

# Asset managers search for value and quality in expensive equity markets

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***Equities markets are overvalued and expensive, if you ask asset managers. A survey this month of global fund managers by Bank of America Merrill Lynch showed that 78 per cent believe that stock markets are currently overvalued, which marks the highest level since the closely-watched survey began in 1998.***

The S&P 500 has already rallied almost 40 per cent off March's coronavirus sell-off lows, and prices have kept rising even as company earnings forecasts were slashed, which has sent the forward price-earnings ratio up to over 23 times.

“Equity markets are too high from a standpoint of the value of future earnings. This has been spurred on by stimulus but is not at all sustainable. We see a second correction striking,” says Simon Black of wealth manager Dolfin.

Markets have reflected increasing optimism about the effectiveness of government and central bank stimulus to spur economic recovery. In the same Bank of America survey, 46 per cent of participants said they expect a prolonged recession, dramatically down from an overwhelming 93 per cent in April.

Black says that Dolfin, which has about USD4.1 billion of client assets on its platform, is choosing to remain 'very underweight equities' (6 per cent of the portfolio), but he says that untenable valuations are forcing the asset manager to rethink conventional wisdom about how to manage a portfolio.

"We've had to change, adapt, and adjust what a 'balanced portfolio' is. It used to be that a balanced portfolio was 50 per cent fixed income, 50 per cent equities. The starting point is the ten-year government bond, which when yielding 4 per cent, gives a 2 per cent kick through the portfolio, meaning that equity allocations are going to have to give you 4 to 6 per cent return in order to generate 4 per cent to 5 percent each year at a portfolio level."

"But when your US ten-year yield is 0.7 per cent annually, or 0.26 per cent in UK, - 0.46 per cent in Germany, your starting position is so skewed, as is its ability to generate its portion of returns."

But other options are limited, says Black, with high-yield corporate bonds and dividend stocks among the top picks. Black says this means that more resource has gone into business analysis to continue earning after Covid-19.

Even then, as Black says, "you can't replace the five-year UK government gilt with a BT stock holding", since even holding income generating stocks will raise the portfolio's volatility and impact its risk profile.

"We've started exploring so far a route of rotating out of government bonds to corporate bonds, which have a positive nominal yield. We've not yet gone down the route of income generating dividend stocks," says Dolfin.

But they may be worth considering. Goldman Sachs said in a note in May that it was seeing the widest gap in 20 years between valuations at the top and bottom ends of S&P 500.

The "collective top 20 per cent of stocks from every S&P 500 sector trade at a median [second fiscal year] multiple of 27x, while the bottom 20 per cent of stocks with the same sector composition trade at a multiple of 9x," says Goldman.

This means that for the canny value investor, there are opportunities to be had on the lower end. If, as Black says, a market correction is coming and we are on the brink of a bear market, value investors could soon expect to see a period of outperformance on a par with the early 2000s, after the dotcom bubble burst.

Value investor Azvalor's International equity fund lost 32.7 per cent of its value in the three years to the end of April 2020, thanks to a heavy commodities sector weighting in its portfolio. Undeterred, CEO and co-CIO Alvaro Guzman de Lazaro, says: "We believe that on a price-to-value basis, our funds are worth two times the current price."

The Spanish asset management firm believes that the intrinsic value of many businesses over the next five, 10, or 20 years, has not changed, despite a short-term knock from Covid-19.

“If the farm is good, the soil is good, and the farmer is good – you just have to wait for the sun to come out and then harvest the crops. You just need patience,” says Guzman.

“For us, we anchor ourselves around business analysis, not market valuations. Markets fluctuate a lot, with about 50 per cent between year highs and lows, and instead of being guided by them, we have value business and incorporate a margin of safety by using conservative assumptions.”

In recent years, stock market indexes have skewed more towards technology, which tends to command higher valuations in recognition of ‘growth’ potential, but Azvalor says commodities firms are where the real bargains lie. Having already been at very low valuations heading into this crisis, commodities took an additional hit when oil futures tanked in April.

“The question that is really worth thinking about is ‘what do you think the business is worth?’. We see stock prices as expensive in general, and so we find most of it unattractive. We see value in energy businesses, because although earnings are depressed and a lot of capital has left, we like the prices that pessimism produces,” says Guzman.

Most of this is in “very specific good businesses” in oil, as well as “pockets of value in copper mining”. It all depends, says Guzman, on analysing the balance sheet and forward earnings of individual businesses.

Guzman gives the example of UK-listed energy industry engineer Petrofac, which has seen prices fall by 90 per cent since 2012 to a current price of around GBP2, partly due to a Serious Fraud Office (SFO) investigation into the firm.

But Azvalor sees the market’s pessimism as “all wrong”, and chooses to put its faith in Petrofac’s net cash positions and excellent engineering track record. In their view, even if the oil price stays low and earnings are hit, “it has the financial power to survive”. Guzman says that after Petrofac’s SFO investigation is solved and oil prices improve, the stock will trade north of GBP6. “Even if it takes seven years to reach that, it will be a great return for us.”

Many managers are fed up with markets not accurately pricing value. “It is like a group of rats exposed to radiation,” as James Montier, an asset allocator for GMO, recently put it in an interview with Barron’s. “Those that didn’t die are stronger than the ones that died, but not as strong as before you ghosted them with radiation. To me, risks aren’t being reflected in pricing.”

Then again, perhaps neither are rewards, and it may be looking like time for long-only managers to ignore market valuations, and look instead towards balance sheets and future earnings to determine stock selection.

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