August 2019

CORPORATE EXCELLENCE INSIGHTS

Hérens Quality AM is a specialized provider of systematic Quality Investment Solutions and one of the few providers of Quality equity investment strategies worldwide. Corporate Excellence Insight is our monthly publication that includes a brief update on markets and our thoughts about major trends that are impacting the investment management industry.

MARKET UPDATE: MODEST ADVANCE

US equities made gains while European equities were virtually flat in July. The Federal Reserve lowered interest rates for the first time since the Great Recession in 2008 to help stave off the possibility of an economic downturn. Interest rates are now set to hover between 2% and 2.25%.

0.2%

EUROZONE ECONOMY EXPANDED BY JUST 0.2% IN Q2

That was lower than a growth rate of 0.4% in Q1. Annual inflation dropped to 1.1% in July from 1.3% in June. ECB indicated that it was drawing up plans to stimulate the economy given the weak growth and below-target inflation.

$8bn

P&G TAKES $8 BILLION GILLETTE WRITEDOWN

The charge was driven by more competition over the past three years and a shrinking market for blades and razors as consumers in developed markets shave less frequently. P&G paid $57 billion in 2005 for Gillette.

-25%

LUFTHANSA 2Q ADJUSTED EBIT FELL TO 754 MILLION EUROS

Lufthansa is braced for very tough price competition with Ryanair and easyJet for at least the rest of this year as it reported a plunge in second-quarter earnings.

MONTHLY TOPIC: WHAT'S UP WITH VALUE?

Historically, value stocks have been superior to the growth stocks: since 1933, value has outperformed growth in 60% of periods. However, now it seems that market paradigm has changed: the trend reversed in 2006 when growth stocks became superior vs. value, therefore recording the longest secular bull run.
Knowing that the growth style success and value style troubles are to a great extent explained by the sector weighting in the respective indices, we decided to examine how the performance results would alter in case of sector-neutral value and growth indices. We found that, in fact, value started to lose its position to growth just in the beginning of 2017.

Equity markets became much more efficient and sophisticated than they used to be, and if the stock is cheap, then it is cheap for a reason. If stock's valuation is on a low level, it can be well-explained by the fundamental problems, which undermine or will undermine quality status of the company.

Stock investing based on valuation level or earnings growth, respectively sticking to growth or value styles, will not be sustainable in the long-term as the growth cycle will be replaced by value cycle and vice versa. The best recipe is careful and systematic selection of stocks with performance and risk characteristics independent of value and growth styles.

Read full Article on Page 2 ↪

Information about us: www.hqam.ch
Contacts: ✆: +41432223141; ✉: info@hqam.ch

WINNING GROWTH, BEATEN VALUE, BENEFITTING QUALITY

Low valuation indicates fundamental problems

Historically, value stocks have been superior to the growth stocks: since 1933, value has outperformed growth in 60% of periods. Tailwind from value recognition probably helped the most well-known value investor W. Buffett to earn his fortune. However, now it seems that market paradigm has changed: the trend reversed in 2006 when growth stocks became superior vs. value, therefore recording the longest secular bull run (Clissold, Nguyen, 2019). To a great extent, it was caused by the unprecedentedly long cycle of low interest rate environment, when every grain of growth becomes valuable.

Before we discuss the reasons of value underperformance in detail, it has to be mentioned that equity markets became much more efficient and sophisticated than they used to be, and if the stock is cheap, then it is cheap for a reason. If stock's valuation is on a low level, it can be well-explained by the fundamental problems, which undermine or will undermine quality status of the company. Such companies, classified as Dogs according to BCG matrix, often experience business model erosion, which is acknowledged by the market that assigns them a certain discount.

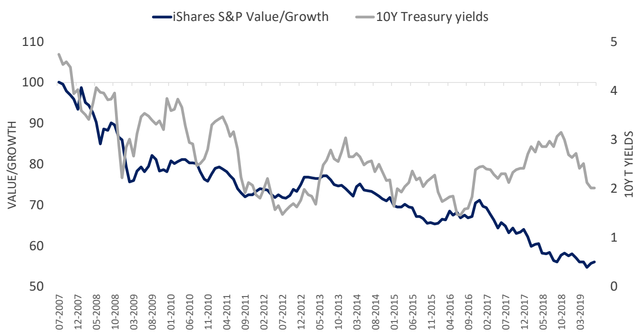
The examples of value traps that we mention here speak for themselves. Bed Bath & Beyond, a clear value company with PE of 13 in 2016 and 6 in 2019, declined 80% since 2016 as the management responded too late with digitalization and e-commerce initiatives. The company has witnessed declining gross and operating margins, declining same store sales and deteriorating trends in free cash flow generation.

Walgreens with PE of 10 also faces troubles with regard to its business model. Since the merger of Walgreens and Boots, the company struggled with comparable store sales growth in North America and United Kingdom, where saturation is already quite high. Additionally, the launch of Amazon's drug delivery services created pressure on forward-looking growth guidance for Walgreens' pharmacy stores.

Blame low rates and sector bias

But, back to the most evident reasons of growth outperformance. One of the most significant factors supporting the performance of growth stocks during the last decade were low interest rates, which are responsible for a lower discount factor. Discounting future cash flows of growth stocks to the present provided additional support for their performance.

Fig. 1: Value vs. growth performance and 10Y Treasury yields

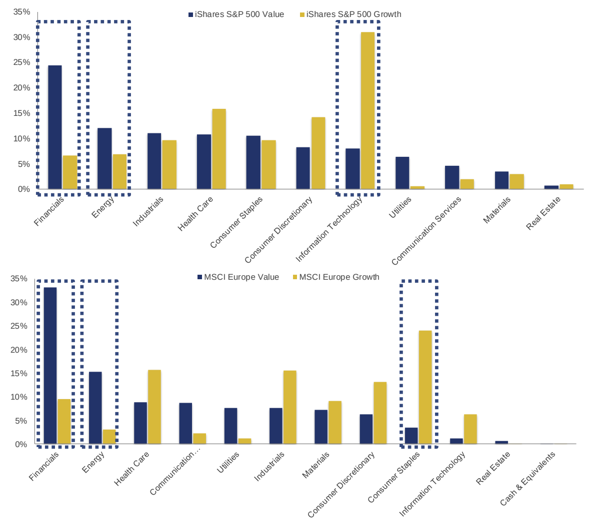


Source: Hérens Quality Asset Management, Reuters

It does not seem that the era of low interest rate environment will end soon, so the supporting factor to the growth stocks will continue to be valid.

The common explanation of the growth superiority over value is sector bias: heavily indebted, slowly growing financial and energy companies prevail in value-tracking indices, while IT companies, hyping on massive digitalization trend and boasting of high development pace, are crowding growth indices. For instance, IT in USA value index has just 7% weight, while in growth index it has 31%.

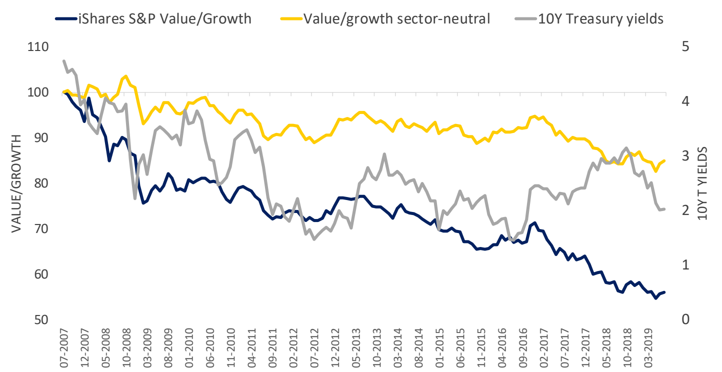
Fig. 2: Sector breakdown of value and growth indices in USA and Europe



Source: Hérens Quality Asset Management, Reuters

However, we decided to examine how the performance results would alter in case of sector-neutral value and growth indices, respectively calculating TR based on iShares S&P 500 value and growth ETFs that are rebalanced monthly using representative weights in each sector in line with the S&P 500.

Fig. 3: Sector-neutral value vs. growth performance and 10Y Treasury yields



Source: Hérens Quality Asset Management, Reuters

The chart above compares the performance of S&P value/growth indices and sector-neutral S&P value/growth indices. In fact, we do not see a significant discrepancy in these style performance as contrasted with the 'traditional' value and growth indices. Value started to lose its position to growth in the beginning of 2017, but before that, one should not have blamed 'traditional' value style for poor performance – it was mainly sector tilt.

Stock selection within quality pays off

We are, however, persuaded that the stock investing based on valuation level or earnings growth, respectively sticking to growth or value styles, will not be sustainable in the long-term as the growth cycle will be replaced by value cycle and vice versa. To be able to stay in the outperforming league, the best recipe is careful and systematic selection of stocks with performance and risk characteristics independent of value and growth styles. We consider it imperative to select companies, which operate sustainable business models within promising market niches and favorable market environment, have a good management team focused on the long-term value creation and as an addition are attractively valued.

References

1. *Clissold, E.; Nguyen, T. (2019). Will Value ever outperform again? A Featured Report by Ned Davis Research.*