VALUE INVESTING – A CONTRARIAN BET WITHIN EUROPEAN EQUITIES

Value investing had a tough decade of underperformance – and despite extensive research showing value outperforms over longer time horizons, it looks like European fund managers have shifted their exposures to overweight growth stocks. Investors may be prudent to bear this in mind as they rebalance or make fund selections.

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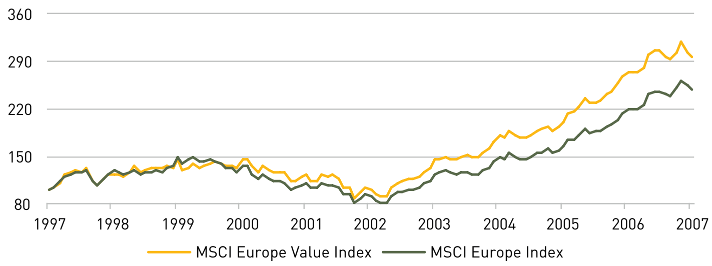
When investors structure and diversify their equity portfolios, a key reference is the value/growth style framework that has dominated the fund industry for decades. Once target allocations are set, investors then select the funds offering the most appropriate risk and reward characteristics. When investors evaluate individual funds, it is only natural that one consideration is historical performance against a benchmark or a peer group, where funds are compared to others with a similar style. As we all know, even a short spell of underperformance can get a fund manager fired or a fund closed down. Arguably, one knock-on effect is that fund managers become more short-term in their thinking, and are more tempted to invest in recently outperforming stocks.

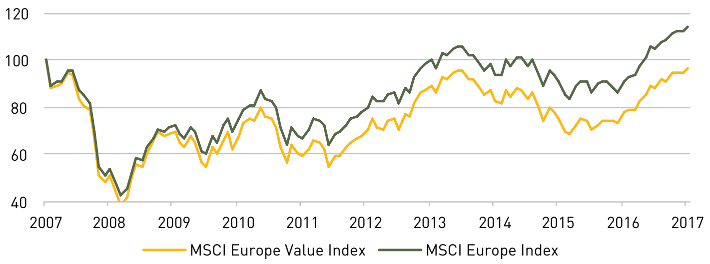
However, there is a wealth of literature warning against short-term performance chasing. Most investment professionals will probably agree that it makes no sense to sell one fund – or stock – after a short period of underperformance, only to jump into another one with a better short-term return. Whether selecting funds or stocks, performance chasing often damages long-term returns. Yet in reality, it is quite common, and leaves many investors underexposed to whatever underperformed recently.

A strategy that hit a rough patch in the past decade is the traditional value strategy of buying undervalued stocks. In the decade leading up to the financial crisis, the MSCI Europe Value Index had gained almost 2 percent annually compared to MSCI Europe. By contrast, in the following decade, the same value index lagged the broader market by 1.7 percent annually. The question is whether those 10 years of growth outperformance have led to a distinct growth bias for investors.

1997-2007: European Value outperformed 2 percent ann. (USD)



2007-2017: European Value underperformed 1.7 percent ann. (USD)



Source: Bloomberg, MSCI (base 31.12.1997=USD 100), Source: Bloomberg, MSCI (base 31.12.2007 = USD 100)

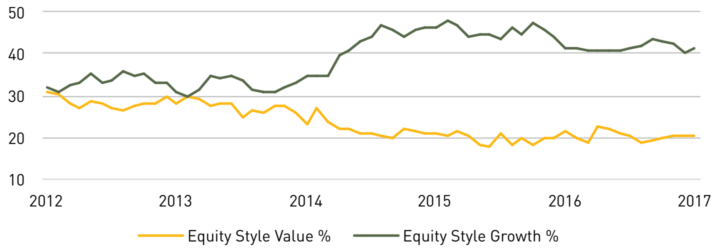
Where does the crowd invest today?

A first glance at the universe of European equity funds does not suggest any overall change in style exposure. According to Morningstar Direct's useful data on fund allocations and flows, the largest part of the market is 'Europe Large-Cap Blend' funds – a large pool of funds covering everything from style agnostic to style timing funds, from semi-value to semi-growth funds. AUM in this category roughly doubled over the past five years. That is also true of the 'Europe Large-Cap Value' and 'Europe Large-Cap Growth' categories, both of which have now reached about EUR 35 billion in AUM.

So, it looks like allocations to value and growth funds have not shifted. That said, the number of funds in the 'Large-Cap Value' category has dropped from 557 funds five years ago, to 336 funds now. Meanwhile, the corresponding growth category went from 155 funds to 355 today. Whether the decreased number of value funds is due to managers closing their funds or changing their style, one senses there may be a correlation with value underperformance. Value investing is perhaps less popular among fund managers than it used to be.

If you go one step deeper and look at the underlying style exposures of the funds within each category, the data starts to reveal some interesting shifts. For instance, if you amalgamate the funds in the 'Large-Cap Growth' category, they always had some underlying exposure to value, core and growth stocks. The value exposure used to be much higher, peaking above 30 percent, whereas today it is at a historical low of only 10 percent. In other words, growth funds became a lot 'growthier' as the style kept outperforming. Another large European category is 'Flex-Cap Equity'. This is a style agnostic flex-cap category, so you might expect it to be somewhat style neutral on average. Five years ago, it had an underlying exposure to value stocks of 30 percent, whereas today that number is below 20 percent.

Morningstar's European Flex-Cap universe is currently only 20% value exposure



Source: Morningstar Direct

In fact, looking at Morningstar's 13 major European fund categories, which cover almost EUR 700 billion in AUM, it appears that in just five years the underlying exposure to value stocks dropped from 33 percent to 25 percent.

Clearly, fund managers' style allocations are influenced by many factors other than simple performance chasing, and one cannot deny that since the financial crisis, it has been profitable to underweight value stocks. Nonetheless, it appears that over the last five years, there has been a distinct shift away from value within European equity funds. Might it be time to start thinking differently?

Contrarian Thinking

'When everybody thinks alike, everybody is likely to be wrong'. This easily remembered maxim seems just as relevant today as it was more than 60 years ago, when Humphrey Neill minted it in his timeless book, "The Art of Contrary Thinking". Investors who think differently and invest against the overall market trend are often called 'contrarians' as they watch for crowd behavior to lead to mispricing, which they can exploit. Value investors focus primarily on identifying stocks where the market price offers a deep discount to the company's intrinsic value – and of course, this can mean they often go against the herd and consider stocks, which are currently unloved by the market. In other words, they often find themselves among the contrarians.

The data suggests that many managers have increasingly positioned themselves in the same part of the market – in the growth stocks that outperformed in recent years. Many market participants argue that value stocks are cheap on a relative basis, and see potential catalysts for a value resurgence. Yet even investors who disagree should perhaps consider increasing their value exposure. One of the most compelling reason lies in a proper rebalancing strategy. Rebalancing is, by its very nature, quantitative contrarian thinking: recent outperformers are sold and laggards are bought. At first glance, the data seems to suggest that in recent years, investors have rebalanced and maintained their exposure to value funds – but when one looks at the breakdown of the underlying fund holdings, it appears that as value stocks underperformed, fund managers reduced their value exposures. It may be prudent for investors to take that into account when rebalancing between funds. History suggests periods of value underperformance always end – and often they end abruptly. Considering that, thinking a bit less like everybody else may not necessarily be a bad strategy. On the contrary.