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Global research and insights from Frontier Advisors

Issue 45 December 2019

The Global Value Opportunity

Equities European Research Trip

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25
years

Frontier regularly conducts international research trips to observe and understand more about international trends and to meet and evaluate, first hand, a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This edition investigates trends that will impact how asset owners invest and manage increasingly complex and global investment portfolios as learned by members of our very own Leadership Team.

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Fraser joined Frontier in 2012 and is the Head of Equities. He was previously at Ibbotson Associates/ Intech Investments for nearly 15 years where he held a variety of roles including five years as Head of Manager Research and five years as Head of Equities and Property. Fraser started his asset consulting career at Towers Perrin in 1994 as a Research Analyst in its Melbourne and London offices. Fraser holds a Bachelor of Commerce with Honours from the University of Melbourne and a Graduate Diploma of Applied Finance and Investments from Finsia, and is a Fellow of Finsia.

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Sarkis Tepeli is a Principal Consultant at Frontier, having joined the firm as an Associate in 2007. His current responsibilities include leading several client service teams across the superannuation and higher education sectors and membership of Frontier's Responsible Investments Group (RIG). On the research side, Sarkis contributes to the Equities Team. Before joining Frontier, Sarkis was employed by WorleyParsons as an Engineer/ Consultant working in the Oil & Gas Customer Sector Group before moving to Electrical Power Group. Sarkis holds a Masters of Applied Finance from Macquarie University. He also holds a Bachelor of Commerce and Bachelor of Engineering (Electrical) (Honours) from the University of Melbourne.

The global value opportunity

As part of ongoing research into both new and incumbent fund managers, Frontier's equities team regularly travels internationally to meet managers on their home soil. This enables greater opportunity to meet team members who are not regular travellers, see systems in action and engage at a deeper level. This travel typically involves meeting Frontier's Global Investment Research Alliance (GIRA) Partners, LCP (in the UK) and Segal Marco (in the US), as well as meeting large numbers of managers.

During our October 2019 research trip, in addition to our manager research, there was one item that was raised frequently – the divergence in performance between the value and growth investment styles. This can be measured in a variety of ways, but on this recent research visit, we heard many managers raise that they felt the level of divergence had reached an extreme.

This most recent trip was essentially a European research trip with around 30 managers visited in Copenhagen, Edinburgh and London, followed by two final days in Hong

Kong. While these managers are often global equity managers, investing all over the world, we wondered whether by virtue of being predominantly a European trip (and not visiting the USA where the growth style has been most effective), if the feedback would have been the same had we conducted a US research trip instead.

Our conclusion is that the feedback and evidence does support the fact that divergence has occurred. In this report, we consider the evidence and outline the implications for client portfolios and potential actions.



¹Meeting notes for each of these meetings can be found on the Mercury module of the Frontier Partners Platform

An illustration of the value-growth divergence

There were many managers with charts to show Frontier on the current value opportunity.

The following charts come from Schroders and highlight:

- the underperformance of value versus growth in the past decade; and
- the increasing attraction of value versus growth from a valuation perspective.

The common message was that the value style has clearly underperformed for a decade following the GFC and reached a point of a heightened discount relative to the average discount. We did hear references that this heightened discount was an “extreme”.

The views of managers

Value managers regularly showed Frontier these charts and provided explanations around this opportunity in value. Colourful terms were often used to describe non-value stocks. One such reference was to describe quality and low volatility stocks as “eye-wateringly expensive”. Of course, value managers have a vested interest to talk up the value opportunity, so we keep that in the back of our mind, particularly given some cheap stocks can and do become cheaper (historically called value traps), and can stay cheap for long periods of time.

We did not expect growth managers or other managers with a non-value style to be as enthusiastic as those with greater value orientation. In general, however, we found managers with other styles to be relatively subdued and modest in their optimism. It was common for growth and quality managers to note that valuations had become expensive in pockets within their universes. These managers had often redeployed capital into other more attractively valued segments of their universe (albeit still growth and quality companies).

Chart 1: Cumulative return: MSCI world value vs. growth

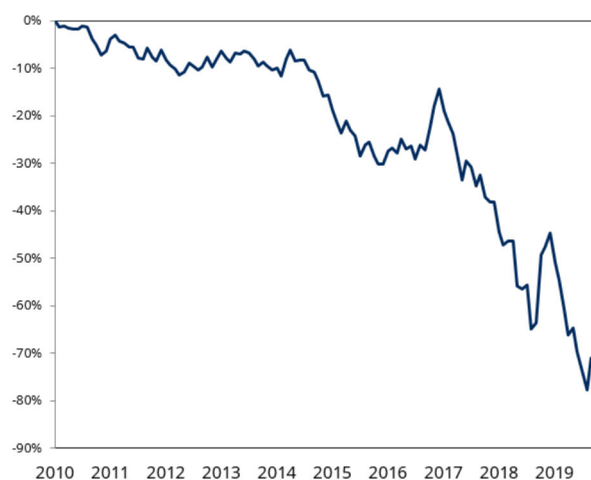
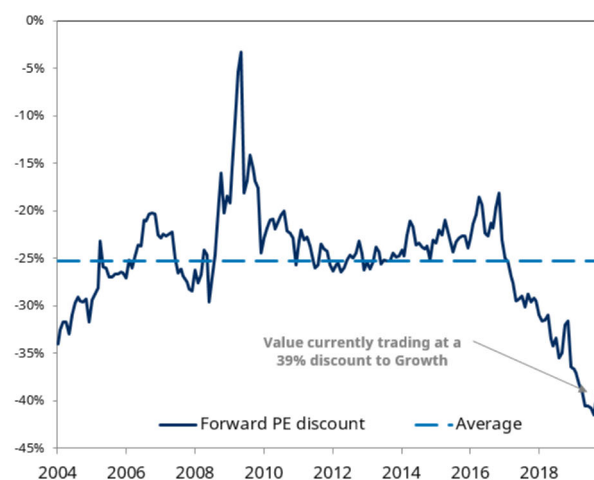


Chart 2: Forward PE discount: MSCI world value vs. growth



Source: Schroders with Frontier's overlaid comments

Explanations of why we may be at a point of opportunity for a value style?

Momentum of flows into ETFs and passive management

It was generally acknowledged that asset flows had been channelled into the more favoured segments of the market. New vehicles (such as ETFs) had exacerbated this with assets flowing into branded products (such as low volatility ETFs) that kept the momentum flowing.

Similarly, flows into passive management were reported by managers. By its nature, passive investment results in a bias towards larger market cap stocks. In today's global equities market, these larger stocks are technology related businesses that we would associate with a growth style.

Flows towards passive investment results in capital being invested in the largest market cap stocks and can accentuate the outperformance of growth, when growth is dominating the large cap landscape. The top ten stocks in the MSCI World Index (as at 29 November 2019) are shown in the following table and this highlights the dominance of growth stocks in the index. The last decade has seen a significant increase in the uptake of passive management at the expense of active management, and it is likely this has had an impact on style performance differentials.

Table 1: Top ten stocks in the MSCI world index

Stock	MSCI World Style Index	Market Cap (US\$ b) ¹	Current P/E
Apple	Growth	1,208	21.9
Microsoft	Growth	1,098	29.9
Amazon	Growth	757	78.4
Facebook	Growth	485	23.7
JPMorgan Chase	Value ²	421	13.1
Alphabet C	Growth	408	29.4
Alphabet A	Growth	391	29.4
Johnson & Johnson	Value ²	363	21.5
Visa	Growth	319	33.6
Nestle	Growth	309	32.8

¹Free float adjusted market cap

²Both of the stocks in the MSCI Value Index are trading at a significant premium relative to their average price/earnings ratio. JPMorgan Chase's current P/E ratio is at a 21% premium and Johnson & Johnson is at a 26% premium.

The following chart displays the funds under management (FUM) associated with US active and passive investment (data at a global level is more difficult to come by), and passive investment has overtaken active investment in recent

times having increased over 75% since 2014, while funds under management associated with active management has only increased marginally.

The market's emphasis on governance

One manager suggested the value opportunity has come about from the market's wide dispersion in the pricing of governance. The argument was that well governed stocks are on very large premiums to book value while there are many stocks priced at a discount to their book value (the market penalising these companies for not being well governed). Obviously, this was a generalisation as we know that there are some highly priced stocks with governance issues as well (e.g. Facebook, Uber), although arguably the valuations of

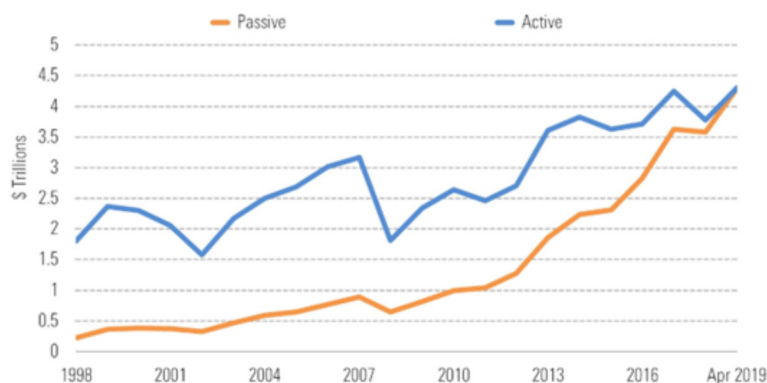
these stocks could be higher if their governance issues were resolved. This manager was owning stocks priced at a discount to book value and undertaking actions/engagement in an effort to improve the governance of these firms. In this case, where an improvement in governance occurs, a reappraisal back to book value represented a good return opportunity, with a further opportunity that these companies might eventually exceed their book value.

Could this be a false signal for the value style?

We are open to the idea that this manager enthusiasm displayed for a value recovery could be misplaced. In terms of counter arguments that we have heard/seen:

- one manager commented that if Fama/French did analysis today they wouldn't find a significant value premium. It was also noted that the original Fama/French research used data over a period (1963-1990) where bond yields were significantly higher than they are today. If that is the case, Managers could possibly be looking for a rebound in a value premium that is less meaningful than the industry has historically believed; and
- we also note a recent academic paper from October 2019 titled "Explaining the Recent Failure of Value Investing" written by Baruch Lev (New York University - Stern School of Business), and Anup Srivastava (University of Calgary - Haskayne School of Business). This paper outlines two major reasons for the recent failure of value investing – 1) accounting deficiencies (essentially related to intangibles) that systematically mis-identify value and growth stocks; and 2) economic developments (i.e. disruption and the contraction in bank lending) that have compromised the mean reversion of value stocks.

Chart 3: US Equity Funds Active versus Passive Assets



Source: Morningstar

The final word...

Portfolio implications

Frontier believes that portfolios should generally be balanced across different risk factors, but there are certain tilts that are rewarded over the long-term. We still believe value is one of those long-term risk premiums. This remains an area of ongoing research for Frontier and we expect to publish a more comprehensive paper on the value factor in 2020.

The feedback from this most recent international research trip left an impression that the value style might have experienced some of its worst years. When combined with supporting charts, there seems a reasonable probability for the value premium to exceed the market return in the future. We haven't seen this happen for a while and we think many funds are not well positioned should the value style perform well versus the broader market. Our observation is that many global equities portfolios that have drifted away from value in the past five years (i.e. are underweight value and have increased growth, quality and low volatility exposures – particularly at times when they have done well).

Potential actions

Now might be a good time to closely examine the current portfolio and be clear on the biases that exist within the portfolio. Frontier would be happy to assist clients in this analysis. We acknowledge timing styles is notoriously difficult, so we are not advocating for funds to adopt a large overweighting to value. However, rebalancing would seem in order if underweight to value. Finally, Frontier is not dismissing that future league tables of super funds global equities returns might look different. It is feasible league tables might be led by those funds that were positioned for a reversal in the fortunes of the value cycle.



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