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A painstaking search for value in Europe

In a universe of more than 3,500 European companies, should it be tough to find value? Yes, according to a leading European fund manager who looks after two European fund strategies. Because identifying companies that are under-valued, relatively immune to macro factors and that have sustainable cash flows is very tough. Which means that when found, they should be held for many years.

Executive summary

When the markets are weak and prospects weakening, value often becomes the key focal point for many investors. But for value investing strategies to work, buyers must take a longer-term perspective. J O Hambro Capital Management (JOHCM) sent one of its leading fund managers on a roadshow to Asia to explain why the two value funds he co-manages have the right approach.

Luis Fañanas has little interest in macro factors, he has only modest interest in market vagaries. What does fascinate him is finding companies that combine value and sustainable, predictable cash flows. Fañanas is co-manager of two funds, the JOHCM European Select Values Fund (ESV) and the JOHCM European Concentrated Value Fund (ECV).

His roadshow was to highlight the appeals of both strategies for wealth management intermediaries and wealthy investors under the banner "Value has Different Faces". During his whistle-stop roadshow, Hubbis assembled a group of leading wealth management professionals to a private briefing in Hong Kong at which Fañanas and colleagues expounded their views.

Value, predictability, sustainability, durability and long term were all watchwords for a fascinating summary of the search for value and return.

ANDREW ANG, JOHCM'S SINGAPORE-based Director of Asian Sales, began the private briefing that Hubbis had organised by introducing JOHCM and outlining how the UK-headquartered firm manages around USD40 billion across a variety of equity strategies and a recently-launched multi-asset value strategy.

"We are performance-driven, aiming to deliver sustainable alpha to our investors," he explained. "We run capacity-constrained funds, and the two funds we are here today to highlight are our two most successful offerings here in Asia. Both portfolios adopt the same philosophy, same process, and same team, just have a different focus, with ESV multi-cap and ECV large cap."

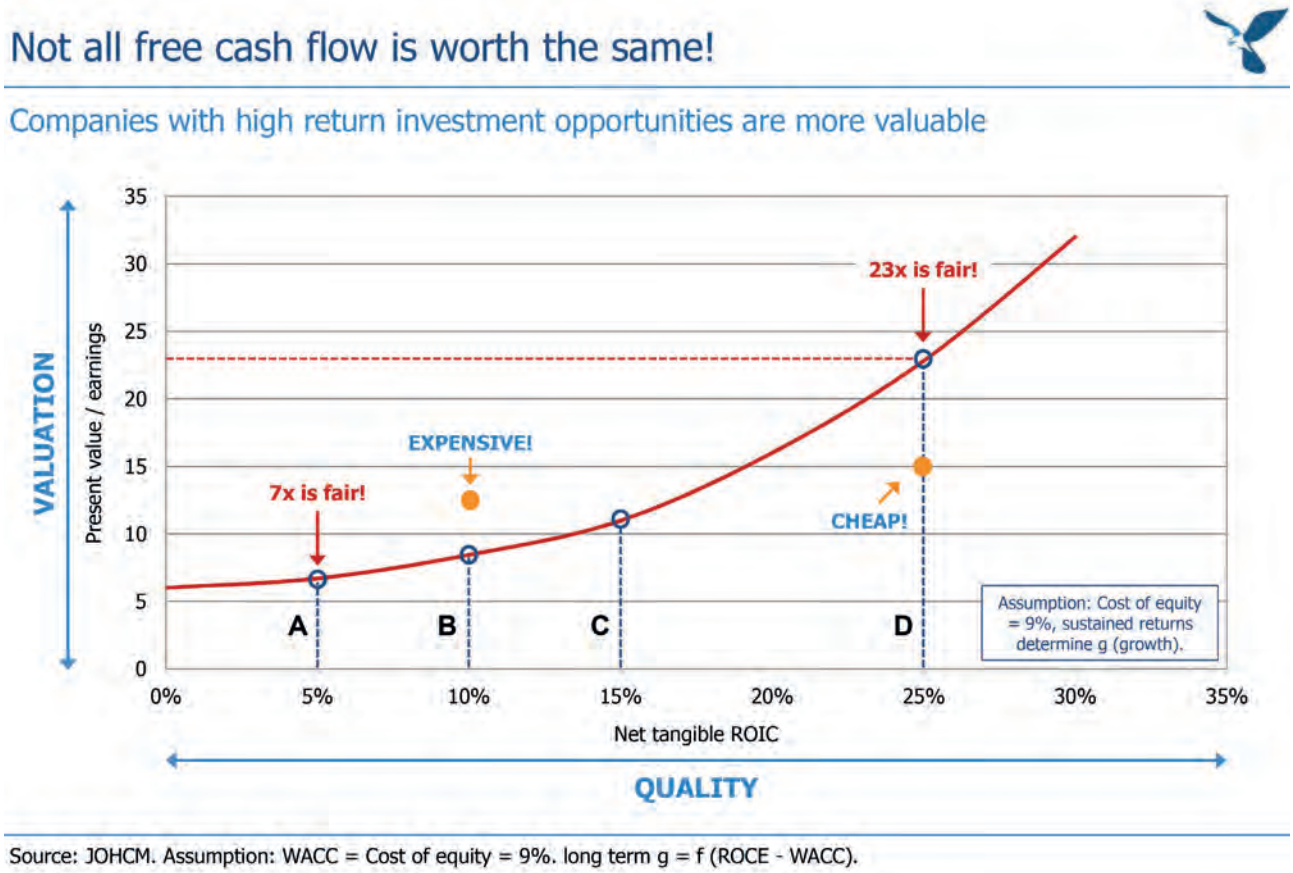
Fañanas took the floor, explaining that he and co-manager Robrecht Wouters look after both strategies. He noted that ESV is soft closed in order to try to protect performance, while ECV, which typically covers large-cap stocks of more than EUR5 billion market cap, is not.

Value? Remember that word?

"As a short background into our style, our approach, I want to comment that people tend to believe that when you are a value investor you only buy companies selling at low multiples," he reported. "But that is not true for us. We focus on and we buy when there is a significant mismatch between price and value, which can mean that sometimes we buy high-multiple stocks. Why? Because we focus on companies with a high degree of predictability as that is where you reduce the risk of being wrong in your research."

He cited the example of Heineken. "We do not know what growth Heineken will register over the next few years, but we do know that if it is not 3%, it is going to 5%, or might be 2%. However, if you buy an autos producer, VW Group, for example, we have to call the cycle and we don't like playing that game."

On the other hand, this does not mean that the funds shun cyclical names. "We own some cyclical stocks," he continued, "but only when there might be a special situation, for example, a restructuring, or where there is a spin-off coming through and their value is not recognised by the market. For example, we own ThyssenKrupp, but this is because



Source: JOHCM. Assumption: WACC = Cost of equity = 9%. long term g = f (ROCE - WACC).

Portfolio structure: top 10 equity holdings

JOHCM European Select Values

	Security Name	Port-folio (%)	Sector	Country	Share Price	Fair Value	Upside %
1	Metro (C)	5.43	Consumer Staples	Germany	13.5	22	63.2
2	Liberty Global (C)	4.86	Telecommunication Services	Britain	28.16	59	109.6
3	Rolls Royce (Q)	4.43	Industrials	Britain	987.4	1,742	76.4
4	Oracle (Q)	4.3	Information Technology	United States	51.56	67	30.6
5	SBM (C)	4.18	Energy	Netherlands	15.59	24	52.7
6	Danone (Q)	4.11	Consumer Staples	France	66.7	90	35.1
7	Thyssen Krupp* (C)	4.05	Materials	Germany	21.74	40	84.3
8	Nokia (C)	3.87	Information Technology	Finland	4.78	7	49.3
9	Vivendi* (C)	3.56	Consumer Discretionary	France	22.17	27	22.2
10	Wolters Kluwer (Q)	3.29	Industrials	Netherlands	53.68	60	12.2

European Select Values Fund **+53.5%**

JOHCM European Concentrated Value

	Security Name	Port-folio (%)	Sector	Country	Share Price	Fair Value	Upside %
1	Rolls Royce (Q)	5.77	Industrials	Britain	983.6	1,742	77.1
2	Liberty Global (C)	5.72	Telecommunication Services	Britain	27.61	59	113.8
3	Oracle (Q)	5.64	Information Technology	United States	51.8	67	30
4	Danone (Q)	5.49	Consumer Staples	France	68.11	90	32.3
5	Nokia (C)	5.16	Information Technology	Finland	4.82	7	48.1
6	Metro (C)	5.11	Consumer Staples	Germany	13.52	22	62.9
7	Wolters Kluwer (Q)	4.89	Industrials	Netherlands	53.86	60	11.8
8	Vivendi* (C)	4.59	Consumer Discretionary	France	22.15	27	22.3
9	JC Decaux (C)	4.51	Consumer Discretionary	France	31.22	48	52.2
10	SAP (Q)	4.44	Information Technology	Germany	106.68	126	18.6

European Concentrated Value Fund **+39.5%**

(C) = Classic Value
(Q) = Quality Value
* = Special Situation

Fundamental undervaluation!

Source: JOHCM/Bloomberg as at 30 September 2018.

of restructuring under a new management, not because of any call we make on their industry cycle."

Predictability and value – tough to find

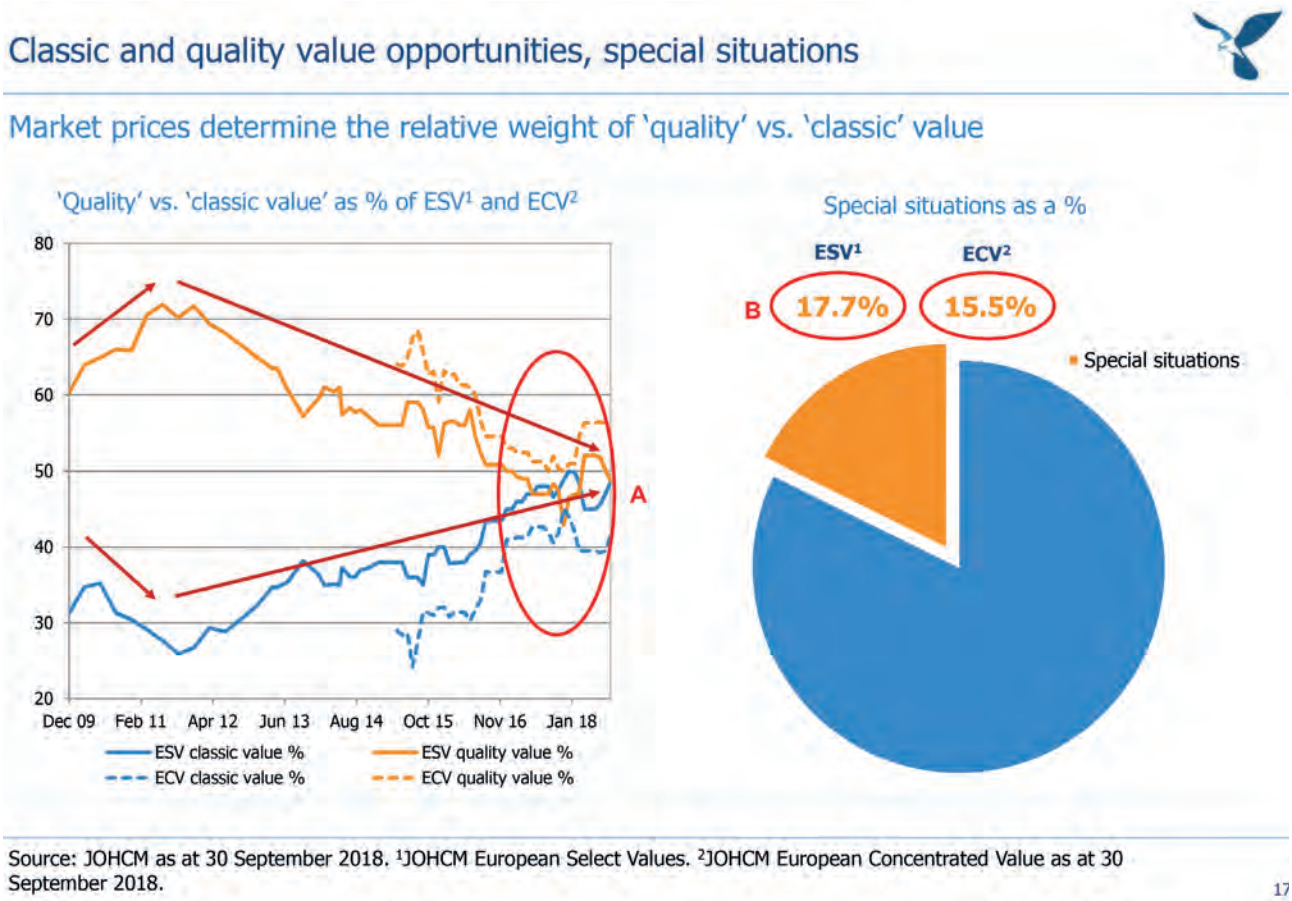
Fañanas referred to a graphic from his presentation which showed what constitutes good value for ESV and ECV. "We believe you must look to the return on capital of the business," he explained. "You have to look how predictable the business is. We invest below the 'red line' I am highlighting, either in the quality area, in the high growth and high return, or in the classic value. We can buy companies at high returns, or companies at lower returns but which are cheap, not only low multiples, not only high return companies. If you have a company that can reinvest at rates of 25% return on invested capital (ROIC) then you can buy at high multiples because the net present value (NPV) is very high."

Fañanas then pointed to Heineken, where cash flow is ex-growth but where the multiples are high. "The key here," he explained, "is that we understand what capex they invest for growth and how much is to maintain the current capacity. Heineken is investing EUR645 million to maintain the current footprint and EUR1.4 billion for growth; this means the EUR2.1 billion of free cash flow is actually EUR3.4 billion, so the multiple is only 13 times rather than the optical 22 times. This is the sort of exercise we make in every single company we select. Heineken is a company making an almost 30% return and selling at around 13x cash flow, therefore it represents value for us."

JOHCM's top 10

Fañanas then referred the guests to the top 10 positions of the two strategies. "We are a two-person team, we only invest in 40 to 45 companies in total, we do all our valuations ourselves. We have a lot of stocks which are very contrarian and that is because we focus on aspects that a lot of people don't focus on. Our main screening starting point is the worst performing stocks."

He explained that there is one key commonality in the top 10 positions - very few of them are exposed to macro factors. "They are companies which normally are very large, very well known, numbers one, two or three in their industries, very stable revenues,



often a subscription business base, high visibility."

He highlighted Rolls-Royce as seemingly a departure from that. "But what we look at here is not the cycle, but that when they sell engines, they sell with a 20 to 25-year service contract. Wärtsilä is a Finnish company that supplies equipment for the shipping industry, ergo it should be super cyclical but about 75% roughly of their operating income and of the cash flow is driven by the services they charge for maintaining the installed based. Their cash flow profile has little sensitivity to the macro dynamics."

ECB's manipulative behaviour

"In Europe," he explained, "as everywhere in recent years, there has been manipulation of interest rates. The visible cash flow has gone looking for yield, for a visible dividend. Accordingly, the quality businesses in Europe have gone through the roof, so we have rather been forced to sell those types of businesses. On the contrary, we have been finding a mismatch of price versus value in the lower quality businesses, that is why today the portfolio is mixed, 50-50." He was quick to note that this does not mean the portfolio is weaker, it is simply different.

He then shifted attention to the differences in approach between ESV and ECV. "We have soft-closed the ESV strategy where we have all sort of cap size stocks. The small caps are much higher risk investments, so we demand higher returns; if they make one bad acquisition that can majorly derail them. But if a big cap does so, it is unlikely to have such a dramatic impact, so we demand lower returns."

The not very active 'active' managers

"We focus on the longer term," he then explained. "We normally buy only two or three stocks each year and we hold over years on average. We are very exhaustive with our deep research; it takes time for us to make a decision. The longer the stock is in the portfolio the better their contribution, the better the result. Some stocks have been in from the inception. We don't sell such stocks because the companies have their own life, things change, things sometimes

improve, sometimes get wrong, but we still bet on them. We are not traders of stocks, although we can adjust positions sometimes."

He gave the example of Wolters Kluwer, a European professional information publisher supplying to lawyers, accountants, the medical fraternity, compliance departments, and doing so for subscription fees largely. "It had been in our top position for a long time, but while it remains in the portfolio it is not now a top stock. Why? Because we deem the upside to no longer be the 30% to 40% we require. If nothing changes, the valuation of our stocks should increase every year by around 9%, but Wolters Kluwer has dropped to below 20% upside, so we are very tough in our decisions. That is why it has been downscaled in importance."

Sidestepping the macro factors

Fañanas noted that there are 25 stocks in the ECV portfolio of large caps. "All of them are global. We incorporate macro in our selections, but we do not make calls on cycles and we have little sensitivity or exposure to the macro dynamics. For example, we don't have German autos, we don't have auto suppliers, we don't have industrials or that type. We avoid the cyclical, especially at current times after a few booming years."

On the other hand, Fañanas explained that they have significant exposure to the US dollar and of course the fund's base currency, the euro. "What we do not like is exposure to emerging market currencies. We do not like exposure to those politics, inflation potential, and their currencies tend to depreciate over time against the dollar and the euro. If we are exposed to any such companies' emerging markets exposure, we apply a higher beta, and we explain to the management of the companies why they should not increase exposure in those countries and even why they should think about exiting those countries. Think about Russia and Turkey for evidence of the risks of weakening currencies."

When quizzed which countries he refers to as emerging markets, Fañanas quickly noted that China is not considered in that category. "We consider the renminbi a strong currency, but my wider point is that we avoid major exposures to emerging market currencies, even ones such as India where the currency has performed okay against the euro.

Portfolio buy/sell decisions and turnover

JOHCM European Select Values Positions turnover

	INs	OUTs
October 2015	Acerinox	Smith & Nephew
November 2015	-	-
December 2015	-	-
January 2016	-	-
February 2016	Royal Dutch (BG Group swap)	Schindler, BG Group (bid/swap)
March 2016	-	-
April 2016	Lab.Farm.ROVI	-
May 2016	Konecranes	-
June 2016	Coats, Vivendi, Bayer	BAT, QSC
July 2016	-	-
August 2016	SFR	-
September 2016	-	Syngenta
October 2016	-	-
November 2016	-	-
December 2016	Mediaset (stub)	Mediaset (stub)
January 2017	-	-
February 2017	Metro AG	Swedish Match, Ageas
March 2017	BORR Drilling	Forbo
April 2017	-	-
May 2017	-	-
June 2017	Solocal	-
July 2017	-	Bekaert
August 2017	-	-
September 2017	-	SFR
October 2017	-	-
November 2017	-	-
December 2017	Aryzta	-
January 2018	-	-
February 2018	-	-
March 2018	Reckitt Benckiser	RELX, Pernod Ricard
April 2018	-	-
May 2018	-	-
June 2018	Oerlikon	-
July 2018	Telenet	-
August 2018	-	-
September 2018	-	Coats

JOHCM European Select Values Value turnover
(12 months rolling)

JOHCM European Concentrated Values Positions turnover

	INs	OUTs
February 2017	Metro AG	Swedish Match
March 2017	-	-
April 2017	-	-
May 2017	-	-
June 2017	-	-
July 2017	-	-
August 2017	-	-
September 2017	-	SFR
October 2017	-	-
November 2017	-	-
December 2017	-	-
January 2018	-	-
February 2018	-	-
March 2018	Reckitt Benckiser	Ceconomy
April 2018	-	-
May 2018	-	-
June 2018	-	-
July 2018	-	-
August 2018	-	-
September 2018	-	-

Source: JOHCM/Bloomberg. Rolling 12 month average turnover, lesser of buys and sells from 31 August 2009 to 30 September 2018. Stocks in red circles sold because of an M&A event.

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We try to simplify things."

Fañanas also noted that Europe has a universe of roughly 3,000-3,500 companies to consider, so finding 25 to 30 companies which are cheap is their mission. "We always try to be fully invested," he reported. "We have been running at less than 6% cash and generally 2% to 5%."

Favoured sectors and those to avoid

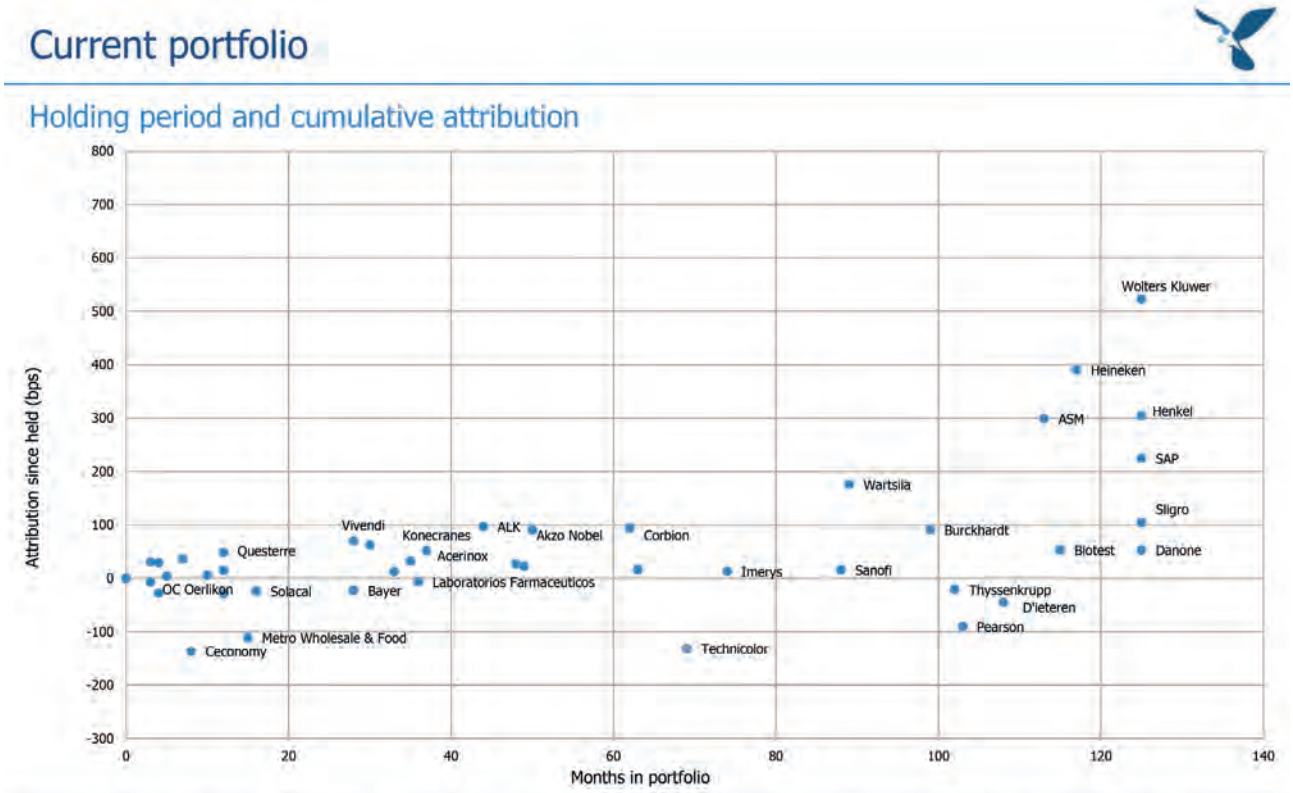
Fañanas also highlighted some of the key sectors the funds invest in, noting that weightings for both strategies are far in excess of the benchmarks for consumer discretionary, consumer staples, IT and materials, whereas there is zero exposure to financials and utilities, while telecommunications and healthcare are also downsized relative to the index.

When asked about Brexit, or the possibility of Italy leaving the euro, Fañanas explained again that macro factors are not a priority, far from it in fact. Nevertheless, he also noted that there is only one small-cap Italian stock in the strategies.

He also noted that Swiss companies are amongst the highest quality available but do not come cheap, so there is also only one Swiss stock in the two strategies. "Givaudan," he explained, "is the largest global supplier of aromatics, of flavours for the food industry, for the cosmetic industry. They provide critical inputs which are very low cost, but very expensive to buy. This is the type of company we love."

Fañanas explained that what worries him more than Brexit, or Italy or other major events and potential turning points, is access to such cheap capital. "We worry more about the manipulation of interest rates in general," he remarked. "German companies that get access to funding at completely ridiculous levels, for example, issuing bonds at 1% and with five times leverage while losing money. That does worry us."

He also pointed to the European Central Bank's reduced bond purchases during October. "Ten-year bond yields are, of course, rising, exacerbated by the reduced central bank purchases," he explained. "Is that going to affect our performance? Yes, the main concern is this ongoing manipulation of interest rates,



Source: JOHCM/Inalytics as at 30 September 2018. This chart displays a scatter chart of current holdings plotting the number of months they have been held within the Portfolio against the attribution returned since the position was opened. The maximum holding period is 125 months, the total time period since 1 September 2008 when Robbie Wouters took over management of the fund.

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Meet the Managers

Robrecht Wouters, Senior Fund Manager for both strategies, has 28 years' industry experience and joined JOHCM in September 2003. Prior to joining JOHCM, Wouters had a career in equity research at leading UK, US and European firms. He holds a Master's Degree in Applied Economics from the University of Leuven in Belgium.

Luis Fañanas, Fund Manager of the two strategies, has more than 23 years' experience. He joined JOHCM in March 2015 from T Rowe Price International, where he was a Senior Buy-Side Analyst and member of the Investment Committee for the Global Small-Mid Cap team, with the main focus on Europe. From April 2004 to July 2012, Luis was a Sell-Side Equity Analyst at Deutsche Bank in Madrid and later London, becoming a Research Director for the European Small Caps in 2010.

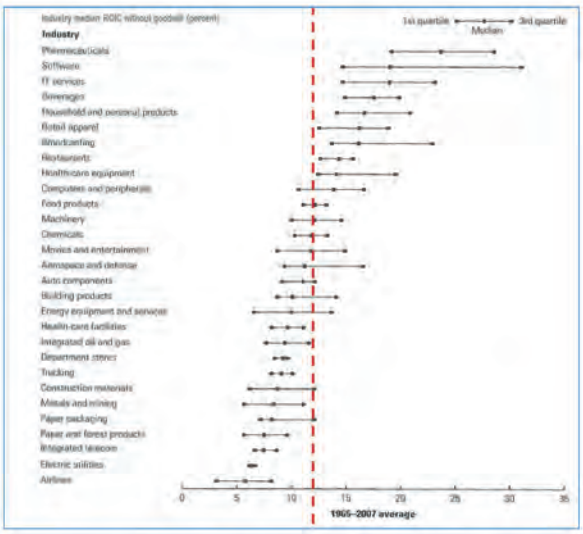
because there is no European economy that could survive with interest rates of 300 basis points above current levels. Perhaps Germany could survive as it has a fiscal surplus and a low level of debt, but Italy, France, UK, Spain, the other major economies, they could not. For those countries, debt to GDP is already around/above 100% and servicing debt is already 2% to 3% of GDP, so if the cost of debt doubles, it is trouble."

Monsters in the banks' cellars

This brought a guest to question the antipathy to banks. "I know the banks well, I used to work for Deutsche Bank, for example, for eight years. My view is that there is no stable outlook for bank cash flows. Secondly, their balance sheets are exposed - for example, they have far too much sovereign debt. However, they have large index weightings, so people invest in them; we nevertheless have zero exposure whereas financials represent 22% of the MSCI Europe index. Of course, they have performed at times. For example, the index went up nearly 100% in

Portfolio structure

Strategy leads to structural sector biases



Overweight

Underweight

European Select Values

	Fund Weight %	Index Weight %	Relative Weight %
Consumer Discretionary	23.35	10.60	12.75
Materials	14.25	8.39	5.86
Information Technology	11.32	5.61	5.71
Telecommunications	0.00	3.18	-3.18
Utilities	0.00	3.57	-3.57
Financials	0.00	19.12	-19.12

European Concentrated Value

	Fund Weight %	Index Weight %	Relative Weight %
Consumer Staples	25.46	13.35	12.10
Information Technology	15.11	5.61	9.51
Consumer Discretionary	16.94	10.60	6.34
Health Care	9.35	13.09	-3.74
Energy	2.82	8.56	-5.73
Financials	0.00	19.12	-19.12

Structural overweight to Consumer Discretionary, Technology & Consumer Staples. Financials, Utilities and Commodities are a cost of capital business.

Source: Compustat. McKinsey Corporate Performance Centre analysis. Portfolio data shown as at 30 September 2018. Benchmark: MSCI Europe NR Index (12pm adjusted). Top and bottom three sector weights.

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2016, but we were not in there. We do not look at short-term plays."

He also noted that technology is limited in Europe in terms of the numbers of companies in the sector. “If you think about technology, Asia and US are the winners, while here in Europe we only really have SAP and ASML.”

Timing is (not) everything

The discussion closed with a guest pressing Fañanas on the outlook for equities. “They have performed long term and they will perform long term in the future,” he said. “We own some small-cap stocks in Europe that we believe will triple. And amongst large caps, we think stocks like ThyssenKrupp has a more than 60% upside. And my final message is to not worry too much about the timing, as whenever we try to time something we are usually very wrong, very wrong indeed. Ignore timing and focus on what you are buying and why." ■

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