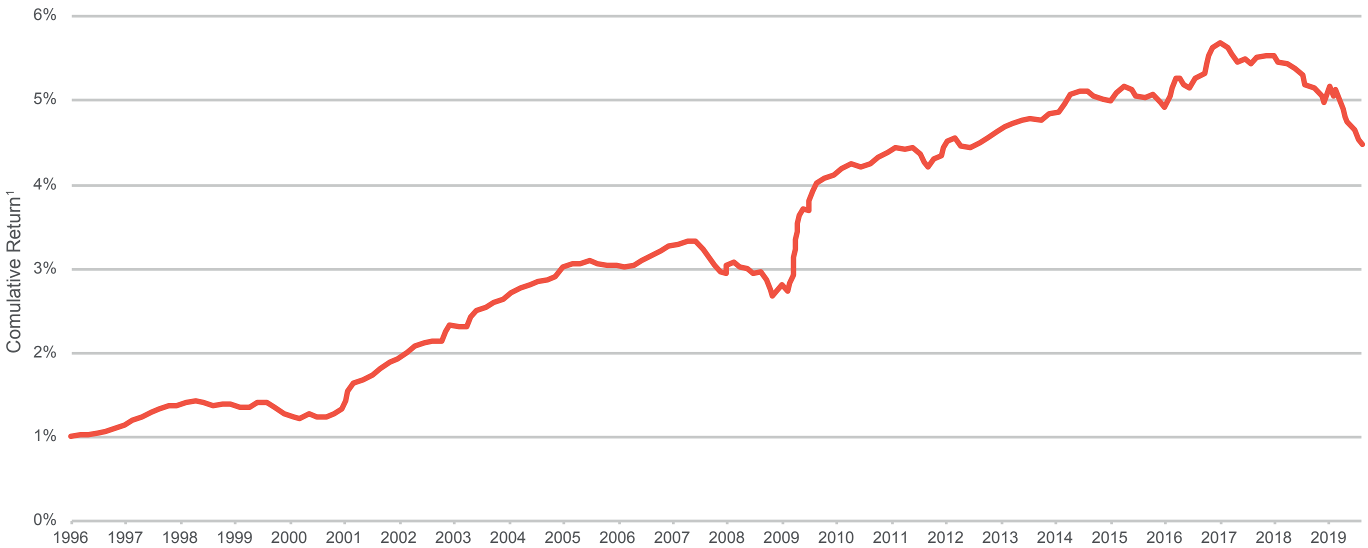
Value stocks are another area of opportunity

Another area of opportunity are value stocks. Figure 3 shows the long run performance of value whilst also highlighting the three largest drawdowns in the strategy since 1993. Note that the first two of these drawdowns preceded the events to which I referred above and were followed by periods of substantial value outperformance, whilst the third has occurred in the last couple of years. Indeed, three of the worst months for value in the last thirty years have occurred in 2019.

FIGURE 3: LONG-RUN VALUE PERFORMANCE



Sources: QMA, Universe = Russell 3000 Index, 31 August 2019

1. QMA composite value factor, where a factor spread has been computed on returns on a monthly basis. Specifically, each month the universe is sorted into thirds. The top third represents the stocks with factor attributes expected to produce the highest return in the future, and the lowest third the stocks with factor attributes expected to produce the lowest return in the future. The equal weighted return of stocks in each tercile is computed. The spread return is the difference in return between tercile 1 and tercile 3.

Past performance is not a guide to the future. The price of investments and the income from them may fall as well as rise and investors may not get back the full amount invested. No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.

Again, this continued selling pressure on value stocks has, we believe, created an opportunity for those willing to take the other side of the trade. Value currently stands at the same discount to growth that it stood on in 1999 (Figure 4) and from which level it posted considerable returns.

FIGURE 4: VALUE VS. GROWTH

Source: Morgan Stanley, 2 September 2019

Why has value done badly?

We are frequently asked why value has done badly in recent years and the honest answer is that we don't know for sure, but our best guesses are as follows.

- Lower interest rates favour long duration assets (growth stocks) over short duration assets (value stocks)?
- Belief that disrupters will triumph over disrupted (eventually there will be only one retailer left in the world and it's called Amazon)?
- Herding and fear of missing out (everyone recognises the huge disparity in valuation between value and growth, but they are waiting for their competitors to move first for fear of running against the herd and getting trampled)?
- Fears of economic slowdown or hard Brexit which favour defensives?

Investors need to recognise that the factors above may well be the narrative that has created today's dislocation (today's version of the late nineties' TMT bubble). Even if these predictions are correct, there is a strong likelihood that they have already been priced in, in which case no excess return should be expected. If they are wrong, then we could see returns from value stocks exceed those of growth stocks significantly given the lopsided positioning in which most investors appear to be over-exposed to quality growth and under-exposed to value.

But won't value stocks do badly in a recession?

Probably the push back we receive most often from investors is the perception that our stocks will do badly in the event of a recession. Our riposte to this is as follows.

1. What will happen to them if there isn't a recession? Value stocks have already been priced for a recession. For example: the RBS share price has recently responded positively to market news (Figure 5).

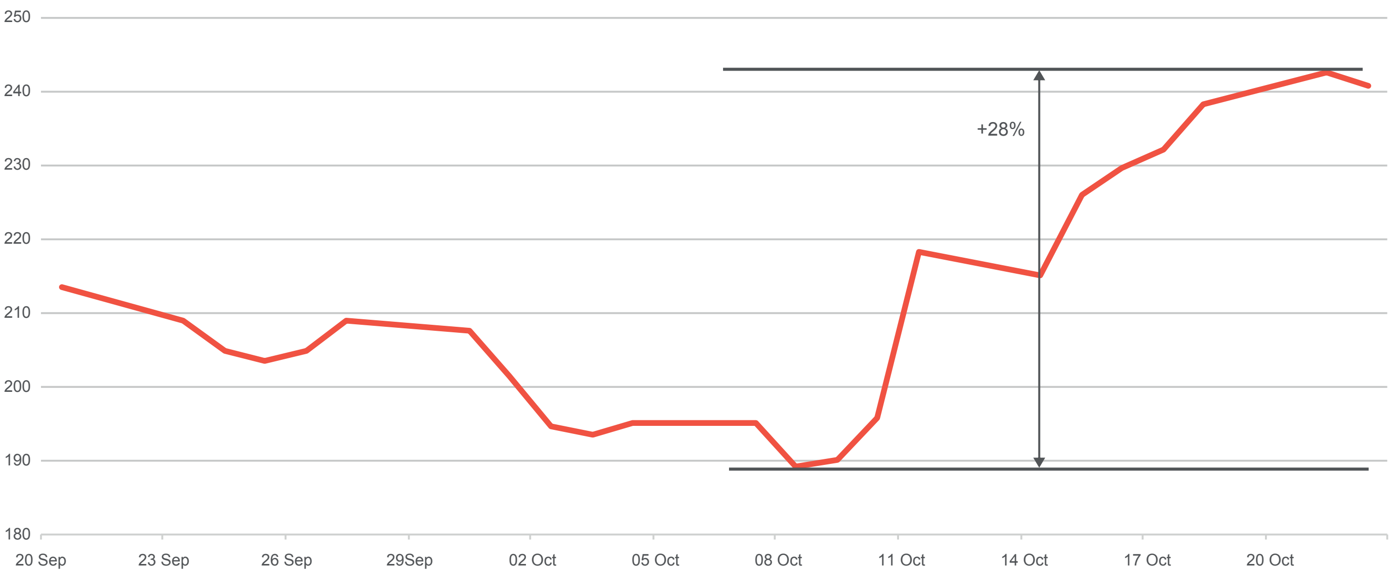
   Many investors seem to be positioned for economic Armageddon by holding predominantly bonds and bond proxies and will be therefore be pointing completely the wrong way if it doesn't happen. Value stocks can almost be thought of as a hedge on the non-zero probability of the economy doing better than expected.

2. What if we are already in a recession? Recessions can only be identified after the event whereas the stock market is a discounting mechanism and looks forward. As UK GDP contracted by 0.2% in the second quarter of 2019, we are one negative quarter away from it being declared that we are in recession and share prices will have once again successfully anticipated this. Since the market usually looks forward, however, it may well be that the trough for cyclicals has already passed as they now begin to discount the recovery.

3. Maybe the expected outperformance of defensives over cyclicals has happened already? Conventional wisdom is that consumer staples do well in an economic decline and cyclicals do badly. However, I am not convinced that this necessarily holds from today's starting point with some cyclicals having lost 70-80% of their value leaving them on P/Es of 6-10x and dividend yields of 5-8% whilst consumer staples sit on P/Es of 25x and dividend yields of 2%. Arguably 'the recession' has been priced in already – Is it realistic to expect them to keep falling once a recession is confirmed?

4. Do you genuinely believe you can call the turning point to the day or week? If you think a stock is worth 220p and the share price is 100p, isn't the most important factor that there is potentially 120% of upside? Yes, it might go there via 80p but alternatively it might not.

FIGURE 5: RBS SHARE PRICE



Source: Bloomberg, 22 October 2019

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Should you position before or after the turn?

Some investors seem to be waiting for front page of the Financial Times to tell them that a regime change has occurred and that it is now time to start selling quality growth and buying value stocks. In my experience, life is not that simple or as the expression goes ‘nobody rings a bell at the top’.

Frequently there is no catalyst and the regime change only become apparent after the event. The problem this creates is that waiting for it to become apparent usually means missing out on a significant part of the gains.

When valuation dispersions are as extreme as they are today, they are like a stretched rubber band and tend to snap back very quickly and hence it is crucial to position before the turn if you want to capture the gains.

Conclusion

We understand more than most that value investing is behaviourally difficult (James Montier once described it as like having your arm repeatedly broken) and hence we can completely sympathise with those who don’t want to put all their assets in to a value strategy. Having identified some of the multi decade extremes in the previous pages, however, we find it hard to see why those who have the significant bulk of their money in quality growth stocks which have done very well and now look very expensive can’t see any merit in at least moving a portion of this back to value. The case for this type of hedge strikes us as very compelling.

Unless stated otherwise, all opinions within this document are those of the RWC Equity Income investment team, as at 22nd October 2019.

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