Taking Stock

October 2019

Fundamental Value Equities

Concentrating on Long-term Value

STATE STREET GLOBAL ADVISORS

The Big Picture

Barry Glavin
Chief Investment Officer

Over the first nine months of 2019, our suite of Spotlight strategies have typically delivered a total return in the high single digits (in USD). That is a healthy return and broadly in line with the annualised returns achieved since the inception of this team and process at the end of 2007.

We would have happily taken that outcome, if offered, on January 1. But any assessment of that performance today cannot ignore the fact that the market has delivered almost twice that return. While we have had a number of portfolio holdings — although no more than usual — that have disappointed, the fundamentals of our portfolio companies are generally tracking well relative to our expectations. The challenge on the relative performance front has been that we are not exposed to the types of stocks that have been driving stock markets higher.

Value in the Spotlight

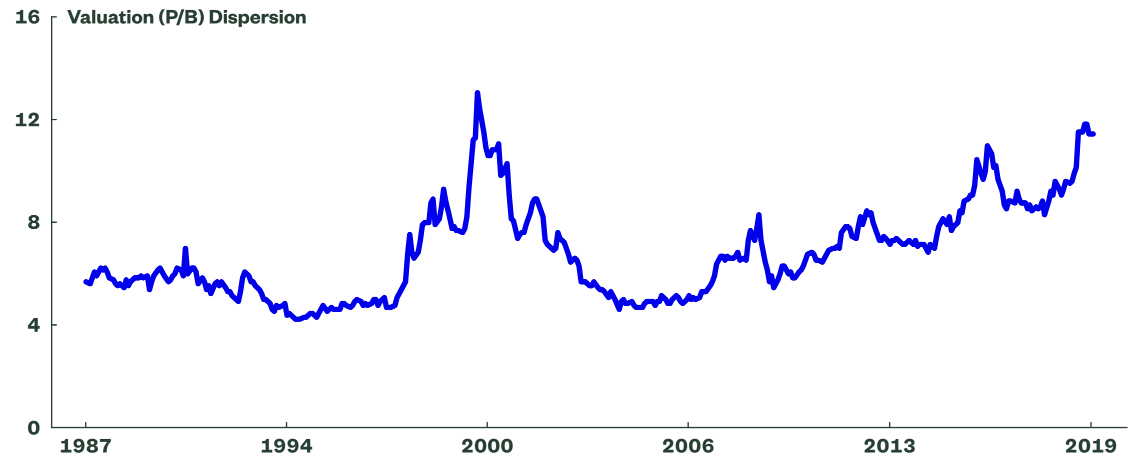
Notwithstanding the reversal of fortunes of value in September, the topic of value investing has been much discussed of late due to the style's sustained underperformance. Some would assert that the investment approach is a structural impediment to participating fully in this and future market rallies.

The case against value can be easily made. As a factor, it has consistently underperformed other investing styles since the financial crisis, and more recently that trend has gone parabolic. To many, this represents definitive proof that value investing relies upon an outdated valuation framework that is centred on an increasingly irrelevant metric (book value) to justify investments in old world companies under siege from asset light, intellectual property heavy challengers and disrupters. Based on that view of the world, share price performance and relative valuations merely reflect that truth.

The result of this price action is a polarisation in valuations to levels not seen since the dotcom era. This is illustrated clearly in Figure 1, which plots the dispersion in the price/book ratio (PBR) across the market. It displays how, since the financial crisis, the median PBR of the most expensive quintile of the market has consistently expanded relative to the median PBR of the cheapest quintile. In its quest to secure growth, quality, defensiveness, or bond-like characteristics, the market has favoured stocks on high multiples of book value and driven valuation differentials to rarely-seen extremes.

Figure 1
Expensive Stocks Get More Expensive

Most expensive quintile of MSCI World Index constituents divided by cheapest quintile



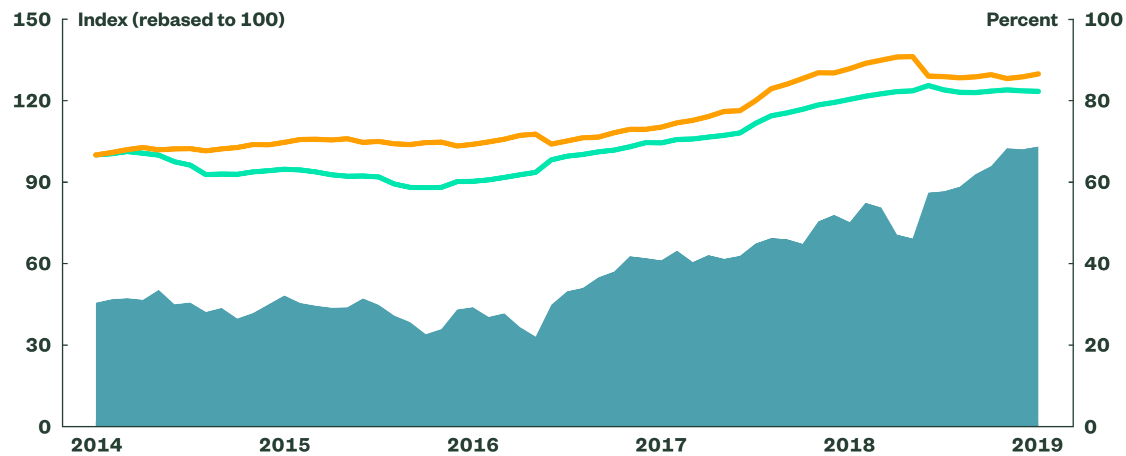
Source: State Street Global Advisors, MSCI as at 30 September 2019.

Growth Premium Detached from Earnings Reality

If book value is deemed irrelevant at this point, then let's consider profits. Figure 2 suggests that the market is not too concerned about profits either — the chart maps the evolution of earnings per share (EPS) for both the MSCI World Value and MSCI World Growth Indices. It's interesting to us that despite the ubiquitous narrative, the earnings differential between Growth and Value is actually quite modest. The shaded area represents the difference in the price/earnings (P/E) multiple that the market applies to each of the Value and Growth earnings streams. And this is where the action is. It is clear that the relative performance of growth versus value is NOT being driven by the aggregate earnings power of the companies in each index. It is being driven by the price investors have attached to these earnings. The P/E premium of growth over value has soared to 70%.

Figure 2
Growth Extends Premium Over Value

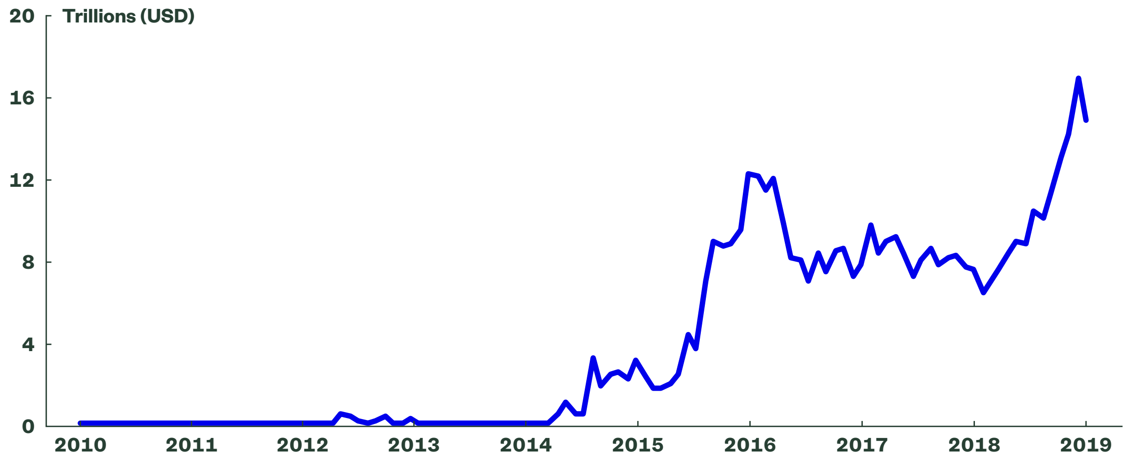
PE Premium (RHS)
MSCI World Value Index EPS
MSCI World Growth Index EPS



Source: State Street Global Advisors, FactSet as of 30 September 2019. Past performance is not as indicator of future returns.

This chart isolates quite early the challenge we face in terms of relative performance. It is rooted, not in the fundamentals of the companies in question, but rather in the market's appetite to pay up for certain types of fundamentals. From our perspective, the choices facing investors are not about philosophy or style or factor. It's about risk. We consider the recent acceleration in this type of price action to be a straightforward mispricing of risk. It's no coincidence that the parabolic move in the growth premium corresponded with the soaring stock of outstanding debt — sovereign and corporate — offering negative yields (Figure 3).

Figure 3
Value of Bonds with Negative Yields Soars



Source: Bloomberg Finance LP as at 30 September 2019.

Priced for Certainty in an Uncertain World

It's up to others to decide if they believe lending money to highly indebted entities at negative interest rates is a good use of capital, but when it comes to equities, our required return is more demanding. When you pay a high P/E multiple for a stock, you are effectively discounting future earnings at very low rates. This implies that you are increasingly indifferent to the timing of profits — whether the company is profitable today, tomorrow or sometime in the future, the net present value is not too dissimilar. In other words, you need to be very certain about what the future holds to justify paying a high multiple. Our goal is to secure as much earnings power as possible for as low a price as possible, rather than paying a high price for the promise of future profits. From our perspective, no matter how strong the momentum, or how much conviction commentators have in their forecasts, the future remains as uncertain as it always has. And yet, in many parts of the market, investors are no longer demanding to be compensated for that uncertainty.

Time, Not Timing

Momentum is a very powerful force in financial markets. In most walks of life, demand curves are typically downward sloping: higher prices tend to reduce demand for goods and services. It's not so clear-cut in financial markets. It seems that the more the price of a security climbs, the more demand there is for that security. When this becomes extended, prices are no longer supported by fundamentals, but by investor sentiment, and sentiment — other people's optimism — is too fickle for our tastes. The sudden reversal in September out of momentum and into value stocks provided a glimpse of what can happen when sentiment shifts. It remains to be seen whether this rotation will endure at this time. It's unlikely we will proceed in a straight line, but at a minimum it has established that this momentum trade is no longer a free one-way bet.

A Focus on Fundamentals

We've made the point before that "buying good quality businesses that are cheap on a long-term view" is easier said than done, and the relative price action year to date underpins why. We come from an investment culture that has faced similar challenges in the past; Japan in the 1980s and Technology in the 1990s. In each case, the investment team chose to focus on long-term returns, confident that common sense and discipline would prevail and relative returns would follow. They took the difficult decisions that clients respected at the time and appreciated in hindsight.

The decisions required in today's market look equally difficult, but in reality are still quite straightforward. Our focus is to ensure that every dollar of client assets we deploy secures the maximum sustainable earnings power. Many areas of the market — defensive stocks, growth stocks, quality stocks, bond proxies, not to mention the unicorns — no longer offer the prospect of a reasonable return on our clients' capital.

While these types of stocks do offer attractive qualities given the current environment, those qualities come with valuations that are inconsistent with acceptable returns. In the Tech Bubble, investors justified the valuations of internet companies on the grounds that these businesses would change the world beyond recognition. They were right. In fact, even the most bullish predictions probably underestimated their impact since. However, if you paid the wrong price for those stocks, you lost money. A lot.

Finding Value — Dali Foods

William Killeen
Portfolio Manager

In an increasingly affluent and outward-looking China, the gastronomic habits of Chinese consumers have been evolving. Against the backdrop of rising urban populations, longer commutes and longer working hours, increased sports participation and broadening food tastes, convenience shopping and associated snack food consumption are taking an increasing share of disposable income.

To get a sense of the potential market, spending on snack food per capita is still amongst the lowest in the world — just US$5.75 in 2018 compared to over US$200 in the USA. For companies that have a diversified offering in snacks foods and the ambition to innovate and enter new categories, the potential is enormous. Dali Foods is such a company, and its strong balance sheet, relatively attractive valuation and shareholder-friendly ethos, made it a strong candidate for our portfolios.

The Company

Dali Foods Group is a Chinese food and beverage (F&B) producer, with a stock market listing in Hong Kong since 2015. Operating in various F&B categories — bread, cakes and pastries, biscuits, potato chips, herbal tea, plant-based dairy beverage, energy drinks and soy milk — the company achieved revenues of RMB20.9bn (US$3.1bn) in 2018. The CEO of Dali Foods, Xu Shihui, started his career with the company back in 1989 when it was a collective, and by 1998 he had driven the transformation of a regional player into a national one. Together with his daughter, Xu Yangyang (a Dali executive director), they own 85% of the company. With the Xu family wealth tied up in the success of Dali Foods, there is strong alignment with shareholders.

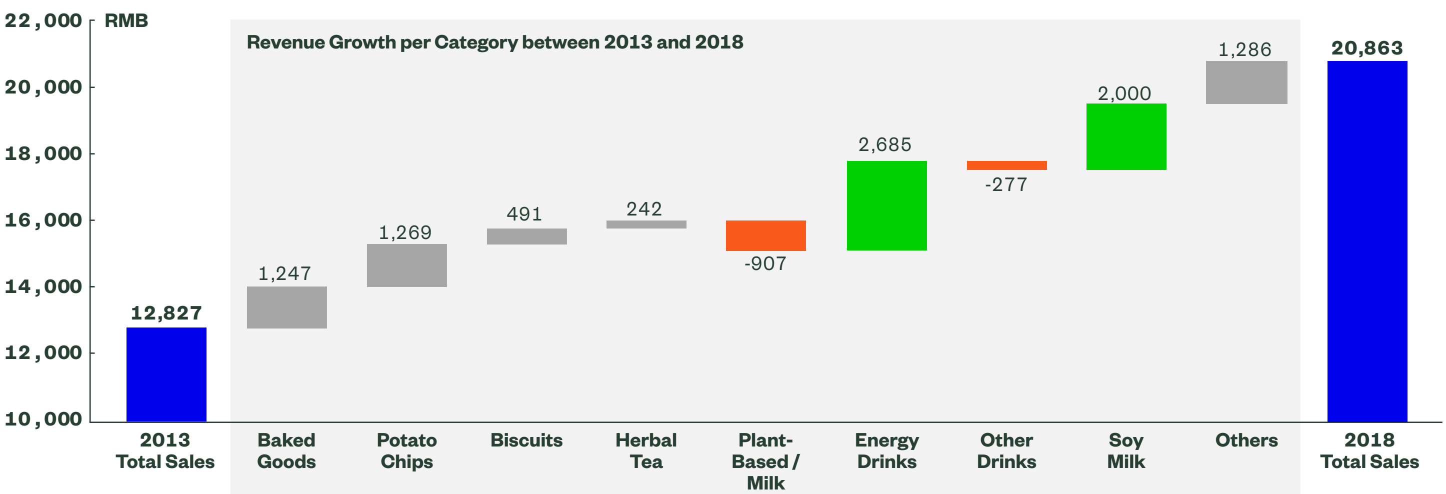
Consistent Innovation Drives Revenue Growth

Dali is both an innovator and a fast follower. It favours a strategy of creating many independent brands in multiple categories. Typically, every two to three years, Dali has entered a new product category. Multiple categories mean a diversified portfolio for management and investors alike. Mr. Xu puts a lot of emphasis on the effectiveness of research and development (R&D) in developing new products. An appreciation of local Chinese tastes is an important part of this process.

In the baked goods market, *Daliyuan* brand was launched in 2012. Dali is now a market leader in bread, cakes and pastries with over 20% market share. In potato chips, it also commands a 20% share nationwide. It holds the number two position behind Red Bull in the energy drinks market with a 15% share, and its 2017 launch of its soy milk brand has made it a serious contender in this category.

Figure 4 illustrates how important launches of products in two new categories (green bars) have been for revenue growth. But Dali has also reinvigorated existing categories: in baked goods, it has launched a short shelf-life 'breakfast fresh' range of breads to cater to changing tastes.

Figure 4
Drivers of Revenue: Category Expansion and Innovation



Source: State Street Global Advisors, Dali Foods Annual Report 2014–2018, Bloomberg.

Revenue, Operating Margins and Cash Generation

Dali has a distinctive business model; its category ASPs (average selling price) tend to be well below that of international competitors. For instance, its *Hi Tiger* energy drink retails at about 30% below the ASP of their largest competitor.

Dali Foods has experienced strong revenue growth, as shown in Figure 4. Despite intense competition from local and international peers, management argue that there is abundant opportunity for innovative firms.

Expanding Margins

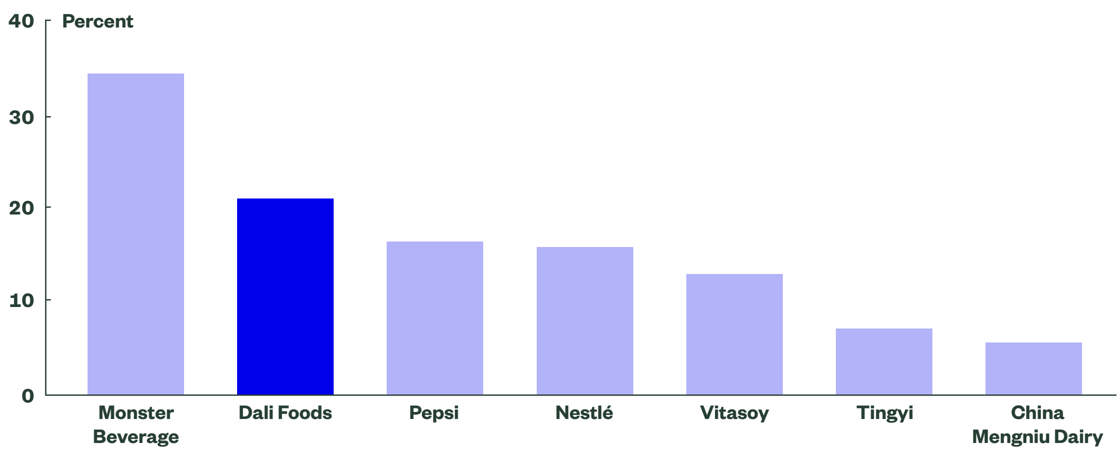
Dali's operating margins are set to reach 20% in 2019, supported by a distinctive cost structure. Dali Foods' products are distributed by c. 4,600 independent agents who largely absorb the cost of advertising and promotion (A&P). In return, they receive significant discounts to allow a significant channel mark-up. And margins are set to improve further, with the main driver being the shift towards higher-margin beverages. The beverage category is increasingly driving revenue growth with gross margins of 46%, which is about 10% higher than gross margins in the food categories.

Growing Footprint

Traditionally, Dali has tended to focus more on smaller cities in China, but it is now addressing modern retail channels in larger cities. This should result in higher ASPs (removing need for such dramatic distributor mark-up), but also increasing A&P spend as they support customers with their own sales teams. The net impact is likely to be positive.

Figure 5 shows where Dali's operating margins fit relative to both local and international peers. Operating margins reflect its efficient cost structure, scale and product mix. In Dali Foods, there is something of the Nestlé and something of the Monster Beverage, with the potential of capitalising on the under-penetrated snack market that is China.

Figure 5
Dali Foods Operating Margins Versus Peers
Last Reported Year



Source: Bloomberg Finance LP as at 30 September 2019.

Return of Capital to Shareholders

Dali Foods has no debt on its balance sheet and a cash pile equal to 19% of its equity market value. It recently announced that was returning cash to shareholders via a special dividend (effectively doubling its interim dividend) after a strong first half of 2019. The current dividend yield is tracking at 4.7%.

Summary

The Dali Foods opportunity is not without risks. Consumer brand loyalty in China is considered to be lower than in western markets. Consumers demand continuous innovation. Competition from local and international players remains formidable, especially against the backdrop of a cooling economy. However, we believe that Dali Foods has showed a patient and prudent approach to growing its business. Dali Foods trades at a cash economic price to earnings (P/E) multiple of 17.6x (2019E) compared to the Global Consumer Staples sector's more extravagant rating of 25.7x.[1] Generating a free cash flow yield to market valuation (ex-cash on balance sheet) of 9%, and an ambition to position itself with Chinese consumers for the long term, we believe Dali Foods presents as an attractive opportunity for value investors such as us.

Research Briefing

Peter de Lacy
Research Analyst

Robert Allen
Research Analyst

Laura Jordan
Research Analyst

The technology sector has been a significant driver of global stock market returns over the past decade, particularly so in the experience of the US market. But memories of the dotcom bust are not so distant that the rise in valuations has gone without notice or comment.

We caught up with our Technology and Communications equity research team to ask whether they were seeing red flags or opportunities.

There's a perception that technology companies are expensively priced. For value investors, are there opportunities to be found in this environment?

Tech is certainly a sector where we need to be particularly conscious of value traps — low valuations of past or current earnings are often justified by significant technology shifts that can mean a company's historic earnings power bears little relevance to their future prospects. And because disruption is often the norm in tech, there is less 'reversion to the mean' than we see in other sectors.

So we have seen that the companies leading the disruption, the so-called 'winners', tend to come with high expectations and correspondingly high valuations. But that disruption can also create opportunities for us as value investors, particularly among the incumbents whose prospects are often mistakenly or prematurely written-off.

Incumbents are not necessarily the dinosaurs of the tech industry then?

Not at all. Japanese security software company Trend Micro is an example that springs to mind. Trend Micro was perceived and valued as a legacy security player, but our research found that the company had invested early in several next-generation technologies. This meant it was capable of competing with new cyber-security entrants in a rapidly-changing environment. As high growth strategic products increased in the company's revenue mix, the stock's valuation multiple expanded through the 2012–2018 period.

US networking leader Cisco is another incumbent considered to be at risk from disruption amid shifts in technology and an exciting new entrant, Arista Networks. However, Cisco responded effectively by keeping their product offering up-to-speed with the market, while still maintaining their high profit margins; the company's valuation re-rated higher as a result.

So, where else do you currently see potential value in the tech sector?

We have a "valuation versus returns" framework that has helped us identify opportunities for our portfolios within a number of tech industries that have an attractive combination of valuation for a given level of returns. For example, we have uncovered opportunities in IT subsectors such as Technology Distributors, Technology Hardware, Electronic Manufacturing, Semiconductor Equipment, and IT Consulting and Services. Even in Communications Equipment, which is less appealing at an industry level, F5 Networks attracted our interest.

F5 appears to have been heavily discounted as a result of market concerns about the shift of application workloads to the Cloud, and away from the on-premise equipment segment where F5 originally built its business. We believe that F5 has taken sufficient strategic steps to keep itself relevant to companies, especially in the Hybrid Cloud world — this is where companies maintain computing infrastructure both on-premise and in the Cloud. As a trusted neutral provider of software for optimising computing resources and securing data flows, the firm appears well-placed to manage this transition to the Hybrid and Multi-Cloud environment.

And what areas of the sector do you consider to be overvalued?

We think that the most obvious area of overvaluation is to be found in the initial public offerings (IPO) market for large cap companies. Collectively for this financial year, this group of companies are forecast to have an Earnings (or Losses) Yield of -11.2%, and a Free Cash (out)Flow Yield of -3.5%. This compares to the MSCI US Tech index Earnings Yield of +4.2% and FCF yield of +4.7%. That is a pretty large differential!

Clearly, in order for such valuations to be justified, high levels of growth are required. But the problem we see is that some of them don't have a clear path to profitable growth in the near term, meaning the risks are high for investors. In fact, the top seven new listings in the last two years have generally performed very poorly, with Pinterest the only exception.

Figure 6
Company Share Price Performance Since IPO

Issuer Name	Listing Date	Offer Size (M)	Return (%)
Uber Technologies Inc	10/05/2019	8,100	-32
Lyft Inc	29/03/2019	2,340	-43
Pinterest Inc	18/04/2019	1,639	39
Chewy Inc	14/06/2019	1,023	12
Spotify	03/04/2018	929	-31
Slack	20/06/2019	886	-38
Dropbox Inc	23/03/2018	869	-4

Source: State Street Global Advisors, Bloomberg Finance LP as at 30 September 2019.

Is this poor post-IPO performance the result of funding rounds prior to market listings?

Well, there is some evidence to support that. The $100bn Softbank Vision Fund has grabbed headlines due to the high prices it has paid for some of its late stage venture capital (VC) investments — indeed, Softbank has accounted for over 10% of VC dollar volume in 2019. But this is partly a symptom of the highly-competitive and crowded earlier-stage VC rounds, which have been driven by the low cost of capital and the search for growth. It's a combination that has helped chase up valuations in the pre-IPO market, leading to the current overvalued situation. US venture capital funding in the first half of 2019 was the highest since the peak of the DotCom bubble in 2000.

Overall though, it's not just the recent IPOs and unicorns that have struggled to with profitability?

One of the things that we have noticed of late is the significant proportion of the sector's US large cap universe[2] that has a low profit margin, or even none at all. The number of stocks that screen as investable for us has increased over time, but right now around a third of these names are earning less than a 2% pre-tax margin. The majority of these firms are actually reporting losses.

If a third of the sector is effectively out of reach, how do you find opportunities?

We believe there will continue to be opportunities to find "hidden growth" on cheap valuations. Looking to some of our past experiences, ASM International serves as a good example. We considered ASM's core semiconductor capital equipment business to be poised for strong growth. Taking into consideration its large cash balance and its holding in another listed business — which we valued separately using our framework — we uncovered an opportunity to invest in that core franchise at a significant discount to market multiples. Another example was Microsoft — in this case, we observed a company under new leadership that was investing cash from its existing high return businesses into "the Cloud". We believed this significant growth potential was hidden within the larger organisation and, having applied robust conservative assumptions around the complete business, our analysis showed a value opportunity.

Endnotes

1 Economic P/E is defined as Enterprise Value/Invested Capital divided by Cash Flow Return on Invested Capital (CFROI® — a registered trademark of Holt and Credit Suisse).

2 Market cap greater than $1.75bn and daily liquidity greater than $5m.

About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's third-largest asset manager with US $2.9 trillion* under our care.

* AUM reflects approximately $36 billion (as of June 30, 2019), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated

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