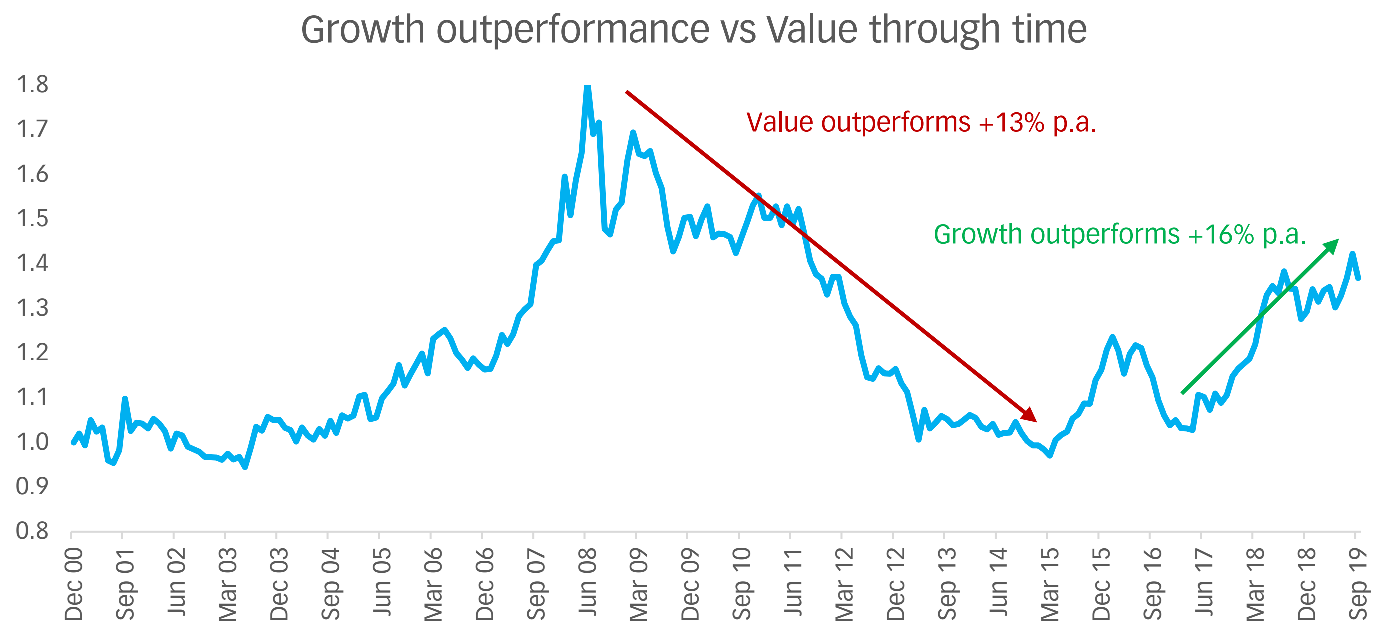
Growth vs Value (Part 2) – Are value stocks at an inflection point?

October 2019 – James Miller, Portfolio Manager

Are value stocks at an inflection point?

In almost 20 years of Australian equity market data seen in the chart below, we have observed five distinct growth and value cycles as defined by MSCI Australia. The most recent of these market cycles started around January 2017, a period where 'growth' companies have outperformed 'value' stocks by approximately 16% p.a. as indicated by the upward sloping trendline.



Source: MSCI Australia

The recent outperformance of growth vs value stocks has led to some market commentators to ask the question, 'Is value investing dead?'

However, in September 2019 we saw Australian 'value' stocks stage a short and sharp recovery, outperforming growth by approximately 4%. And whilst one month's data point is not a trend, it is a timely reminder that markets move in cycles. And this market cycle is as likely to come to an end as previous growth cycles have done in the past. So, is this the turning point for value stocks? This is a topic we covered in detail in a recent article here.

What factors could have triggered the sudden reversal in trend for value?

With the benefit of hindsight, there are several factors that contributed to the sudden reversal in the trend for value. The most powerful of these was the calming of geopolitical risk. In particular, the de-escalation and potential calming of the trade war between the US and China, as well as a higher probability of a Brexit deal between the UK and Europe.

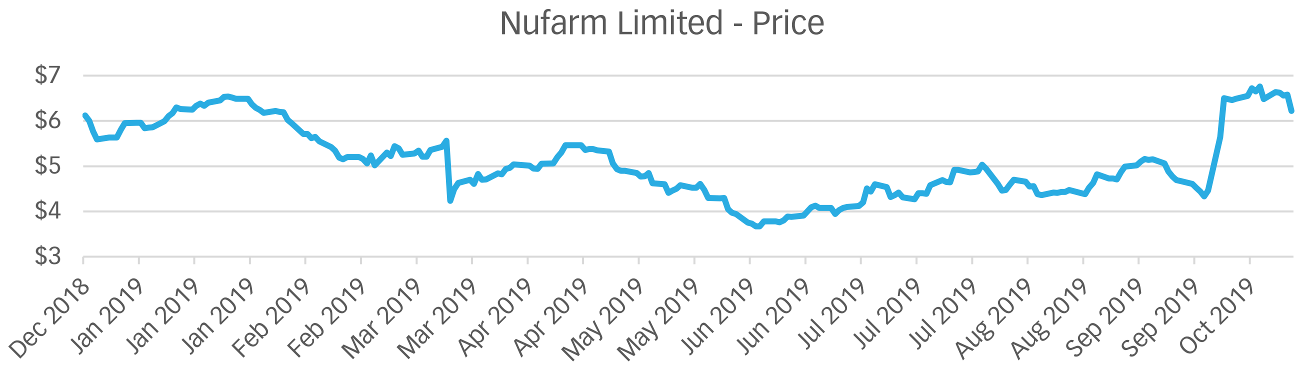
The above factors triggered a rise in bond yields. Growth and defensive assets subsequently underperformed. And value outperformed. But the rally in value has been relatively subdued. To get a broad-based and sustained rally in value stocks, fiscal stimulus is required to 'lift all boats' across the economy, rather than just low interest rates driving asset prices higher.

As an investor, how do you position your portfolio for potentially sharp changes in market cycles? Our approach is to focus on bottom-up stock selection, take a longer-term view, and invest in the best growth AND value companies we can find across the Australian market. We don't try to predict the next Trump tweet or try to time the turning point in growth and value cycles (both of which we believe are near impossible to predict). Instead, we focus on the company specific opportunities and aim to buy companies at a material discount to their intrinsic value. This allows us to buy undervalued growth and value companies and largely ignore things we can't control or predict.

Our top pick from today's value stocks

One of our top picks for 2019 was Nufarm, an Australian company that specialises in chemical crop protection globally. Our investment thesis for Nufarm was covered in detail in a December 2018 article titled, 'Our number one stock pick for 2019.'

Since writing the article less than 12-months ago, the share price performance of Nufarm has been volatile. The company has dealt with multiple headwinds including two consecutive droughts in Australia and flooding in the US. However, the investment thesis remains intact and we continue to remain patient investors in Nufarm for the long-term. Nufarm is now trading at similar levels to when we first wrote the article, however the chart below highlights that investing in value stocks requires conviction and a longer-term mind-set. It is not for the faint-hearted.



Source: Factset

With that in mind, we move on to our pick for today's most compelling value stock, Clydesdale Bank.

Clydesdale is materially undervalued, trading on less than 0.5x book value. When we look across the developed market, Clydesdale stacks up as one of the cheapest banks globally. To put the valuation into context, Australian banks trade anywhere between 1.4x to 2.0x book value. So, why is Clydesdale so cheap?

One reason is Brexit. All UK banks are trading at historically low multiples because of Brexit uncertainty. Importantly, we do not know what the outcome of Brexit will be. However, the UK is the world's 5th largest economy and banking is an integral part of that economy. The UK mortgage market is continuing to grow despite the uncertainty caused by Brexit and Clydesdale is a UK focused business with no European passport issues like some if its major UK banking peers. As long-term investors, the share price reaction to Brexit has created an opportunity to be greedy when others are fearful and buy a good business at a material discount to its historical multiple and peer valuations.

The second reason Clydesdale is undervalued is the company has disappointed on earnings expectations, post the acquisition of Virgin Money in 2018. Short-term earnings downgrades by the company have been disappointing. However, we believe the longer-term prospects from the Virgin acquisition are compelling given it provides Clydesdale with:

1. **A compelling brand (Virgin)** - which resonates in key growth areas for the business. Particularly in metro areas such as London where Clydesdale did not have a strong brand or presence.
2. **Strategic synergies and cost-out opportunities –** delivered by a management team with a solid track record delivering on cost-out targets.

Putting the revenue and cost opportunities together, we believe Clydesdale can grow earnings over the next few years, despite the challenges that Brexit and acquiring a new business represent. At current prices, the market believes that things will not get better for Clydesdale from here. However, experience has taught us that some of the most compelling value opportunities are in unloved companies in an unloved sector. At 0.5x book value, Clydesdale is a compelling value opportunity for the patient, long-term investor.