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Value done differently

The investing playbook has changed.

While it's largely only garnered attention in recent months, the return of value investing started about a year ago, when the global economy began to show signs of recovery following the onslaught of the COVID-19 pandemic.

The last decade or more has undoubtedly belonged to growth investors, almost primarily because of global central banks pumping out stimulus measure after stimulus measure in the wake of the Global Financial Crisis and the pandemic. The most powerful tool in the banks' arsenal, interest rates, have been at historic lows and have added to the inflated valuations of companies not expected to generate their greatest profits for some time.

But that seems to be over now and the first half of this year has seen some of the worst performance on record for growth stocks. For value however, it's experiencing its renaissance, powered by rising inflation and interest rate increases.

And while many may think the shift is cyclical, Lazard Asset Management portfolio manager and analyst Matthew Landy[01] believes its more likely structural.

"If you look back over the last 10 years, we've been in a very unusual environment with abnormally low interest rates, particularly in the context of GDP growth that's been reasonably healthy at 4-5%. Having interest rates of 1-2% is historically unusual – we all got accustomed to it, but it's not the norm," he explains.

The combination of inflation and central banks raising rates means the great normalisation is here, Landy says, adding that this environment is quite favourable to value stocks.

And there's no telling how long it will last as it typically depends on how far from normal markets and the economy have strayed.

"The sheer degree of growth versus value over the past decade has been almost unprecedented," Landy notes.

"If you look back over 100 years, there's been times where each has outperformed but typically value has had the upper hand – but over the past 10, even 15 years it's really been all growth. The degree of normalisation and mean reversion that needs to happen or could happen is just beginning."

And it could spell trouble for some of those that have benefited in recent years, with Landy reminding us that low interest rates have created distortions in a range of assets; consumer staples, profitless technology companies and speculative stocks at high valuations, bond proxies at double the multiple they were previously.

Looking at it from a fundamental perspective, the only thing that underscores all these developments is low interest rates, Landy says.

"We think that many of those market valuations won't survive a higher interest rate environment," he says.

As a portfolio manager of the Lazard Global Equity Franchise Strategy, Landy focuses on a very unique universe of companies called Economic Franchises – companies with very large competitive advantages and forecastability, meaning relatively predictable cash flows over five, 10, 15 and 20-year periods.

"One of the biggest issue we face as investors is making forecasts, which is difficult, so we're trying to reduce that forecasting error over the long-run cash flows," Landy says.

To have those two characteristics present in the one company is rare, with just 220 investment opportunities identified by Lazard in the strategy's investment universe.

It should also be noted that, unlike most value investors, the strategy does not invest in banks, energy stocks and any other companies seen as deeply cyclical because they don't meet the key criteria for the fund.

By maintaining that criteria, Lazard is aiming to reduce the risk of a value trap.

"It's one of the biggest risks you face as a value investor, where the earnings of the company turn out to be structurally lower than you forecast. So, by focusing on Economic Franchises that have competitive advantages such as brands, intellectual property, scale economies, network effects and switching costs, we think we reduce that risk," Landy says.

These companies also tend to earn higher returns on capital.

"When you're a value investor and you buy a business that's trading below what you think is its intrinsic value, it often takes the market quite a while to come round to your point of view. But if you're an Economic Franchise, throughout that period the business is compounding economic value, so your risk of a bad outcome is reduced," he explains.

It's also easier to minimise forecasting errors when focusing on Economic Franchises, he adds.

"One of the biggest issue we all face as investors is making forecasts, which is difficult, so we're trying to reduce that forecasting error over the long-run cash flows," Landy says.

"And we're also obviously trying to buy these companies at discounts to intrinsic value, so we do a lot of detailed modelling and cash flow work to understand the businesses."

The strategy's composition today reflects the strategy's investment team's view that, while the environment is changing rapidly, stock markets are still expensive. This means the portfolio is quite concentrated, with 26 stocks in total as at 30 June 2022; a mix that Landy describes as "eclectic".

These include IGT, the largest owner of lottery concessions around the world, and H&R Block which is the US's largest tax advisory business. Other holdings include Midtronics, Mednax and CVS Health.

It's concentrated but diversified, he says.

Looking forward, Landy says it's important for investors to realise that the investment playbook that's worked for the last 10 years may not be the playbook that works in the next 10 years.

In terms of tips for investing in such uncertain times, in addition to reconsidering growth stocks and bond proxies, he says investors should probably reconsider indexed investments.

"What's happened in the last decade with declining interest rates is you've had significant multiple expansion across most stocks. We think that's much less likely to be the case and you need to be more selective," he says.

And finally, it's no surprise he'd say this given he's a value investor, but Landy believes valuations become even more important in an inflationary environment.

"The opening valuation you pay for a stock is going to be a very important driver of your total return because you're not going to get that free kick from falling interest rates," he explains.

In his opinion, companies with pricing power, particularly in elastic demand, low capital intensity and minimal risk will be investors' friend.

"If you overpay for assets that do have inflation protection, you might have a bad outcome. If you focus on businesses, maybe in the energy sector that may be benefitting from inflation now, it's still risky because you're effectively making a bet on where the oil or copper price might be in five- or 10-years' time," he says.

"Don't take on too much risk in the pursuit of inflation protection." FS

The quote

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