J O Hambro
Capital Management Group

Leyland's Global Look

FOR PROFESSIONAL INVESTORS ONLY

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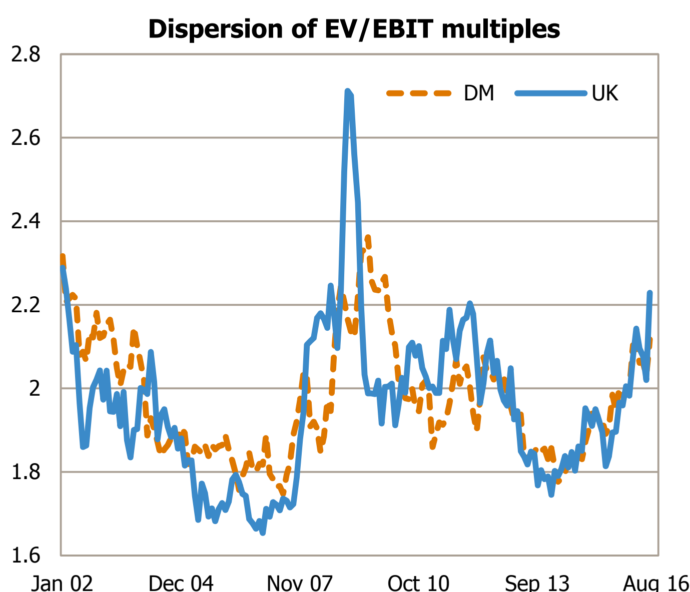
The chart below highlights valuation dispersion in developed stock markets as a whole and for the UK in particular, where valuation dispersion is defined as the ratio between the top and bottom quintiles (the top and bottom 20% of listed stocks) of EV/EBIT (enterprise value divided by earnings before interest and tax) multiples.



Source: Bloomberg

Valuation dispersion in equity markets reached extremely low levels in 2013 and has been rising since early 2014. This change has been focused on developed markets – dispersion in emerging stock markets has generally been much higher and much more stable. In 2014, the rise in developed market dispersion was driven by a significant re-rating of the top quintile of US stocks, principally technology and biotech names. In 2015, it was driven more by a de-rating of the bottom quintile, as the resources and financials sectors underperformed.

What is particularly notable is the spike in dispersion in the UK equity market at the end of June 2016 following the shock Brexit referendum outcome. In contrast to multinationals, of which there are many listed in the UK, domestic UK earners, such as housebuilders and retailers, have suffered from the double impact of currency weakness and the anticipation of a cyclical downturn. There has been a significant 'flight to quality', exacerbated by forced selling of liquid assets (i.e. equities) in response to the gating of certain real estate funds.

This has consequences for where we look for value. When dispersion is low, the market is not paying much of a premium for quality or growth characteristics, so we are likely to be rewarded by focusing on high quality, reliable compounders. That has clearly been a successful strategy for a few years now. By contrast, when dispersion is high, the relative valuation opportunity is more likely to be in the areas of the market which are perceived as lacking quality or growth. Often this perception is correct, and there are plenty of 'value traps' which carry too much structural risk, or where the downside can spiral out of control as a result of overleverage. But occasionally companies with strong franchise characteristics or long-term growth potential become very cheap when faced with short-term negative earnings momentum. Such investments usually offer the best risk-adjusted returns over a sensible medium-term horizon. Of course, the extent of the opportunity will depend on absolute, not relative, valuations, which is why we also monitor the median multiple. In all regions, this currently remains high. As well as being selective, we must therefore remain patient as investors.

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