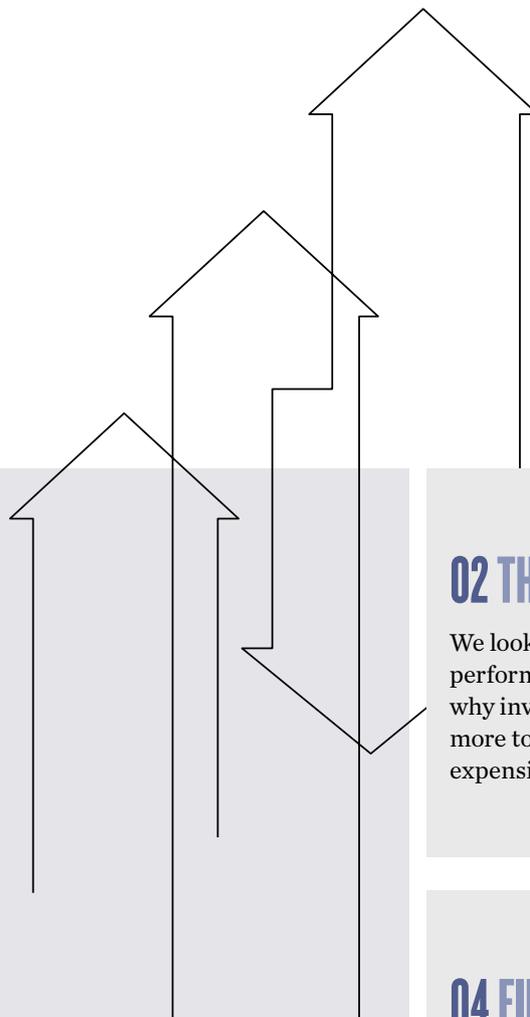


Taking Stock
Q4 2018



FUNDAMENTAL VALUE EQUITIES

Concentrating on long-term Value

**STATE STREET
GLOBAL ADVISORS®**

02 THE BIG PICTURE

We look at the patterns of market performance in 2018 and question why investors were drawn once more to stocks that are already expensively priced.

04 FINDING VALUE

In a difficult year for Materials stocks, fertiliser group Mosaic was a strong performer. For investors, does it continue to present attractive value credentials?



06 RESEARCH BRIEFING

The market tilt towards 'defensive' sectors in recent times serves to highlight the value opportunities that are emerging in more cyclical sectors.

THE BIG PICTURE



Brian Routledge
Head of Portfolio Management

Following a turbulent year for financial markets, taking stock of where global equities travelled and how we as a team of value investors fared seems appropriate. Quite simply, 2018 was a year where the cheap and unloved became more unloved, the popular became more popular and many predictions of the future (across markets, economies and politics) foundered on the rocks of unusual occurrences.

Diverging Fortunes

At the start of 2018, as illustrated in Figure 1, the US equity market was riding high; valuations were stretched amid investor optimism around the Trump tax cuts and the super-normal profitability of a group of (mostly) US technology companies. European markets were decidedly less popular by comparison, while Asian equities drifted toward decade-low valuation levels.

By year-end, the US had maintained its valuation premium despite the stock market’s worst December outcome since 1931. Europe is paying a high price for the lack of progress on Brexit, while rising populism has also unnerved investors. In Asia, concerns about the Chinese export growth engine mounted amid trade skirmishes with the potential to erupt into full-blown conflict. And in Emerging Markets, valuations showed once again how EM often seems to channel investors’ hopes and fears.

Moving beyond regions, a theme of rising inequality emerged across the various sectors and industries as a ‘winner takes all’ mentality appeared to take an even greater hold of investors’ perspectives about the future. Oliver McClure expands on this in greater detail on page 6.

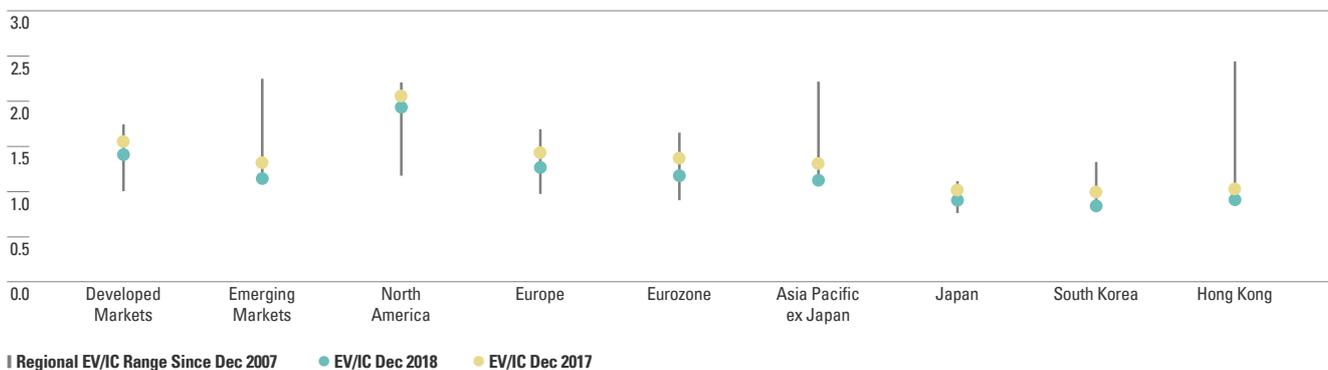
Maybe it is different this time, but as students of stock market history, we can’t help but think that valuation will matter again.

Market Returns Driven by Expensive Stocks

The richly-valued segments of the markets became even more so as investors concentrated on an ever-smaller cohort of growth stocks with supposedly unique attributes of high, enduring, and seemingly “priceless” returns. It is unusual for us to see non-holdings show up as large detractors/contributors to our relative performance, but we observed just that on several occasions in 2018 when FAANG-type¹ stocks featured.

It is not particularly surprising that our relative performance struggled as the cheaper segments of the market that we favour continued to languish. Casting an eye across market returns for 2018 (Figure 2), the USA’s stellar performance and high index weight meant it dominated global index returns; at the end of 2018, the weight of US equities in the MSCI World Index was among the largest on record. Meanwhile, poor-performing European, Asian and regional value indexes became even cheaper. Similarly, the most expensive and popular sectors of a year ago entered 2019 having outperformed significantly.

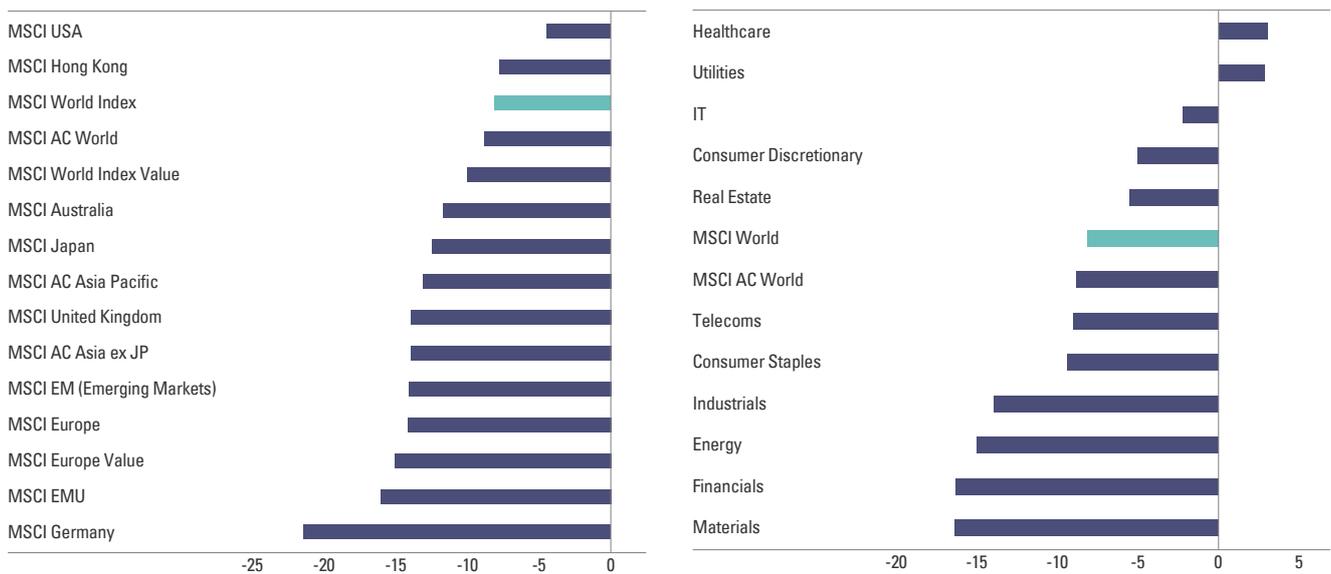
Figure 1: Across the Regions – Enterprise Value/Invested Capital Since Dec 2007*



Source: FactSet, MSCI, State Street Global Advisors.

* In our investment framework, the market rating of capital is measured as Enterprise Value divided by Invested Capital, or EV/IC. Enterprise Value is the market valuation of the firm’s capital, and includes the market value of equity, debt, pension liabilities, associate investments and minorities. Invested Capital is the measure of capital intensity of the firm, and represents the replacement value of all assets on the firm’s balance sheet, adjusted for working capital.

Figure 2: How Markets and Sectors Performed in 2018 (Net, in USD terms)



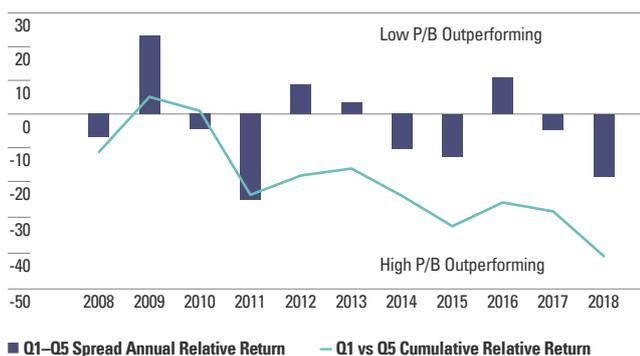
Source: FactSet, MSCI, State Street Global Advisors.

Since we are positioned in the cheapest companies, which tend to be in the less expensive regions and sectors, their underperformance dragged on our relative return. Certainly we have also made mistakes at an individual stock level; that is a normal hazard of our style of concentrated value investing, but the performance penalty for mistakes was larger this time as markets were quick to punish even moderate disappointments.

Valuation: A Poor Year for Price to Book

Figure 3 shows the spread of performance by quintiles of price-to-book (P/B) inside the MSCI World index. Our

Figure 3: Cheapest Quintile Extends Underperformance



Source: MSCI, State Street Global Advisors.

portfolios sit firmly in the bottom quintile by valuation. In 2018, the cheapest quintile of stocks was the poorest performing, while the most expensive quintile drove most of the index-weighted returns. Is this unusual? In a long-term historic context, it is. The Fama French data on returns by P/B established that there is a return premium over time to lowly-valued market segments, but it's not that unusual for cheap stocks to lag for extended periods.² Our track record over time has bettered value indexes as our stock selection skill has overcome headwinds. But we were unable to do so in 2018. This echoes our experience of the other relative performance drawdowns over our tenure: 2014 and 2011. Our portfolios recovered well from those periods and we are confident that the stocks we own, and their valuations in early 2019, set up our portfolios well for the future.

We've often remarked that buying cheap, out-of-favour stocks on a long-term view is harder than it sounds. Ten years into this bull run, which has seen equity markets nearly triple from the 2009 lows, our portfolios are about as cheap as they have ever been, with P/B ratios of 1.0–1.5x (roughly a 40–50% discount to the market) and substantially lower financial leverage. In short, our work suggests that we own significantly undervalued portfolios of good quality businesses with strong balance sheets where earnings, and thus valuations, are temporarily depressed.

¹ FAANG — An acronym for five well-known technology stocks (Facebook, Apple, Amazon, Netflix, Google).

² Eugene Fama and Kenneth French; Ken French Data Library.

FINDING VALUE



Owen Dwyer,
Research Analyst

Mosaic

2018 was a challenging year for most cyclical sectors, with Resources, Industrials and Banks all down in absolute terms by double-digit percentages. The Materials sector was down 19% (in USD) in 2018 with only 12 out of 129 names showing a positive return for the year. Mosaic was one of that select group of cyclical stocks that was up in absolute terms in 2018, recording a 13% gain. In terms of return on invested capital (ROIC), the company is expected to report 2018 numbers up by more than 150bps on a year-over-year basis; but at 5.4%, this remains well below what we would see as a normalised return of 10%.

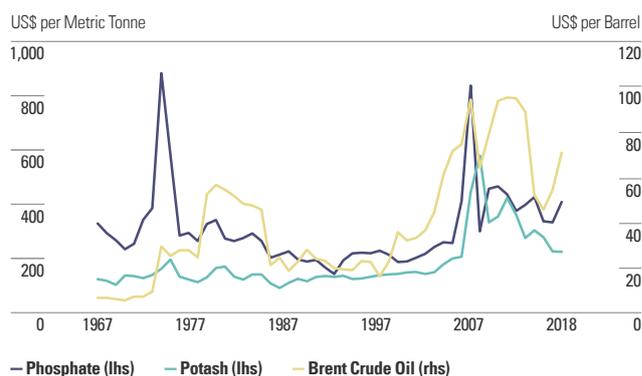
The Company

Mosaic is the second-largest fertiliser company globally, with long-life, low-cost assets. Phosphate and potash are essential nutrients in the optimal development of plants and are required for root development, stem strength, crop maturity, and disease resistance.

The fertiliser industry is highly cyclical, requiring high levels of capital investment, and end demand is subject to the vagaries of weather and crop prices on a year-to-year basis. However, over time, demand should see structural growth of 2–3% per annum driven by demographics (population growth, urbanisation and increased calorific intake). On the supply side, access to low-cost potash and phosphate assets is severely restricted by geology (there are few large-scale, low-cost resources) and economics (current prices well below a level that would justify investment). As such, we would expect ROIC for the industry to bounce back, with better players such as Mosaic earning a premium to cost of capital.

From 2015–2017, Mosaic and the wider industry endured significant pain as record grain harvests lowered grain prices, in turn impacting farmer profitability at the same time as new capacity (particularly in potash) came on stream. During this period, Mosaic has also hit by a number of company-specific operational problems which added to investor concern about the share price outlook. Finally, Mosaic management made a significant move to significantly strengthen its position in Brazil by acquiring fertiliser assets for a combination of cash and equity. The consequence of all this led to the share price more than halving from mid-2015 levels of \$45 to \$20, before recovering to \$32 by the end of 2018.

Figure 4: Nutrient Prices Bottoming? (Average Annual Prices – 1967–2018)



Source: World Bank, State Street Global Advisors.

Revenue, Operating Profit and Cashflow Outlook

Product price decreases, driven by increased supply as well as farmer profitability, cut deep into the industry cost curve. In response, Mosaic and its industry peers cut production by c10%, thus allowing inventories in the supply chain to run down. The result of this action is that the market for the nutrients bottomed at the start of 2018, and began to tighten up as the growing season in the northern hemisphere progressed. Post the bottoming of prices, our projection is for Mosaic revenue to increase from here as stock levels in the supply chain recover to normal levels while underlying demand continues to grow. This should flow through to operating profit as the cost base was addressed during the downturn (e.g. cost of potash down c\$40/tonne) with margins recovering.

In addition, there are a number of Mosaic specifics which should potentially lead to a strong profit recovery from here.

- The acquisition of Vale Fertilisers at arguably the trough of the cycle was the sort of counter-cyclical investment that value investors like to see. Mosaic paid \$2bn for enormously strategically attractive assets in a core agricultural geography where Vale had invested c\$8bn in 2010/11.
- In phosphate, the company has been working to improve the value-add nature of its product mix, which is less evident at the trough of a cycle. With a recovery in commodity prices, the margins in these specialty micronutrients are likely to increase, which in turn should be positive for returns.
- In potash, Mosaic has been investing in building an alternative mine shaft at its large Esterhazy mine to eliminate a c \$300m p.a. cost and take the largest mine in its portfolio from a mid-cost position to first quartile.

With the bulk of its capital commitments behind it, integration of the Vale acquisition progressing well, and the price outlook for its main commodities looking well supported, a substantial improvement in Mosaic cashflow seems likely to follow.

Invested Capital

While the most egregious destruction of capital in the so-called commodity supercycle took place elsewhere, Mosaic and the fertiliser industry were not entirely blameless — a large element of the 2015–2017 downturn was driven by the over-investment in previous years that brought new supply on stream. Some of this capacity remains to be absorbed, but the peak looks to be passed.

At the same time, given strong underlying demand for its products, the market is likely to need new capacity in phosphate and potash within the next five years. At current prices for both nutrients, we don't believe returns are sufficiently attractive to justify investment. In fact, we believe the current replacement cost of Mosaic's operations would be c \$100/share versus today's share price of \$32.

Summary

Mosaic currently trades below 1 times EV/IC (enterprise value to invested capital), at about one third of replacement cost with long-life, low-cost assets in vital commodities with strong structural growth and no alternatives. For value investors, such metrics make Mosaic attractive both in an absolute sense and relative to more economically-sensitive investments.

RESEARCH BRIEFING



Oliver McClure,
Head of Research

Plus ça change...

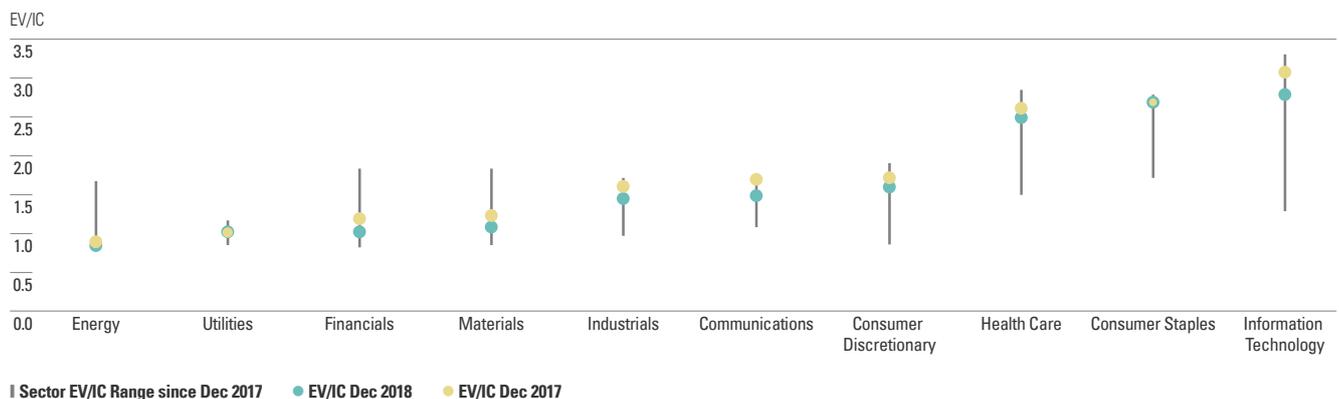
The advent of the new year has brought change to the Research Team at Fundamental Value Equities. I have stepped into the role of Head of Research following the retirement of Jeremy James. While naturally hopeful that the next six years prove less treacherous for value investors than the six years of Jeremy’s leadership, the team’s approach will sustain his relentless focus on maintaining a disciplined investment process. This has been critical to our continued success and underpins our confidence as we head into 2019.

As outlined in the opening section of Taking Stock, reviewing sector dynamics in 2018 and assessing the outlook for 2019 leaves one with a sense of “more of the same.” Indeed, over the period since the financial crisis, in many years we have found the sectors that started a year with elevated expectations, and therefore elevated valuations, often outperformed in that year. Figure 5 reflects the broad long-term trend of lagging cyclical sector valuations, while also showing that expensive sectors such as Healthcare and Technology ended 2018 close to the year’s peak levels — even after a final quarter sell-off that particularly impacted many tech stocks.

The technology sector was the poster child for the ‘winner takes all’ trend that drove market momentum in 2018. At the start of last year, the sector was already expensive relative to the market and its own history, with the main driver of the sector’s performance being a large increase in earnings expectations. For many years, we have been dealing with a technology sector that has become more and more concentrated in a smaller and smaller number of companies. This concentration was further emphasised in 2018 as we saw just five companies account for over 50% of the change in the sector’s earnings expectations; so it’s too simplistic to say the sector merely reflects superior earnings prospects.

The market turmoil of the fourth quarter was particularly interesting from a sector perspective. The high-flying technology sector cracked on concerns over the outlook for smartphone demand and Apple’s share within that, particularly as it flagged slowing sales in China. That a relatively modest revision to expectations for one product could have such a large impact on the performance of the entire sector (representing 15% of the

Figure 5: Expensive Sectors Remain Expensive (EV/IC – Dec 2007 to Dec 2018)



Source: FactSet, MSCI, State Street Global Advisors.

global equity indices) clearly illustrates the concentration risk that we have highlighted.

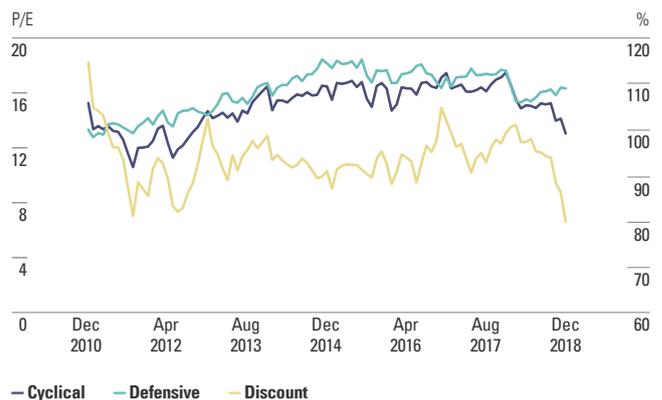
As we would have expected, our team’s technology holdings proved somewhat defensive in the fourth quarter shake-out. Unfortunately, this was largely offset by a steep sell-off in our other cyclical holdings on deteriorating macro expectations amid souring US-China trade relations and concerns over Brexit. In addition, the sharp oil price decline in Q4 erased virtually all the outperformance delivered by the energy sector in the first nine months of the year. As cyclicals sold off, investors dusted off their post-financial crisis playbook as bond proxies such as Real Estate and Utilities and defensive sectors such as Consumer Staples and Healthcare rallied.

...plus c’est la même chose...

We find ourselves starting 2019 in familiar territory. As bottom-up value investors, we do not allocate according to sector; however, we have seen a greater number of value opportunities emerging in the Energy, Materials, and Financials sectors. This is amply illustrated in Figure 6, which shows the widening valuation gap between Cyclicals and Defensives. In simple terms, cyclical earnings appear cheap relative to defensive earnings. We’ve seen a number of instances of similar dislocations in the decade since the financial crisis and such periods have consistently provided us with opportunities to add value to our portfolios.

We continue to believe a set of robust and conservative assumptions that estimate the sustainable earnings power of a business is the most important element in determining the intrinsic value of that business. We believe that the future is inherently unpredictable and that the key to generating alpha is to take positions where the current valuation maximises the percentage of future outcomes that are profitable. This is the fundamental building block of our margin of safety. In addition, where the dispersion of future outcomes is wide, we seek to ensure that the company has the balance sheet and capital resources to see them through the possible delays or uncertainties in an earnings recovery.

Figure 6: The P/E Discount of Cyclicals versus Defensives (Dec 2010–Dec 2018)**



Source: FactSet, MSCI, State Street Global Advisors.

** Defensive Sectors: Telecoms, Consumer Staples, Healthcare, and Utilities.
Cyclical sectors: Consumer Discretionary, Financials, Industrials, and Materials.

ssga.com

Marketing communication.

State Street Global Advisors Worldwide Entities

Abu Dhabi: State Street Global Advisors Limited, Middle East Branch, 42801, 28, Al Khatem Tower, Abu Dhabi Global Market Square, Al Mayah Island, Abu Dhabi, United Arab Emirates. T: +971 2 245 9000.

Australia: State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services Licence (AFSL Number 238276). Registered office: Level 17, 420 George Street, Sydney, NSW 2000, Australia. T: +612 9240 7600. F: +612 9240 7611.

Belgium: State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036. F: 32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom.

Canada: State Street Global Advisors, Ltd., 770 Sherbrooke Street West, Suite 1200 Montreal, Quebec, H3A 1G1, T: +514 282 2400 and 30 Adelaide Street East Suite 500, Toronto, Ontario M5C 3G6. T: +647 775 5900.

Dubai: State Street Global Advisors Limited, DIFC Branch, Central Park Towers, Suite 15-38 (15th floor), P.O. Box 26838, Dubai International Financial Centre (DIFC), Dubai, United Arab Emirates. Regulated by the Dubai financial Services Authority (DFSA). T: + 971 (0) 4-4372800. F: +971 (0) 4-4372818.

France: State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92.

Germany: State Street Global Advisors GmbH, Brienner Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89 55878 400. F: +49 (0)89 55878 440.

Hong Kong: State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103 0288. F: +852 2103 0200.

Ireland: State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered number 145221. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300.

Italy: State Street Global Advisors Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), with a capital of GBP 62,350,000, and whose registered office is at 20 Churchill Place, London E14

5HJ. State Street Global Advisors Limited, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 06353340968 - R.E.A. 1887090 and VAT number 06353340968 and whose office is at Via dei Bossi, 4 - 20121 Milano, Italy. T: 39 02 32066 100. F: 39 02 32066 155.

Japan: State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan, T: +81-3-4530-7380 Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association.

Netherlands: State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. T: 31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom.

Singapore: State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826 7555. F: +65 6826 7501. Switzerland: State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16.

United Kingdom: State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350.

United States: State Street Global Advisors, One Iron Street, Boston MA 02210. T: +1 617 786 3000.

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor. All material has been obtained from sources believed to be reliable. There is no representation or warranty as to the accuracy of the information and State Street shall have no liability for decisions based on such information.

This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

Investing involves risk including the risk of loss of principal.