Samantha Gleave: Repositioning portfolios as the value rally evolves

Geopolitical turmoil at the start of the year is likely to have rendered many analysts' 2022 economic and market predictions immediately out-of-date. Such is the nature of the forecasting game. Luckily for us, our investment process doesn't require us to forecast any macroeconomic variables or company financials. Instead, it is built around the forensic analysis of company cash flows, investor behaviour and market valuations. It is through this prism that we have observed the market's reaction to Russia's invasion of Ukraine and adjusted our investment exposure.

Since the historically brutal sell-off in markets that accompanied the outbreak of Covid-19, our investment indicators have been steering us towards 'value' style equities. However, the value rally has evolved significantly over the last two years and its path has been volatile. This has required us to both maintain our conviction and reappraise the nature of the rally. Events so far this yar have, in our view, required some modest repositioning. Most recently, we reacted to increasing signs of corporate over-investment and high levels of investor anxiety by picking up some more defensive exposure in early February.

To understand how different types of value investment appeal in different circumstances, its useful to look back to 2020. At this time, as the pandemic hit, we were investing in contrarian deep value stocks – those that were experiencing particularly tough trading conditions and whose share price valuations reflected very high scepticism. This investment style had suffered many years of chronic underperformance, while – at the other end of the valuation spectrum, quality growth had enjoyed a buoyant decade-long run of outperformance and looked very expensive. Deep value stocks we invested in included container shipping company AP Moller-Maersk, which had to withdraw financial guidance as Covid-19 impacted global growth, and Danish jewellery company Pandora, which was unable to operate out of most of its physical store estate due to various lockdowns.

As we know, the market rally that began in earnest in late-2020 on positive vaccine news and stretched through 2021 was characterised by a reversal of fortunes where value outperformed quality.

During 2021, we then recognised that leadership of the rally was transitioning from deep value stocks to those value stocks showing some evidence of recovery and momentum.

We ran our quantitative analysis on the European companies with the best cash flow characteristics -creating our 'Cashflow Champions' watchlist – and then we used a scoring system to target companies showing positive business momentum, generating significant cash flows as the damaging economic impacts of Covid waned, and which were returning that cash to shareholders.

Stocks we were investing in at this time included banks Bank of Ireland and BNP Paribas and auto companies Daimler (owner of Mercedes Benz) and Stellantis (Peugeot and Fiat Chrysler).

By the end of 2021, interest rate expectations were on the rise due to rampant inflationary pressures which accompanied the global economy's bounce back from the restrictions imposed during the early stages of the pandemic. This served to further strengthen the sense that the value rally was accelerating. With discount rates heading higher, long-duration growth stocks looked likely to suffer relative to shorter-duration, and often more inflation-resilient, value stocks.

While this narrative really gained traction in January 2022, with a very sharp investor rotation from growth to value, geopolitical turmoil has now injected a huge amount of uncertainty to the equation.

At times like these, we always rely on the framework provided by our investment process – as we did when Covid hit in early 2020. As I alluded to earlier on, we have repositioned our portfolios, but we have maintained a heavy tilt towards value stocks.

This repositioning has been driven by analysis of our proprietary market regime indicators. These include valuations, investor anxiety, corporate aggression and market momentum. The indicators are telling us that the valuation dislocation in markets is still very significant with high-forecast growth stocks looking very expensive, and many cash generative value stocks trading on depressed share ratings.

However, some of the signals we are observing – high investor anxiety, rising corporate aggression, expensive aggregate valuations, and a market that is rolling over – also makes it very clear to us that it could be a dangerous time to be contrarian.

In response, we have removed some of the more contrarian value names that were still in the portfolio at the start of the year and taken the decision to follow the momentum. While some of the more cyclical value areas have hit headwinds, there are plenty that have retained momentum, with oil and commodities being the most obvious examples.

At the start of February, we also supplemented our existing holdings in value stocks showing strong evidence of recovery with a selection of stocks with defensive and quality characteristics. Stocks fitting this bill include Roche and Ipsen.

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[22/246]