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INCREASING PESSIMISM LAYS THE GROUNDWORK FOR A VALUE COMEBACK

Paul Ehrlichman
Head of Global Value Equity
Managing Director, Portfolio Manager

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- While we don't know when the recent selloff will end, we do know that value stocks typically bottom in such dire environments.
- Though painful, a period characterized by recession fears and low expectations is part of a healing process necessary for value to regain its leadership.

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Increasing Pessimism Lays the Groundwork for a Value Comeback

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The concerns over global growth, commodity prices and divergent economic policies that limited global equities in 2015 morphed into outright fears to open the New Year, igniting a selloff that has led most global equity benchmarks into bear market territory. Equity losses have been amplified by currency volatility as carry trades, where an investor borrows cheaply in weak and falling currencies to invest in assets with higher growth and at higher interest rates, are unwound and loans must be repaid. We appear to be heading into a period of maximum pessimism and our timing indicators still point to continued downside in cyclical, commodity and banking sectors. While we don't know when the selloff will end, we do know that value stocks typically bottom in such dire environments. Though painful, a period characterized by recession fears and low expectations is part of a healing process necessary for value to regain its leadership.

Global Market Overview

Prior to the recent selloff, the combination of a less robust than expected global economic expansion and deteriorating corporate earnings growth along with persistent worries about growth in China led to a challenging investment environment in 2015. As a result, cyclically dependent and higher risk assets substantially underperformed higher quality and defensive assets. Share prices globally fell by 2.4% in 2015 as measured by the MSCI All Country World Index.[1] U.S. markets performed relatively well, given the strength of large cap technology, consumer and health care stocks and a rising dollar. Developed international equities declined an average of 0.8%, ranging from an 8% gain in Japan to an 11% loss in UK stocks. Asian shares experienced a drop of 12%, weighed down by slowing growth in China and led by significant weakness in Thailand, Malaysia, Indonesia and Singapore. Australia was also hurt by weakening commodity prices and posted losses of nearly 14%. Chinese shares in the MSCI index declined 10% while Hong Kong saw a relatively modest 3.3% drop. Despite evidence of continued economic recovery, European markets lost 5% overall with gains in local currencies erased by weakness in the euro. Hardest hit was Norway, off by more than 17% due to falling oil prices, followed by losses in Spain and Sweden. Relatively defensive Denmark led with a 22% rise along with solid gains in Ireland, Belgium and Austria.

Emerging markets[2] were pulled lower for another year by macroeconomic concerns, falling commodity prices and a rising U.S. dollar. Share prices fell by 17% with Emerging Asia off by 12% and Latin America hit by nearly 33%. Losses were led by a 43% drop in Brazilian equities and a 62% plunge in Greece. Both economies faced political uncertainty and a deepening recession. Poland, Turkey, Peru, Columbia and South Africa also posted declines of more than 25%. On the positive side, Russia ended the year basically unchanged, Argentina rallied to close off only 1% and Hungarian stocks jumped by 33% on a recovery in local banking and health care companies.

If commodity prices were to just remain stable then 2016 could mark the end of the focus on deflation.

From a global sector standpoint, scarce growth and defensive industries performed best. Falling energy prices and improving labor markets led to a 16.5% rise in retailing stocks, especially in the U.S., Europe and Japan. Software shares posted a 13.8% gain as internet, cloud and e-commerce related companies reported solid profit growth. Less cyclically-dependent food and beverage producers enjoyed a near 7% gain along with a 4.5% rise in health care stocks. Economically-sensitive industries fared the worst with energy losing nearly 25%, materials down 19% and transportation off by 12%. Banking equities also underperformed with a fall of 12% due to sluggish loan growth, slim net interest margins and increasingly restrictive capital requirements.

Macro fears, driven mainly by a slowing Chinese economy along with sluggish global earnings growth led to outperformance for quality, low beta[3] and growth investment factors. This was a continuation of the trends of the past three to five years which tended to also support relative strength in momentum-based metrics. Valuation factors suffered from exposure to cyclicals and banks and the correlation[4] with high beta, low quality and negative price momentum. The performance of high dividend payers followed the pattern of the overall market with defensive yield working well while cyclical income stocks lagged. Smaller capitalization firms generally outperformed the broader benchmarks, benefitting from greater exposure to domestic demand relative to weak growth in global exports.

Added into this mix was nearly $13 trillion sitting idle on central bank balance sheets. Very little of this capital found its way into the real economy but instead sought refuge in those rare investments offering both perceived safety and strong growth. This created many divergences in relative valuation and performance at levels last seen at the height of the 2000 technology bubble. One of the most popular was the gap in gains between four U.S. technology stocks, dubbed with the acronym "FANG," and the rest of the S&P 500.[5] Without the gains of Facebook, Amazon, Netflix and Google this U.S. index would have fallen by more than 5%.

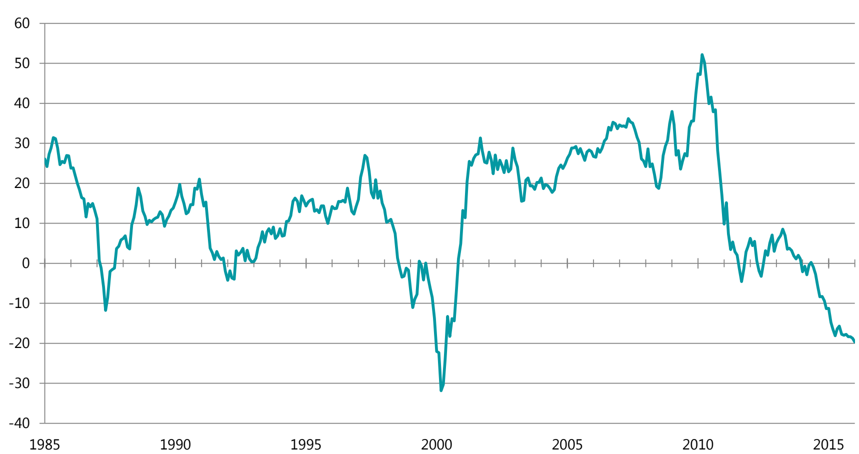
Growth-Value Gap Widens Further

Investment style performance also reached a similar extreme last encountered when the cover of Institutional Investor magazine posited the question "Is Value Investing Dead?" (Figure 1)

Our main point in highlighting the aspects of the current investment landscape that are far from "normal" is to help understand the drivers of these trends, both behavioral and fundamental, and discuss some potential opportunities and risks.

It is tempting, especially for a disciplined contrarian value manager, to characterize the performance of markets last year as anything but driven by rational fundamentals. While there are a number of unsustainable trends poised to reverse over the next three to five years, relative share price performance was highly correlated with relative earnings growth in 2015. Therefore, the key to stronger performance from value stocks[6] and the currently depressed cyclical, emerging market, banking and non-U.S. shares must be an improving global economy and broadening corporate profit growth.

Figure 1: MSCI EAFE[7] Value vs. Growth (Ten Year Rolling Relative Performance - Annualized): The underperformance of value vs. growth is the widest since the technology bubble burst in 2000.



Data and chart are obtained from Bloomberg and ClearBridge research and is believed to be reliable and accurate. Past performance is no guarantee of future results. Periods greater than one year are annualized. Preliminary data, subject to revision. Data as of Dec. 31, 2015. **Past performance is no guarantee of future results.** Please note that an investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment

China Rebalancing Painful but Productive

Developments in China continue to be a key focus and concern for investors. The transition in China from an investment-led to a more market-driven consumer economy is impacting everything from global capital flows to commodity prices. The previous boom in producer assets, primarily in the mining and energy sectors, is being unwound. Demand for housing, luxury goods and automobiles is slowing from the robust expansion of the past 20 years. We believe the shift to a slower but sustainable level of expansion is typical for the current stage of development in China and consistent with the experience of Japan, Taiwan, Singapore and South Korea. At this level of per capita income and GDP[8] the economy grows at a lower rate but it is driven by rising productivity, demand for services, value-added industries and strong income gains. Historically, equity assets respond by appreciating significantly faster than underlying GDP as capital efficiency improves.

The recent move by the Chinese central bank to shift from a U.S. dollar peg to a trade weighted basket is also widely misunderstood. It is not a devaluation to bolster export competitiveness but supports the stated goal of having the yuan eventually become a freely floating global reserve and trade currency. Removing the strict ties to the U.S. dollar will give the People's Bank of China more room to ease monetary policy while the Federal Reserve[9] embarks on the first rate increases in nearly a decade. In order to support ongoing structural reforms, both fiscal and monetary policy will likely shift to a more "flexible and forceful" stance according to the press release from the recent Central Economic Work Conference. Already, government spending jumped 25% from a year earlier in November of 2015.

The Chinese economy is showing signs of stabilization and even improvement. Retail sales recently gained 11.2% year-over-year for the best showing of 2015. Industrial output also rose a healthy 6.2% while property sales, loan demand and money supply growth all were accelerating at year end. This is encouraging even before the implementation of pro-growth policies including corporate tax cuts, rural housing reforms and New Silk Road[10]-related spending. These improving conditions are not reflected in the depressed valuations of Chinese shares trading in Hong Kong.

Regional Outlook

Emerging markets experienced the largest outflows in history in 2015 and are now back to the valuation lows of 2009. This reflects a perfect storm of slowing global growth, falling commodity prices, political turmoil and the negative impact on monetary policy of weakening currencies due to a stronger U.S. dollar. The basic nature of developing countries is that they are dependent on both foreign demand and capital which tend to become scarce at the same time. Eventually, improving terms of trade due to currency depreciation, falling labor costs and depressed asset prices begin to stabilize the economy. Since monetary policy often works in reverse in emerging economies, the central banks can only begin to lower rates after a recovery is already in place. Then the combination of a growing economy and falling interest rates leads to a significant rise in stock prices. High-quality emerging market shares are likely to experience this dynamic over the next few years and are attractively valued, in our opinion.

Europe continues to emerge from a significant balance sheet and banking system recession. Consumer confidence rose in December to the highest level since 2007. Depressed real estate and auto demand appears to be recovering strongly, especially in Spain, Ireland, Holland and Italy. While hurt by slowing demand for exports to China, German consumer spending remains healthy. Monetary policy is stimulative as the European Central Bank[11] expands its balance sheet with a substantial quantitative easing[12] program. Unlike in the U.S., some of these funds appear to be leaking into the real economy as broad money supply is growing by over 11%. Greece remains an unresolved issue and a populist backlash against needed reforms could spread to other EU nations. Millions of immigrants fleeing the civil war in Syria are also placing fiscal and social pressure upon Europe. Overall, we expect the recovery to broaden and strengthen in 2016 and the economic surprises to be on the upside. Select industrials and global consumer product exporters are becoming more compelling values, in our opinion.

The UK domestic economy remains relatively strong, driven by a booming real estate market and robust consumer spending. Industrial, export and commodity firms are being negatively impacted by the sluggish global economy. This mix leaves monetary policy steady for now but with a bias towards beginning to raise rates sometime this year. A public referendum on departing the European Union[13] referred to as "Brexit" could weaken the British pound and create uncertainty for foreign investors. As a result, risks in the UK economy and domestic demand dependent stocks could be to the downside.

Japan produced the strongest earnings and dividend growth in the world last year as companies focused on improving profitability. Prime Minister Abe's program of reforms also stimulated tourism, household formation and a rebound in housing investment. The central bank has embarked on a massive quantitative easing program designed to stoke inflation while suppressing interest rates. Falling energy prices have made hitting the stated 2% goal for inflation difficult but the Bank of Japan (BOJ) is unlikely to provide more aggressive stimulus in the near term. BOJ head Kuroda is waiting to see if record high corporate profits lead to rising wages and investment spending before deciding if monetary policy needs to be adjusted. Stock valuations have risen over the past two years to reflect improving profitability so further gains will need to be fueled by strong top line growth. Stock selection will be key as the period of broad outperformance of the Japanese market may be ending.

We believe in 2016 that central banks might begin to succeed in their goal of decreasing the real burden of unfunded long-term liabilities by raising inflation, boosting nominal GDP growth and currency debasement. The moderating pace of quantitative easing, while removing some support for asset prices, should actually result in more rapid money supply growth. This is due to the paradox of artificially low rates which tend to shift capital towards investment in existing assets and away from "riskier" new productive assets. Simply put, higher rates raise the compensation for providing money to consumers and businesses. Additionally, China moving away from a U.S. dollar peg will allow for aggressive easing of monetary and fiscal policy. If commodity prices were to just remain stable then 2016 could mark the end of the focus on deflation.[14]

The Case for a Value Reversal

The foundation of our investment process is identifying factors that have a high probability of delivering superior performance over the long term. We then review the current fundamentals of a particular company and begin a process of adjusting this base level probability to come up with an estimate of odds of outperformance and reaching our target price. In his excellent 2015 book, *Superforecasting: The Art and Science of Prediction*, Phillip Tetlock provides a detailed review and analysis of such a thought process. His idea is to improve the accuracy of forecasting by beginning with an unbiased starting point and then asking a set of reasonable and relevant questions. He also discovered that making frequent and small adjustments when new information becomes available can further add to forecasting precision.

The benefits of Professor Tetlock's methods resonated with me as I recalled our decision to adopt a negative view of commodity prices back in 2011. At the time, the consensus of most experts and many investors was that demand from China would continue to drive basic material prices higher. Instead of starting with this assumption we began with the fact that the long-term average return on commodities is basically zero. We also noted that prices tended to be mean reverting[15] so the fact that current levels were well above normal decreased the odds of a continued rise. Adding in the record capital spending of energy and mining firms to boost supply and the structural slowdown likely in China, we concluded that falling prices were a more likely outcome.

We can apply this same process to the key question of how likely is it that value stocks outperform growth-oriented equities and the overall market. First we need to define the question more precisely by looking at a three to five-year period. The base level probability ranges from 60% to 80% depending on particular time frame and country. To be conservative we can begin with 60% as our starting point. We know that other factors can influence the relative performance of value stocks, many of which are contrarian in nature. Adding to the odds are extended prior underperformance, depressed earnings and low expectations for cyclicals and banks, above-average premiums being paid for quality, growth and momentum factors, below-normal valuations in emerging markets and negative economic sentiment. Decreasing the case for a reversal in the growth-driven market environment is the currently high level of profit margins, especially in the U.S., a low but positive level of global GDP growth and extremely low interest rates. Taken together, our subjective estimate of the odds that value beats growth for the next three to five years is about 77%. This is fairly high given that the probability of being wrong always must be a non-zero number. While we reserve the right to change our thinking as the facts change, the direction of our adjustment is steadily higher. In sum, we believe the time to invest in value stocks has seldom been better.

Investment risks

Investments in small-cap and mid-cap companies involve a higher degree of risk and volatility than investments in larger, more established companies.

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Endnotes

1 The **MSCI All Country World Index (ACWI)** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices.

2 **Emerging markets** are nations with social or business activity in the process of rapid growth and industrialization. These nations are sometimes also referred to as developing or less developed countries.

3 **Beta** measures the sensitivity of an investment to the movement of its benchmark. A beta higher than 1.0 indicates the investment has been more volatile than the benchmark and a beta of less than 1.0 indicates that the investment has been less volatile than the benchmark.

4 **Correlation** is a statistical measure of the relationship between two sets of data. When asset prices move together, they are described as positively correlated; when they move opposite to each other, the correlation is described as negative or inverse. If price movements have no relationship to each other, they are described as uncorrelated.

5 The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S.

6 A **value stock** is one that tends to trade at a lower price relative to its fundamentals (i.e. dividends, earnings, sales, etc.). Common characteristics of such stocks include a high dividend yield, low price-to-book ratio and/or low price-to-earnings ratio.

7 The **Morgan Stanley Capital International (MSCI) EAFE Index** is an unmanaged index of equity securities from developed countries in Western Europe, the Far East, and Australasia. **Value** refers to the stock of a company that is believed to trade at a lower price relative to its fundamentals (i.e. dividends, earnings, sales, etc.). **Growth** refers to the stock of a company whose earnings are expected to grow at an above-average rate relative to the market.

8 **Gross Domestic Product ("GDP")** is an economic statistic which measures the market value of all final goods and services produced within a country in a given period of time.

9 The **Federal Reserve Board ("Fed")** is responsible for the formulation of U.S. policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

10 The **New Silk Road** refers to the proposed development by China of a land transport network of rails and roads that will reduce the distance goods must travel from West to East by thousands of miles. It derives its name from the lucrative trade in Chinese silk during antiquity.

11 The **European Central Bank (ECB)** is responsible for the monetary system of the European Union (EU) and the euro currency.

12 **Quantitative easing (QE)** refers to a monetary policy implemented by a central bank in which it increases the excess reserves of the banking system through the direct purchase of debt securities.

13 The **European Union (EU)** is an economic and political union established in 1993 by members of the European Community. The EU now comprises 28 countries after its expansion to include numerous Central and Eastern European nations.

14 **Deflation** refers to a persistent decrease in the level of consumer prices or a persistent increase in the purchasing power of money.

15 **Mean reversion** is a theory suggesting that prices and returns eventually move back towards the mean or average.

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