Mind the gap (again): beware the bubble in growth / low volatility stocks

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Back in January we wrote a paper ('Mind the gap: five valuation arguments for the JOHCM UK Equity Income Fund') which, as well as highlighting what we believed was a strong case for the value contained within our fund, underlined how thoroughly undervalued the UK stock market was versus its international peers.

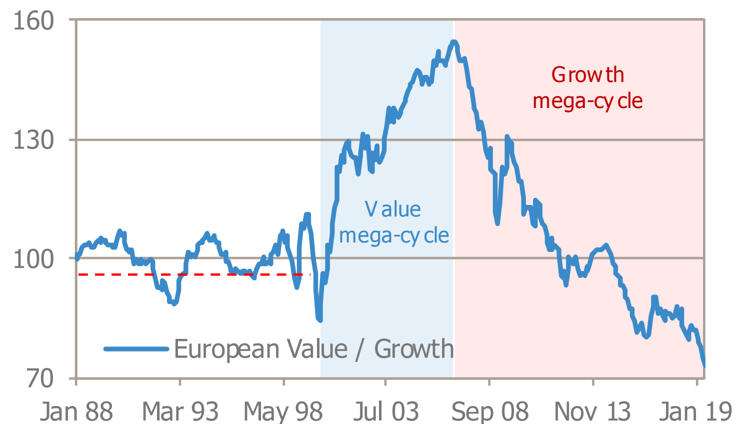
That hasn't changed, if anything UK stocks are even more unloved by overseas investors and domestic fund buyers as the Brexit process rolls on. As for our own fund, while it is up 7.8% since we wrote that paper (to 30 June 2019), it has continued to underperform as growth/low volatility shares have continued to dominate (its benchmark, the FTSE All-Share Index 12pm adjusted, is up 13.0% over the same time period). We highlight later in the document why the relative value inherent in the fund is, in our view, even greater now than it was at the start of the year.

Our focus in this paper, though, is to offer evidence for our view that a dangerous bubble with historical parallels has formed in growth/low volatility stocks. Remarkably, this bubble has become so inflated that it has surpassed the TMT bubble of 1999-2000 in scale. This can be seen in the first graph below, which shows the price performance of the MSCI Europe Growth index relative to the MSCI Europe Value index, and the second graph, which highlights the growth mega-cycle we have witnessed since the global financial crisis, with growth stocks surging to levels beyond those seen at the start of the century.

TMT bubble redux: the stark performance gap between growth and value stocks

Source: MSCI, FactSet Morgan Stanley Research as at 30 June 2019.

The growth mega-cycle – creating significant valuation risk in parts of the market



Source: MSCI, FactSet Morgan Stanley Research as at 30 June 2019.

Bombed out value factors, crowded growth and quality trades

If we drill down into individual factors, we see confirmation of how the incredible rally in growth has led to a marked bifurcation between value and growth stocks.

Europe factor performance	Valuation Percentile vs. History
Value	6
PE	9
PB	3
DY	4
FCF/EV	3
Quality	98
ROE	97
Low leverage	62
EPS Stability	99
Growth (eps)	94
Growth (sales)	94
EPS Mmt	93
Price Mmt	93
Low vol	95
Nifty 50	100

Source: Exane, as at 30 June 2019.

	MSCI Style	
	Value	Growth
PER	10.5x	19.9x
Price to Book	1.24x	3.86x
Dividend Yield	6.2%	2.6%
FCF Yield	8.9%	4.0%
EV/EBITDA	5.9x	12.8x

Source: Morgan Stanley / MSCI Style as at 3 July 2019

This first table on the previous page requires a little explanation. Based on the European equities universe, it shows that value factors (P/E, price-to-book, dividend yield and free cash flow/enterprise value) are hugely out of favour versus history. For example, price-to-book levels have only been cheaper 2% of the time since 1995.[1] In contrast, quality, growth, momentum and low volatility factors are at extreme highs relative to their history. Earnings per share stability, for instance, has only been more highly rated by investors 1% of the time. What is also noteworthy in this table is how bunched the values are at either end of the value/growth spectrum. One would normally expect to see a greater dispersion rather than this clustering at the extremes.

[1]Based on research from Exane BNP Paribas Research – "The Nifty Fifty versus the Shifty Fifty".

The second table is easier to understand and summarises the tremendous discrepancy that currently exists between value and growth stocks, as represented by their respective MSCI UK style indices. Value stocks now sit on a lowly 10.5x earnings, on average, while growth stocks are on 19.9x in comparison. A comparison of price-to-book values is even more stark: value stocks are on 1.24x their book value, on average, versus 3.86x for growth stocks.

These tables paint a picture of an extremely polarised market, one where value factors and value stocks have almost never been so out of favour, and one where investor demand for growth factors and growth stocks has almost never been so rampant. This polarisation has become even more acute since May 2018, making for a significant performance headwind for value-oriented investors such as us over the last 12-14 months. It is also rendering stock specifics less potent. Rather than good news triggering 10% or 15% share price gains on the day as we would normally expect, it is often being met with a shrug of indifference from a stock market that currently only prizes earnings momentum.

The new Nifty 50

Older readers or keen students of financial history will be aware of the so-called Nifty 50. This originally referred to a group of the 50 most popular New York-listed large-cap stocks in the 1960 and 1970s. Owing to the consistent earnings growth of these companies (household names such as Coca-Cola, General Electric Company and IBM), they became viewed as "one-decision" stock picks, because they could be bought and held indefinitely. Many investors were unconcerned by the premium stock market ratings that went hand in hand with the Nifty 50's earnings momentum.

We believe a new Nifty 50 may be developing in the UK stock market. Five growth stocks (Diageo, Unilever, Relx Group, Compass Group and Experian) now account for 9.6% of the UK stock market (FTSE All-Share Index) – five years ago they constituted 5.7% of the index.[2] These are all fine companies, but we do not own any of them. Besides not meeting our dividend yield criterion, we would argue that their valuations have reached dangerously high levels, as illustrated in the table below. We believe passive investors are being exposed to substantial valuation risk.

[2]Source: FactSet. Data as at 30 June 2014.

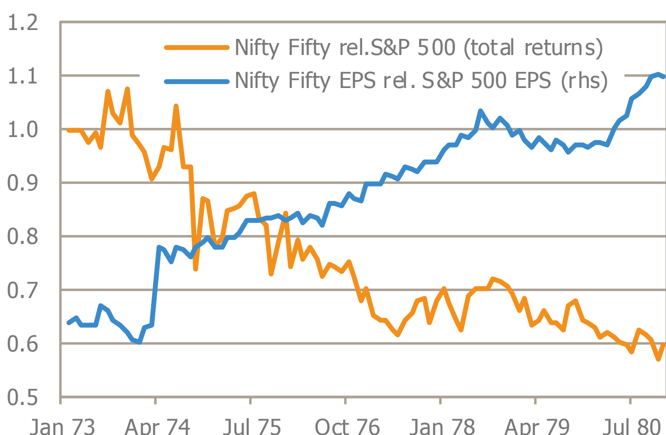
Portfolio voids – The new 'Nifty 50'?

	% of FTSE All-Share	PER	Dividend Yield	Net Debt : EBITDA
DIAGEO	342bp	26.7x	1.9%	2.6x
Unilever	234bp	22.5x	2.9%	2.3x
RELX Group	156bp	21.5x	2.3%	2.1x
COMPASS GROUP	130bp	22.6x	2.1%	1.5x
experian.	93bp	28.1x	1.7%	2.0x
	c. 10% of UK market			

Source: JOHCM. Based on 2019 forecasts.

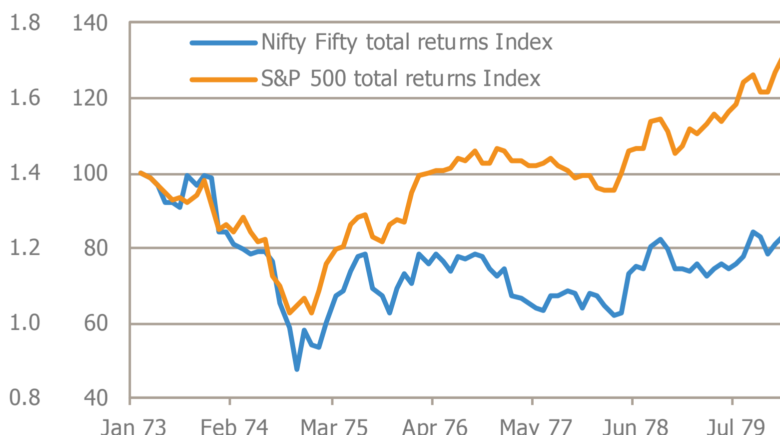
What happened to the Nifty 50? Well, they delivered what they promised, with their earnings rising but they dramatically underperformed the market over the 1970s. Indeed, the Nifty 50 did not recover their 1973 highs for the rest of the decade.

The Nifty 50 delivered what they promised: earnings beat the S&P, but they dramatically underperformed...



Source: Exane BNP Paribas estimates, Datastream.

...The Nifty 50 did not recover their 1973 highs for the rest of the decade



Source: Exane BNP Paribas estimates, Datastream.

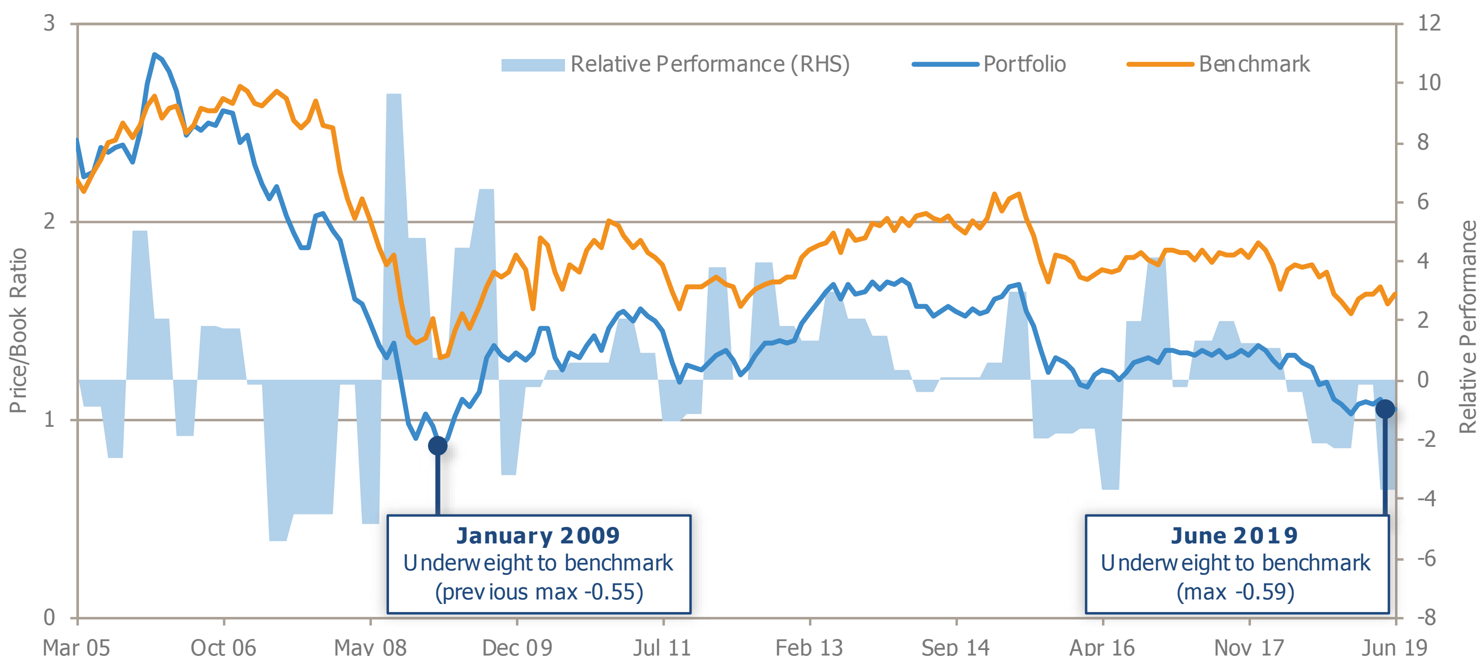
One of our fundamental tenets as investors is that investment success is determined by your starting valuation. The extortionate starting valuations of the Nifty 50 doomed these stocks to underperform, irrespective of how good these companies were and no matter how stable their earnings growth. Gravity-defying valuations for their latter day UK stock market counterparts suggest to us a similar story could well play out over the next decade for Diageo et al.

JOHCM UK Equity Income Fund: a tough 14 months behind us but optimism aplenty ahead

The past 12-14 months have been tough for the fund. Confronted with the growth stock tsunami, the fund's relative performance has been poor. To our fundholders, we say thank you for your patience and ongoing support, particularly through one of the most challenging periods in the fund's 15-year history.

Looking ahead, however, we see two major reasons for optimism:

1. Unprecedented valuation – the fund's price-to-book valuation versus the market is at its lowest ever level



Source: JOHCM/Fund analytics as at 30 June 2019.

- 62% of the fund (by value) has a dividend yield of >6% to June 2020
- 63% of the fund (by value) has a free cash flow yield of >10% to June 2020
- Only 9% of the fund has net debt/EBITDA of >2x (excluding financials)
- Almost 50% of the fund (by value) has committed to buy back equity over the next 12 months

2. Another year of healthy fund dividend growth

2012	2013	2014	2015	2016	2017	2018	2019
+10.9% (actual)	**+9.6%** (actual)	**+14.7%** (actual)	**+9.1%** (actual)	**+8.6%** (actual)	**+13.4%** (actual)	**+18.2%** (actual)	**+ Low-mid single digit %** (forecast)

Source: JOHCM.

Being early in Q3, the fund's dividend growth for 2019 is now clearer. Our previous guidance of low to mid-single-digit growth year on year remains intact, indeed it may prove to be a little cautious. The growth rate should be seen in the context of a strong 2018, when fund dividend growth was +18%.

Thus far, 2019 has mainly seen a reasonable delivery of results from our holdings. However, the cautious environment caused by the fall in global markets in Q4 2018, coupled with ongoing political risks (primarily Brexit and China / US trade concerns), has tempered capital allocation decisions, resulting in slower dividend growth in a number of stocks. In some cases, share price weakness has led management teams to switch course, from what would have been stronger dividend growth to share buybacks (which we do not include as income). This cautiousness can be seen in many of our holdings working to more conservative net debt to EBITDA / target solvency ratios. Some of this will unwind as the political trajectory becomes clearer and these safety buffers are used. We had built an allowance into our original guidance to account for such a theme developing during the year, given the nature of some of the risks coming into the year.

Based on our current guidance of low to mid-single-digit growth, the dividend for 2019 would be 19.84p per unit ('A' accumulation share class), which would represent a forward dividend yield of 5.4%.[3]

[2]This dividend is not guaranteed and figures have not been audited.

Outlook – sticking with valuation, not momentum

Few investors that worked through the TMT bubble ever expected leadership and relative valuations within stock markets to ever return to the same extremes. Yet that is the point at which we find ourselves at the mid-point of 2019. How did we get here?

A combination of many factors have been at play, including nervousness about global growth/trade disputes, a view that global interest rates will stay lower for longer, technological change creating a perceived binary list of winners and losers, Brexit uncertainties and incremental flows into passives and ETFs. Whilst many market participants observe the current status quo as unsustainable, they also understandably question what will force a change in this dynamic in the coming months.

Of the factors listed above, the one with most scope to change is the perceived risk around President Trump's Chinese trade agenda, particularly because he will increasingly have an eye on his own electoral cycle as 2019 progresses. Any sense of progress or even a less antagonistic dialogue could see a material shift in the bond market's view on risks to global growth and commensurately the need for monetary policy easing. This would have big implications for leadership within the stock market.

In the meantime, we will continue to focus upon valuation rather than momentum, an approach that has served us well over the last two decades, even if it has reaped little reward in the last 12 months.

Discrete 12-month performance (%) to:

	30 June 2019	30 June 2018	30 June 2017	30 June 2016	30 June 2015
JOHCM UK Equity Income Fund – A Acc GBP	**-9.44**	**13.04**	**30.31**	**-9.31**	**7.29**
FTSE All-Share TR Index (12pm adjusted)	0.14	8.66	21.37	-0.60	3.39

Past performance is no guarantee of future returns. Source: JOHCM / Lipper Hindsight. NAV per share calculated net of fees, net income reinvested, 'A' accumulation share class in GBP. Performance of other share classes may vary and is available on request. Inception date: 30 November 2004. Index return is net income reinvested, adjusted for 12pm.

Past performance is no guarantee of future performance. Source: JOHCM/Bloomberg unless otherwise stated. Fund launch date 30 November 2004. Issued by J O Hambro Capital Management Limited authorised and regulated by the Financial Conduct Authority. 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 and not guaranteed. 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. The Fund's investment include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile. Source: JOHCM/Bloomberg/FTSE International. Note for return history: NAV of share class A in GBP, net income reinvested. Benchmark: FTSE All-Share TR Index. Performance of other share classes may vary and is available on request. 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. 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.