Polar Capital European Income Fund

The Increasing Importance Of Valuation Discipline

The increasing importance of valuation discipline

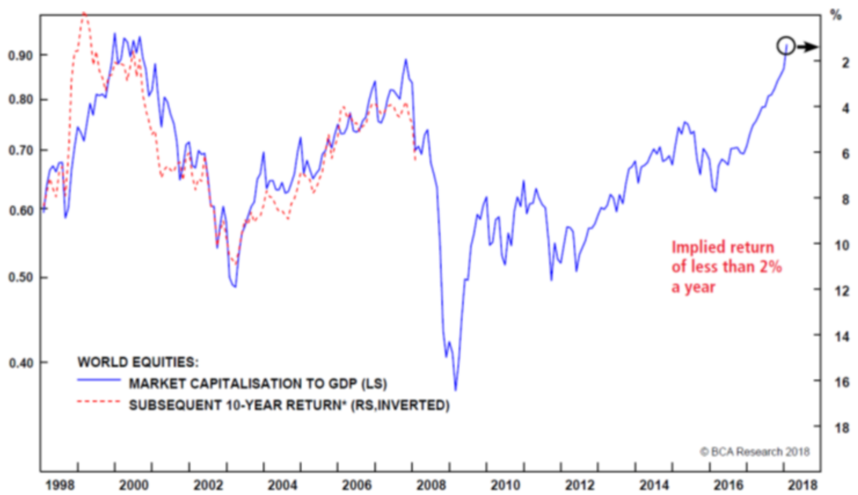
Our investment process is built on two pillars – a quality threshold (we only invest in companies that can make a 10% return on equity through the cycle) and a valuation discipline (we have a yield objective of 10% above the index yield). Put simply – we are looking to pick up our yield premium by buying good companies when they are out of favour as opposed to buying stodgy ex-growth high yielding names. The quality threshold means that when there are deep value rallies, we would be expected to underperform. The valuation discipline should in theory give a smoother relative return profile than pure quality styles (as by definition they have a bigger style factor skew).

The falling bond yields of the last few years has rendered valuation discipline less in favour. Europe's highest quality companies have become ever more expensive justified by lower discount rates in valuation calculations and an asset allocation effect of chasing scarce growth in a low growth backdrop. While much of the focus on potential bond market moves talks about bond proxies, this is a broad range of stocks with quite different characteristics – it is applied to telecom incumbents on 15x PE (6% FCF), ex-growth stocks with 4-6% dividend yields and consumer staples stocks on 20+x PE with heavy emerging market exposures. The traditional defensive playbook has been upended by the dramatic re-rating of the secure growth defensive stocks in recent years (they typically still have low earnings risk but today have much higher valuation risk).

On a five-year view, there are two key drivers of investment outcome – starting valuation and compound earnings growth. European equity aggregate returns were dominated by valuation re -rating in the recovery from the 2012 troughs – with aggregate earnings only returning to growth in 2017 given the lagged recovery relative to other regions. Given the high historical valuations of most asset classes, there is more worry that starting valuations will limit medium-term returns from here (see exhibit 1) – in effect elevated multiples today have pulled forward future returns from growth. While European aggregate valuations look neither cheap nor expensive – there is a broad divergence between some still cheap stocks to some now very expensive ones (see exhibit 2). After several years of growth stocks rerating, we believe that there is more valuation risk than investors have had to worry about in recent years.

Exhibit 1: Starting valuation key to long term prospective returns

World equity market-cap to GDP implies a feeble prospective ten-year return



*Rolling ten years, capital plus income, annualised.

Source: BCA, January 2018.

Exhibit 2: Some cheap sectors still… others less so

Stoxx Euro 600

	Absolute level					% Difference from long-term average				
GICS Sector	Trailing P/E	Forward P/E	Price to Book	Price to Sales	Price to Cash Flow	Trailing P/E	Forward P/E	Price to Book	Price to Sales	Price to Cash Flow
Basic Materials	15.1	14.4	2.0	1.2	8.9	2.4	11.0	4.9	11.6	15.9
Consumer Goods	17.2	15.9	2.9	1.5	11.4	4.9	8.8	16.6	42.2	22.7
Consumer Services	17.1	15.8	2.8	0.9	10.4	-7.6	-2.8	8.9	14.4	4.9
Financials	13.4	12.1	1.0	1.5	NM	0.7	6.1	-22.0	5.8	NM
Healthcare	17.5	16.6	3.5	3.1	14.7	-2.3	0.9	-5.1	6.4	4.0
Industrials	19.7	17.7	2.9	1.2	12.6	22.3	25.0	31.0	50.8	39.6
Oil & Gas	17.4	15.6	1.3	0.8	6.3	37.1	30.0	-31.5	-2.0	1.0
Real Estate	19.7	19.7	1.0	10.5	18.5	-0.9	3.5	2.7	45.9	-0.5
Technology	24.1	21.1	3.1	2.8	19.2	-19.5	-4.3	-27.6	16.9	3.2
Telecomm	17.7	15.5	1.9	1.2	4.8	-12.5	-10.5	4.1	-23.7	-22.7
Utilities	15.1	14.7	1.5	0.7	5.9	9.5	10.5	-14.0	-19.0	-1.1

Source: Jefferies, December 2017.

The term “bond proxy” is applied to equities that demonstrate bond like qualities. However, we like to differentiate between “perceived bond proxies” and “true bond proxies”. They both demonstrate degrees of correlation with the bond market, but for different reasons. We define “perceived bond proxies” as defensive growth – these might not necessarily have attractive dividend yields, but their low exposure to cyclical factors and long duration cash flows make them bond like in profile. Bond yields are an important input into the valuation of these companies because they tend to have a high terminal value implicit in their valuations that is very sensitive to changes in the discount rate used to value that point in the future today.

The “true bond proxies” we define as being stocks with flat and high dividend yields. These are essentially very mature ex-growth companies that have little reinvestment needs so consistently return cash to shareholders but are unable to grow those cash flows. These stocks tend to be inexpensive, so have a lower discount rate sensitivity. However, given their main appeal is yield, they are directly comparable to the yield on bond instruments. Very low bond yields makes these types of equities attractive to yield hungry investors, but they deserve a spread over bonds because equities are typically riskier than bonds (i.e. there is no set date to reasonably expect your principal back). The lack of ability to grow earnings means they cannot compound over the medium term – this makes entry and exit multiples key drivers of returns.

Our approach to these two different types of bond proxies is markedly different. We never own ex-growth flat and high dividend yielding stocks – they do not compound dividend growth over time which is in our view, fundamental to a good medium investment outcome. On the other hand, we often own “perceived bond proxies” because we like visibility and resilient compounding profiles. Many of these stocks have re-rated dramatically over the last few years in the low inflation, low growth and low bond yield backdrop (see exhibit 3). Our dividend yield target to yield 10% more than the index gives us a valuation discipline that forces us to sell stocks as they re-rate (i.e. their yields fall relative to the index).

Exhibit 3: Europe's highest quality companies have re-rated materially in the last decade

Equally weighted PE ratio basket of stocks (2012-2017)

Source: Polar Capital, Bloomberg, January 2018.

Note: Equally weighted basket of Christian Hansen, Rational, Geberit, L'Oreal, Atlas Copco, Campari, Kerry, Symrise, Essilor, Remy Cointreau, Luxottica, Legrand, Novozymes, Relx.

The short-term relative attractiveness of our Fund is a function of the style factor skews of the investment process and the broader market regime that we are in. We have a skew to higher dividends – and given our focus on sustainability of dividends, we also have a skew to higher free cash flow yields. The Bernstein analysis (in exhibit 4) shows four market regimes – recession, recovery, expansion and slowdown. Dividend yield and free cash flow yield have historically done least well in the expansion phase which has typically favoured momentum and growth factors. This was a headwind to our performance in 2017 – and these types of markets should be seen as a "keeping up" phase for conventional income strategies in our view. This profile is balanced by how well dividend and free cash flow factors perform in the slowdown phase. Looking at sector valuations today, the defensive sectors look cheap relative to the cyclical ones. This is not that surprising given the strength of soft data (e.g. stretched PMI surveys), but suggests low margin for error if growth were to soften in 2018.

Exhibit 4: Factor returns in different market regimes

Economic cycles and factor returns

		Recession		Recovery		Expansion		Slowdown	
Style	Average return all periods, %pa	Return, %pa	t-stat	Return, %pa	t-stat	Return, %pa	t-stat	Return, %pa	t-stat
Comp Value (cheap/expensive)	8.43	2.27	-2.93	19.24	5.72	-0.19	-4.73	18.01	3.92
Price to Book (cheap/expensive)	3.19	-4.72	-5.01	22.06	11.07	0.03	-2.16	-0.01	-1.68
12m Fwd PE (cheap/expensive)	11.24	6.00	-2.30	18.04	3.29	4.68	-3.37	20.49	3.67
Div Yield (cheap/expensive)	7.23	5.51	-0.86	8.84	0.86	-2.98	-5.91	22.67	6.87
Return on Equity (high/low)	8.56	9.60	0.67	1.93	-3.72	1.73	-5.31	24.45	10.00
Comp Growth (high/low)	-1.23	1.24	1.65	-8.48	-4.99	7.41	5.58	-7.25	-3.38
LT Growth (high/low)	-0.01	-3.92	-2.38	4.42	3.13	7.88	5.92	-8.85	-5.49
FCF Yield (high/low)	7.66	13.32	4.11	7.25	-0.33	-1.00	-9.91	12.65	4.31
Price Momentum (high/low)	4.28	6.11	0.65	-5.47	-3.70	14.26	5.25	0.13	-1.71
Size (small/large)	6.36	-2.32	-5.12	35.00	14.25	8.27	1.34	-9.75	-9.09

Two samples t-test (Welch's t-test) with unequal sample sizes and unequal variances with α=5%

t-stat significance - +

Figure shows the annualised return from factor portfolios in different economic cycles from 1990-2015. Factor returns are defined as the long-short return of the top-bottom quintile from the 500 largest stocks in the MSCI World index. Portfolios have been rebalanced quarterly and returns are on equal-weighted total return basis. Periods of the economic cycles are defined by the normalized seasonally adjusted composite leading indicator from the OECD. The universe of the indicator is based on the OECD + the six Major Non-member economies. We divide up the world into four phases, with an expensionary level (>100) and positive first differential of the leading indicator being classifed as an 'expansion', an expansionary level with negative first differential being a 'slowdown', a contraction level (<100) and positive first differential being classified as a 'recovery' and a contraction level with negative first differential being a 'downturn'.

Cycle definition	Level	1st diff
Recession	<100	<0
Recovery	<100	>0
Expansion	>100	>0
Slowdown	>100	<0

Source: Bernstein analysis, Datastream, OECD, January 2018.

It should not be assumed that recommendations made in future will be profitable or will equal performance of the securities in this document. A list of all recommendations made within the immediately preceding 12 months is available upon request.

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We believe that the valuation (see exhibit 5) and style characteristics (see exhibit 6) of the portfolio are compelling given the strong recent performance of cyclicals and the elevated current levels of optimism in equity markets.

Exhibit 5: Median valuation characteristics of our portfolio relative to the benchmark

European Income non-Financial positions:	FCF Yield	P/E x	Div Yield %	1YR ROE %	ND/EBITD A x
Median Portfolio	6.1%	15.8	4.5%	14.8%	1.8
MSCI Europe – Median	4.9%	17.6	2.7%	15.5%	1.0

European ex UK Income non-Financial positions:	FCF Yield	P/E x	Div Yield %	1YR ROE %	ND/EBITD A x
Median Portfolio	6.1%	15.2	4.6%	13.1	1.5
MSCI Europe ex UK – Median	4.7%	18.1	2.6%	15.3	0.8

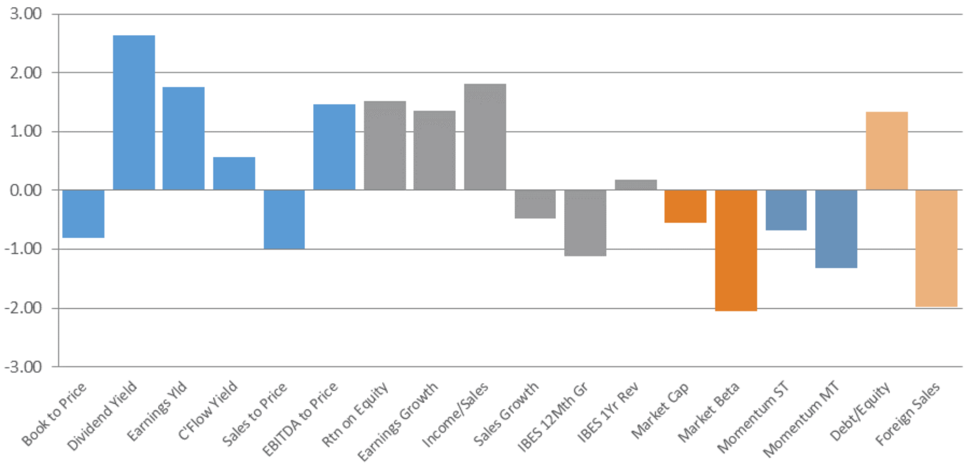
European Income Financial positions:	P/B x	P/TB x	P/E x	Div Yield %	1YR ROE %
Median Portfolio	1.3	1.5	12.1	4.7%	11.0
MSCI Europe – Median	1.1	1.2	11.8	4.1%	9.7

European ex UK Income Financial positions:	P/B x	P/TB x	P/E x	Div Yield %	1YR ROE %
Median Portfolio	1.3	1.5	12.1	4.7%	11.2
MSCI Europe ex UK – Median	0.9	1.2	11.7	4.1%	9.3

Source: Polar Capital, Bloomberg, MSCI Europe, January 2018.

Note: Dividend yield is shown gross of withholding tax. Historic yield of the portfolio was 3.6% and 3.7%, at 29 December 2017, for the European Income Fund Eur I Acc and the European ex UK Income Fund GBP I Acc Share Classes, respectively.

Exhibit 6: Style analysis of our portfolio



Source: Style Analysis, December 2017.

Conclusion

European markets are currently seeing more bullish consensus sentiment – which is justified by the improved hard data of 2017. That being said, we continue to see a moderate medium-term growth outlook due to debt and demographics. Sentiment will continue to be volatile around this trend – we went from the low rates forever consensus in spring 2016 to the bullish sentiment of early 2018.

In a world of so many asset classes looking expensive, we see our portfolio as continuing to exhibit attractive valuations. Starting valuation has historically been, will continue to be, in our view, a key determinant of medium-term investment returns. After several years of markets looking through rising valuations to seek secure global growth stocks, we believe there are better valuation opportunities elsewhere in European equities.

Low risk equities with reasonable and growing dividends continue to look attractively valued relative to other asset classes in our view. We are more sceptical on the prospects for high yielding stocks with no growth and see them as particularly vulnerable to uncertainty in the bond market.

Nick Davis
Fund Manager, Polar Capital European Income Team
30 January 2018

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Eligible for inclusion in a plan d'épargne en actions (PEA).

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