ViewPoints

Relative Value Analysis –
The Anatomy of an Investment Decision

Entasis

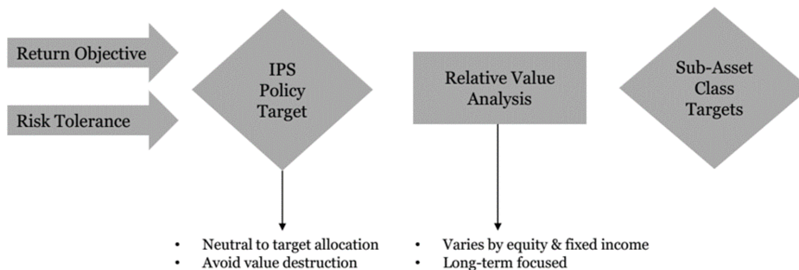
ASSET MANAGEMENT

Last year we put together a ViewPoints called Manager Research – The Anatomy of an Investment Decision, which discussed our manager research process in relation to portfolio changes that were executed at the time. In this ViewPoints we will take a more detailed look at another part of our research process, Relative Value Analysis, to share how it contributes to investment decisions. Our recent increase to the amount we have invested in emerging market equities sets the foundation for this discussion.

We provided an overview of our relative value analysis in the Research Focus section of our 3Q'17 Newsletter. This ViewPoints will review and expand upon the overview provided in the newsletter.

Relative Value Background

Our relative value analysis is a key component of our asset allocation process, which can roughly be summarized by the following graphic.



Our relative value analysis follows a goals discussion, risk and return assumptions and broad investment policy targets, which are formalized in a written investment policy statement (IPS) with each client. The IPS is a written document that we develop to make sure all parties are on the same page about the investment strategy we plan to use prior to investment. We do not vary portfolio weights much from the broad equity and fixed income asset allocation targets we establish in the IPS. Outside of temporary allocation shifts driven by market movements, we view broad asset allocation shifts as market timing. We have always viewed market timing as damaging to a client's long-term investment goals.

However, we do maintain the flexibility to vary underlying "sub-asset class targets" in portfolios based on the outcomes of our research and relative value analysis. Sub-asset classes are asset class groupings within a broad asset allocation target. Within equities, for example, we will consider the relative value of U.S. v. Non-U.S. stocks, Developed v. Emerging Markets stocks, Large-Cap v. Small-Cap stocks or Growth v. Value stocks.

So, what does relative value mean? Simply put, it means comparing the characteristics of a sub-asset class grouping to its own history, to other sub-asset class groupings and to forward expectations to determine if it is attractively valued.

Charles (CJ) Batchelor, CFA
Chief Investment Officer - Equity

Summary

We increased the amount of emerging markets exposure we have allocated within client equity allocations.

We do not vary portfolio weights much from the broad equity and fixed income asset allocation targets we establish in the IPS with clients.

We do maintain the flexibility to vary underlying "sub-asset class targets" in portfolios based on the outcomes of our research and relative value analysis.

Our relative value analysis is a means of comparing the characteristics of a sub-asset class grouping to its own history, to other sub-asset class groupings and to forward expectations to determine if it is attractively valued.

Our opinion on emerging markets is based on a mosaic of economic, currency and growth fundamentals, as well as valuation levels and examination of historical performance cycles.

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Some of the underlying characteristics that we examine during the relative value process include valuation (price-to-earnings ratio, price-to-earnings growth ratio, free cash flow yields, etc.), growth (earnings growth, return on equity, etc.), capital flows, economic health (GDP growth, inflation, interest rates, debt levels, etc.) and currency (notably for foreign investments), among others.

<u>Trade Background</u>

We have had a relatively large investment in emerging markets (compared to our blended equity benchmark) since the inception of our firm, so our favorable view of emerging markets is not new. However, we have continued to see positive developments in emerging markets over the past 12 months. As a result, we recently increased the amount of emerging market equities in portfolios at the expense of domestic market equities. There was no net increase in equity exposure.

Our decision was based on a mosaic of economic, currency and growth fundamentals, as well as valuation levels and an examination of historical performance cycles. The mosaic approach is central to the relative value analysis portion of our research process. We have witnessed the pitfalls of overly-simplistic analysis (I.e. analysis that is only predicated on one or two data points), and have also witnessed the pitfalls associated with behavioral biases, such as “confirmation bias” (I.e. only searching or interpreting data in a way that confirms the initial belief). We want to ensure that we are conducting detailed analysis that examines an idea from multiple perspectives. We also seek to strike a delicate balance between over-simplification, and “paralysis by analysis” (always looking for one more data point, or waiting for the perfect time).

Regarding the last point (waiting for the perfect time), it is important to note that we do not establish “target” levels that initiate a “buy” or “sell” for individual investments or sub-asset classes either. We believe that “bottoms” and “tops” tend to occur over a period of months or quarters, not hours or days. Plus, we are fully aware that we are rarely, maybe ever, going to pick the perfect bottom or top (on a relative or absolute basis), unless we are lucky. However, we believe that we have the ability to invest at a *relatively* attractive time – a time when we believe the risk/reward of a portfolio change is strongly in our favor.

<u>Trade Mosaic</u>

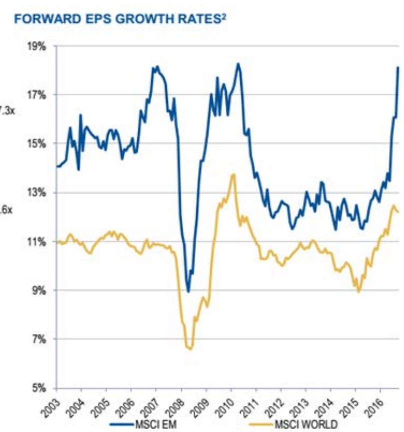
Our relative value mosaic for emerging markets that led to our decision to increase our exposure can largely be broken down into three parts – fundamental data (valuation), economic data and performance data.

Fundamental Data

- Forward Price-to-Earnings (P/E) Ratio
    - Based on a variety of valuation metrics, emerging markets (in aggregate) are less expensive than developed markets (in aggregate). One valuation metric that we monitor is the forward P/E for developed markets (U.S. and other foreign developed markets) compared to the forward P/E for emerging markets (see chart 1).

Chart 1

Chart 2



Sources: FactSet, Bloomberg. Data as of Aug. 31, 2017.
1. Based on FY1 P/E estimates.
2. Based on 3-5 EPS growth rates.

Charts courtesy of Neuberger Berman – Investment Strategy and Asset Allocation September 2017.

- Since 2011, developed market P/E ratios have expanded much more than emerging markets P/E ratios. While emerging markets have historically traded at a discount to developed markets, we believe the current, relatively large valuation gap will narrow in the coming years.

- Forward Earnings Per Share (EPS) Growth Rates
  - There has been renewed strength in emerging markets corporate earnings growth. Generally, equity prices tend to follow earnings growth.
  - As can be seen in chart 2 on the prior page, there was little in the way of corporate earnings growth in emerging markets from 2011-2016. However, this changed significantly over the past year.

Economic Data

Chart 3

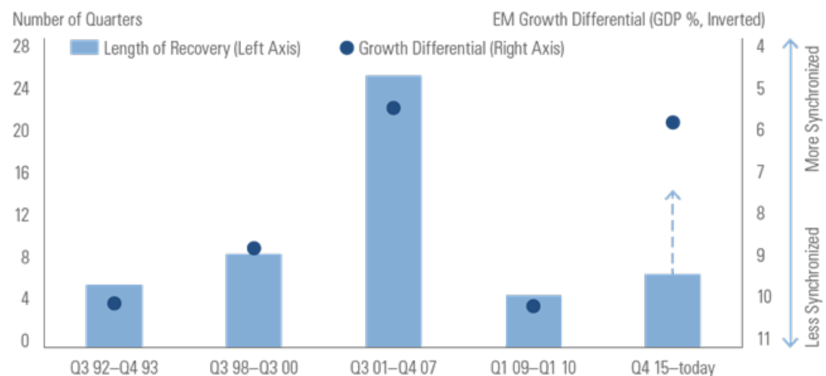


Chart courtesy of Goldman Sachs Global Investment Research and GSAM – Market Know-How Q4 2017.

- GDP Growth
  - Emerging markets GDP growth has accelerated after a period of subdued growth. Over the past 12 months, emerging markets have been responsible for 80% of total global GDP growth, yet only account for 40% of global GDP.
  - Current International Monetary Fund (IMF) estimated GDP growth rates for emerging markets are +4.6% (2017) and +4.9% (2018). These growth rates have already been revised higher and we believe they may still be understated.
  - Emerging markets growth has become much more synchronized. Based on data from Goldman Sachs, synchronized growth has historically led to longer periods of economic expansion in emerging markets. Based on the data in chart 3, we may be in the early stages of a relatively healthy expansionary period.

- Trade
  - According to data from Ashmore, intra-emerging markets (intra-EM) trade is the fastest growing segment of emerging markets trade. Intra-EM trade has grown to approximately 41% of all emerging markets trade (up from 26% in 1990), and is expected to increase to roughly 50% by 2026.
  - The increase in intra-EM trade is not just a China growth story. 90% of all intra-EM trade is with emerging market countries other than China.
  - The increase in intra-EM trade (and breadth) is important because this may help to mitigate (at least partially relative to history) any future external demand shocks from developed market countries and customers.
  - The relative importance of developed market trade with emerging markets was also discussed by Andrew Foster from Seafarer in one of our recent In the News summaries. For more detail on this topic and Foster's thoughts on emerging market decoupling, click **here**.

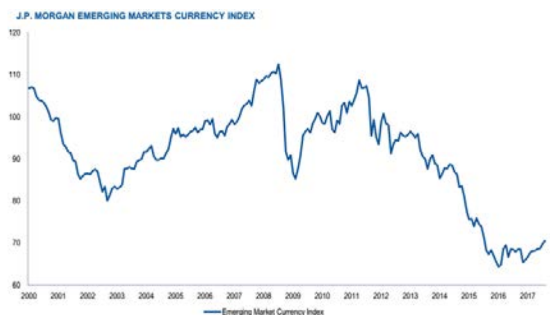
- Inflation and Interest Rates
  - During the period of quantitative easing (QE) in developed markets, emerging market interest rates increased by +200bps (2%), while inflation declined from 5% to 4%. Inflation is now even lower than the levels experienced during the global financial crisis when demand was exceedingly weak.
  - Relatively high real yields (inflation-adjusted yields) have begun to attract capital flows from investors, which may provide an added level of stability in the future. Capital flows also help to increase domestic demand within emerging markets, which in turn leads to relatively less reliance on growth of exports to developed markets.
  - Higher beginning interest rates (relative to developed markets) provides emerging markets with the flexibility to stimulate (cut interest rates) their economies during periods of economic weakness. Divergence in interest rate cycles (another point raised by Andrew Foster of Seafarer in support of emerging markets decoupling) is evident in chart 4.

Chart 4

Chart 4 courtesy of T. Rowe Price – Balancing Yield and Risk in a Changing World (October 26 2017).

- Debt
  - Emerging markets (in aggregate) have healthier balance sheets than developed markets (in aggregate). In the period following the global financial crisis, emerging market indebtedness remained relatively tame, while developed market indebtedness exploded. Developed market debt (as a percentage of GDP) has increased to 107% while emerging market debt (as a percentage of GDP) is 47%.
- Currency
  - Emerging market currencies experienced large losses (-45%) relative to the U.S. dollar during QE. However, our view is that strong underlying economic fundamentals (notably relative to developed markets) make it less likely that emerging markets currencies will experience any sizable, sustained setbacks from this point forward.
  - Inevitably, there will be bouts of U.S. dollar strength, especially over shorter time periods and volatility may be greater because most emerging markets currencies (notable exception is China) now "float" relative to the U.S. dollar, which allows for relatively quicker currency fluctuations than in the past.
  - Regardless, as can be seen in chart 5 courtesy of Neuberger Berman – Investment Strategy and Asset Allocation September 2017, it appears that emerging markets currencies have generally stabilized relative to the U.S. dollar.

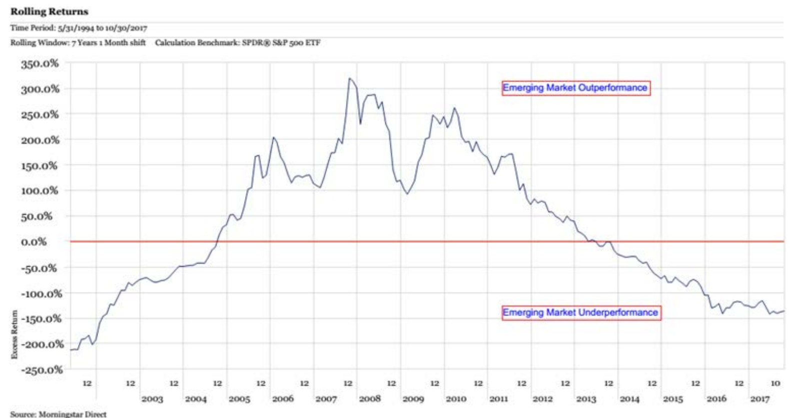
Chart 5



Performance Data

- Performance of U.S. equity markets relative to foreign equity markets (developed and emerging) diverged significantly from 2011-2016. This was partially a function of U.S. dollar strength (relative to foreign currencies), in addition to strong U.S. corporate earnings growth.
- Chart 6 displays the rolling seven-year excess return of the Vanguard Emerging Markets Stock Index Fund compared to the SPDR S&P 500 ETF. Our opinion, based on historical data, is that relative out- and underperformance of emerging markets tends to occur over extended timeframes.
- We believe that the most recent multi-year cycle of U.S. equity market outperformance may have ended, and that we may have only recently entered an extended period of emerging markets outperformance.

Chart 6



Overall, we believe that we are at the beginning stages of a shift in market opportunity from domestic equities to emerging market equities, which is based on a mosaic of relatively positive economic fundamentals, valuation levels, future growth potential and relative performance trends over the past six years. While we are uncertain of what will transpire over the short-term, we believe investors may benefit from the trade over the intermediate- to long-term (2-5 years or longer).

IMPORTANT INFORMATION

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Forward P/E is a measure of price-to-earnings using forecasted earnings estimates.

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