For Professional Investors and Advisers Only

RWC European and UK Equity

Investor letter Q3 2019

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Graham Clapp

In September 2017 Graham completed a deal to join RWC Partners, along with his investment team, from Pensato, which he founded in 2008. At RWC Graham is focussed on using his extensive research capacity to manage both long-only and long-short European equity funds. Before establishing Pensato, Graham worked at Fidelity Investments for 22 years, leading its European Institutional Group from 1991 to 2004.

When Graham started work at Fidelity in London in 1984, the company was a mid-ranked firm in the UK asset management industry with approximately EUR10bn of assets under management and a European investment team of less than 10 people. In the late 1980s, Graham spent some time at Fidelity in Boston, working with Peter Lynch. Graham brought back to London significant experience from Boston and has implemented the same approach to fundamental investment ever since.

Having delivered strong investment returns while running the European Institutional Group, Graham was asked in 2002 to take over Fidelity International's flagship European fund – the Fidelity European Growth Fund. The fund had previously been managed by Anthony Bolton. Between 2002 and 2006, Graham grew assets in the European Growth Fund from approximately EUR 9bn to EUR 25bn becoming the largest mutual fund in Europe. Fidelity European Growth delivered outperformance of 6.7% p.a. versus the FTSE World Europe from Dec 2002 – Dec 2006.

During his time at Fidelity, Graham was highly instrumental in the growth of the London investment business. By 2006, Fidelity had established a market leading position in London with assets of approximately EUR 350billion and an investment team of nearly 50.

However, in 2006 Graham wanted a new challenge and he founded Pensato Capital to manage European long/short equity funds. Pensato has now been successful for over 10 years and won the Eurohedge European Equity Hedge Fund (Sub $500m) award in 2015.

Russell Champion

Russell joined RWC from Pensato where he was a partner and assistant portfolio manager with a particular focus on small cap, technology & media stocks. Technology is a sector in which Pensato funds made positive returns in each of its 9 years.

Russell started work as an equity analyst at Fidelity International from 2005 to 2008, where he worked with Graham Clapp covering pan-European technology stocks. After Graham left in 2006, he was made assistant portfolio manager to the UK team after a successful stint in the small cap team under Colin Stone.

Russell left Fidelity to join Pensato when it was originally set up by Graham – making partner in 2012.

Before joining Fidelity and while still at school, Russell co-founded Dedipower Managed Hosting Ltd in 1997. Dedipower was a cloud hosting business that was successfully sold to Bridgepoint in 2011 and is now part of Pulsant. Russell has since become involved in a number of successful technology start-ups as an investor and also mentors Fintech participants at Level 39.

Mind the GAAP

A well-established investment strategy GARP (Growth At a Reasonable Price) looks to combine both Growth and Value. Graham was exposed to this style under legendary investor Peter Lynch while working at Fidelity in Boston and developed our philosophy from his process to focus on the fundamentals. Investments of this type make up the 'Secular Growth" and the 'Hyper Growth' groups in our portfolio. In today's market however, the team needs to avoid GARP stocks which have become GAAP stocks (Growth At Any Price). GAAP stocks (and those managers exposed to the style) have outperformed in the recent market rally, but the team feel these stocks are unlikely to produce strong returns going forward, especially if the recent market rotation away from Growth and Momentum into Value continues.

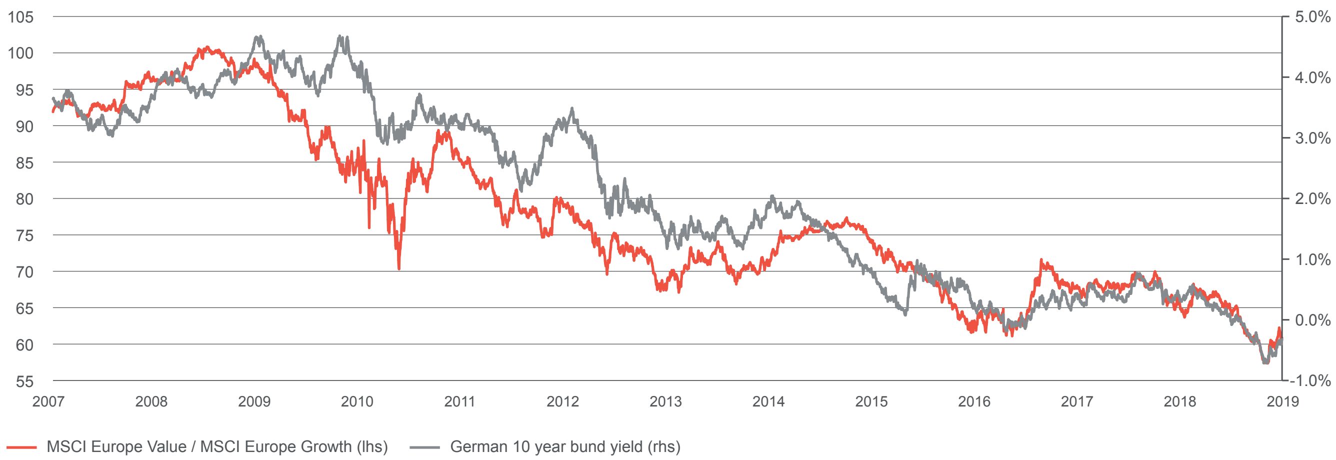
What caused GAAP?

The lasting effects of the unprecedented levels of monetary easing witnessed since the financial crisis will potentially take years to fully manifest themselves. In 2012 Mario Draghi stated the ECB would do "whatever it takes" to preserve the euro, and his parting gift at the end of his 8-year tenure this September was to cut rates deeper into negative territory and to restart quantitative easing. Whilst proponents argue this is needed in the face of weakening economic growth and anaemic inflation expectations, opponents contend that such measures introduce bubbles into the system with no firepower for central banks to combat future downturns.

One of the clear effects of aggressive easing has been asset price inflation as interest rates have fallen. Longer duration assets have materially outperformed as a result, given that a greater portion of their value is ascribed further into the future, now being discounted to the present at a lower discount rate. Consequently, Growth stocks have significantly outperformed Value counterparts, as seen in figure 1, but why is the correlation to the bund important? With the relative outperformance highly correlated to long dated bund yields (as interest rates fall, lowering the cost of equity growth stock begin to outperform value). This trend has now stretched to almost 12 years, with their P/E expanding at a faster rate, as predicted by economic theory, and the valuation premium for high growth companies is back towards dotcom levels, as seen in figure 2. Given expectations of future inflation are at record lows, this trend is expected to continue. Problematic demographics, disruptive innovation and too much debt in the system are all likely to keep a lid on inflation in the coming years.

FIGURE 1:

Growth has outperformed Value since 2007 as interest rates have fallen



Source: Bloomberg, 5 November 2019

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.

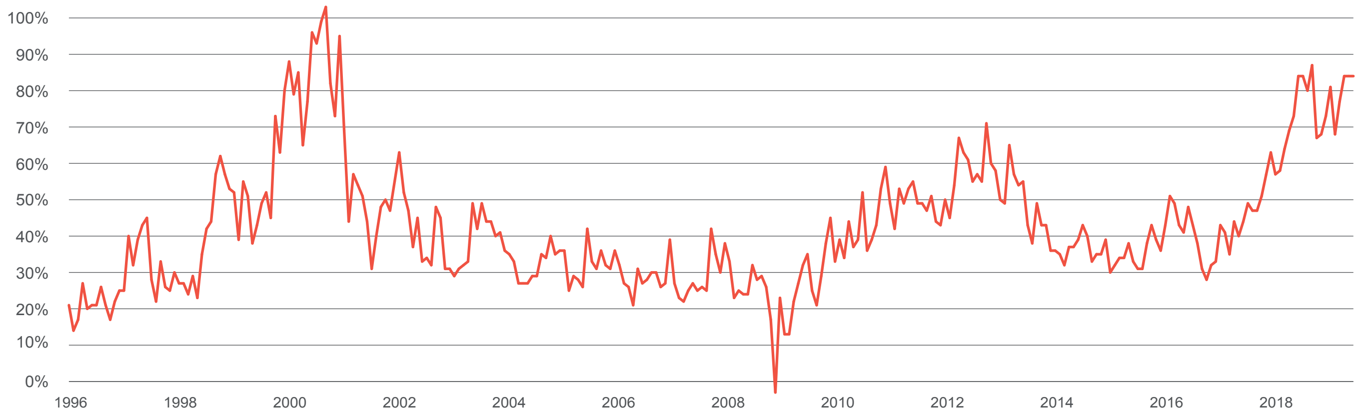
No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.

Theory states that the value of a company can be calculated as a sum of future dividends discounted to their present value using the cost of equity (CoE), and that it should be able to grow dividends (g) at its return on equity (RoE) multiplied by the proportion of earnings it retains (1 – dividend pay-out ratio). The theoretical forward P/E ratio can therefore be calculated as (1 – g/RoE) / (CoE – g).

As the cost of equity decreases (implied as an equity risk premium over a risk free rate), the P/E ratio increases, and at a faster rate for higher growth companies as illustrated in Figure 3. For a company with a 10% RoE and a long term growth rate of 4%, if the cost of equity decreases from 7% to 6% (arrow A, Figure 3), because the risk free rate drops 100bp all else equal, the implied P/E should increase by 50% (20x to 30x). In the case of a company growing just 1%, this increase is merely 20% (15x to 18x, arrow B, Figure 3).

FIGURE 2:

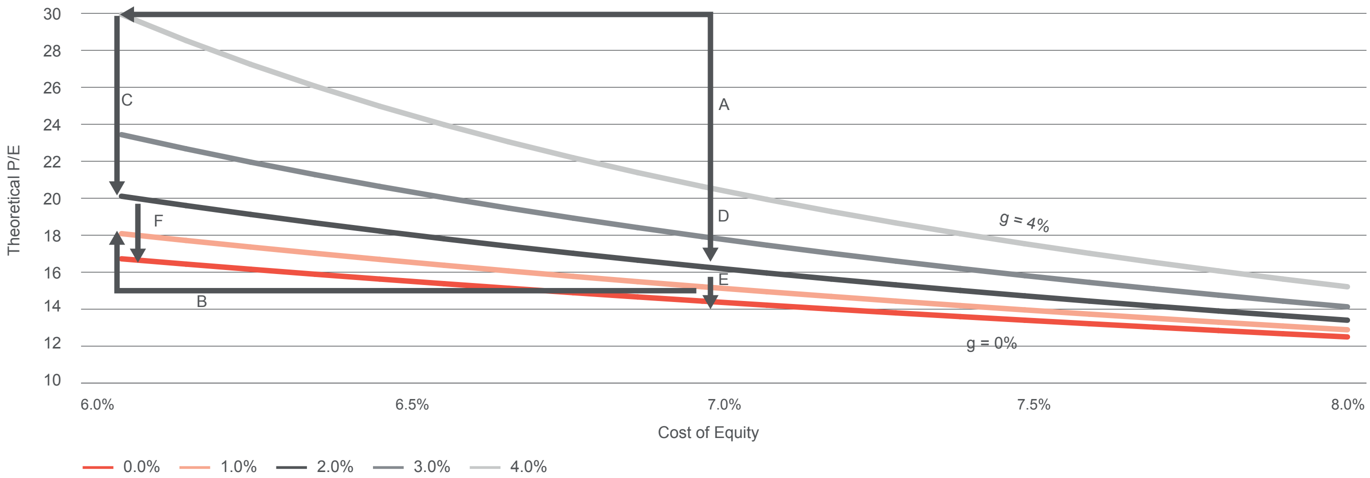
P/E premium of High vs. Low Sales growth companies within Stoxx Europe 600



Source: I/B/E/S, Datastream, Goldman Sachs Global Investment Research, 5 July 2019

FIGURE 3:

Theoretical P/E for a company with a 10% RoE at different long term growth rates



Source: RWC, 5 November 2019

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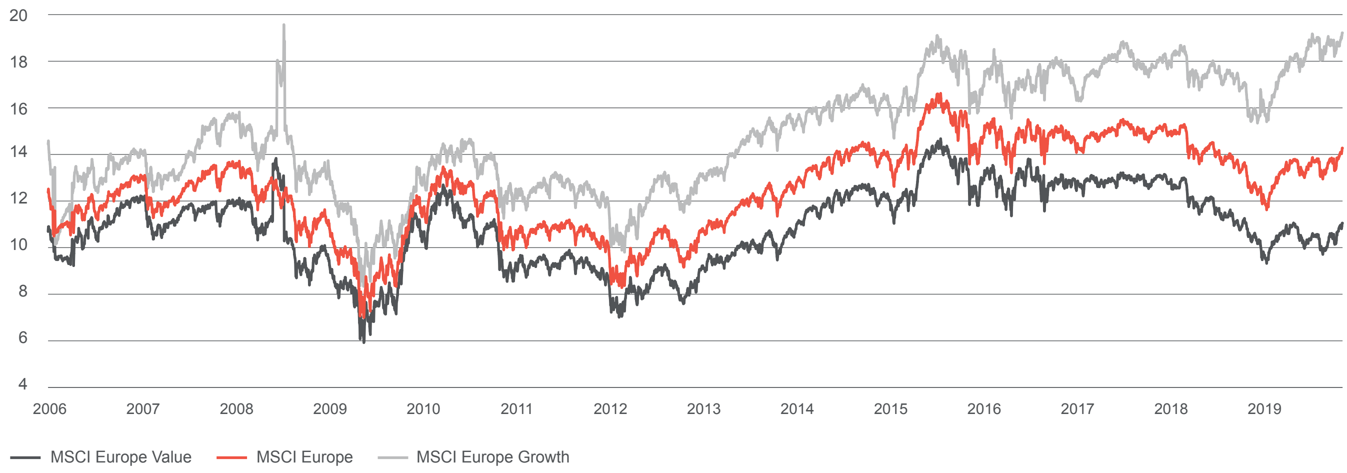
Many market commentators have argued of late that the market is expensive often quoting Shiller P/E ratios and other long term valuation measures. Given the fall in bond yields however, the relative valuation of European equities compared to other asset classes remains highly attractive, especially when some of those assets like many long term euro denominated bonds, guarantee a loss if held to maturity. The MSCI Europe Index is trading in the middle of its 12-16x corridor that it has traded within for the last 6 years, despite German 10 year bond yields dropping by c220bp over the same period. Growth stocks are trading towards the top end of historic range, although not to extreme levels, with the valuation expanding further given the high leverage to a fall in discount rates. Value stocks remain cheaper than recent levels in contrast to the theory, suggesting all else equal that future growth going forward may be slower.

FIGURE 4:

12m Forward P/E ratio of European Growth and Value Indices vs MSCI Europe



Source: Bloomberg, 5 November 2019

How are we looking to take advantage of GAAP?

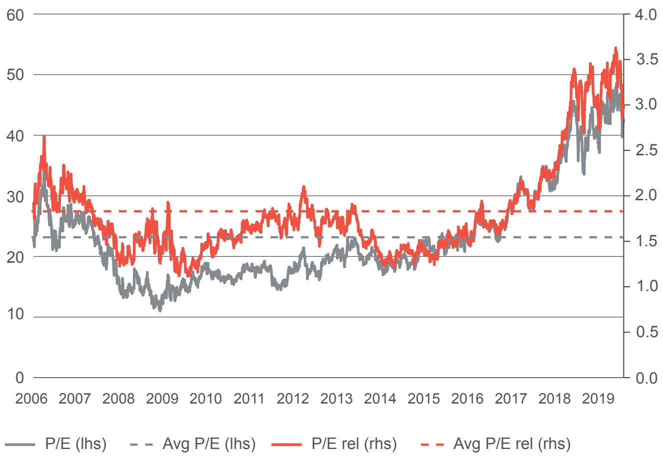
The valuation expansion has manifested itself most visibly in sectors where there is strong, predictable, above-GDP organic growth that investors do not expect to fade such as within Healthcare or Technology. Here there are secular growth drivers including favourable demographics, new products or disruptive technologies that are underpinning growth regardless of the economic environment.

> “We take positions in companies where we believe the economic potential of the company is different to that implied by the share price.”

GRAHAM CLAPP

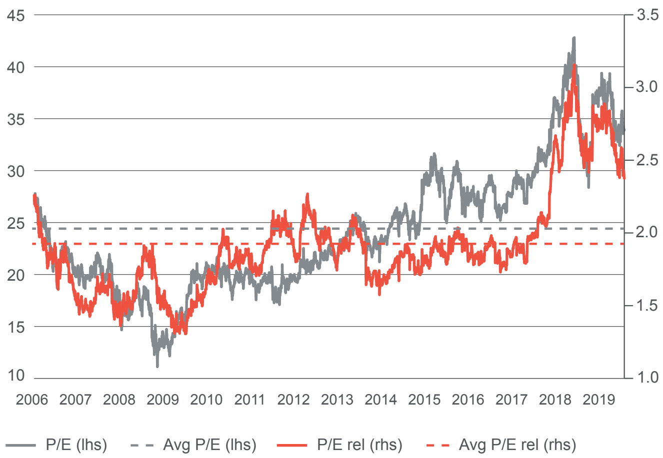
We have had good experience of owning companies within these sectors and have tended to remain overweight in terms of sector positioning, given high returns on capital employed, a large expanding total addressable market and high organic growth rates. Although a fall in the discount rate has caused valuations to increase, we have always picked stocks where the economic fundamentals are not reflected in the current share price, and not purposefully managed a portfolio with an intrinsic bias hoping to benefit from monetary policy and changes to the relative cost of equity. We take no strong view on the further direction of interest rates, rather choosing to base our view on current rates and their effects on both a business' bottom line and where the valuation should be.

FIGURE 5:
Carl Zeiss Meditec P/E relative to MSCI Europe



Source: Bloomberg, 5 November 2019

FIGURE 6:
Dassault Systemes P/E relative to MSCI Europe



Source: Bloomberg, 5 November 2019

Two companies that we have previously owned include Carl Zeiss Meditec and Dassault Systems. Given the GAAP phenomenon we exited our positions as in our opinion the valuation became increasingly elevated, and the risk became asymmetrically skewed to the downside.

Quality biased investors would state that companies with higher Cash Flow Return on Investment (CFROI) will outperform in the long term, as they will be able to compound earnings and reinvest capital at a higher rate of return. Over a long enough time frame this will far outweigh any short term changes to valuation, as extreme as they may be. Value biased investors on the other hand would argue high returns on investment may get competed away, with long term returns fading towards the cost of capital and that growth might slow.

Analysts often overestimate growth potential to justify their recommendations, which leads to the risk of a painful combination of missing expectations whilst at an elevated valuation for GAAP stocks. The higher the growth and multiple, the more painful the multiple contraction is if growth begins to slow. Clearly the ability to identify the key drivers of earnings is extremely important in this market environment.

In a 7% cost of equity world, we believe a 10% RoE company should de-rate 20% from 20x to 16x if growth rate slowed from 4% to 2% (arrow C, Figure 3), but in a 6% cost of equity world the implied derating increases to 33%, from 30x to 20x (arrow D, Figure 3). Low growth companies however do not face such a headwind, with a 2% growth company theoretically derating 11% at a 7%cost of equity (arrow E, Figure 3) or 17% at a 6% cost of equity if it were to go ex-growth and pay out a constant dividend into perpetuity (arrow F, Figure 3).

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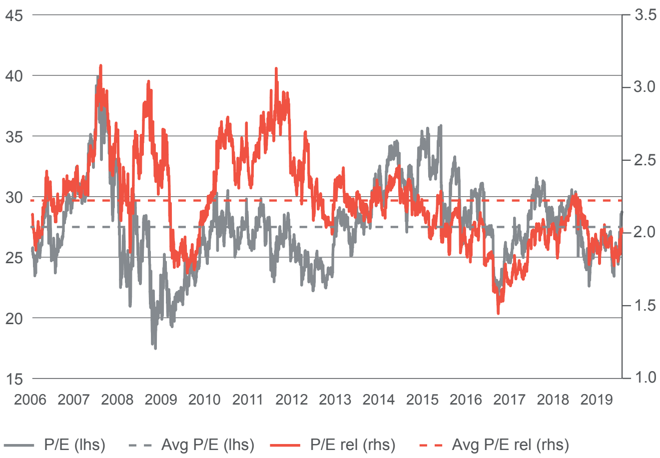
FIGURE 7:

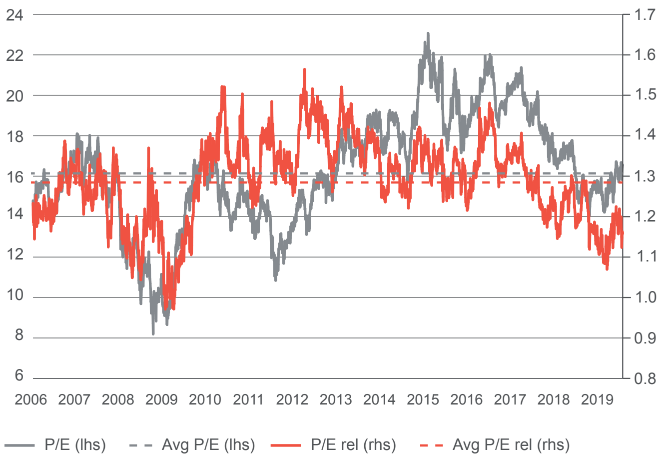
Novozymes P/E relative to MSCI Europe



Source: Bloomberg, 5 November 2019

FIGURE 8:

Henkel P/E relative to MSCI Europe



Source: Bloomberg, 5 November 2019

Two examples of companies we have held in the past are shown in Figures 6 and 7. Danish enzyme producer Novozymes witnessed 5% organic sales growth from 2010-18, which combined with 650bp margin expansion over the period, has seen earnings per share growth of c. 10% per year. However, with increasing pressure on customers and weak commodity prices meaning their products have a lower economic benefit, organic growth has slowed materially and this year is expected to be negative. As a result, Novozymes is trading at a discount to historic levels, despite interest rates at record lows. Likewise, Henkel has seen significant pressure and a slowing organic growth outlook, which has fallen from 3.1% in 2017 to 0-2% expected this year, and now trades in line with its historic absolute valuation, but at a discount to its historic premium valuation relative to the wider market. In both cases it was important for us to identify that growth was going to slow and that multiple contraction was therefore likely.

Finding reasonably priced, high quality companies which can sustain high growth rates remains our aim in the growth groups of our portfolio, Hyper Growth, Secular Growth and Cyclical Growth. These businesses should be able to grow sustainablyabove market expectations and beat the fade, and be reasonably priced relative to history. Analysing key product cycles and disruptive innovations, has been critical in identifying where consensus may be underestimating growth.

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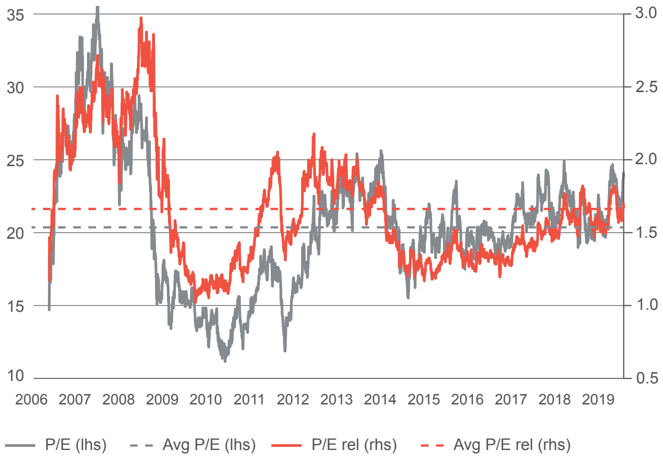
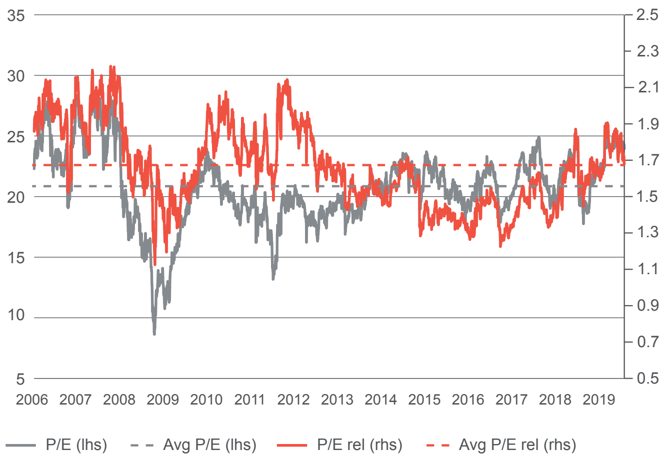
FIGURE 9:
Grifols P/E relative to MSCI Europe



Source: Bloomberg, 5 November 2019

FIGURE 10:
Sonova P/E relative to MSCI Europe



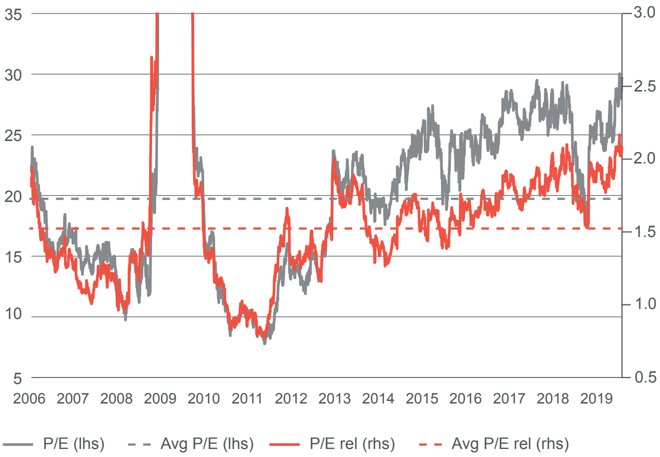
Source: Bloomberg, 5 November 2019

Current portfolio holdings within these buckets include Grifols, Sonova, ASML and Alten.

Spanish blood plasma protein producer Grifols is currently trading at a discount to its historic c60% P/E premium to the market, and in absolute terms is trading broadly in line with its average of the last 7 years, despite the outlook for future earnings and cash flow growth looking extremely positive. The plasma market is currently growing 7-8% per year, and Grifols is gradually taking share. Margins are below peak levels and are improving, through better collection centre utilisation and favourable last litre economics driving operating leverage. R&D innovation is supportive in the long term, in particular the use of albumin for the treatment of Alzheimer's disease. As a result we expect Grifols to grow earnings at a low double digit percentage rate, ahead of consensus expectations.

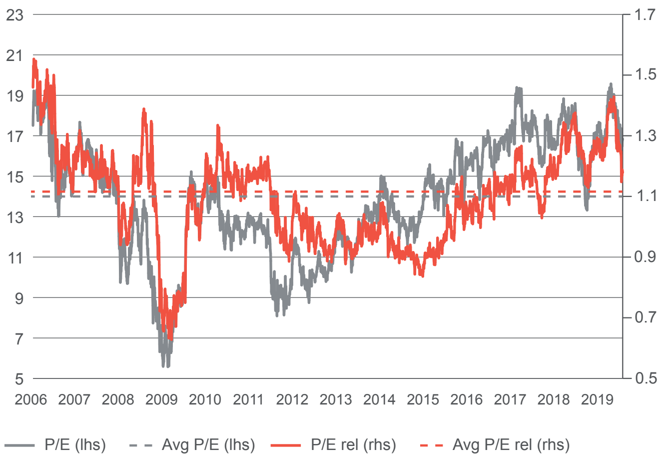
Hearing aid manufacturer Sonova is trading at only a small premium to historic levels despite a favourable growth outlook driven by strong demographic trends and recent product innovation. Sonova had been suffering from several disappointing product launchs in recent years, which have allowed competition to gain share with audiologists. The launch of the new Phonak Audéo Marvel in 2018 however has proved to be a significant success, and we expect Sonova to continue to regain lost market share over the coming years and deliver organic growth ahead of expectations. Market volume growth should remain healthy in the coming years too, due to fast growth in the population over 65, driven by the baby boomers. As a result, we expect Sonova to exceed the 4-6% annual market growth for several years.

FIGURE 11:
ASML P/E relative to MSCI Europe



Source: Bloomberg, 5 November 2019

FIGURE 12:
Alten P/E relative to MSCI Europe



Source: Bloomberg, 5 November 2019

Technology has been a sector which has outperformed with strong earnings growth and multiple expansion. Many companies have moved from GARP to GAAP as a result. In this environment we own ASML, a company we have owned several times over the past 10 years. We took a position at the end of 2018 as the stock retrenched to a reasonable valuation due to fears of a slowdown in the market for semiconductor sales. After speaking to the company, it was clear that its foundry and logic customers needed to order their latest extreme-ultraviolet lithography (EUV) machines in order to progress in line with Moore's Law. This has played out in 2019 and ASML has recently reported very strong order intake.

Another technology stock we own is Alten. It is a provider of outsourced R&D to industrial companies and IT departments. The strong earnings growth is being driven by organic expansion and price increases caused by strong demand for digital transformation. We see these drivers as somewhat independent of the economic cycle although the company will not be completely immune. Again, we believe the valuation is attractive relative to other software and services names with similar profit growth.

Why not shift to pure value?

Style drift is never a great idea for investment managers. But we see a compelling reason to stay away from some of the deep value stocks in our target universe.

The European corporate universe is continuously impacted by long-term change (technological, environmental, economic, demographic). Investment opportunities can be generated from a fundamental assessment of how companies' strategies are responding to these changes. A key part of our research process looks to identify those companies who's earnings are at risk of deteriorating significantly. When looking at the cheapest stocks in the market, our analysis often suggests that disruption is likely to impact the earnings more than expected, and so the business may be expensive on a longer-term view. With the FANGs growth ambitions and a plethora of well-funded start-ups any weakness will be exploited in short order. We will continue to meet those companies in our target universe that we consider to be both cheap and disrupted in the hope that they can find solutions to drive shareholder value.

> " Disruptive innovation will drive winners and losers. The fund aims to own the winners and avoid the losers. "
>
> RUSSELL CHAMPION

FIGURE 13:

YTD performance of Value vs Growth

Source: Bloomberg, 5 November 2019

In conclusion the impacts of low interest rates and crowded positioning on growth companies deemed to have a defensive moat has resulted in these companies becoming highly rated relative to history. The team are working hard looking forpotential investments within our target universe to find attractive ideas across all our buckets. Within the growth buckets we are looking for companies who can demonstrate above market top line growth while maintaining attractive returns at a reasonable valuation. Valuation is never the starting point for an investment thesis, but we have to Mind the GAAP!

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