Value, volatility & European equities in 2017

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Recent performance

Following a strong year in 2016, it is very pleasing to see the Neptune European Opportunities Fund at the top of the IA Europe ex UK sector over one year, but more so that we remain close to the top over ten years and since launch nearly fifteen years ago. We still have work to do getting back into the top quartile over three and five years – given we had a very tough year in 2014.

Performance drivers & attribution

In the first half of 2016, the Fund had a difficult period, with performance some way behind the MSCI Europe ex UK Index. The banks were causing some of the difficulty but actually, the Fund was underperforming in a few areas. However, in the second half of the year, things bounced back strongly and the Fund ended the year well ahead of the Index. This was due to value sectors and stocks starting to work, whilst sectors in which we are underweight – consumer staples and healthcare for example – underperformed significantly. One of the Fund's best performers over the year was French bank BNP Paribas.

Interestingly, when we analyse the entire year, European banks did not actually contribute any alpha towards the Fund's outperformance. They cost the Fund in the first half and helped our recovery in H2, but actually underperformed the benchmark in 2016 as a whole. We hope that this sector will now actually generate alpha over the full year in 2017, but we are using this example just to point out how modest value's recovery has been so far – it was a fierce recovery in the last quarter in particular, but came from a very low base. Indeed, we have taken profit in quite a few of our best performers in 2016 and we feel that the Fund is nicely refreshed and well-poised to continue to outperform in 2017.

Value versus growth

In terms of the value story, it is something that we have been discussing for a year or two now and I just wanted to share some of our insights. The main point is that value has significantly outperformed growth as a style over the last 90 years. This can be shown using Fama-French data from the University of Chicago, which highlights that value has outperformed growth by more than five times over the very long-term.

Whilst Fama-French deals with US companies, we have also analysed data from the MSCI Europe ex UK Index since its inception in 1975. Over this time period, once again value has significantly outperformed growth, so much so that growth has actually meaningfully underperformed the wider benchmark. Consequently, this data is telling us that cheap companies systematically outperform both the benchmark and expensive companies. This is particularly relevant as quality growth companies have been absolutely in vogue over the past decade, but does not in fact have such a great long-term track record.

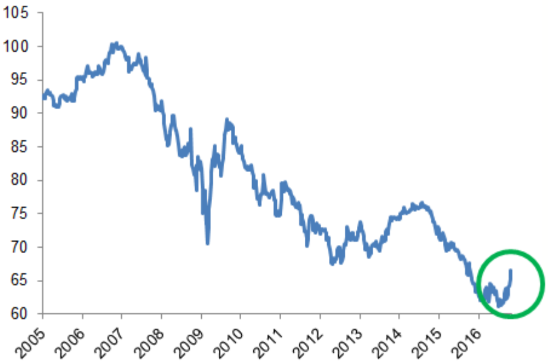
Short-term trends

Since 2007, value has underperformed growth by nearly 50%. As a result, value has not worked for nine years which, in this industry, is enough for it to not only to be out of vogue but there are now very few value funds left. There has been a raft of fund closures and managers have often been fired. We believe this has provided us with a great opportunity; very few investors are positioned for value but the important point here is that the recent underperformance of value is anomalous relative to history.

Despite enduring a tough ride over the past 11 years we have seen a recovery in value in the last six months. However, there is a concern amongst some investors that we have had this recovery and that this could be it.

MSCI Europe Value relative to MSCI Europe Growth

2005 to 2016



Source: Morningstar Direct, January 2017.

We do not subscribe to this view. We believe we are just at the beginning of this recovery for value and take the position that all of its underperformance since 2005 will be unwound. Our analysis has shown, however, that only 7.8% of the assets under management in the IA Europe ex UK sector are in value strategies, according to Morningstar data.

The fundamental backdrop

We have talked about history but what is the actual mechanism that has held value back and therefore can get value to work again? We believe that the single most important metric here is declining interest rates. When nominal interest rates decline, it lifts the present value of all assets based on their estimated future cashflows. However, it lifts the future value of assets that are the longest duration the most.

Just like a bond, when interest rates fall longer duration bonds go up more than shorter duration bonds. In equities, the concept of duration also exists, although it is not so well discussed. If you have a very stable business that is very defensive, with a very predictable earnings stream – such as Nestle – when interest rates decline, those earnings all the way out in the future can be revalued up.

Our research has shown that when nominal rates stop falling, the headwind to value is removed. For example, in every decade when rates have been stable or rising, value has outperformed growth. Value experienced a bear market during the Great Depression in the 1930s and in the 1990s, which again saw big declines in nominal interest rates. Therefore, we believe the fuel for quality growth's outperformance is simply falling interest rates.

Can rates go lower?

We think it is very unlikely that they can, primarily because of what happened when the ECB threatened to cut rates even further in January 2016. We all recall that the banking system was put under huge pressure as there is a limit to how much margin decline can be forced upon a banking system. The ECB have seemingly learnt their lesson and now know that there is no positive economic benefit from cutting interest rates at this point, actually quite the reverse.

There would be a major economic dislocation caused by interest rates going lower, as shown by two Princeton economics professors, who published a book called The Reversal Rate. This has been well-received in central banking circles, we have been told.

Fund positioning

Given this economic backdrop, looking forward we expect value to outperform. This is why the Neptune European Opportunities Fund continues to be overweight banks, which represent 35% of the portfolio. This is a significant differentiator versus the benchmark and peer group. We are also overweight materials, industrials and energy, whilst remaining very underweight in consumer staples and healthcare.

Therefore, we have a deliberately cyclical bias, primarily because we believe there is so little value in defensive assets today. There has been a bull market in defensive assets since 2007, resulting in them being significantly overpriced. As a result, we protect the Fund from not owning these kinds of companies in two other ways. The Fund's primary support is its dividend, with our underlying holdings set to payout 3.9% gross in 2017. In addition, all the companies we own are cheaply valued, even on low multiples of earnings and trough margins. Our margin of safety is very much driven by this concept of trough margins and trough multiples. If you can have both of these, the margin of safety is extremely high as we see it.

The European financials sector

European banking stocks have been through three failed recovery attempts post the Lehman Brothers crisis but we believe this time is different due to interest rates not declining. When the ECB cuts rates, net interest margins fall for banks, which means profits fall. Since 2007 up until the first quarter of 2016, interest rates were still declining. However, we believe this has now stopped and therefore bank margins are beginning to bottom out. Furthermore, the second headwind that has also had an impact has been regulation.

We have had an avalanche of regulations demanding higher capital ratios in recent years, but we believe we are nearly at the end of this cycle, with the details of Basel IV coming in the next few months.

Most banks are more or less up to speed with where they need to be and we do not think there are likely to be any major surprises at the system level. The final hurdle the sector needs to overcome is litigation. Now, although we can never say litigation is over, the huge scale of litigations that the banks have endured post-crisis is coming to an end, following recent settlements from Deutsche Bank and Credit Suisse.

We believe these three major headwinds – falling interest rates, higher regulation and litigation – are beginning to abate. Therefore, we predict a more durable recovery and an end to the attack on the banking system from the ECB.

Dividend outlook

We expect the banks can now rehabilitate in a more benign environment than they have been in since 2007, but what else leads us to be positive on the sector. A key component to total return over the last century has been dividends. Not many investors realise that banks are now the second highest yielding sector in Europe, paying out nearly 5% this year and above 5% in 2018. Importantly, they also have the lowest payout ratio in Europe. For example, even though utilities companies pay out a little bit more in terms of dividends, their payout is nearly 100%. Within banks it is about 50%. Now, we are not expecting to get to 100% payout ratios, but they can certainly go up from 50% to 60%, if not to 70%, over the next few years. Therefore, there is tremendous scope for dividend increases, irrespective of earnings growth. However, we do expect to see earnings growth coming through too.

Despite their performance over the last six months, there is still significant valuation support as well. Companies such as Societe Generale are up nearly 70% since the end of June, but still trades on just 9x 2018 forecast earnings. Consumer staples on the other hand trade at nearly 18x 2018 earnings. In our opinion, European banks will deliver higher earnings growth than their consumer staples counterparts, yet trade at half the price.

2017 catalysts

In addition we are beginning to get earnings upgrades coming through the financial system. It looks like the US investment banks had a wonderful fourth quarter in terms of their fixed income revenue and earnings momentum has also surprised on the upside in the majority of cases. This is starting to translate to some earnings upgrades in Europe. In terms of the banks that we still like, we still remain holders of BNP Paribas and Societe Generale, which were our biggest weightings last year. However, we have trimmed our positions given the scale of the rally they experienced in the last six months.

Elsewhere, we are also fans of the Norweigian bank DNB NOR, which has also been a strong performer, and we have recently been buying Credit Suisse in the last couple of months as well. In total, we believe we have a wide array of exposure to this sector and we see significant valuation and dividend support, as well as considerable upside in a number of individual stocks.

Politics

Understandably given last year's events, there is a lot of nervousness within the investment community and the first date on people's minds is 15 March. This is the date of the Dutch elections and Geert Wilders of the PVV is the man people are nervous about

However, given that he is currently only polling about 23%, we do not believe he is in the position he needs to be in to control the government. The PVV would need to go into coalition – which no other party wants. Clearly there is a risk – and 2016 proved the pollsters wrong – but our base case is that Wilders will not win. However, it is something we are monitoring very closely.

The other event that is coming in to focus is the French election. The first round will be held on 23 April and Marine Le Pen of the Front National is the talking point. However, she has been polling around the 25% for the past 12 months. This does not mean that she could jump higher, but we think it is unlikely. In our view, Francois Fillon is the front runner to win it for Les Republicains.

More importantly, these political fears are causing a lot of caution in the European market at present. This can be shown by highlighting the flow of US dollars investing in the three largest ETFs used by some US investors for their European exposure. In early 2015 we saw a big surge of money from US investors coming in to Europe, whilst in 2016 we saw pretty relentless cumulative outflows. In these three funds alone a total of $18 billion came out of the market. A lot of investors are therefore remaining on the side lines, particularly in the US and – if le Pen does not win for example – we think this could be a bullish event and that some money could come back into European equities.

Questions

How resilient do you think the portfolio will be if the recent inflationary trend continues?

At the moment we have an interesting set-up whereby Italian inflation is quite low, whilst German inflation is rising towards the 2% level. The ECB's goal is to have inflation at just under 2%, so they are not quite in a tricky position just yet. However, there is a chance that German inflation moves up in the next few months and that this will impact the German elections in September and October. This would put pressure on ECB President Mario Draghi to take action.

In our view, we believe there is upside risk to inflation. As a result, we believe we are very well positioned. For example, if the ECB introduce tapering of any kind, this will cause an upward movement in long bond yields in Europe and banks are the major beneficiaries of that over the medium and long term. In the rest of the portfolio, our materials and industrials stocks are also quite positively correlated to inflation generally and so any pick-up we would benefit quite strongly from.

How do European equities stack up against other markets for the year ahead?

In our analysis of comparing the value opportunity within markets, one way of doing it is looking at the spread in the price-to-book (P/B) ratio within sectors. You can do this by taking the difference between the cheapest quartile and the most expensive quartile, which is a simple way of looking at how far the elastic band as it were has been stretched. In a global context, European equities screen the best on this metric, with Japan in second place. Therefore, there is also a value opportunity in Japan in my view, although clearly I am not a specialist.

How do you think the euro will fare against sterling and the dollar?

Currency predictions are very hard, but it is possible that US rates could rise and the dollar could weaken. One of the fundamental things we lean on when we look at currencies is interest rate differentials. The typical investor looks at interest rates rising in the US and therefore thinks that interest rate differentials are going to be in favour of the dollar. That is certainly the case at the short-end but at the long-end, if the ECB does some tapering, our research shows that German bund yields are approximately 150 basis points below their fair value based on current inflation and growth estimates.

As a result, tapering could cause German bund yields to move up sharply. That would support the euro, as would an unwinding in political risk and strong economic data – which we are already seeing. Therefore, I do not believe there will be any strong moves in cross rates in the near future.

What would be a sell signal to reduce some of your banking exposure?

As an investor focused on prices and valuations, the simplest way would be to see the sector's share prices rally significantly higher than they have already. In my view, around 1.3 to 1.4x book value is around fair value for the banking sector over the next three to four years. Another simple rule of thumb would be to track the dividend yield. If you look at the last 30 years, European banks have had an average yield of 3% yet they are currently yielding c.5%. Therefore, if the banking sector rallied up and pushed that dividend back down to 3%, that would be another time to step back.

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