Taking Stock

JULY 2019

FUNDAMENTAL VALUE EQUITIES

Concentrating on long-term value

STATE STREET GLOBAL ADVISORS

THE BIG PICTURE

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As long-term contrarian value investors, we often find ourselves swimming against the tide of popular wisdom. One of the key aspects of the culture we have built over the past dozen or so years is a determination to invest with conviction, and that means following the facts and strongly interrogating the analysis we do on companies. When we do swim against the current, we do so fully aware of the challenge.

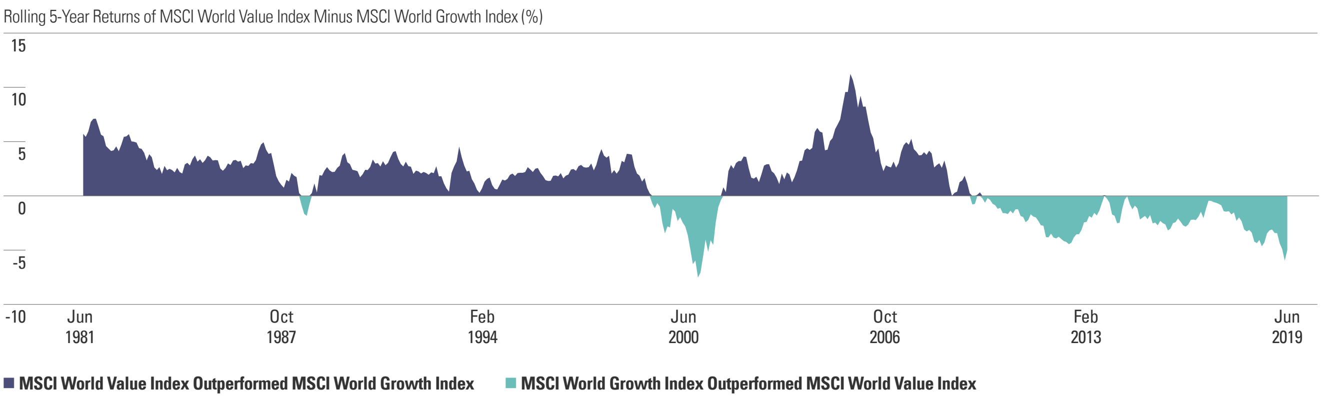
We have been battling this current for some time, with value investors of all stripes facing stern questioning about the seemingly unrelenting underperformance of cheap stocks. The market's appetite for growth or quality at virtually any price seems insatiable. This flies in the face of decades of market history, but it stands to reason we should ask that question: is it different this time? Well, it certainly has been to date (Figure 1).

What is Weighing on Value?

Or perhaps more pointedly, what continues to feed the popularity of more highly-valued stocks? We have written previously about the impact of ultra-low interest rates on the price-to-earnings (P/E) multiple of high-duration growth stocks and the opposite effect they have had on shorter-horizon economically-sensitive shares. We have seen a plethora of studies recently trying to explain the performance gap, with many settling on periods of low inflation or low interest rates as likely culprit. As investors, our job is to determine whether the gap in performance and valuation is justified by the facts, in this case the fundamentals. The most often-cited rationale for the performance spread in favour of growth stocks is that superior earnings growth validates a higher starting earnings multiple. Certainly, there is a broad consensus view that the global equity market is being driven by a historically unique set of monopoly-like technology firms, where terms such as valuation or mean reversion no longer seem to apply.

The performance spread between growth and value has been particularly acute over the last five years — the question that requires answering is whether growth has delivered or value has disappointed enough in a fundamental context to justify the valuation gap.

Figure 1: Recent Headwinds to Value Have Been Intense



Source: State Street Global Advisors, MSCI. Past performance is not a guarantee of future results. The MSCI World Value Index and MSCI World Growth Index were incepted on 8 December 1997. Results prior to this date were calculated by using available data at the time in accordance with the Indices' current methodology. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income. The performance includes the reinvestment of dividends and other corporate earnings and is calculated in US dollars.

Growth Premium Stretched

If we go back to 2014, the MSCI World Value Index traded at about 13 times forward earnings, while the Growth Index traded around its usual premium at 17x. What is fascinating to us is that the Value Index (with all the caveats that apply to index construction) appears to have delivered compound annual growth in earnings of about 3% over the past five years, while the P/E multiple has de-rated to less than 12x.

And while the MSCI World Growth Index did deliver superior earnings growth, the spread might surprise; the annual growth rate was 4%. It is arguable whether a 100 basis points spread in earnings growth would warrant the starting P/E premium of 30%, but it is more difficult to justify that premium expanding to 70% today (Figure 2).

One argument used to support why it is different this time is that growth companies generate superior return on equity (ROE), and that this justifies the PE premium. It's a point on which we agree. This is a key lesson from the "style map" underpinning our investment philosophy: companies with higher returns on invested capital (ROIC) deserve to trade at higher enterprise value to invested capital (EV/IC) multiples if they sustain those returns and can grow invested capital.

However, those higher ROEs or ROICs are only truly valuable if they deliver superior organic earnings and cash flow growth. The actual results over the past five years suggest that while returns are currently high, it's difficult to grow at these high returns.

This might explain the popularity of high-multiple share buybacks and high-priced acquisitions amongst growth companies.

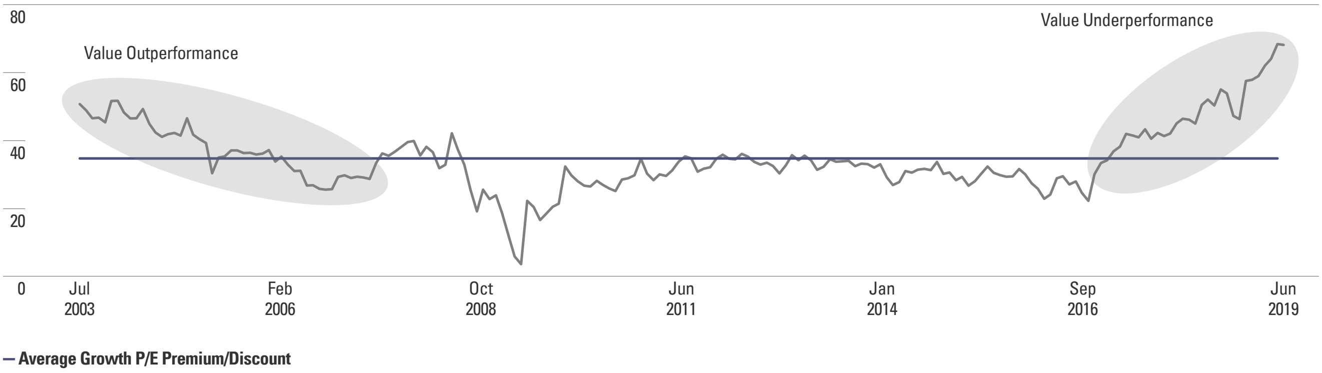
Value Stocks Even Cheaper

At the mid-point of 2019, we are 11 years into a bull market that has seen stock prices and expectations rise to historically high levels. As we take stock of the current situation, we note that cheap stocks have gotten cheaper and expectations from here appear quite low. Our portfolios sit firmly in the bottom quintile of the market and peer groups by valuation, which over the past decade has been a headwind to performance (as opposed to its historic tailwind). Our track record over our tenure has been better than the performance of the simple value style as our stock selection skill has overcome these headwinds. However, this has not been the case over the past 12 months as the factor headwind has been quite strong.

We have seen this before and we note similarities to our experience of the other large relative performance drawdowns, specifically in 2011 and 2014. Our portfolios recovered well from those periods and our experience gives us confidence that the stocks we own and the valuations at which they trade set our portfolios up well for the future. Meanwhile, the rest of the market is trading at high multiples with even higher growth expectations relative to what has actually been delivered.

Figure 2: MSCI World Growth/Value P/E Dispersion is Extended

MSCI World Growth Index P/E Divided by MSCI World Value Index P/E (%)



Source: State Street Global Advisors and MSCI. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income. All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment. Characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

FINDING VALUE

PJ Davies,
Research Analyst

BMW

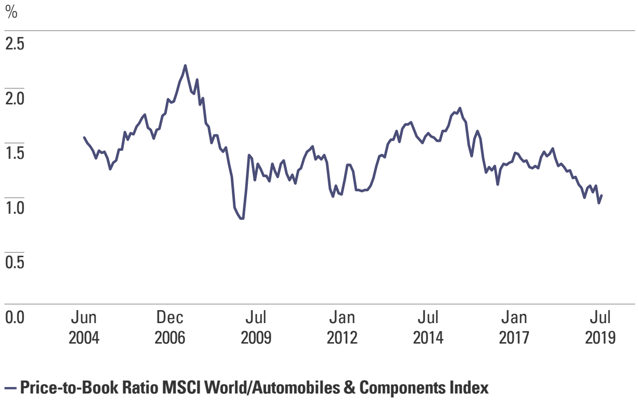
BMW is a high-quality manufacturer of luxury cars with a large global customer base. Despite notable challenges for the industry in recent times, BMW remains one of the few auto companies not to have made a loss at any point in the last 20 years. BMW's cheap valuation, along with its high margins, strong R&D policy, electric vehicle advances and China sales growth, prompted us to take a closer look under the hood.

In the last five years, the global automobile sector has fallen 2% in US dollar terms, while the overall market has delivered a positive total return of 40%.[1] A number of structural concerns have conspired to keep investors away. Ever-stricter emissions standards are forcing companies to spend more on research and development; "dieselgate" and accusations of collusion are a particular German headache; the growing electric vehicles segment is causing investors to worry about competition from new entrants like Tesla; and autonomous vehicles could decimate the industry if consumers choose to abandon car ownership in favour of cheap as-required rides.

In addition to such structural concerns is the worry that the global automobile market is due a sharp slowdown, led by China, after 10 years of growth. Car companies' profits are cyclical — high fixed costs and relatively low margins can tip them from profits to losses very quickly.

The upshot of this negative sentiment is that the sector is almost as cheap now as it was in the depths of the financial crisis, when General Motors was filing for bankruptcy and BMW was talking about how the crisis

Figure 3: Auto Company Valuations at Decade-low



Source: MSCI.

would have a "massively adverse impact on the global automotive economy" (Figure 3).

The Company

As noted, BMW is a leading manufacturer of luxury cars (and a few motorcycles) which it sells to aspirational drivers globally. As well as being one of the only car companies not to incur losses at any point in the last 20 years, it has also maintained the highest average margin over that period.

Like many car companies, BMW has a bank embedded in the business to facilitate the purchase of its vehicles. Over 80% of cars in the developed world are bought with financing. By keeping that business in-house, the companies secure an additional revenue stream and are able to control the release of off-lease vehicles into the second-hand market. BMW's finance subsidiary is big, accounting for about 60% of group assets, with that of Daimler being similar; the subsidiaries of VW and Toyota are at around 45%. In order to value the group, we need to split the two businesses and value them separately — one as an industrial company and one as a bank. In BMW's case, this is particularly tricky, but input from our industrials and financials analysts proved invaluable.

Our analysis of BMW's finance subsidiary shows it to be a well-managed business with a conservative funding structure and very low credit losses, even during the worst days of the financial crisis.

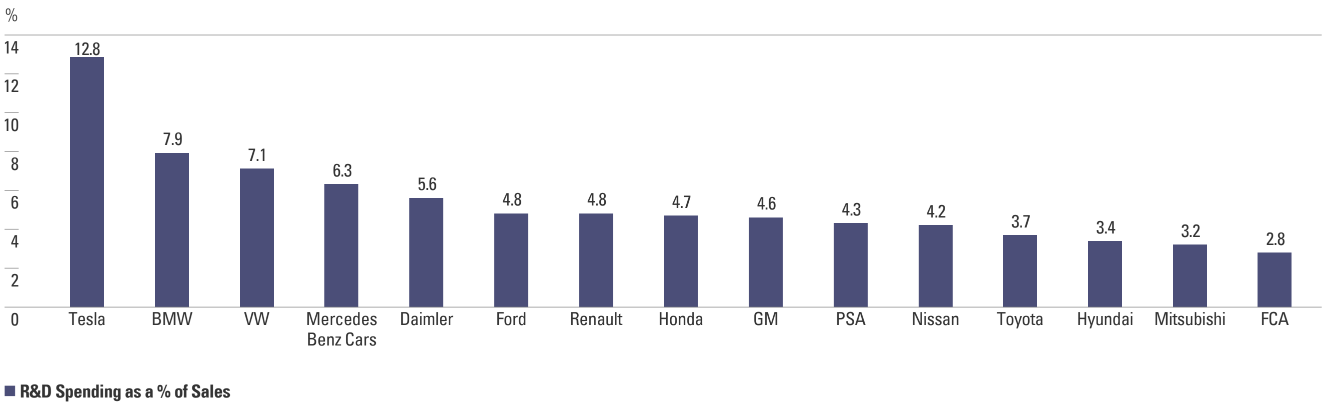
Profit Drivers

Given all the changes coming down the line, what gives us confidence that BMW can continue to be as resilient and successful in the future as it has been in the past? Three things provide comfort:

R&D: BMW spends a lot on R&D. As illustrated in Figure 4, it is second only to Telsa in terms of R&D as a percentage of sales (Tesla is only first because its sales

[1]Bloomberg Finance L.P., as at June 28, 2019.

Figure 4: BMW Leads Most Rivals on R&D Spending



Source: Annual accounts for each company for 2018.

are so small — BMW outspends it 4-to-1 in US dollar terms). If R&D is an investment in the future, then BMW is positioning itself well. It's also worth noting that its spending is concentrated on the relatively narrow segment of up-market passenger cars, while other companies have to spread theirs over a broader range of cars and sometimes commercial vehicles too.

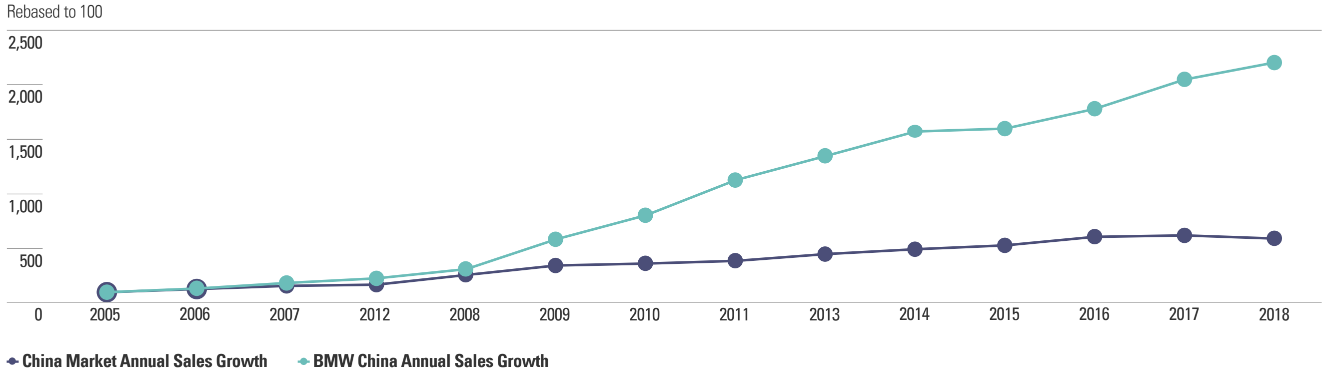
Electric Vehicles: According to Bloomberg New Energy Finance, an independent researcher, BMW is the best positioned non-Chinese company in the electric car space. Their analysis looks at electric vehicle (EV) sales relative to total sales, the number of EV models in the line-up, and plans for future EVs. Not only does BMW hold the top spot, but it has improved its position the most over the last three years. It already has two battery factories in Germany and later this year it is opening a Battery Cell Competence Centre in Munich. In 2017, it opened a High Voltage Battery Centre in Tiexi in China, and in 2018 it undertook a massive expansion of a Chinese battery factory. From 2020, the fully electric BMW iX3 will be manufactured in China for export worldwide.

China: BMW Brilliance Automotive (BBA), a joint venture with Brilliance China Automotive Holdings, has been manufacturing cars in China — the world's biggest car market — for 15 years. Locally produced cars now account for over 70% of the company's Chinese volumes, with the remainder mainly imported from the US. Nearly a third of BMW's revenues come from China, and the company is bucking the recent slowdown in that market, with sales continuing to grow strongly (see Figure 5).

Invested Capital

The investment in R&D, much of which is capitalised, takes its toll on returns; the capital base has grown faster than revenues for a number of years. We believe this will continue for a while. The result is a significant decline in return on capital. However, BMW's returns should remain well above its cost of capital, as the investments in the future help it maintain and build on its competitive position. The only way the current low valuation is justified is if you believe returns will fall below the cost of capital in perpetuity. We don't; hence the opportunity.

Figure 5: BMW Annual Sales Growth in China Outpaces Market



Source: BMW, Bloomberg Finance L.P.

RESEARCH BRIEFING

Paul Carthy,
Research Analyst

Joe Lawlor,
Research Analyst

Healthcare has been in the vanguard of the global equity market rally over the past decade. The traditional perception of it as a 'defensive' investment destination has, to some extent, been upended as returns have outpaced nearly all but the technology sector in this time. One might reasonably ask whether there could be much upside opportunity left for value investors at this stage of the cycle. We put that very question, and others, to our healthcare team of Joe Lawlor and Paul Carthy.

Q: After such a great run, can the healthcare sector still really offer fertile ground for investors with a value investing philosophy?

PC: It is true to say that headline valuations might appear expensive at this point and, indeed, the medical devices area of the market contains stocks that are trading close to all-time highs. However, our experience as bottom-up stock-pickers has been that the idiosyncratic nature of many healthcare companies means that value opportunities can persist amongst an otherwise expensive peer-group. However, it does take considerable in-depth analysis to identify these prospects.

Q: In that context, are there specific characteristics of the sector that you believe make your investment approach particularly relevant?

JL: A long-term view is important. The drug discovery and development process is notoriously lengthy; new drugs often spend a decade in the lab, with a similar time on the market following regulatory approval. Drug patents confer quasi-monopoly status to sales up until the patent expires and generic competitors are allowed to enter the market. As a consequence, the price environment for biopharma products is considerably more stable for longer than that of other industries.

This means that drug pipelines and on-market product sales are reasonably visible and durable (although not without risk), and it allows us to more confidently forecast further into the future than may be the case with companies in other sectors.

We have found our long-term, returns-focused value investing framework to be excellent for assessing pharmaceutical and biotechnology (biopharma) companies.

Q: Within the biopharma space, can you detail some of the difficulties that this approach aims to overcome?

PC: For biopharma companies, near-term earnings and returns often do not reflect what is sustainable over the longer term. For example, cash flows associated with an individual drug will include research and development (R&D) costs, investments in the commercial infrastructure ahead of launch, as well as ongoing sales and marketing expenses once the drug has made it to market. The net cash flows associated with new drugs will usually be negative for several years before and after the market launch.

So, if a business has just released a significant new product, valuing that business on the basis of temporarily-depressed current earnings can be misleading. At this stage, the risk of clinical trials disappointing or failing to clear regulatory hurdles is minimal, meaning there is likely a reasonable line of sight to a rebound in profitability.

JL: Of course that also works in reverse — valuing companies on the basis of near-term earnings when patent expirations are looming carries the risk of over-estimating the worth of the business.

Q: If near-term returns or earnings multiples could present misleading signals in the healthcare space, how do you leverage additional tools to identify investment opportunities?

PC: The members of the Fundamental Value research team work closely together in our Dublin office, and this relationship between valuation and near-term returns was something we recently discussed in detail with our colleagues. We looked at enterprise value/invested capital (EV/IC) and at next year's expected return on invested capital (ROIC). And we found that, relative to many other sectors, a low percentage of the variation in valuation in healthcare is explained by the variation in next year's expected returns. We attributed this to the effect of the sector's biopharma companies for the reasons already noted.

JL: We also have other tools that we can use to help unearth opportunities and inform our estimate of value for any business. Our proprietary house screen looks at a decade of history to identify potential investments on which we will then undertake detailed fundamental analysis. We model each business for many years into the future on our discounted cash flow (DCF) model. Other tools that can help inform our decisions include assessing stocks using an EV/NPV framework.

Q: Why do you find an EV/NPV framework useful?

JL: It's similar to a DCF model in that it captures the cash flow of each product over its full lifetime. We think of it as being similar to a "run-off" valuation. An advantage of this approach is that it values pipeline assets on the same basis as marketed drugs — this helps to identify the long-term value drivers of a company, which can sometimes differ from near-term earnings drivers. This framework serves as a useful sense check to ensure our assumptions are both conservative and robust.

It also helps us to determine the value of on-market products per share, to assess the risk-adjusted value of the pipeline per share, and — if we buy the stock today — to calculate how much of this pipeline value we are paying up for. Essentially, it's just a tool that allows us to focus on what the risk/reward trade-off is for a stock — it ensures we are thinking about our margin of safety. Like any model, however, we still need to test the assumptions that underpin it.

Q: So where are you are seeing value at present?

PC: We have seen some attractive opportunities in certain emerging market stocks. Within our portfolio, Hungarian drug company Richter Gedeon is a good example, where despite some recent set-backs and execution missteps, our fundamental analysis has given us confidence that the business can deliver sustainably higher returns over the coming years and we expect the shares to re-rate.

Frequently, investment opportunities can arise in areas where the market fears future disruption and assumes the worst. This has happened with drug distributors in the US, where concerns around the threat posed by Amazon, a lack of drug price inflation, and potential changes to rebates in that market have depressed share prices. Some of these businesses and companies have a wider moat than we believe the market is giving them credit for, and we believe companies in this space such as McKesson can successfully navigate these issues and achieve a re-rating of their shares.

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