

# Global rotation

Martin Steward finds pure value and pure growth strategies starting to take the lead as the quality theme begins to run out of steam

## Strategy Review

As the market regime has started its transition from quality-growth to value through 2014, some of the long-term outperformers in the global equity universe have tumbled down the rankings.

It is for that reason that the Strategy Review does something a little unusual this month, and takes a look at a purely quantitative strategy in the form of **Swisscanto Asset Management's** Selection International portfolio. This strategy maintains a low tracking error and sector neutrality against its benchmark while seeking excess returns from diversified exposure to six groups of risk factor, or alpha sources – quality, growth, value, risk, momentum and size.

The portfolio has a strategic tilt to value as a proven long-term risk premium and also, currently, a slight tactical tilt to value. But as the consistent numbers it has posted across different time horizons suggest, the essence is diversification.

“Our process always keeps its bias to good quality, good value, low risk, higher growth and good momentum, so we would never find ourselves buying really-low-quality, deep-value stocks,” as Andreas Kappler, senior portfolio manager in the systematic alpha team, puts it.

“Apple is a case of one of those rare companies that fulfils all our criteria,” adds Michael Bretscher, head of systematic alpha and smart beta, describing the current top holding. “It has been value for a long time; momentum has picked up over recent years and has been very strong over the past few months; it has always been a high-quality company in terms of its high margins and cash flows; its day-to-day volatility is relatively low; but it is still a company that is achieving growth.”

Within the six groups of alpha sources there is further diversification, as well as tactical tilting, which has added to the ability to ride market cycles – and specifically to adapt to the ‘quality-value’ environment of recent years.

“In recent years, cash-flow-based measures were clearly much more useful in the value group than the others, and our resulting tilt to stocks that look cheap on those cash-flow measures has had a lot to do with our good performance,” says Kappler.

Today, the rising uncertainty of a market regime change is leading to some of the more pronounced style tilts in the portfolio to smooth themselves out again.

“When the market gets very nervous the volatility of all of our alpha sources increases, and when that happens it’s more difficult to distinguish between the different [alpha sources],” says Bretscher. “At that point in our optimisation we tend to weight the factor groups more equally and take less extreme bets on any one or two alpha sources.”

It is a warning relevant to any non-quant

### Under review

Name of strategy	Inception date	Portfolio manager	Key positions
Artisan Partners Global Value	Dec-07	David Samra; Dan O’Keefe	High cash levels on valuations; finding value in UK and US banks
Robeco Global Value (‘Global premium’)	Dec-04	Christopher Hart	Remains quality-biased; retreating to US mega-caps on valuations
Swisscanto Selection International	Nov-05	Michael Bretscher, Andreas Kappler & the systematic alpha team	Quantitative strategy: diversified, sector neutral; factor tilts becoming more neutral
Morgan Stanley Global Opportunity	Nov-10	Kristian Heugh	Growth; platform IT franchises; EMs, esp. China on-shore

Source: IPE

strategist running a portfolio with significant strategic style or factor biases. If it has not started already, your performance may be about to take a sharp corner.

### The last war

With that in mind, let us first consider our two featured portfolios that are explicit ‘value’ strategies: **Artisan Partners’** Global Value and **Robeco Boston Partners’** Global Value Equities.

It quickly becomes clear that neither is exactly deep-value.

At Artisan, lead portfolio manager Dan O’Keefe looks for sustainable competitive advantages, high returns on capital and strong balance sheets. But he warns against the “quality-at-any-price” legacy of the financial crisis.

“We might call this ‘quality value’, but I don’t like the quality coming before the value,” he says. “The most important thing we do is invest in companies at a significant discount to their intrinsic value. The quality aspect is about correcting for some of the classic mistakes that value investors make.”

The portfolio’s multiples remain marginally below the benchmark’s and, as O’Keefe points out, P/E understates the value because it does not take account of the cash his portfolio companies hold.

But just as those companies find it challenging to put their cash to work, so, increasingly, does O’Keefe himself; his cash position has fluctuated between 10% and 15% over recent months, the top end of its allowance.

“Valuations are unattractive,” he concedes. “We need to re-invest, given how fairly-valued our portfolio is, but we are having a hard time

finding good prospects.”

This is evident from some of the portfolio’s own recent sector and regional rotations. Over the past 12 months consumer discretionary stocks have fallen and emerging markets are underweight – with a bias to cheaper, western-facing companies such as Kia and Samsung.

“Our thoughts about ‘quality at any price’ are really strong in emerging markets,” O’Keefe explains. “Look at Brazil: if you want to look at anything with a reasonable P/E you are looking at Petrobras, some of the banks and homebuilders, and Vale. Higher-quality businesses like Natura, Ambev or Hypermarcas are at 20 times earnings, 26 times earnings and 30-plus times earnings. Anything of even reasonable quality trades at ridiculous multiples.”

There are stocks that O’Keefe is still happy to hold on to, and many are in the IT sector, which has grown to a sixteen-percentage point overweight. Oracle is now the top holding and Microsoft comes in third. O’Keefe sees a tendency to undervalue IT as a

whole as a result of some growth problems in more “hardware-centric” names.

When it comes to new additions, some special situations have arisen, most recently in Qualcomm. Long term, its virtual monopoly on 3G intellectual property should generate significant royalties as mobile phone penetration continues. Short term, however, the authorities in China are investigating it for monopolistic practices – ironically, at the same time as it struggles to enforce its intellectual property rights on local mobile manufacturers.

“A lot of Chinese companies are now refusing to pay Qualcomm its royalties – so that impacts

***“When the market gets very nervous the volatility of all of our alpha sources increases”***

Michael Bretscher

growth expectations,” says O’Keefe. “But Qualcomm isn’t sitting still on this and, in any case, our view is that even if these Chinese phone manufacturers refuse to pay Qualcomm what it is owed, the business should still grow quickly enough to make it an attractive investment at the current price.”

The biggest theme, however, is the one that marks this strategy out from some of the more doctrinaire-quality portfolios – a 14-percentage-point overweight in financials.

There are genuine value plays alongside custody banks like BNY Mellon, even in the top-10 holdings: RBS leads a number of UK names, where O’Keefe likes the consolidation of the market and the fact that re-capitalisations were made early in the recession.

“At different times over the last year or so we have noticed that banks are one of the few places that are priced attractively,” O’Keefe says. “I do think a lot of people are fighting the last war. So many other assets are pricing-in a good business environment, which simply isn’t compatible with a strongly negative view on financials. Compared with where we were before this recession, the capital positions of not all, but many, banks is frankly a whole new world. In the US, we particularly like Citigroup, which today could go through a 2008-09-scale recession and not have to raise capital.”

### ‘Growthy’

Whether or not it is fighting the last war, the Robeco portfolio certainly takes a more orthodox quality position on banks, with a five percentage point underweight in financials that is itself tilted towards diversified insurers and US regional banks.

“The US has been experiencing loan growth at the level of the regional banks, and that’s where our exposure has been,” says portfolio manager Christopher Hart. “Europe’s banks are undercapitalised, weighed down by regulation but at the same time evidently less trustworthy, as we have seen from a couple of incidents over recent months – none of the data is believable because the industry is very politicised.”

It is this kind of difference of emphasis that starts to explain the divergence, through Q2 of this year, between strategies like Artisan’s and Robeco’s that look superficially similar.

“We are highly sensitive to valuation,” says Hart, echoing O’Keefe’s warning about ‘quality-at-any-price’. “If you overpay for quality you will find it difficult to consistently make money.”

Like Artisan, this portfolio’s valuation multiples come in a shade under the benchmark’s. Is Hart finding it similarly difficult to find quality at a sensible valuation?

Where O’Keefe finds himself pushed up against his cash holdings limit, Hart’s portfolio seems to be retreating to the larger end of the US market for similar reasons.

Almost half of a position in European mid-caps that had been in place since late 2012 has been sold since the beginning of this year, as valuations “normalised”. While telecoms and utilities have been absent from the portfolio for some time, other sectors that dominate large-caps and mega-caps and are a feature of most quality strategies remain overweights – consumer discretionary, healthcare, IT. It is notable that this lends a discernible growth flavour to this nominally value strategy.

“The portfolio has its highest average-weighted market cap since inception, with our exposure to companies over \$13bn at 70%,” says Hart. “We see more core-to-growth companies, mainly based in the US, because that’s where the combination of quality and value is taking us.

At the same time, the valuation gap between



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Kristian Heugh

Europe and the US has closed a lot, but looking at underlying earnings revisions we do not have so much confidence in Europe, compared with what we see in North America for a very slightly higher price.”

### Platform

If Robeco’s Global Value Equities is taking on a “growthy” tilt, **Morgan Stanley Investment Management’s** Global Opportunity portfolio is the only one of this month’s selection that could be described as all-out growth. All of its valuation multiples sit at around twice the levels of its benchmark’s. Volatility and beta have also been high at 18% and 1.24, respectively, over the past three years.

The strategy styles itself as seeking after-quality growth, but its big sector bets – overweight IT and consumer discretionary but underweight staples, industrials and healthcare – distinguish it from the sort of bond proxies that have been



**“We need to re-invest, but we are having a hard time finding good prospects”**

Dan O’Keefe



**“The portfolio has its highest average weighted market-cap since inception”**

Christopher Hart

most in favour over the past three years. What really drives this portfolio are ‘differentiation’ business strategies and, especially, the growth potential of ‘network effects’ – both of which tilt it towards platform companies.

“Facebook is the classic network-effect company,” explains portfolio manager Kristian Heugh, describing his largest and fourth-largest holdings. “The more friends you have, the more valuable Facebook becomes to each individual user, and the more its costs scale down. Google is the classic differentiation strategy: they don’t charge a different price for their product, but rather provide a search service that is just a little bit better than any of their competitors. But it also benefits from network effects, in that the more individuals use their search engine, the more Google understands what each group of users wants to find when they search for certain key terms. That sort of thing may not show up on the P&L every day, but the fact is that ▶

◀ their businesses are getting better and better every day.”

It is the same reason he owns South Africa's Naspers – for its substantial stake in China's major platform company, Tencent.

It is this kind of exposure that caused the damage evident in Q2 of this year – it sat through a wave of selling by hedge funds that were disproportionately invested in the same, high-momentum themes. Importantly, this was not about being on the wrong side of the rotation out of quality.

As such, despite a valuation threshold of 70-80% or less of a fair value, based on free cash flow expectations, Heugh does not experience the same difficulties finding opportunities as Hart or O'Keefe.

“If the market goes up another 10-20% and we

start to get free cash flow yields in the 4-5% range, it's going to be more challenging but, so far, we have not been affected,” Heugh says. “And what we can also say is that the opportunity-set has never been as broad as it is today – we are finding a lot of individual ideas that are interesting.”

Chief among the sources of these ideas are the emerging markets, from which the quality-value strategies have left because of stretched valuations. Heugh is almost 25 percentage points overweight.

The main factor behind this seems to be Heugh's location in Hong Kong: the portfolio has 20% of its assets in Chinese stocks and Heugh sees it as particularly well-positioned to take advantage of the Hong Kong-Shanghai Stock Connect project, which he expects to correct a lot of “valuation discontinuities” between the

two markets. This is how good prices can be paid for companies that, on the face of it, seem to offer very high quality – like top-10 holdings TAL Education, which runs schools in China, and Kweichow Moutai, its leading provider of alcoholic beverages.

“These are companies that almost no-one around the world has ever heard of,” Heugh says. “However, with the Hong Kong-Shanghai Connect coming, they will be hearing about them.”

Overall, the message from the global equity portfolio rankings is fairly clear as we approach the end of 2014. There is room for genuine value strategies and there is room for genuine growth strategies. The quality theme now seems finally to have run its course – and mega-cap core appears to be the place where quality managers are seeking shelter.

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Dan O'Keefe is lead portfolio manager of Artisan Global Value Fund. For the purpose of determining the Fund's holdings, securities of the same issuer are aggregated to determine the weight in the Fund. The holdings mentioned comprise the following percentages of the Artisan Global Value Fund as of 30 Sep 2014: Kia Motors Corp 1.6%; Samsung Electronics Co Ltd 2.4%; Oracle Corp 4.7%; Microsoft Corp 3.9%; QUALCOMM Inc 2.5%; The Bank of New York Mellon Corp 4.0%; Royal Bank of Scotland Group PLC 3.6%; Citigroup Inc 3.0%. Holdings discussed, but not included here are not held in the portfolio as of the date indicated. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities.

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