overberg asset management

WEEKLY REPORT

OVERBERG MARKET REPORT

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Global Report

Nick Downing

Buying into a valuation outlier

Financial markets appear to be past the point of peak inflation, peak central bank hawkishness and peak bond yields. Overberg Asset Management is gradually reinvesting the cash that has been raised in portfolios over the past 15 months. The timing is supported by positive year-end seasonal trends, China's reopening, excessive bearishness, and the US midterm election effect. Since 1930, US markets have typically performed strongly in the year following the midterm election. There have only been two years of negative returns and even then, not by much: In 1947 and 1978, US markets dropped by 0.5% and 2.4% under presidents F. Roosevelt and J. Carter, respectively.

Europe is a valuation outlier. Its markets are extremely cheap versus its own history and versus other markets. The Eurozone market trades at a 35% discount to the US market on a forward price-earnings (PE) basis, and after ironing out the outsized weighting US markets have in higher rated technology and healthcare sectors, the discount is still at a sizeable 22% (on a sector neutral basis). According to JPMorgan Cazenove these ratings are lower than in any of the past 4-5 crises. The Eurozone forward PE is 11x well below the long-term average of 13.8x, while the trailing PE is 12x versus a long-term average of 15.5x. Price to book is 1.36x versus the 1.76x average. Valuations on all counts are more than 2 standard deviations below mean.

Meanwhile, Europe's economy is in surprisingly good shape, based primarily on the financial health of its households, banks and non-financial corporates. The decade of deleveraging that followed the 2008/09 Global Financial Crisis has fully restored private sector balance sheets. MRB Partners states that "Euro area households, businesses and banks are in solid shape which provides a much greater foundation than a decade ago." As a result, it forecasts the Eurozone will grow at a faster pace in the next decade than the last, with annual growth picking up from 0.9% from 2011-2021 to around 1.5%.

MRB argues that consumer spending accounts for the bulk of final demand in the Eurozone so vastly improved household balance sheets, with low debt and low debt servicing burdens, supported by strong wage growth and healthy savings should boost GDP growth. Household debt and debt servicing costs are back to their early 1990s levels. Other factors point to a strengthening growth trajectory, including a rising employment to population ratio and over the shorter-term, significant pent up tourism expenditure. Meanwhile, the risk of another 2011 Eurozone Sovereign Debt Crisis is greatly reduced. The finances of member states are healthier, and the ECB is prepared with its Transmission Protection Mechanism to underpin sovereign bond prices, if market stresses materialise.

While markets are preoccupied with all that is going wrong in the region, including the war in Ukraine and the energy supply shock, these headwinds are likely to subside over time. When they do, Europe's markets should outperform strongly as they re-rate from deeply oversold levels and solid economic fundamentals reassert themselves. Capital Economics forecasts Europe will enjoy the best equity market returns amongst developed market economies in 2023 and 2024. Europe is expected to deliver annual dollar-based returns of 23.7% over the two years, compared with 10.1% in the US and global returns of 14.1%.

European gas prices have already dropped by 75% from their peak levels, helped by unusually mild weather. A cold snap is inevitable, but gas storage levels are at a record with unprecedented inventories expected to ease Europe through the winter without the need to resort to punitive rationing or loss of industrial capacity. There are also hopeful signals of increased diplomacy between the West and Russia, aimed at providing Putin a face-saving exit from Ukraine.

As Europe's dismal year comes to an end there are a lot of things that could go right for the region in 2023. Cheap valuations do not necessarily provide for outperformance over the short-term, but they almost ensure it over the longer-term. As we reallocate cash to equity markets in an improving global environment, Europe is top of the list due to its bargain prices, robust economic fundamentals, and the potential for war risks to recede.

Elevated bond yields and the relatively stretched valuations of "growth" investments compared with "value" style investments has led us to add Fidelity European Trust PLC (FEV) to our clients' portfolios. The managers of FEV favour attractively valued cash generative companies with strong balance sheets that have the potential to grow their dividends consistently over a three to five-year period. Performance has been strong with a net asset value (NAV) return over the past 5 years of 65.5% (FY ended December 2021) versus 33.9% for the MSCI Europe ex UK index. Over the 5 years, FEV has generated an annualised alpha versus the market of 3.4% per annum (measuring the excess return above the benchmark) with a beta of 0.97 indicating lower volatility than the market which has a beta of 1.0. FEV is the largest company in its European-focussed peer group with a market capitalisation of around £1.2 billion. It also trades at an appealing 6% discount to NAV and 2.2% dividend yield.

Local Report

Elzje Kolver

Asset classes and types of stocks

During our market reviews, we often refer to asset allocation. What do we mean when we refer to asset allocation? We are referring to factors that could influence the return on your investment when you invest in certain asset classes. The main asset classes are shares (including preference shares), bonds, cash equivalents and money market vehicles, real estate, commodities, and these days also cryptocurrencies. We invest in all these asset classes, but we avoid direct investments in cryptocurrencies. The share universe can be broken down to a few distinct types of shares, like growth shares, value shares and high dividend paying (income) shares.

We construct clients' portfolios to give them exposure to different asset classes and distinct types of shares. The goal is to reduce risk, increase growth, or create income depending on a client's financial goals and mandate. A financial advisor can be key in assisting you to construct a portfolio that will aid you in reaching your financial goals. When an investor decides to buy, or sell stocks, it is particularly important to look at what you currently have in your portfolio. The following are examples of three types of shares and why they should be included, or excluded, from a portfolio.

Value Stocks: How do you know if your chosen stock is a value stock? If the stock's market price is lower than its book value, or net asset value (NAV), your stock is seen as a value stock. We will say the stock is trading at a discount to its NAV. The discount is often referred to as a "Margin of Safety." It is like buying something on a sale in a shop. It is more difficult to recognise a stock that is on "sale" than let us say a clothing sale, since there will not be a "For Sale" sign posted at the JSE or LSE. You would need to calculate the discount to NAV when you do your financial analysis on the company to determine the share's NAV. Typical value stocks are Remgro and Naspers that are trading 10 – 20% below their NAVs.

A value stock is a type of stock that could be profitable for your portfolio. The strategy is built upon the expectation that an event (a catalyst) will unlock the stock's value. An example is the accommodation industry that was hit hard during the Covid lockdowns. Now that people are free to travel again, we can expect the accommodation industry to recover. When you are buying shares in a company, you become a part-owner of the company. It is important to understand the industry. Do not invest in something that you do not understand. It is considered best practice to examine the make-up of the company, analyse the financial statements, and decide if it is a sound business, regardless of what other investors are saying.

Secular Growth Shares or non-cyclical Growth Shares: A second way to classify a stock is to look for what we consider a secular or non-cyclical stock. Secular stocks must not be confused with cyclical stocks. Secular is a term used to describe a stock's behaviour over a prolonged period, regardless of other trends occurring within the market over a short term. The beauty is that secular shares are immune to short term volatility. Secular or non-cyclical companies' primary business normally relates to consumer staples or products that most households consistently use or cannot do without. Medicine and food are good examples. Typical companies are Shoprite, Spar, Pick n Pay and Dis-Chem.

Cyclical Shares: Cyclical stocks are affected by global economic conditions. When the economy is doing well, so do cyclical stocks. When the economy is doing badly, so will the prices of cyclical stocks. An example of cyclical shares would be luxury goods. This is the pattern: (1) The economy is booming, allowing people to have discretionary money to spend on luxury goods. Sales of luxury goods consequently increase, resulting in higher profits and higher share prices. (2) During a recession, there is a decline in employment, and consequently less discretionary money for households. Households then spend less on discretionary goods. The consumer has an option (discretion) to delay the purchase of discretionary items. Consumers can delay the purchase of furniture, clothing, and luxuries like holidays and jewellery. Sales of discretionary goods, like jewellery, drop; profits drop, and so does the price of the stock. Timing is everything when investing in cyclical stocks. Investors need to detect the early signs of whether the industry is picking up or slowing down. Be alert to catalysts that could trigger the change in the stock price and when the catalyst emerges, act quickly. Typical cyclical stocks would be clothing companies (Mr Price), restaurants (Spur), hotels (Sun International), furniture retailers (Lewis), and car retailers (Motus).

BOTTOM LINE: There are more types of shares like growth shares, commodities, and preference shares. Unfortunately, we do not have the space to discuss all of them. Stocks can be bought for specific reasons. It is important to build your portfolio and have a goal in mind for each stock in your portfolio. Each stock in Overberg Asset Management's model portfolios has been carefully selected to support our clients' journey beyond wealth. Our investment team works hard to ensure that the right mix of assets and types of shares are allocated for each of our clients. This article is not intended to be financial advice. Please contact one of our consultants for advice.