MAINFIRST

IS VALUE SET FOR A COMEBACK?

WHY IT'S WORTH TAKING A FRESH, SELECTIVE LOOK AT THIS ASSET CLASS.

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"Price is what you pay, value is what you get."

WARREN BUFFET

ONLY FOR
PROFESSIONAL INVESTORS

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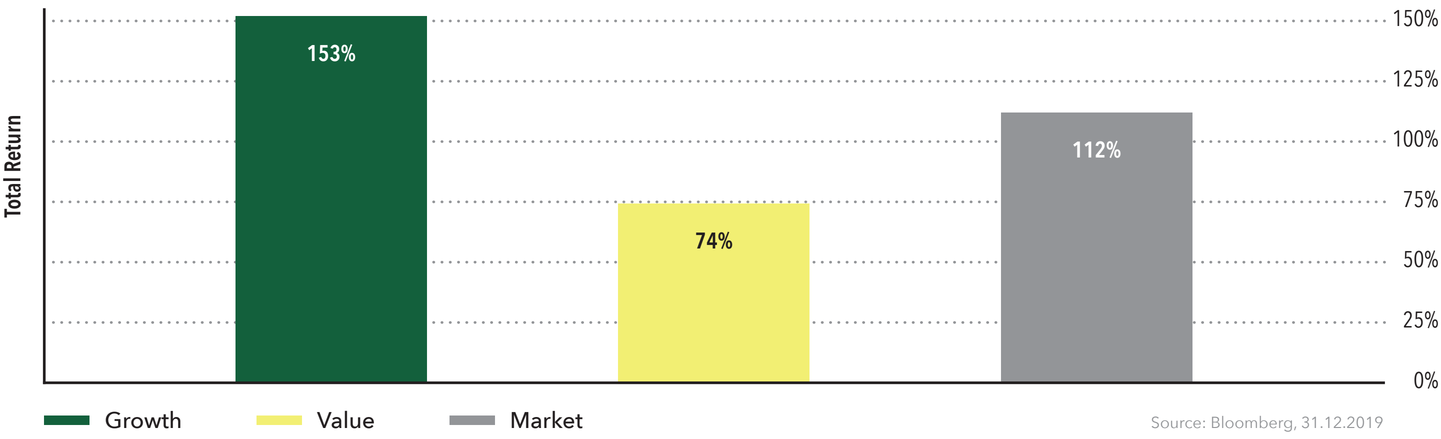
VALUE – LIKE A PHOENIX FROM THE ASHES

2019 will go down in the history books as one of the most successful years ever for German equities. With an advance of around 25%, the DAX's performance last year was pretty impressive. At times this caught some market participants by surprise, particularly in light of the fact that 2018 saw Germany's leading index suffer its worst losses since the financial crisis struck in 2008. However, closer examination reveals that 2019, too, had its winners and losers. Many value investors lost out yet again after ten years in the doldrums, and were looking at the competition from the growth and defensive segments with envy. Given this situation, an increasing number of investors are asking whether and when the tide will turn back in favour of value investments. Or do investors now need to abandon their belief in the once-popular value stocks?

FIGURE 1: ABSOLUTE PERFORMANCE OF GROWTH VS VALUE OVER 10 YEARS: GROWTH GAINS MORE THAN DOUBLE VALUE GAINS



Source: Bloomberg, 31.12.2019
Indices:
Value = MSCI EUROPE VALUE NET RETURN EUR
Market = MSCI EUROPE NET TOTAL RETURN EUR
Growth = MSCI EUROPE GROWTH NET RETURN EUR

THERE IS MORE THAN ONE ASPECT TO VALUE

First of all, it should be remembered that "value investing" is a distinctly multi-faceted term. Calling everything that falls within this category "cheap" – and therefore worth buying – is much too simplistic. Furthermore, such an approach can prove to be a big mistake. The fact is, there can be a big gap between the price and the intrinsic value of an individual stock; one should not be seen as synonymous with the other. The concept of value investing – first coined by investment legend Benjamin Graham and which made other investors, such as Warren Buffett, a role model – is actually rather different. In the words of Warren Buffett: "Price is what you pay, value is what you get." The value of a share can equally be derived from its particular earnings quality, outstanding quality of management, or in the form of high intrinsic value and impressive dividends. "A stock can be classed as 'value-oriented' merely because the market accords it a very low valuation on the back of a performance that is not expected to be especially good." Such periods – in which the price is below the actual value – provide particularly attractive entry points. Profitable, well-positioned companies should increasingly come back on the investor's radar. That has not been the case during the past decade. Many investors simply went with the flow and blindly put their faith in growth stocks. For many investors, there seemed to be virtually no alternative to growth. Reasons can obviously be cited for the assumed "superiority" of this investment style in recent years.

For example, a comparatively unfavourable backdrop has ensured that value shares have been the underdogs in the battle with growth stocks for around ten years now. Structurally low interest rates and the slowdown of economic growth together with the hunt for decent returns have led to a stampede towards growth-driven business models and quality stocks with low volatility and high dividend yields as a substitute for interest rates. Investment decisions are increasingly concentrated on growth speculation. Investors should nevertheless be asking themselves on a regular basis whether these high expectations are actually justified and rational in relation to the current share price. Every company should ultimately be judged by the earnings it actually generates. To that extent, the current run could likewise end in disillusionment sooner or later, especially considering how so much – if not too much – is now being paid for supposedly high-growth companies. The valuation gulf between these growth stocks and value is massive in some cases. Once this realisation dawns on the market, the time will have come for value stocks again. A look back in time, i.e. to the beginning of the millennium, shows that this is not just hypothetical.

FIGURE 2: PERFORMANCE OF VALUE VS GROWTH COMPARED TO THE MARKET

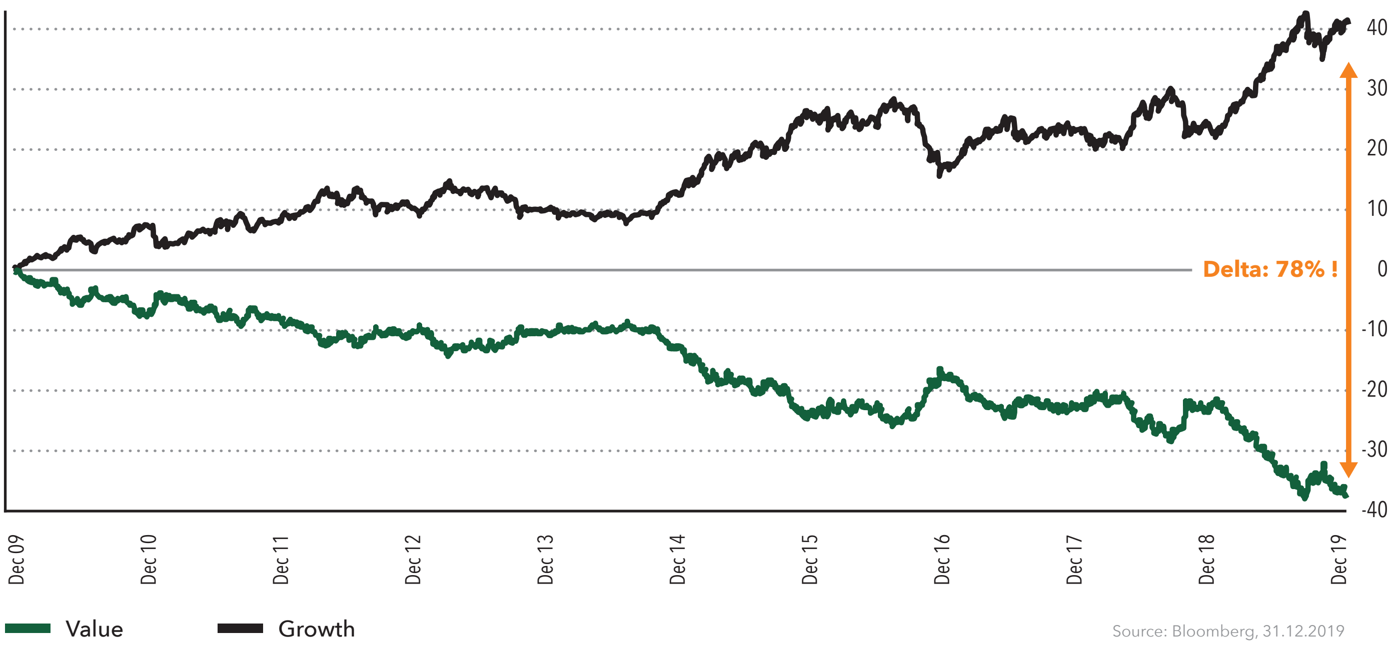


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FIGURE 3: REASONS FOR FAVOURING QUALITY & GROWTH

Record low interest rates

Dividends as a substitute for yields

Passive investment

Risk aversion

Stability

Stable cash flows

Momentum

Stocks of defensive companies offered an alternative for bonds given apparently stable & predictable dividends.

Only for professional investors. Do not forward to retail clients. The risk considerations on page 8 apply to all information in this publication.

LESSONS FROM THE PAST

At the time of the Neuer Markt, many hopes and dreams suddenly evaporated into thin air. In most cases, this was a product of failure to deliver on promises of strong growth and earnings. Twenty years on, and we can see a similar scenario. Once again, we have a large number of firms with above-average growth rates but loss-making business models. Current examples include stock-market newcomers/unicorns, most of whom have private-equity origins, such as Uber, Lyft, Slack and the failed WeWork IPO. Another factor that has led to such valuation differences is momentum. With momentum, the past performance of securities is supposed to serve as an indicator of their future development. ETFs have a substantial influence these days, as passive investments replicate the index. Cash inflows are primarily invested in large-cap index heavyweights, which merely serves to widen the valuation gap even further.

MORE THAN A GLIMMER OF LIGHT ON THE HORIZON

The history of the capital markets shows that a corrective trend reversal usually occurs once a substantial discrepancy between value and growth stocks opens up. Such a trend reversal could be sparked by a comprehensive deal in the trade war between the US and China, for example, or a stabilisation of interest rates at a low level. As far as the latter are concerned, we are confident about structurally low interest rates; however, interest rates well into the negative cannot be sustainable on a broad global basis when the alternative of hoarding cash exists. The prospects for value stocks therefore appear attractive. History does not necessarily repeat itself. Nevertheless, it seems highly possible that value shares will now pick up the pace and that they will narrow or even close the gap in returns versus growth stocks in the foreseeable future. "Yesterday's darlings almost never outperform in the future." Now could therefore be the time for investors to review the solidity of individual companies' business models and ultimately turn their attention back to the shares that have been unjustifiably spurned in the past.

FIGURE 4: WHEN SHOULD WHICH STYLE WORK?

GROWTH	VALUE
Falling interest rates	Rising interest rates
Expansionary monetary policy	Uncertainty in the market
Mid/end of cycle	Disappointments with Growth
Reliable economic outlook	Beginning recovery

In the long run, value has outperformed growth!

DIAMONDS IN THE ROUGH

As for potentially attractive value candidates, investors may well find them even in much-maligned sectors such as automotive. It is undeniably the case that the German auto industry is on the brink of a new era. Companies in this industry are suffering from a global fall in sales; technological challenges in terms of powertrain technology; more stringent environmental constraints and rising costs. However, this does not necessarily mean that the sector as a whole is finished. One company proving it is adept at managing these challenges is Hella. Operating out of more than 125 sites in around 35 countries, the Lippstadt-based family firm is one of the world's leading automotive suppliers. To ensure it is equipped to cope with future challenges as well, the company is investing a growing amount – in both absolute and relative terms – in R&D. With a more than solid balance sheet, coupled with new products, Hella should be able to retain its market leadership going forward too.

The banking sector faces problems of a similar magnitude. Probably no other sector is more critically eyed by investors than Europe's banking sector. Progressive digitalisation and the arrival of new competitors together with an ongoing torrent of regulatory requirements make it difficult to achieve a rapid recovery in balance sheets and earnings. That's without even mentioning the burden of low interest rates. Only a few banks can hold their ground in such an environment. Deutsche Pfandbriefbank exhibits strict cost control and conservative management, and is also making targeted moves to expand abroad. Its excellent balance sheet has been cleared of legacy issues, giving it a competitive advantage over other institutions. This has been rewarded by the market with an advance of over 80% including dividend payments since the IPO in July 2015 – at a time when the banking sector lost 20% of its value and the DAX gained just 15% or so.

INTRINSIC VALUE IS NOT DOWN TO SIZE

Sector considerations aside, there's also the key question of whether large firms per se have greater intrinsic value than their smaller counterparts. Our answer to the question is no; quite the opposite, in fact: Small and medium-sized companies that combine an attractive valuation with outstanding growth prospects often score highly.

"We look for high-growth, undervalued, German second-tier stocks. Long-term, these specialised companies outperform other companies thanks to the fact that they often have a dominant position in niche markets, enabling them to generate higher sales and earnings momentum."

A look at valuations versus the fairly defensive blue chips reveals substantial differences. These small and mid caps are in most cases extremely attractively priced and should therefore intrinsically harbour the greatest potential returns.

Is value investing now poised for a lasting comeback? The fact is, the arguments for value strategies probably never lost their validity. Solid, medium-sized companies with proven business strategies constitute the basis of a strong economy.

CONCLUSION

The economic slowdown is over.

There is no alternative to equities in an era of low interest rates.

We do not expect interest rates to fall any further.

We expect a solid equity market performance in the US-election year.

We expect an economic recovery in the course of 2020.

Consumer spending and the domestic economy are shaping up nicely and supporting the economy.

Value should outperform in 2020.

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