2017 Global Investment Outlook

4th quarter insights

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Shoppers love a bargain. The queues outside the Harrods sale are a testament to this. Strangely, when professional investors walk into their office, many of them forget this simple concept and are tempted to pay full price for their investments.

Investors typically overpay for growth

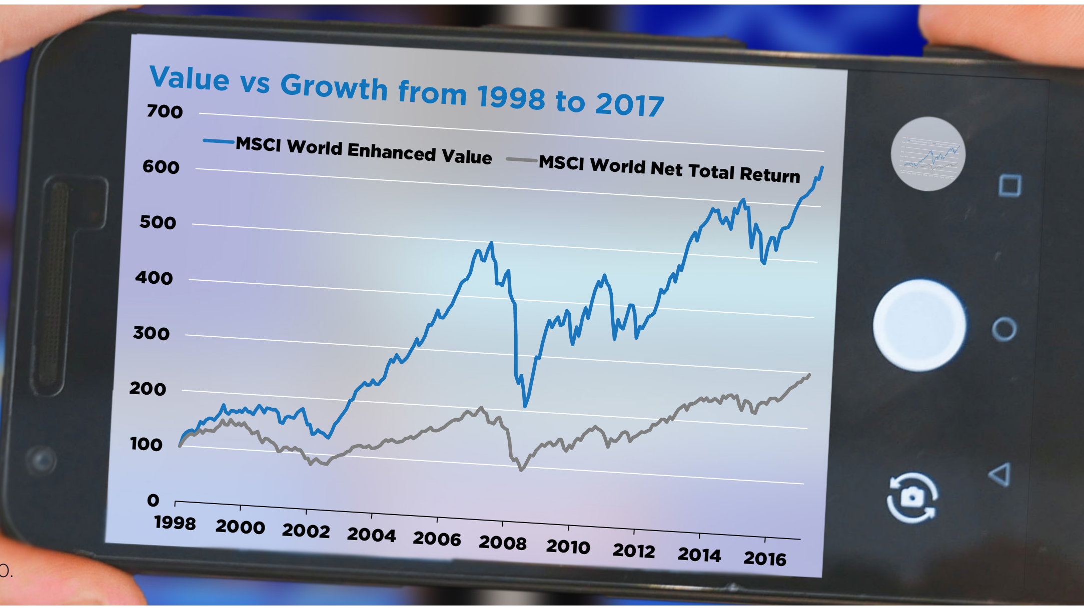
Cheaper stocks are often shunned in favour of more glamorous, exciting stories. Growth stocks sound fun: electric cars, graphene, social media stocks, rare earth, biotechnology. They are often fascinating new themes, the problem is that if you pay too much for any investment, your returns will be disappointing, even if you are right about the theme. And if your favourite theme turns out to be a disappointment, then the results can be shocking.

The best, but by no means only recent example of this was buying the largest companies in the Nasdaq at the peak of the bubble in 2000. Investors had correctly identified that the internet and technology would make a huge impact on the world, but they completely mispriced that growth. Of the top 15 companies in the Nasdaq at its peak, only five have made investors any money at all in the 17-year period that followed. Whilst four stocks were complete wipe-outs, falling more than 90%.

So, investors typically overpay for growth. The result is that growth stocks are more expensive than they should be and value stocks are under-priced. This phenomenon has existed for as long as stock markets: one of the earliest growth stories that changed the world, but was an early stock market disaster, was the arrival of railway stocks in the 1840s. These stocks soared and then crashed when the Bank of England raised interest rates in 1845. Many members of the middle class were caught up in this bubble, including, ironically, Charles Babbage, the father of the computer. Railways are also a reminder that capitalism turns technology companies into utilities, as has happened to mobile telecom stocks over the last twenty years.

Value stocks have outperformed growth stocks by a significant margin since records began in the 1930s.

During which many growth themes have emerged that are at least as significant as photographing oneself and sharing it with friends.



Source: Bloomberg, Oct 2017. Rebased to 100.

Why has value underperformed since 2006?

Since 2006 value has underperformed, not outperformed, the longest period of underperformance in over 80 years, eclipsing the period of underperformance in the late 1990's which ended badly for growth investors with the bursting of the TMT bubble. There are three reasons for this:

1. Firstly, in a low growth environment, investors have been willing to pay more for faster growing companies.
2. Secondly, as bond yields have fallen, investors have paid ever higher prices for so called bond proxies – utilities and consumer staples that typically pay relatively high dividends.
3. Finally, value stocks were expensive relative to their own history in 2006 and have spent over ten years getting cheaper.

We think that value stocks underperformance is coming to an end

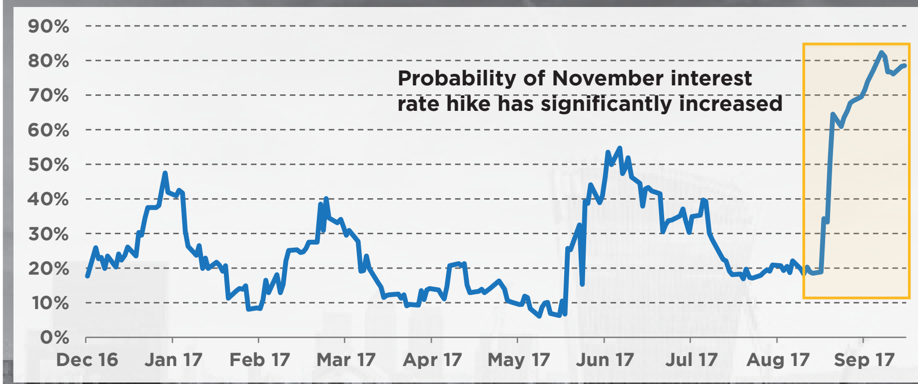
Firstly, from a growth perspective there is a synchronised upswing in global growth. Even more significantly, central banks have got the bit between their teeth and are determined to tighten monetary policy. The Federal Reserve has signalled that they will raise rates in December, the third increase this year. This should encourage investors to switch out of growth stocks and bond proxies and into value stocks.

Even in the UK, where there is huge political instability and uncertainty over Brexit, the Bank of England has indicated that it will raise rates in November.

As the Bank of England's chief economist Andy Haldane says:

"This would be a sign of the economy healing, and therefore adjusting to that healing process," he said. "So rather than being a source of fear or trepidation, this ought to be a good news story about the economy proving resilient."

Probability of a rate hike at November 2017 MPC meeting



Source: Bloomberg, Oct 2017

Finally, we believe that the valuation discount to the rest of the market and growth stocks in particular, looks increasingly stretched and poised to reverse. We can exploit this mispricing either through an active manager that focuses on value stocks or through factor ETFs. Factor or Smart Beta ETFs allow us to actively allocate to stocks that meet strict valuation criteria at very low cost.

Academic research shows that value is not the only factor that works, but it has the best and longest history of outperformance over the long term.

Other factors have demonstrated outperformance over time, these include:

- **Quality** – buying companies with strong balance sheets
- **Momentum** – buying stocks that exhibit strong price momentum
- **Size** – smaller companies

These factor ETFs provide the opportunity for outperformance of an index at a fraction of the cost of an active manager. They work best in large, diversified markets where there is sufficient diversification to eliminate the stock specific risk and just capture the factor. Interestingly, these are just the sorts of markets that active managers can find challenging. Whereas in smaller, under-researched regions, stock picking by talented active managers is still well rewarded.

Conclusion

Exceptionally low interest rates and quantitative easing have pushed up valuations of equity markets around the world. Our approach to this environment is to be highly diversified and to tilt the portfolio towards the cheapest regions and stocks within those regions. This takes us to Europe, Emerging markets and Japan and towards value stocks, particularly in the US, where the broad market valuation is most challenging. After a lean period for value stocks, we think their time has come.

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