December 2019
FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Mind the value traps: beware the illusion of value

JOHCM UK Opportunities Fund

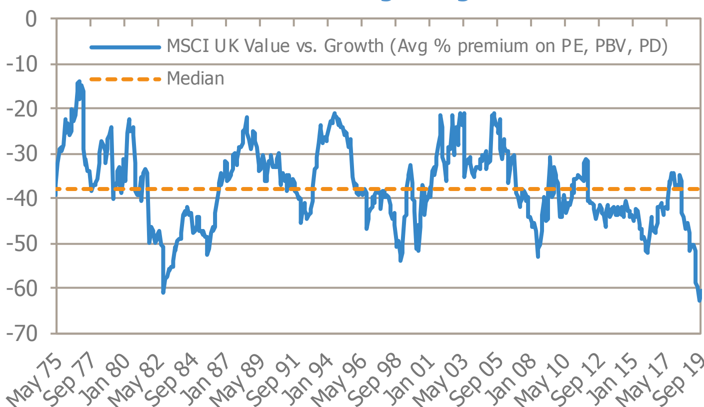
Investors picking between value and growth styles are choosing different ways to lose money

What they tell you

Current conventional thinking says that growth stocks are expensive compared to value stocks. The prolonged period of low interest rates has attracted investors seeking low volatility cash flows and has resulted in growth stocks being valued like bonds. This can be seen by looking at the discrepancy in spot valuations of the MSCI UK Growth and MSCI UK Value indices. Value stocks look cheap in comparison to growth stocks therefore investors are encouraged to fill their portfolios with these companies.

We have believed for some time that many growth stocks are expensive. That is why the Fund no longer holds positions in stocks such as Diageo and Sage. Valuation control and sell discipline are essential for those who aspire to the mantra of "don't lose money", and there is no easier way to lose money than paying the wrong price.

UK market herding into growth



Source: Morgan Stanley research as at 30 September 2019.

What they don't tell you

However, the dangerous inference from the value/growth chart above is that the answer must be to buy value, and specifically the stocks in the MSCI UK Value index.

Our argument here is that, on closer inspection, the stocks in the MSCI UK Value bucket present an equally good way to lose money. Being optically cheap is not the same thing as being good value. What follows in this paper is a look inside that value bucket. We explain the nature of the value traps and how we are sidestepping them, whilst also aiming to avoid overpriced growth.

1. Cheap value is an illusion

The value bucket is full of cyclical businesses. Stocks in highly cyclical sectors, e.g. banks, industrial machinery, consumer retail, mining and oil, make up four fifths of the MSCI UK Value index.

Cyclical stocks have volatile sales, profits, cash flows and even book values (those who rely on book value should remember the scale of equity writedowns in previous recessions).

We have nothing against holding cyclical stocks, but it is better to own them near the bottom of a cycle rather than near the top. We cannot pinpoint the top of the current cycle, nor will we try, but we consider that we are far nearer the end than the beginning.

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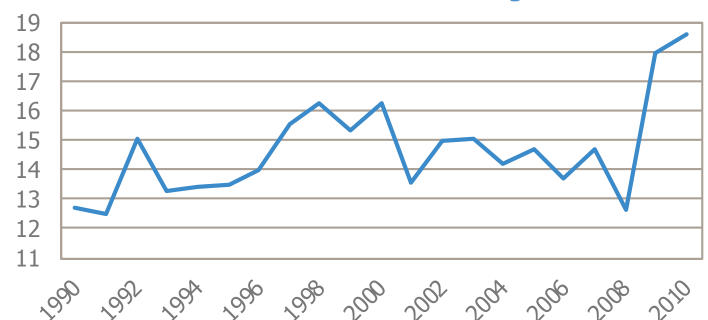
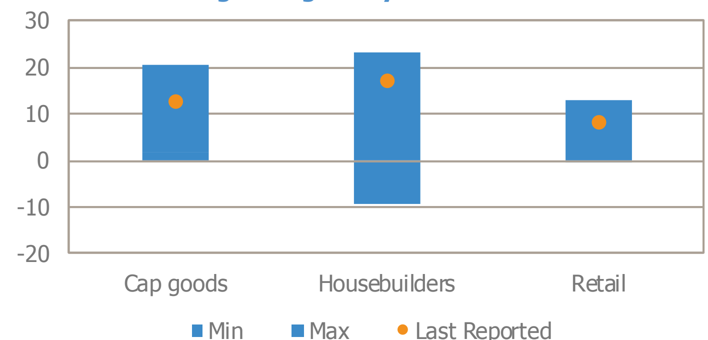
Cyclical stocks have cyclical margins. The constituents of the MSCI UK Value bucket demonstrate this well.

MSCI UK Value EBITDA margin



Margin range of cyclical sectors



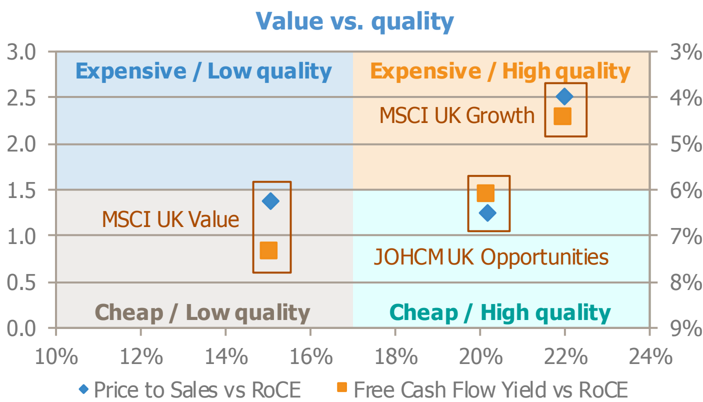
Source: Bloomberg, MSCI, JOHCM. Data based on MSCI UK Value ex Financials margins constituents as at 30 October 2019.

Margins have tended to peak just prior to major market corrections followed by a collapse in earnings. This renders the use of p/e ratios to value cyclical stocks making peak margins dangerously misleading. Forecast earnings fail to materialise and spot valuations rise, even as share prices fall. The earnings prove to be an illusion, as do the perceived attractive valuations.

This is even clearer when we look at the most cyclical sectors. Housebuilders' profit margins are currently close to a 30-year high. Margins for capital goods stocks remain elevated compared to their historical range, despite never fully hitting the heights seen during the excesses of the commodity boom. Even the retail sector, much of which is struggling with structural decline in the face of relentless online competition, currently boasts near peak margins.

Using Bloomberg estimates, the median stock in the FTSE 350 trades on an eye-watering 4.7% free cash flow yield. By contrast, on the same measure, the median stock in JOHCM UK Opportunities Fund is predicted to deliver a more attractive 6.4% free cash flow yield.

As the market polarises between expensive growth and low quality value, we continue to avoid either route. The chart below shows how the Fund has managed to maintain a high return on capital profile whilst implementing valuation control. In essence, the portfolio is positioned to avoid losing money by paying too much for good companies or speculating on poor quality businesses.

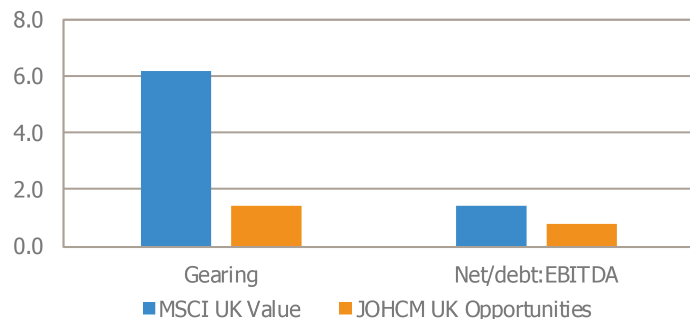


Source: Bloomberg, MSCI, JOHCM. All data excludes stocks within the financials sector. Based on constituents as at 30 October 2019. Data based on Year 1 Bloomberg Estimates Data

2. Value is full of debt

Hiding next to the cyclicality at the bottom of the value bucket is debt. Lots of it. Cyclicality and debt mix like bathtubs and toasters, yet at the top of every cycle managers of cyclical businesses risk the company (and shareholder equity) by taking on debt that looks manageable until suddenly it is not.

JOHCM UK Opportunities has less gearing than the MSCI UK Value index



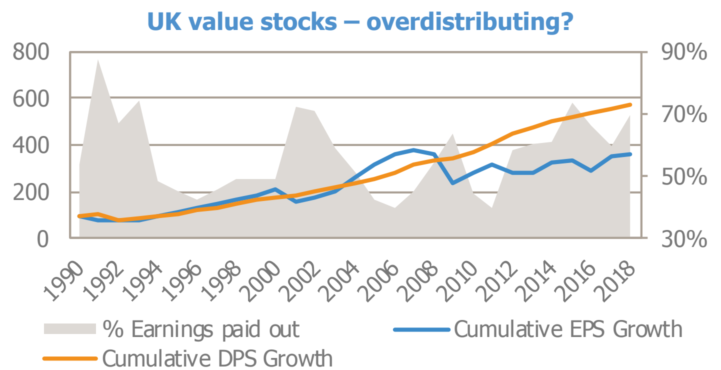
Source: Bloomberg, MSCI, JOHCM.

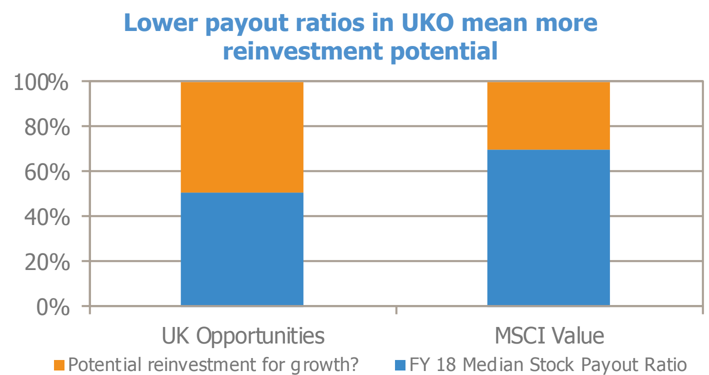
Current corporate debt ratios are comparable to the peak of the tech bust in 2000 and those seen in the 2008 Global Financial Crisis. What is of real concern is that the elevated debt levels we see today are before a downturn has hit. Profits and profit margins fall in an economic slowdown but debt does not, so debt ratios spike. In the next downturn, many constituents of the MSCI UK Value index will see their ratios hit levels not seen in the last 30 years. For these companies it will not be like last time; it will be far worse.

3. The yield on value stocks is unsustainable

One of the attractions of the value stocks within the MSCI UK Value index is the cash they return to shareholders through dividends. Yields have risen strongly since the Global Financial Crisis, and the median UK value stock has a dividend yield above 5%.

Whilst dividends have grown strongly over recent years, company earnings have not kept pace. Consequently, dividends have been consuming higher and higher proportions of company cash flows, leaving little left for reinvestment in growth-enhancing activities. This can be seen in the chart below, which shows how the relationship between dividends and earnings has broken down since the financial crisis.





Source: Bloomberg, MSCI, JOHCM.

The clamour for yield in an era of negative or negligibly positive interest rates is understandable. It filters through to company management, who are under pressure to return more cash to shareholders, regardless of the impact on the underlying business or its balance sheet. Much of the dividend growth will prove unsustainable and may potentially have an irreversible impact on companies that have been starved of investment.

The companies in our Fund paid out around half their earnings as dividends, on average, compared to almost 70% for companies in the UK value bucket last year. That gives the Fund a yield of around 3% despite its current high weighting in cash, a function of our cautiousness around prevailing absolute valuations in the market. In not over-distributing, the companies we hold have scope to reinvest for growth.

4. Value stocks facing disintermediation

We estimate that over one third of the constituents of the MSCI UK Value index are suffering from structural disintermediation, where new entrants with new business models are pressuring the margins of established players. Obvious examples include the High Street retailers, such as Marks & Spencer, travel agent TUI and media companies WPP, ITV and Pearson. Businesses can, of course, reinvent themselves, as Next (held in the Fund) appears to be doing. However, in the main, these businesses are facing disruptive threats that may prove existential in time. Often structural decline is slow and painful. The final blow comes from a turn in the cycle, from which there is no coming back.

Two good ways to lose money

The risk of moving out of overvalued growth stocks and into value is that they are both excellent ways to lose money. We often cite Warren Buffett's summary of this false dichotomy:

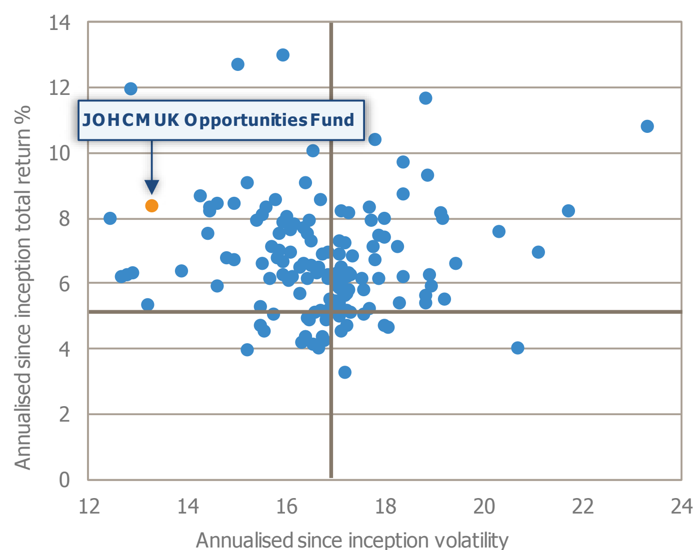
"Market commentators and investment managers who glibly refer to 'growth' and 'value' styles as contrasting approaches to investment are displaying their ignorance, not their sophistication. Growth is simply a component, usually a plus, sometimes a minus, in the value equation."

One way to preserve and grow capital

Our approach has, at its heart, another Buffett rule: "don't lose money". With this in mind, our task is to avoid the fashion for 'bucket' investing altogether. This means sticking to our valuation control and at the same time avoiding the value traps. It means finding out-of-favour businesses whilst not compromising on debt and disintermediation. It means waiting patiently to buy only at the right price and being willing to hold an unfashionably high cash balance to take full advantage of the opportunities when they arise.

Strong track record of risk-adjusted returns

JOHCM UK Opportunities Fund since inception risk return scatter to 30 September 2019 – IA UK All Companies



Past performance is no guarantee of future performance. Source: JOHCM / Lipper as at 30 September 2019 based on JOHCM UK Opportunities Fund A GBP share class against the IA UK All Companies. Please note the IA UK All Companies sector is used for comparative purposes only. The Fund is currently classified within the IA Specialist sector because its UK equities holdings currently represent less than 80% of the portfolio.

JOHCM UK Opportunities Fund

Data as at 30 November 2019

Return history (%):

	6m	1yr	3yr	5yr	SL	Annualised*
Fund	4.82	7.47	15.44	37.94	206.50	8.33
Index	6.65	11.67	24.01	38.66	146.59	6.66
Relative	-1.72	-3.76	-6.91	-0.52	24.29	1.57

Discrete 12 month performance (%):

	30.11.19	30.11.18	30.11.17	30.11.16	30.11.15
A Acc GBP	7.47	1.97	5.35	8.72	9.90

Past performance is no guarantee of future performance. The value of an investment and the income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested.

Source: JOHCM/FTSE International/Bloomberg, NAV of Share Class A in GBP, net income reinvested, net of fees as at 30 November 2019. The A Acc GBP class was launched on 30 November 2005. Benchmark: FTSE All-Share TR (12pm adjusted). Performance of other share classes may vary and is available on request. *Annualised since launch. Relative return calculated on a geometric basis.

Full portfolio holdings (28)

	Weight (%)		Weight (%)
Royal Dutch Shell	5.12	Imperial Brands	2.75
Vodafone	3.44	Barrick Gold	2.69
Next	3.40	DCC	2.66
GlaxoSmithKline	3.36	Tate & Lyle	2.64
Associated British Foods	3.35	Rio Tinto	2.48
Morrisons	3.25	Ibstock	2.36
Smiths	3.25	Compass	2.28
Direct Line Insurance	3.21	Bunzl	2.18
Tesco	3.16	Hays	1.98
Johnson Matthey	3.07	PageGroup	1.89
PZ Cussons	2.97	Serco	1.88
Reckitt Benckiser	2.96	Bodycote	1.68
BP	2.86	Smith & Nephew	1.51
RELX	2.83	Unilever	1.33

Note: Cash position is 23.47%. Cash includes cash on deposit and investments in UK Treasury bills. Please note that due to rounding breakdowns may not add to 100.00%.

Past performance is no guarantee of future performance.

Source: JOHCM/Bloomberg unless otherwise stated. Issued by J O Hambro Capital Management Limited authorised and regulated by the Financial Conduct Authority. Past performance is no guarantee of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment. Dividend yield quoted is prospective, is based on internal estimates and is not guaranteed. The annual management charge is deducted from the capital of the Fund. This will increase the income from the Fund but may constrain or erode potential for capital growth. We recommend that you read the Prospectus and Key Investor Information Document available from the address below or from our website. The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation. Source: JOHCM/Bloomberg/ FTSE International. FTSE International Limited ("FTSE") © FTSE 2017. The Industry Classification Benchmark ("ICB") and all rights in it are owned by and vest in FTSE and/or its licensors. "FTSE" ® is a trademark of the London Stock Exchange Group companies and is used by FTSE International Limited under licence. Neither FTSE or its licensors accept any liability for errors or omissions in the ICV. No further distribution of ICB is permitted without FTSE's express written consent. Information on how JOHCM handles personal data which it receives can be found in the JOHCM Privacy Statement on our website: www.johcm.com. JOHCM® is a registered trademark of J O Hambro Capital Management Ltd. J O Hambro® is a registered trademark of Barnham Broom Holdings Ltd. Registered in England and Wales under No: 2176004. Registered address: Level 3, 1 St James's Market, London SW1Y 4AH, United Kingdom.