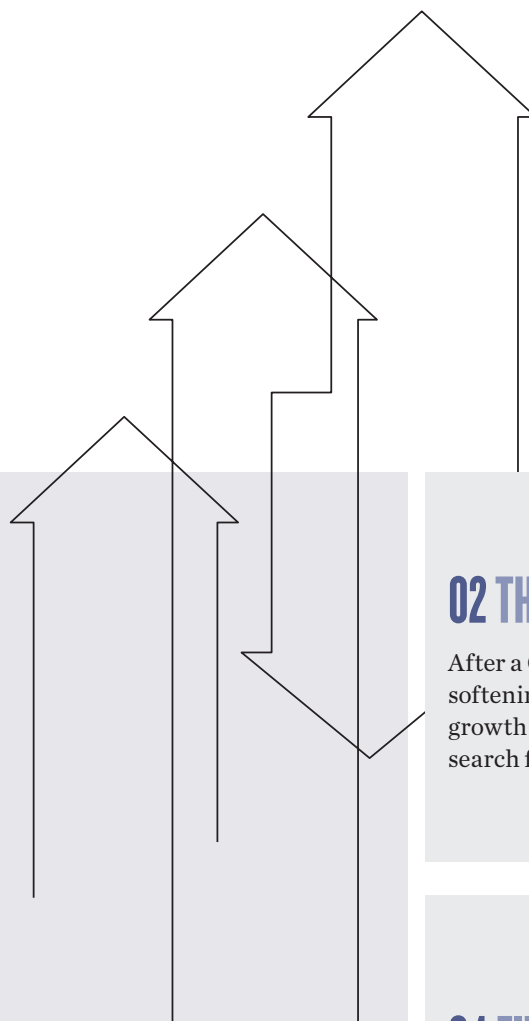


Taking Stock
APRIL 2019



FUNDAMENTAL VALUE EQUITIES

Concentrating on long-term value

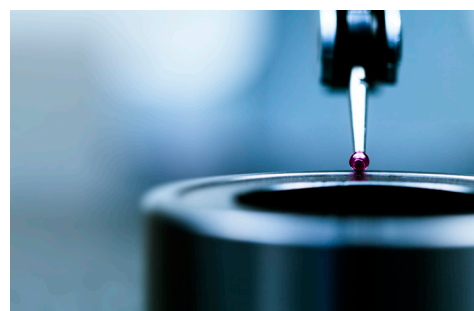
**STATE STREET
GLOBAL ADVISORS®**

02 THE BIG PICTURE

After a Q1 rebound, what do softening economic and earnings growth expectations mean for the search for value?

04 FINDING VALUE

Dürr's strong market positions present an interesting proposition for value investors after a 2018 sell-off.



06 RESEARCH BRIEFING

A sustainable competitive advantage can act as a moat to repel rivals. But within the materials sector, the durability of the moat can differ considerably by industry.

THE BIG PICTURE



Barry Glavin
Chief Investment Officer

The resurgent fortunes of global equity markets in the opening three months of 2019 raises some interesting questions about how the steep sell-off of the prior quarter could so quickly be reversed, given a backdrop of softening economic data and negative earnings revisions. With the MSCI World Index up more than 12% for the latest quarter, the global equity market now sits less than 5% off the record highs printed last year. What does this dynamic tell us about investing in today’s market?

Investors Paying More for Less

It’s not immediately intuitive that a weaker economic and earnings environment would typically be considered conducive to equity markets rebounding so strongly (Figure 1a). For equities to rise we need some combination of earnings growth or an increase in the price investors are willing to pay for those earnings. As Figure 1b demonstrates, with projected earnings growth weakening, this move was largely driven by price-to-earnings multiple expansion. So what prompted the market to pay more for less?

The P/E chart suggests that the aggressive nature of the Q4 downdraft left equities (slightly) undervalued in relation to the long-term average ratio of 15x, and markets

moved swiftly to close this anomaly. History tells us that would be quite unusual. I don’t have insight into the mind set of every market participant, but I suspect part of the move was a sense that the price action in Q4 was perhaps too far, too fast. The recent course-change by central banks may also have played a role.

If one thinks of a P/E ratio as an upside-down discount rate, a fall in the discount rate therefore corresponds to multiple expansion; put another way, low rates drive asset prices higher but (importantly) not to the same extent — that depends upon the sensitivity of the asset to changes in interest rates.

The Sensitivity of Stocks to Interest Rate Changes

We’ve written before about the impact of monetary policy within equity markets. Our theory is that low-multiple stocks (with high implied discount rates) are more sensitive to changes in interest rates than high-multiple stocks (low implied discount rates). The first two months of the year saw stocks rally against a backdrop of stable rates, with US 10-year Treasury yields hovering around 2.70%. During this period, the sectors leading markets higher included cheap cyclicals — industrials, energy, and financials — and in general our strategies performed well. As March progressed and the bond yield fell through 2.40%, equity markets continued to move higher, but the leadership changed — bond proxies and low-beta, defensive sectors such as real estate, consumer staples, and utilities were now leading the tape, and consequently our relative performance deteriorated.

Figure 1a: Global Equities Rebound Towards Record High

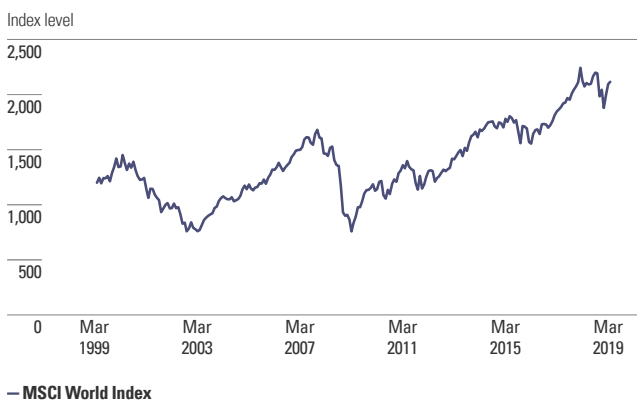
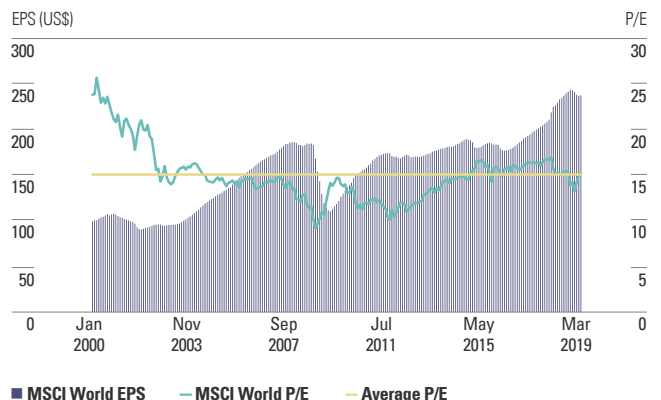


Figure 1b: Valuations Hover Near Long-term Average



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

Uncovering Pricing Anomalies

So where does that leave us? Pretty much unchanged, arguably. On a headline basis — on this simple metric — global equities would seem to be close to fair value. In the vernacular of value investing, we can observe that paying an average price usually means receiving an average expected return. That isn't a bad outcome, but it would seem that upside potential is somewhat limited, as is the margin of safety — paying this price requires earnings to grow. While earnings are forecast to do just that, it is important to note that they are already loitering around record highs. In this context, the breakout of earnings growth over the cycle is informative. Sales growth on average has been muted and much of the growth in earnings has come from margin expansion and buybacks. The case for an upside earnings surprise quite probably hinges on a sales surprise.

As bottom-up value investors, we don't believe that overall market levels and valuations are always the best way to illustrate or capture the attractiveness of the opportunity set. The interest rate regime of recent years has proved a headwind for value managers, but this same headwind has also created a target-rich environment — pricing anomalies that we, as long-term investors seek to exploit.

The line in Figure 2 shows the relationship between the median price-to-book (P/B) valuation of the cheapest quintile of stocks in the index and that of the most expensive quintile. It can be interpreted to illustrate

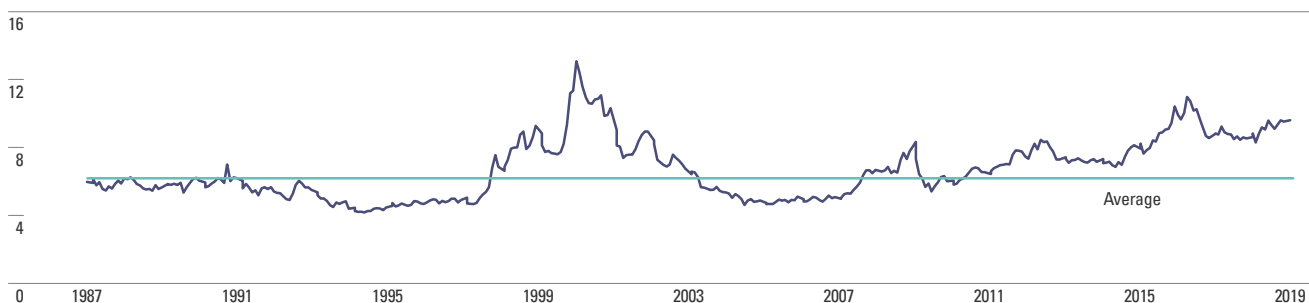
the dispersion around the mean. So while the index may well be trading at an average multiple, the reality is that when valuation dispersion is high, many constituents are substantially cheap or expensive relative to the index. When the line is rising, the gap between the valuation of the cheapest and most expensive quintiles is widening — expensive (high-multiple) stocks are becoming more expensive relative to cheap (low-multiple) stocks; hence, growth is outperforming value.

Fundamental Analysis Key to Excess Returns

In the regime outlined above, one cannot rely upon the multiple alone to drive returns. The value/growth premium has been a headwind rather than a tailwind during this prolonged period of extraordinary monetary policy. The market is not re-rating cheap stocks towards an average level. In fact, it has done the opposite for most of the last decade and continues to do so. In the absence of multiple expansion, we must rely on earnings.

For us to deliver excess returns, getting our fundamental analysis right is key. We scour the cheapest parts of the market to find good-quality, well-capitalised businesses that are misunderstood. Mistakes are punished heavily, but the opportunity set has been sufficient to allow us to add value for our clients. It doesn't look like it's going to get any easier any time soon, but in the words of Charlie Munger "it's not supposed to be easy".

Figure 2: Valuation (Price-to-Book) Dispersion of Cheapest Versus Most Expensive Quintiles



Source: MSCI, State Street Global Advisors.

Past performance is not a guarantee of future results.

FINDING VALUE



James Savage,
Research Analyst

Dürr

Dürr is a German mechanical engineering group with a long and eclectic history. With a core business that is directly tied to the global automotive industry, its share price fortunes have largely mirrored the challenges faced by companies connected to auto manufacturing during recent times. However, a closer assessment of the company's valuation reveals the importance of focusing more on the stock's fundamentals than on auto industry cycles.

The Company

The roots of the modern-day company can be traced back to 1962 and a contract from Ford Motor Company to build a spray-painting and pre-treatment facility for one of its automotive plants. Since then, Dürr has become the world's largest provider of automotive paint shop systems, with a market share in the range of 40–50%.

There are several important aspects to how a paint shop system works – not least that it is a highly-automated process that uses customised industrial robots. One of the unique characteristics of Dürr's offering is that it builds its own robots, while its competitors source them from third parties, including Dürr. The company has a

50% share in paint shop robots globally, and only around 60% of these sales are dependent upon the sale of Dürr's paint shop systems. The rest are bought either for use in competitors' systems or as replacement units in brownfield operations.

In total, approx. 55% of Dürr's revenue is exposed to the automotive sector. In addition to paint shop systems, the company provides final assembly systems and various measurement and balancing technologies.

The main counterweight to this automotive exposure is HOMAG, in which Dürr acquired a majority stake in 2014. Accounting for around 30% of group revenues, this division manufactures woodworking machinery and systems that are used principally in the production of furniture.

Investment Opportunity

Dürr enjoyed high returns on investment between 2012 and 2016. This was mostly due to two factors – (i) strong revenue growth, driven by the fast-expanding Chinese automotive sector, and (ii) the fruition of various cost improvement measures undertaken, e.g. plant closures; product modularisation; process standardisation.

However, a number of events have since occurred to put these returns under pressure, including:

- A cyclical slowdown in investment by the Chinese sector beginning in 2016;
- Greater husbandry by global manufacturers of their overall capital expenditure budgets as they ramp up development of electric vehicles offerings; and
- A softening of Chinese demand during 2018.

In addition, HOMAG has had some execution challenges as it addresses a record order backlog. These have arisen from the need to adapt its main manufacturing facility to be able to deliver a higher output of full production-line systems.

In all, these pressures caused the market value of the company to as much as halve during the course of 2018 – in line with the performance of many stocks with large exposures to the Chinese automotive sector. The stock's HOLT Economic Price-to-Equity ratio fell from 21.5x in October 2017 to 16.3x a year later – a considerable discount to its 20 nearest European machinery peers in market capitalisation terms, which were trading on an average ratio of 21.3x at that time.

The Value Proposition

Balanced growth exposure: In terms of its paint shop offerings, Dürr has a balanced exposure to its customers' short-term (maintenance) and long-term (growth) investment needs. Therefore, while there is a short-term risk that automotive manufacturers defer regular maintenance expenditure, they need to balance this against the risk of costly unscheduled production outages.

On the other hand, Dürr is not overly exposed to its customers' large greenfield investment decisions either, should there be a postponement of such expenditure.

Replacement cycle: Another important consideration is the replacement cycle for both paint shop systems and the robots therein. This cycle is not just supported by some 250 paint shops globally being more than 20 years old, but also by structural drivers such as rising standards in the quality of emerging market production and ever-tightening emissions standards globally.

In addition, industrial robots have a useful life of 10–12 years before needing to be replaced. As we move into the mid-2020s, this should provide an attractive revenue stream for Dürr, given that its global installed base has approximately doubled in size since 2010.

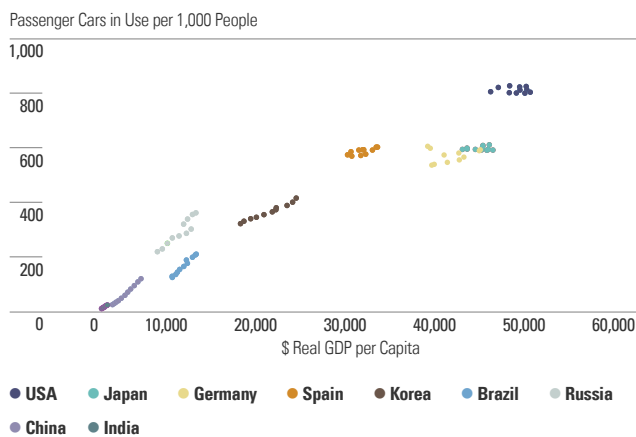
Order book: The company's Chinese order book has held up well despite the slowdown in automotive demand; mostly because investment by local electric vehicle manufacturers has been unaffected by near-term industry pressures. Moreover, this form of investment should remain an important global revenue driver over the next decade.

China potential: Vehicle penetration in China remains very low by global standards, especially when considered in terms of the country's long-term potential for growth in real GDP per capita.

A similar point can be made about Chinese consumer demand for furniture, which would support HOMAG's business activities.

There is also the enormous potential of the Indian market to consider over the long-term.

Figure 3: Long-Term Passenger Car Demand Highlights Potential in China & India (2005–2015)



Source: OICA, World Bank, US Census Bureau, State Street Global Advisors.

Robust Demand Outlook

We believe that the robust demand outlook for Dürr's products supports the company's long-term earnings power and its valuation offers what we consider to be a good 'margin of safety'. This is underpinned by its strong market positions, an excellent reputation with customers, and a clear focus on cost management during cyclical downturns in customer spending.

Furthermore, modest capital expenditure requirements and a customer-funded working capital model support the sustainability of high-teen returns on investment.

Finally, the company retains significant financial flexibility through the maintenance of a net cash position. It has also demonstrated good capital discipline over recent years, despite making notable acquisitions, including that of HOMAG.

RESEARCH BRIEFING



Owen Dwyer,
Research Analyst

Do Moats Offer Protection in the Materials Sector?

A key ingredient in our estimate of intrinsic value for any potential investment is our assessment of that business’s sustainable competitive advantage. The characteristics of this ‘moat’ often differs by company and/or industry, but the wider it is and the longer it can be maintained will determine how well the firm can protect its long-term earnings power. As a philosophy, this makes a lot of sense; but executing on this in today’s equity market can be challenging given current valuations.

More Than a Moat

Uncovering attractively priced companies with wide moats has become more difficult in recent years. After nearly a decade of cheap money, such businesses are generally expensive and arguably offer little in the way of ‘margin of safety’. Indeed, to buy these companies today would seem to break a cardinal rule of the value investor: do not lose money.

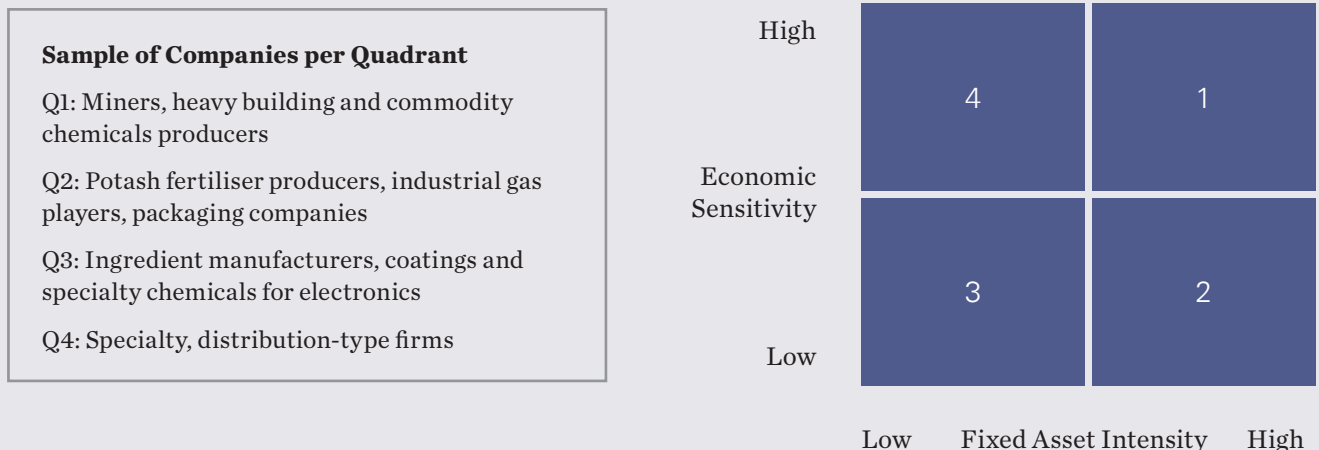
Furthermore, the pace of innovation and technological change means that the concept of a moat is arguably more tenuous than in the past. For example, any firm wanting to compete with Coca-Cola or Hershey 30 years ago while charging higher prices for their products would have struggled from the outset. Today, the growing market for artisanal and premium products indicates that this is no longer the case.

We believe that our approach, which is built on fundamental bottom-up stock-picking, reframes the argument about a business moat by looking beyond the obvious to think about true sustainable competitive advantage. We seek to establish what this means for margins and returns on capital, which leads us to a view on the firm’s intrinsic value.

Moats in the Materials Sector

In terms of industries with a prevalence of strong moats, the materials industry is one that might not spring to mind as a likely candidate. But this sector is home to a wide variety of companies. To this end, we believe that our simple matrix could be helpful in identifying where opportunities may lie (Figure 4).

Figure 4: Nature of Moats Differ



Source: State Street Global Advisors.

Quadrant 1: Hard Cyclical

As measured by economic sensitivity and fixed asset intensity, the upper right quadrant represents the most cyclical part of the Materials sector. Industry returns are typically in line with cost of capital over the long term, and vary between supply destruction at the trough and incentive price returns at the peak. A company's moat can generally be determined by asset quality (cost curve position, economies of scale, infrastructure/logistics advantages) and management quality (capital allocation track-record, operational delivery). We favour companies with top quartile assets, strong management, and robust balance sheets where the share price assumes returns stay depressed in perpetuity.

Quadrant 2: Less Economically Sensitive Cyclical

In Quadrant 2, the sustainability of competitive advantage is typically about the asset base and distribution network, with high barriers to entry a notable factor. These firms tend to be low-growth and strongly cash-generative, thus fitting the traditional criteria of having strong moats. The challenge today is finding attractively-valued businesses, given that many have attracted interest as 'bond proxies.'

Quadrant 3: High Value Add Specialties

Quadrant 3 typically includes materials companies with moats more akin to those of a consumer or technology company. The moats are often derived from patents and brands. Innovation and technological change present a meaningful threat to the period of sustainable competitive advantage that these companies enjoy. However, factors such as scale, R&D, and service make it more difficult for a new entrant than might be the case in a consumer sector.

The current challenge for value investors is finding stocks that are attractively valued. Where we have had success in identifying opportunities, it's often because the business with a strong moat is hidden within a less-attractive business; or because a short-term issue has led to a sell-off; or perhaps because the nature of the moat has changed.

Quadrant 4: Distribution Model

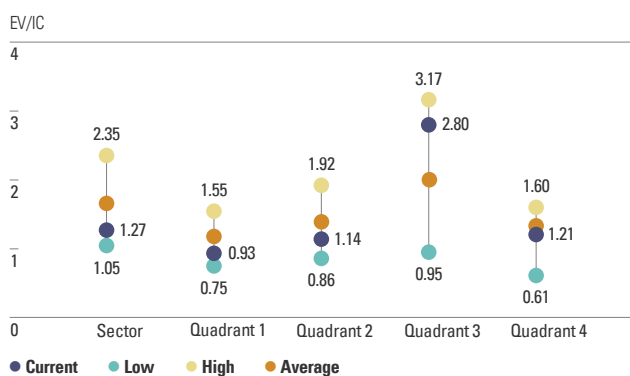
This is the least-populated part of the matrix, containing specialty or distribution-type businesses. Capital intensity is low and the competitive advantage is in technology, distribution, and service into economically-sensitive end-markets such as auto or construction. Potentially attractive businesses that may have been sold off on economic fears and stocking/destocking cycles might be unearthed here by detailed proprietary research.

The Valuation Perspective

From a valuation perspective, the materials sector overall is on an enterprise value to invested capital (EV/IC) ratio of 1.3x (see Figure 5). This represents a slight discount to its 20-year average of 1.4x, and is well below the super-cycle peak of 2.4x. However, there is significant dispersion within segments. The stocks with the strongest moats, quadrant 3, are trading close to all-time highs (2.8x EV/IC). In quadrant 1 and 2, where the high fixed asset businesses are located, valuations are at a discount to average. In quadrant 4, businesses are trading at a slight premium.

In the context of our holdings, it will come as no surprise to learn that we are least exposed to quadrant 3, given the high valuations. But we have still sourced opportunities where we believe the market has not yet fully recognised the strength of the moat around the business. We find most value currently in quadrant 1 — the most cyclical part of the sector — particularly in areas like cement and gold, but also in Japanese chemical companies where the business model is evolving to become less-economically sensitive.

Figure 5: Valuations by Quadrant (as at 28 February 2019)



Source: FactSet, State Street Global Advisors.

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 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, Briener 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.

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.