Taking Stock

January 2020

Fundamental Value Equities

High Conviction You Can Count On

02	**The Big Picture**	Valuations between and within sectors have reached extreme levels, the likes of which haven't been seen since the late-1990s technology investing boom. Are we close to a breaking point?
07	**Finding Value**	Lear Corp supplies the world's leading car makers with seating systems. The auto sector is undergoing significant change, but the switch to electric vehicles presents an opportunity for the firm.
10	**Research Briefing**	Our Q&A with the Consumer Research team captures their thoughts on finding value in a sector that is diverse and complex.

STATE STREET GLOBAL ADVISORS

The Big Picture

Brian Routledge
Head of Portfolio Management

As we enter 2020, the challenge for price-sensitive investors continues to be the widening of valuation multiple spreads. This is not a new development, but it has been particularly evident over the past 12 months, and has been extreme both across and within countries and sectors. Our view has been constant and simple: the valuations demanded for the securities driving indices higher are inconsistent with achieving an acceptable return on our clients' capital.

Momentum: A Powerful Force

In physics, momentum breaks when an opposite force acts upon it. For investors in popular growth stocks, there were several potential opposing forces in 2019 that they could choose to ignore — and many clearly did. Amongst those are historically-stretched valuations unsupported by superior earnings power, global trade wars that threaten to upend the profit machines that investors are so enamored with, and finally, historic political upheaval in some of the world's most important economic engines. Such is the power of momentum that each of these forces has been dismissed in turn. At least so far.

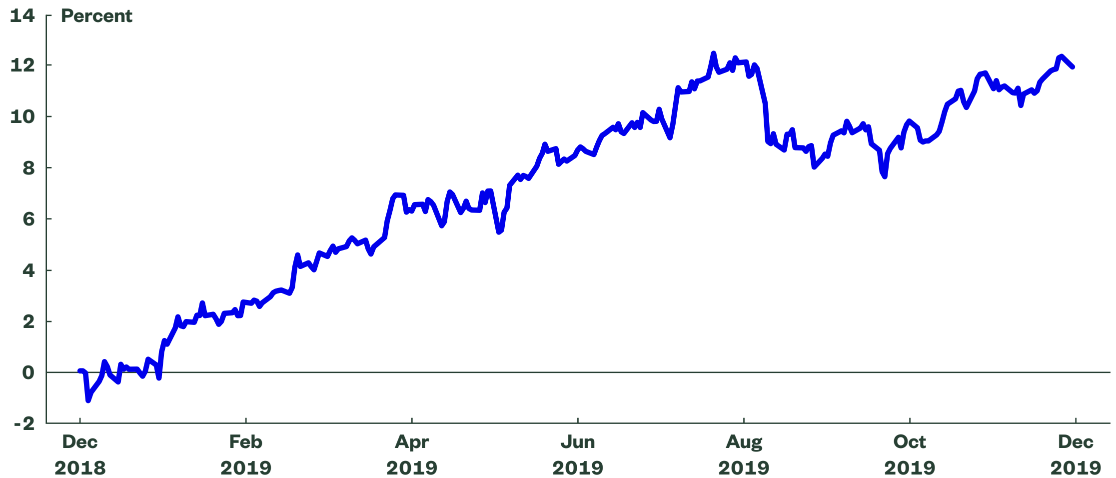
Breaking Point?

Only time will tell whether the acceleration in valuation dispersions seen during 2019 proves to be a final capitulation in the long period of underperformance by Value stocks. However, it is worth noting that these dispersion levels between and within sectors have reached historically extreme levels. The last time we saw dispersion levels close to these was in the late-1990s during the technology investing boom. While this alone is no guarantee that value will now start to outperform, it gives us comfort that markets have reached a point of excess that stacks the odds in favor of cheaper stocks for the medium to long term.

Style Performance

Extreme is the word best used to describe style performance in the final quarter, and especially so for the full year. It is not news that Value has struggled in recent years, but the widening in the relative performance spread between the MSCI World Value and Growth Indexes resulted in an historically wide 1200 basis points spread (12%) in favor of Growth for 2019, despite some short-lived reversal of the trend in the third quarter (Figure 1).

Figure 1
Performance Gap of Growth Over Value Hits 12% For 2019

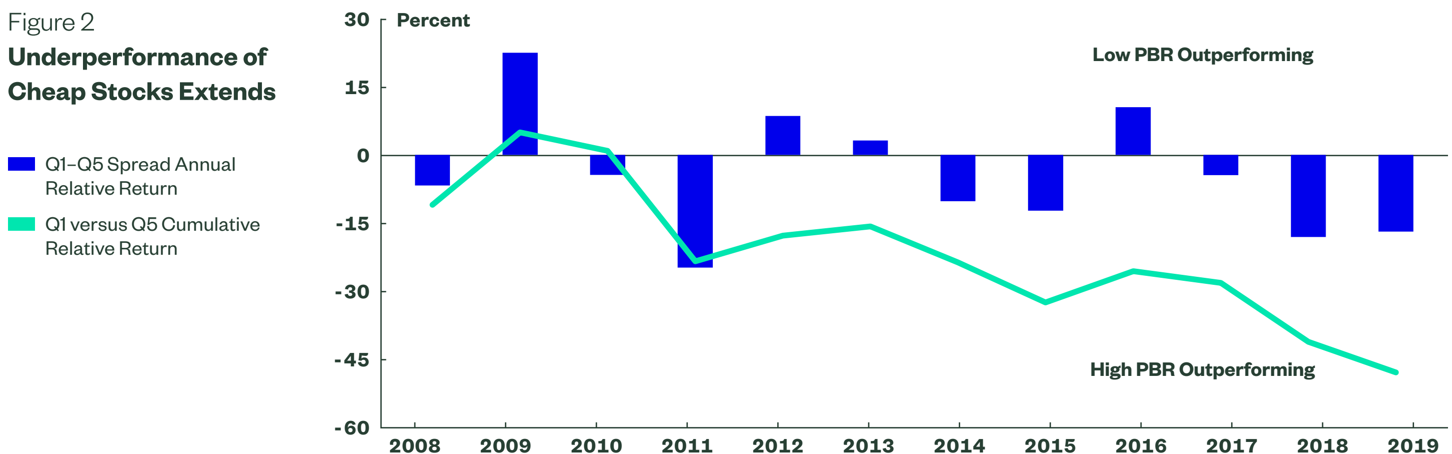


Source: State Street Global Advisors, MSCI. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses

Cheap Stocks Stay Cheap

As measured by price-to-book valuation multiples and ignoring the regional impacts of global index construction — which is now heavily skewed towards more expensive US stocks — the gap in 2019 between the lowest valued cohort and the highest was 17 percentage points, an outcome that echoes the 2018 experience when the spread was similar, but the cumulative gap is quite staggering (Figure 2).

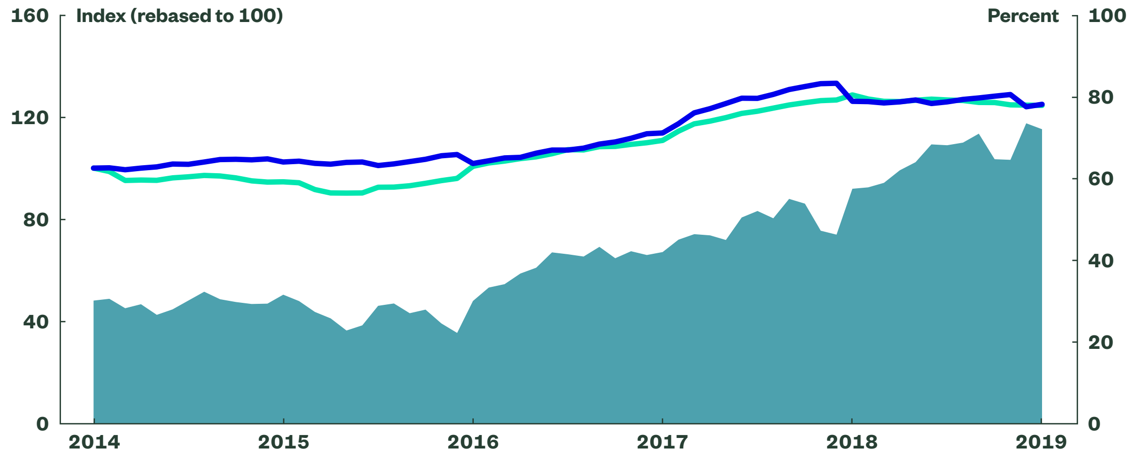
Figure 2
Underperformance of Cheap Stocks Extends



Source: State Street Global Advisors, MSCI. Past performance is not a reliable indicator of future performance

Such a performance advantage for expensive growth stocks might arguably be rational if this superior performance was accompanied by superior earnings growth. However, our analysis suggests it is multiple expansion and not superior earnings that accounts for the lion's share of performance spread between growth stocks and the rest (Figure 3). Furthermore, this multiple expansion seems to be associated with a belief that ultra-low interest rates — and thus discount rates for growth stocks — are permanently lower.

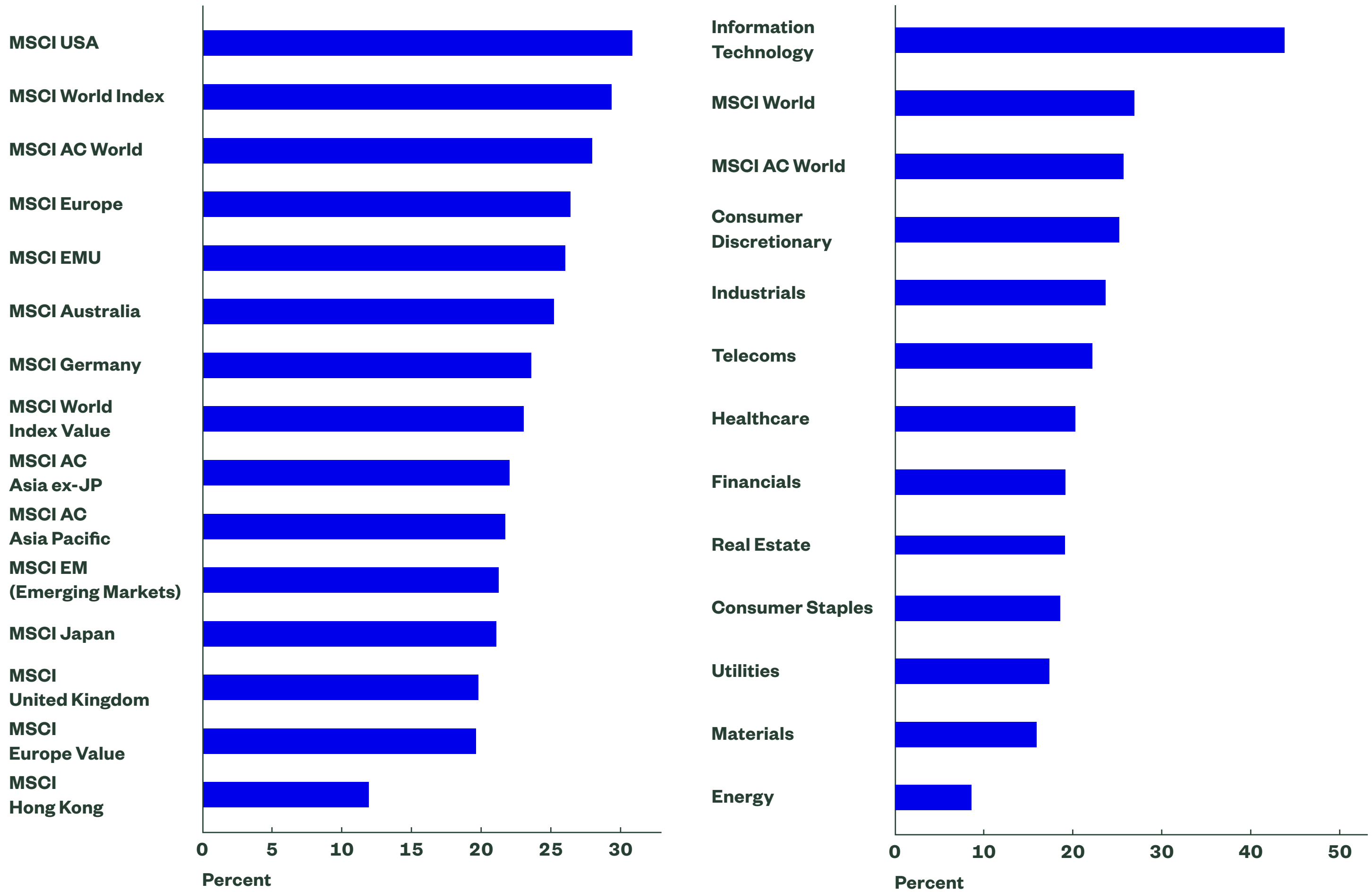
Figure 3
Premium for Growth has Expanded Significantly
MSCI World P/E Premium vs EPS Growth



Source: State Street Global Advisors, MSCI.

Taking a closer look at where performance was concentrated during 2019, we see that the US dominated global equity returns, driving a significant portion of the MSCI Global Equity Index returns; this came despite the US having the highest starting valuations in the developed universe. The gap from US returns to Asian and European returns approached double digits in many cases (Figure 4).

Figure 4
Familiar Trend in 2019 — USA and Tech Outperform (in USD)



Source: State Street Global Advisors, MSCI. Past performance is not a guarantee of future results.
Index returns are unmanaged and do not reflect the deduction of any fees or expenses.
Index characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

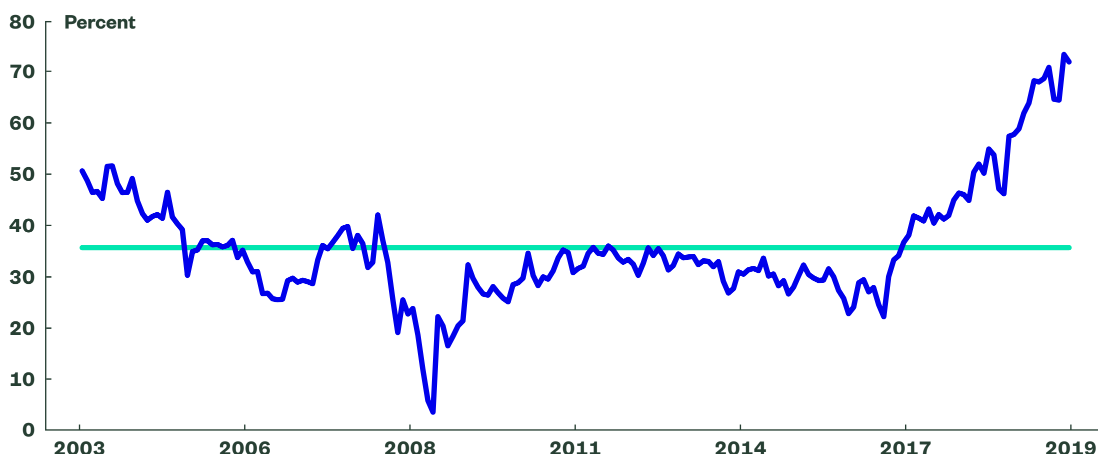
At a sector level, the performance outcome for 2019 was also extreme, with US Technology and Consumer-related growth stocks driving the majority of overall index returns. Most other sectors were unable to keep pace with the index, and Energy and Materials posted the least impressive returns, in absolute terms.

Taking Stock — Staying Patient

Taking stock of the current situation, we note that overall capitalization-weighted market indices are no longer attractively valued, but that cheap stocks have gotten relatively cheaper. Moreover, expectations for select securities appear quite low (Figures 5 & 6).

Figure 5
P/E Premium For Growth Stocks Over Value Stocks Rises Above 70%

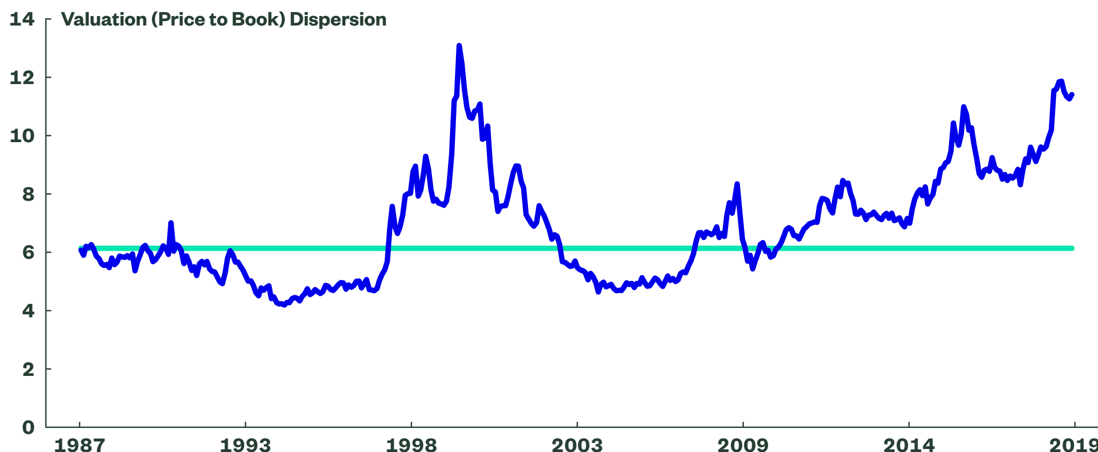
MSCI World Growth P/E Premium
Average



Source: State Street Global Advisors, MSCI.

Figure 6
MSCI World Index: P/B Valuation Dispersion

MSCI World Index: Valuation Dispersion*
Average



Source: State Street Global Advisors, MSCI.
* Most expensive quintile of MSCI World Index constituents divided by cheapest quintile.

We believe our strategies' average valuations sit firmly in the bottom quintile of the market and peer groups of similar managers, with above-average quality metrics. While the backdrop for Value has been difficult for some time, our track record over our decade-plus tenure has been better than the performance of the simple value style as our stock selection skill has been enough to overcome the style headwinds over medium to long-term horizons. However, this has not been the case over the past 12–18 months — momentum in expensive growth stocks has been unusually strong. In any normal period, we would likely not be explaining "underwhelming" absolute returns of close to 20% — but for the most part, our strategies have been unable to keep pace with the global benchmarks for 2019. We have seen this before and our experience gives us confidence that the investments in stocks we own and the valuations at which they trade should be rewarded over time.

Past performance is not a reliable indicator of future performance.

Finding Value — Lear Corp

Lance Graham
Portfolio Manager

Lear is a high quality global automotive supplier whose share price has been negatively impacted by the wider challenges within the industry over the past 18 months. The company's share price weakness during this period resulted in the stock trading at a significant discount to our estimate of intrinsic value and prompted us to take a closer look at this high-returning, well-managed business with good long-term opportunities.

The Company

While the original corporate entity of Lear was seat manufacturer American Metal Products, it gets its name from William Lear, founder of the Lear Jet Corporation. After failing to persuade his board in 1962 to enter aircraft manufacturing he sold his stake in Lear Inc (an avionics company) to the Siegler Corporation in 1962 so he could focus on his business jets company. Lear Siegler Inc. subsequently bought American Metal Products and later changed its name to Lear Corporation.

Lear caters to the world's major automakers and is the second-largest supplier of seating systems to the global automotive industry. It designs, develops and manufactures all components in the seating structures and mechanisms, from seat covers to seat foam to seating-related electrical/electronics. Additionally, Lear supplies the car industry with electrical systems such as wire harnesses, terminals, connectors and electronics. Around 75% of Lear's revenue and profit comes from the Seating Division, while the balance is derived from their E-Systems business.

The Investment Case

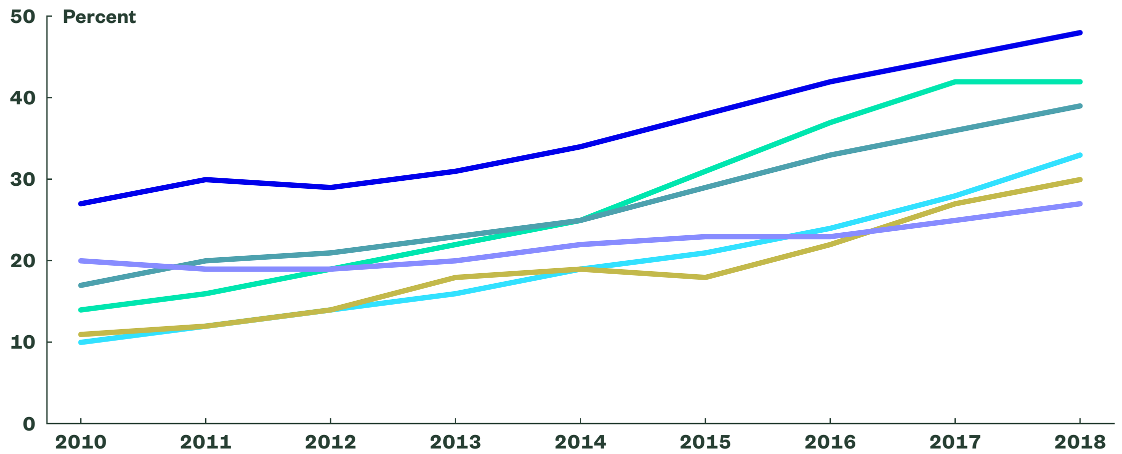
Lear enjoyed strong returns on investment from 2011 to 2018 due to healthy global automotive markets, a focus on returns, growing market share and increased content per vehicle. However, the past two years has seen a cyclical slowdown in the global auto market, alongside trade war concerns and a margin reset in the firm's E-Systems division caused by a slowdown in China. These headwinds have contributed to reduced returns on investment and have negatively impacted the share price.

The company's fortunes are inevitably influenced by global automotive production, but there are a number of secular tailwinds that should benefit the company going forward.

Seating Business

A growing appetite for bigger and heavier cars has been evident for many years, with Sports Utility Vehicles (SUV) consistently accounting for an ever-larger proportion of new car sales. As Figure 7 illustrates, this is not just a North America phenomenon and this trend is set to continue — based on IHS Markit estimates, SUV production as a proportion of global production is expected to rise from 35% to 39% by 2023. Lear is well placed to benefit from this trend as SUVs typically have more seats than ordinary saloon cars, thus requiring more features such as complex second-row mechanisms and higher electrical content.

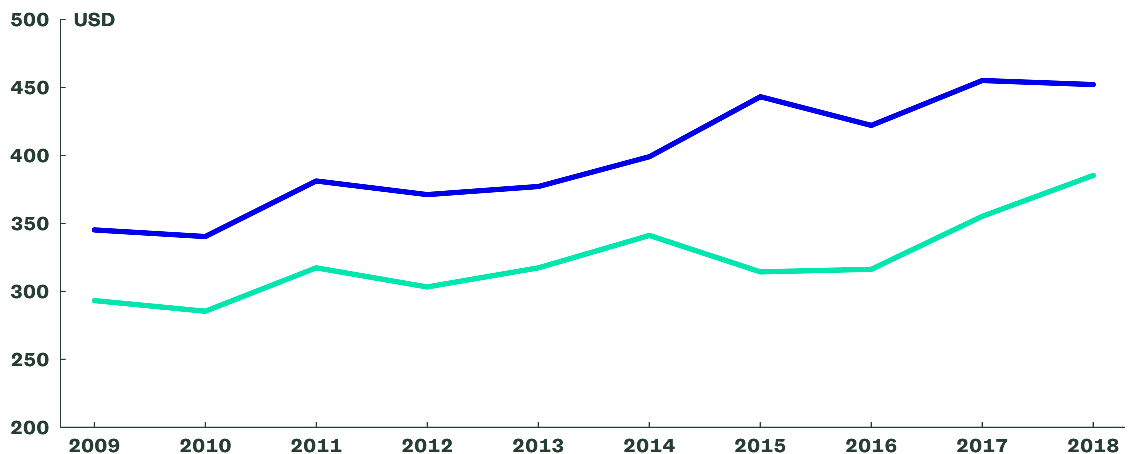
Figure 7
Share of Sports Utility Vehicles (SUV) sales in Key Car Markets



Source: International Energy Agency (World Energy Outlook), IHS Markit.

Sales growth is also set to benefit from improvements to seating options, including powered seat movement, seats that 'remember' your perfect seat position, while newer innovations such as heated and cooled seats should also help drive growth (see Figure 8). Leather as a seat fabric continues to increase its penetration and Lear owns the world's largest supplier of premium automotive leather — Eagle Ottawa — to give it a key differentiator over its competitors. Indeed, Lear has the broadest seating offering amongst the peer group and as manufacturers seek to attract buyers in a competitive market they are likely to increase the quality and functionality of the seats — the potential benefits for a market leader like Lear are clear.

Figure 8
Lear Corp Content per Vehicle (USD)



Source: Lear Corporation.

These factors should enable the company to grow faster than global auto production as content per vehicle increases over time.

Management and Returns

A high quality, experienced and stable management team is an important component of our investment screening process. And Lear ticks these boxes, with the CEO, CFO and the president of the seating division all registering tenure at the company of more than 25 years in various positions. Their return/cash focus has seen them maintain a strong balance sheet while growing the business, making acquisitions and reducing the number of shares in the company by half via share buybacks over the past eight years. As already outlined, return on invested capital has fallen in more recent times, but has remained strong overall despite the wider issues in the sector. Given the management team's experience and strategy, our expectation is that this will remain the case.

The Electric Vehicle Opportunity

One worry for many investors in the auto sector relates to the structural changes that are already in motion; the trend towards electric vehicles and autonomous driving is increasingly gaining traction. We believe Lear is unlikely to be negatively impacted by these changes. Cars will always require seats no matter which drivetrain is powering the vehicle and it is one of the areas that original equipment manufacturers can differentiate their product with higher quality fabrics and extra seat functions. Future vehicles will have higher electronic, connectivity and software content, which represents a significant opportunity for the E-Systems business of Lear. Additionally, Lear's next generation of seating has innovations such as 'Biobridge', a sensor technology that detects stress, drowsiness and heart rate variability, thus combining seating and electronic expertise to deliver a safer driving experience in the future.

Summary

While the automotive sector currently has several challenges, we believe Lear is well positioned to benefit over the long term from the secular tailwinds outlined above. The company is trading on a cash economic price-to-earnings (P/E) multiple of 12x, compared to its peer group average of 16x. The long tenure of the management team at the company, combined with a strong balance sheet and a returns-focused strategy presents an attractive opportunity.

Research Briefing

PJ Davies
Research Analyst

Ciara Lynch
Research Analyst

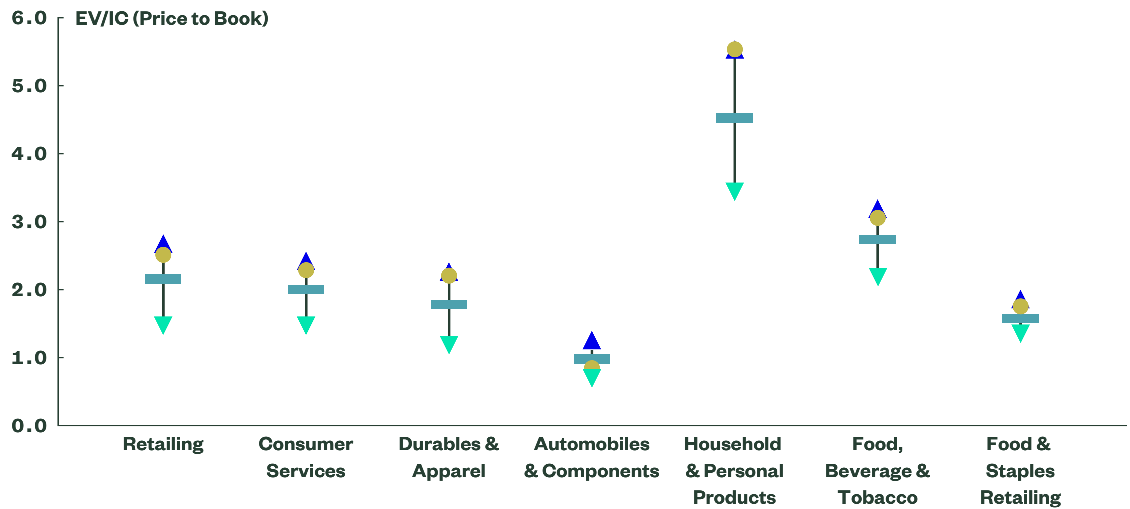
Simon Matthews
Research Analyst

While the consumer sector has generally performed better than the market over recent years, the broad sector index disguises marked differences between stocks, thanks to disruption and uncertainty. Traditional retailing is under enormous pressure from the rise of internet-based competitors, while uncertainty about the transition to electric vehicles and the prospect of self-driving cars has driven auto sector valuations to 10-year lows. We asked the Consumer Research team for their thoughts around whether the sector still contains upside potential.

After a strong run, what are your thoughts about valuations in the Consumer sector at present?

CL: Unfortunately, most of the consumer sector is trading at the top of its 10-year valuation range. Whether you look at price-to-earnings, price-to-book, or our preferred lens of economic earnings yield, the picture is consistent. That said, what I love about the consumer sector is the diversity of the opportunity set; our universe extends from tobacco to autos, hotels to skincare, food retailing to online gaming. So, even with a relatively high headline sector valuation, there are ample opportunities to seek out idiosyncratic situations and business models. That is reflected in our own portfolio, where our investee companies span the range of egg producers to off-road vehicle makers.

Figure 9
Consumer Sector Valuation by Segment — EV/IC (Price to Book)



Source: State Street Global Advisors, CS Holt as at December 31, 2019.

With such a wide array of companies and business models, is a flexible and adjustable approach to company valuations required?

PJD: Actually no, we believe the opposite is true. The complexity and diversity of our sector demands a consistent approach to valuation and stock selection. Our aim is to have comparable valuations across both geographies and sectors. We do this by applying a uniform set of accounting standards — which we call our "Consistent Framework" — to all companies as well as a consistent modelling approach to valuation. This disciplined approach helps us to cancel out some of the market noise around the in-favor and out-of-favor parts of the consumer universe.

Sanderson Farms, a large US chicken producer, is a good example of this. The stock sits in the food segment, where there are many companies with stable and predictable earnings streams. Sanderson, in contrast, is a highly cyclical business with periods of very low and very high returns and a volatile stock price. We believe the clarity and consistency of our approach to establishing the through-the-cycle earnings power of a business helps us to identify opportunities such as this.

The traditional value approach involves buying companies on low price-to-book multiples. Is this still valid given the success of asset-light companies disrupting many consumer segments?

SM: Low P/B multiples in isolation are of low relevance to us if the assets aren't adequately productive. For example, a company with a large amount of off-balance sheet assets may have high returns and trade on a high P/B multiple. Conversely, a business with all its assets recorded on the balance sheet may exhibit lower returns and trade on a lower multiple.

Our valuation framework focuses on the price paid per unit of productive capital and, to the greatest extent possible, we incorporate all assets and liabilities into our valuation. We are agnostic to whether assets are captured on the balance sheet or not, and our methodology treats these two types of companies consistently. We are happy to own companies with high returns and high book multiples if the price we pay per unit of productive capital affords us an adequate margin of safety.

Given the disruption in certain parts of the consumer segment, is your returns lens still effective?

CL: One question we have asked ourselves in recent times is whether the high correlation between returns and valuations persists in the current environment. We have run long-term analysis for the consumer sector (and its sub-sectors) to ascertain the strength of the relationship between return on invested capital (ROIC) and valuation over long time horizons. Our work shows that the relationship continues to sustain and correlations remain high, validating our bottom-up stock-picking approach.

Where are you seeing opportunities within the consumer sector currently?

SM: Our benchmark-agnostic, bottom-up approach to stock picking means we do not target particular segments of the consumer sector. However, the auto segment has been trading close to the bottom of its historic P/B range and, with the help of our screening tool, it has proved a fertile hunting ground for us. The sector is not without its issues though, and there is much concern around disruptive technologies and the associated step-up in investment required for Electric/Autonomous Vehicles, as well as the potential for a downturn in demand. However, these concerns have led to a drawdown in the valuations of all auto stocks, seemingly regardless of the magnitude of individual companies' exposure to such adverse trends. We have found a number of interesting opportunities among leaders in the auto parts space.

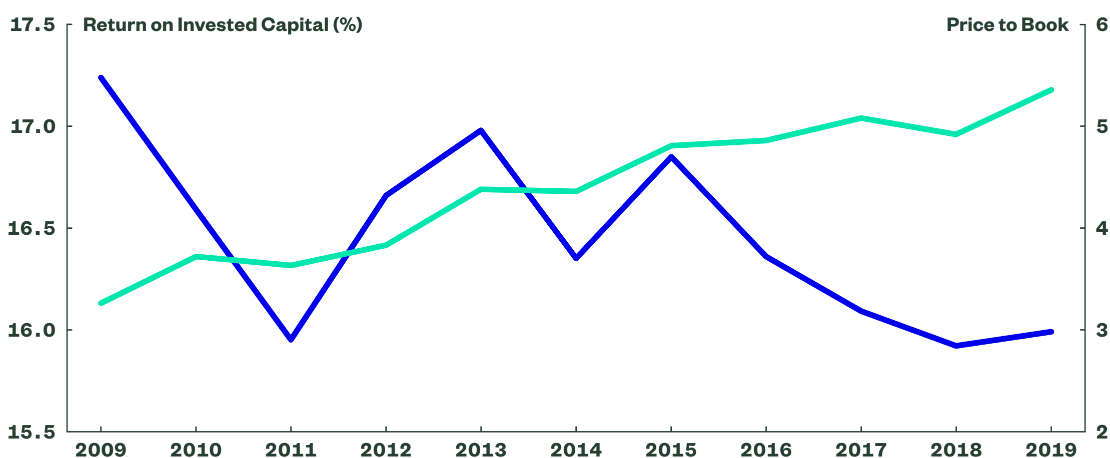
Are there areas of the consumer sector which you are avoiding at the moment?

PJD: We don't explicitly avoid any part of market, but we do have limited exposure to the Household & Personal Care (HPC) segment as we simply don't see much value there at the moment. Returns in this segment have actually been in decline since the Global Financial Crisis, and yet P/B multiples have nonetheless expanded. It is clear to us that the price action in HPC is divorced from the fundamentals and driven instead by a perception that these stocks are low risk and make for suitable bond proxies. With interest rates close to all-time lows, we are sceptical about the risk/reward payoff from holding such highly-rated companies over the medium term.

Figure 10
Household & Personal Care Sector Expensive Despite Shrinking Returns

Returns (Cash Flow Return On Investment (CFROI))

Price to Book (EV/IC)



Source: State Street Global Advisors, CS Holt as at December 31, 2019. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses

A second consequence of this low interest rate/cheap money environment is that the consumer sector has seen a large influx of start-up companies. Many of these operators are exploiting the digital ecosystem to directly reach their customers, overcome previously high entry barriers and disrupt previously-cosy competitive dynamics.

Finally, no discussion of the consumer sector is complete without a mention of Amazon. What is your view of the stock?

CL: Amazon is certainly the giant in the retail space and a large weight in the consumer benchmark. And not owning the stock has been a very significant headwind to performance for the past number of years. The company currently trades on 80 times 2019 earnings, which implies a monumental amount of growth and market share dominance far into the future. In the range of possible outcomes, this is certainly possible, but we don't think it's probable.

However, valuation aside, Amazon's impact on the fundamentals of the retail sector is undeniable. We have seen traffic move away from stores, online delivery options have gotten more competitive, and smaller brands have established a foothold with the more democratised market access that Amazon offers. All of this has served to bring margins and returns down across the retailing space. The result has been a sector ripe for value traps, so we continue to tread carefully.

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 $3.12 trillion* under our care.

* AUM reflects approximately $43.72 billion USD (as of December 31, 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.

ssga.com

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 Maryah Island, Abu Dhabi, United Arab Emirates. Regulated by ADGM Financial Services Regulatory Authority. 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 authorized and regulated by the Financial Conduct Authority in the United Kingdom. **Canada:** State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500, Montreal, Qc, H3A 3A8, 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. **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, authorized 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. Authorized 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 Ireland Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorized 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, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 10495250960 - R.E.A. 2535585 and VAT number 10495250960 and whose office is at Via Ferrante Aporti, 10 - 20125 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 authorized 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. Authorized 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. Authorized 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 any investment. It does not take into account any investor's or potential investor's particular investment objectives, strategies, tax status, risk appetite or investment horizon. If you require investment advice you should consult your tax and financial or other professional 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.

Investing involves risk including the risk of loss of principal.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA's express written consent.

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.

The information contained should not be considered a recommendation to invest in a particular security or to buy or sell any security shown. It is not known whether the securities shown will be profitable in the future.

Diversification does not ensure a profit or guarantee against loss.

Investments in small-sized companies may involve greater risks than in those of larger, better known.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Past performance is not a guarantee of future results.

Equity securities may fluctuate in value in response to the activities of individual companies and general market and economic conditions.

The views expressed in this material are the views of the Fundamental Value Equity Team through the period ended December 31, 2019 and are subject to change based on market and other conditions.

The trademarks and service marks referenced herein are the property of their respective owners. Third party data providers make no warranties or representations of any kind relating to the accuracy, completeness or timeliness of the data and have no liability for damages of any kind relating to the use of such data.

© 2020 State Street Corporation.
All Rights Reserved.
ID141393-2917999.1.1.GBL.RTL 0120
Exp. Date: 01/31/2021