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Has a New Valuation Archetype Emerged, or Will 'Normal' Return to the Global Markets?

Hubbis and our co-host GMO, welcomed 16 Asia-based investment specialists from wealth management firms to a discussion on the outlook for the global financial markets. The guests learned of GMO's quest for value and quizzed GMO on their theories. They heard GMO's credo that a surfeit of optimism and momentum had driven mainstream global markets to excess valuations, but that a return to the historical mean is expected to occur within the coming several years. If they do not, investors might face a new investment purgatory.

The key takeaways

A gloomy picture

GMO's James Montier set the scene as one in which high valuations and elevated (and probably excessive) optimism has made it extremely difficult to find value in developed markets, especially the US, and therefore very challenging to build a portfolio.

Negative returns anticipated in S&P 500

Montier reported that on the firm's seven-year outlook a negative return of 4% per annum is expected. That, he said, is truly miserable.

But EM shines

Nevertheless, selected emerging market (EM) value equities can achieve a real return of about 7.5% in the same time frame, Montier stated. Not a once-in-a-lifetime opportunity, but the best available, he argued.

The appeal of alternatives

Montier also highlighted alternatives, advising a sizable allocation - his fund stands at about 30% - because with low cash rates, low fund rates, alternatives look like a way of generating at least some of the returns that investors might be expecting.

Reversion to norms?

Arjun Divecha, Head of Emerging Markets Equity and GMO Board member, told guests that GMO believes valuations will revert to their long-term averages over the next seven years, as well as profit margins. Given that, growth would need to be truly "heroic", he said, to achieve better than their gloomy minus 4% returns.

If things go better...

If there is no reversion to mean valuations and margins, the best that could be hoped for would be plus 3% per annum. Nothing to write home about.

Moving towards a state of limbo?

But if the reversion does not materialise, returns will stagnate at that level maximum for years to come, bringing about a new investment purgatory in which there will be years, possibly decades of low returns.

US market bifurcation

Profitability in the US stock market is not quite as good as it might appear, with about 25% of the market loss-making, making for a divergence between some extraordinary winners and a large group of stocks to be cautious about.

Stick to your guns

Why should a reversion to the mean occur within the foreseeable future, when the recent years has proven the opposite trend, i.e. higher valuations beget higher valuations? The answer is that value investors have been patient - and, many admit, wide of the mark - long enough. The gospel of value and asset allocation requires patience as well as the ability to wear blinkers to the forces of momentum.

Power to the people

Inflation will not return until the balance of power returns to the labour force. Yet ironically with employment at historic highs in the US and many leading economies, the relative bargaining power of labour versus capital is far below historic levels seen for example in the 1970s. Without a surge in wages, deflation is more likely than inflation. Ergo, rates will stay where they are, at best.

The macro thematic approach

Jason Halliwell, who runs a GMO macro fund, has produced impressive returns of 8.8% annualised for the past 17 years, beating the 7.6% registered by the S&P each year in the same time. He takes a long and short-term view. He likes European equities, dislikes European bonds. He thinks Brexit will be resolved without massive blood loss. He believes the US must consume less and China far more and argues that the US needs to somehow fund its tax cuts and that rates must rise. As a result, his fund is currently short US stocks and long the dollar.

Others see selective value in the US

A guest highlighted pockets of opportunity within large-cap US equities, earning high margins, and with very low levels of debt, including names such as Facebook and Alphabet. These companies are characterised by what this guest termed monopsony power, meaning they are the single buyer, in this case of their customers' data. This offers the chance to build a concentrated portfolio, which avoids yesterday's consumer stocks and branded goods companies, whose margins are likely to be under rising pressure.

Resources - uncorrelated to wider equities?

Another guest highlighted their relatively new resources equity strategy in a long-only format as well as a long-short format can have a positive, non-correlated impact on a global equity portfolio, as well as robust inflation protection. Based on data back to 2000, this could have returned 16% per annum.

Cash - returns light, opportunity heavy

Cash offers minimal returns but should be kept as a store of opportunity for reacting to falls in valuations.

China's alphabet soup

The British educational system traditionally advised students against dropping their "H" when speaking the Queen's English. But in the case of China, value investors far prefer A shares and advise investors to drop the H shares. Why? Because H shares are over-valued, while A shares are under-valued, despite a substantial run-up already in 2019, and are enjoying a flow of liquidity due to foreign investment liberalisation.

Playing climate change for gain

GMO highlighted a two-year-old climate change strategy which has thus far garnered USD200 million of AUM. This is not driven by altruism, it is based on the fundamental belief that there is already a universe of companies that are mature enough to be generating good cash flows around clean energy, around energy efficiency, around batteries and storage, and then playing up and down the value of supply chain.

Value and alpha still have a voice

Neither the hosts nor the assembled guests made any attempt to disparage passive and beta strategies, which have, quite dramatically, gained sway in the past 10 years across the globe. The discussion served to highlight a robust argument that the potential for a return to normalcy in valuations might also presage a return to the precepts of value and of the alpha investor.

JAMES MONTIER, A MEMBER OF GMO'S ASSET ALLOCATION TEAM, opened the discussion with his assessment of the big picture for global economies and markets. "I must at the outset today relay how miserable the picture looks from where we stand. It is very challenging to build a portfolio that is likely to generate decent returns, as the opportunities are poor in equities and fixed income."

Paint it black

"Historically when risk assets are expensive then safe haven assets are often a little bit cheaper but not today, as virtually everything is expensive. For US equities as an example, we project a minus 4% real return for the S&P 500, in other words losing 4% every year for the next seven years. That is truly miserable."

"I must add that we do not think the economy is as robust as many might think. In fact, the recovery since the GFC is the most tepid economic recovery in post-war history, yet there is a lot of optimism being priced into the market.

"The one piece of good news is there are occasional pockets of opportunity and the single most attractive area from our perspective is value stocks in the emerging market (EM) universe. There, based on our seven-year forecasts, we think you actually can get a real return of somewhere around about 7.5% a year. That is not a once in a lifetime opportunity, but we think it is the best available currently."

And 'alt' strategies beckon

"Additionally, we see opportunity in a sizable allocation to alternatives. Why? Because with low cash rates, low fund rates, alternatives look like a way of generating at least some of the returns that investors actually might be expecting."

Montier's colleague Arjun Divecha, Head of Emerging Markets Equity and GMO Board member, offered his insights. "Our seven-year forecasts are based on four elements, two related to valuations and the concept that they will revert to their long-term averages over the next seven years, as well as the theory that profit margins will revert to their historical averages. The other two elements are growth and dividends. In brief, the

Hubbis - GMO roundtable in Hong Kong

minus 4% real returns form the S&P 500 we anticipate are predicated on the view we have on the reversion to a mean of valuations and of margins."

The seven-year glitch

"The valuations are at extremely high levels, at the same time as margins at also near historic highs. Growth would need to be truly heroic to change those dynamics."

Montier re-entered the discussion. "We might be wrong about our reversion to mean scenarios, but I can report that without that reversion we would see plus 3% annual returns for the S&P 500. If you see a reversion to the mean, after seven years, you would suddenly get higher returns of plus 6% or more. But if there is no reversion to the mean, then we see a sort of purgatory of low returns, a world in which the best you can hope for is 3%."

Zoom in to see the true picture

"I also want to quickly address profitability in the US. It is certainly good in the aggregate, but when you look at individual stocks, about 25% or more are actually loss making, so we have a bifurcation between some extraordinary winners, and then a large group one should be cautious about."

A guest asked why reversion to mean should take place, when the world has been dislocated from that type of mean for so long.

"Why now?" Montier considered. "One of the challenges of following any value-based approach is that you have to be very patient and a long-term horizon is integral to following the precepts of value because there is nothing in the value-based approach which says cheap actually can't get cheaper and more expensive

ARJUN DIVECHA
GMO

actually can't get more expensive. And to be honest, we have been on the wrong side of both of those in the last few years. With our liking of emerging markets, we have been seeing cheap assets getting cheaper, with our dislike of US equity markets, we have seen expensive assets become even more expensive."

"We must, however, stick to our precepts and look longer-term. We know that underperformance in the short-term hurts, but we think there is evidence to show that bearing that short-term pain is what creates the longer-term returns that investors really crave. However, let's admit that it is a huge behavioural challenge getting people to not focus on the much nearer-term, and instead talk about seven years. If you really want short-term returns then momentum is probably the best strategy to follow, but that is fine until it is not, and there are very few warning signs to flag when momentum is suddenly going to stop."

Take the long route, but knowing the destination

"We are in asset allocation, so we ignore momentum in our outlook. Jeremy Grantham, the founder of

JASON HALLIWELL
GMO

GMO, often says we win by being prepared to lose more than everybody else, and that is very true. It is why we structured our business as a private partnership so that we are not ourselves beholden to shareholders, but to ourselves and our investors."

Arjun interjected, quipping: "In fact, one of the funny lines that Jeremy Grantham likes to cite is that in the long run, we may arrive, but not necessarily with the same passengers!"

Inflation – to be or not to be?

The discussion turned to inflation, with a value-investor guest voicing his concerns of two divergent views in the market, one that inflation will keep falling because we are in a global deflationary scenario, while on the other hand, the opinion is that trade wars and all kinds of other nationalistic strategies will conspire to deliver a higher inflation over the next five to 10 years."Excellent, yes, you have highlighted the real tension in the inflation-deflation debate," Montier replied. "We actually do not have a particularly strong view on inflation. However, we have done some research and concluded that almost all high inflation follows wars, except in the 1970s due to the oil shock, that then caused a wage-price spiral. We consider that the single most important factor in whether inflation gains a foothold in the system is really about the relative bargaining power of labour versus capital. In the 1970s, the relative bargaining power of labour was pretty high, with one in four people a member of a union in the United States, while today it is less than one in 10."

The shoe is on the creators' feet

"We therefore have a situation where actually there is this large shift from high labour power to low labour power and against that backdrop it is hard for inflation to really take hold in the system. Yes, trade wars might result in higher prices, but without a simultaneous wage spiral, that is simply a blip on the inflation radar."

"Our view is that it is unlikely, albeit possible, that in the next decade labour enjoys a resurgence. The Fed appears mystified about the lack of inflation and the kind of lack of wage rises. The lower the unemployment rate, the higher the chances of labour regaining some of its bargaining power, but we see lilt evidence of that right now."

The macro thematic approach

Jason Halliwell, who runs a GMO macro fund, took the microphone. "We are somewhat different in our approach," he explained. We look only at absolute returns, so long-short rather than just long-only. And we use gross leverage, so the path of returns becomes much more important, so we do use short-term sentiment indicators but combined with value indicators."

JAMES MONTIER
GMO

"In the next year or two, we see a sort of dead zone, too long for real short-term sentiment and too short for long-term valuation. But ours is a very systematic approach, with short-term reactions needed, whereas James' deep value type approach is one in which value signals do not change that quickly."

Stellar return, Jason!

A guest quizzed Halliwell on his strategy, which she noted had produced really impressive returns of 8.8% annualised for the past 17 years, beating the 7.6% registered by the S&P each year in the same time. "What is your view on Europe relative to the US, as I notice you are heavily overweight Europe?"

Europe equity preferred, but debt spurned

"We are currently long only the equity market in Europe, but short bonds and the currency. We are long half UK and half other European markets. At a PE of about 14, it is not deafeningly cheap, but it is not too expensive either. Brexit is a danger if no deal is reached, but we think the likelihood of some type of accommodation is reasonably high. Our

long in the UK is the FTSE 100 futures, and as those are priced in sterling and if the pound is hit the big global constituents which earn heavily in dollars will be ok. Even in the worst case, if there is a significant economic dislocation, the ensuing under-investment will later result in high investment opportunities and eventually good returns. Our view is that uncertainty is damaging, and it will be bad in the short term, but in the long term there can be an adjustment, as there has been in history, right from the Great Depression."

China needs to consume more at home

Looking at the trade wars, China has to become much more of a domestic consumption-driven economy in the long term. China has more workers than the entire developed world combined, so as the GDP per capita rises the world is not big enough to absorb the surpluses in China.

"In the shorter term," he continued, "the valuations in the US are very high, and you have the lowest unemployment since the 1960s, so markets are pricing as if everything will keep going well. But America is living beyond its means, you can't solve the current account balance without America consuming less. The tax cuts are unfunded, so eventually, you either have higher tax rates, bad for the market, or you reduce government spending, also bad for the market, or you start printing money, which will cause inflation eventually."

Rates up says the macro guru

"I think therefore on balance, they will need to increase interest rates, James will debate that with me, but that is my view. This means right now we are short US equities exposure and long the US dollar. So, if things turn out well for the US, we'll lose money on the equity side but likely make money on the dollar. It is the other way around in Europe."

A guest took the opportunity to voice her opinion, first remarking that her group is also value-driven and fundamentals-focused.

"We can, therefore, build a very concentrated portfolio out of that opportunity set," she added, "with more quality tech names in it today, less of yesterday's consumer goods names, certainly less personal brands and product names, as those are the companies that are challenged to maintain the margins that they have achieved over the last four or five years. It is a global opportunity set, but we see outstanding opportunities within the US economy, despite the fact that I would agree that in general, the US market is quite expensive."

Resources – uncorrelated to a broad-based portfolio?

Another guest opened the discussion to the effects of inflation on resources. "We are long-only by protocol, but we actually manage our resource equity strategy in a long-only format as well as a

long-short format," he reported. "Resource equities have certain characteristics that are very desirable in terms of the impact that they can have on an overall global equity portfolio, as they tend to be very uncorrelated with global equities in general."

"They also offer robust inflation protection," he added. "In fact, history shows that in major inflationary periods resources have performed a great job of protecting purchasing power. That is normal, as these are real asset companies purchasing power. But there is no free lunch, the buyers need to bear some pretty extreme short-term volatility, but again, history shows that it does not translate into long-term volatility."

Time will tell...

"What we really like about it is we use value within the space in terms of our stock selection. We know this is a deeply-disliked space. Value managers don't play there because they cannot plug commodity prices into their DCFs. Hedge fund managers don't tend to play there because of the great volatility. Over a long period of time, resources have shown themselves to be very inefficient, but value has worked very well as a stock selection tool within that."

He reported on this basis the returns per annum going back to the year 2000 would have been around 16%, and with only about 15% volatility, levered up at about 150 to 160 aside. "This means the outcomes were effectively a doubling of the alpha opportunity, and while we have been running it in real time over the course of the last 10 or so months it has actually beaten that 16% return and the volatility has been right where we expected it would be."

In the game, but with greater protection

A private bank representative joined the discussion, commenting that as they see it valuations are high, but not excessive; hence they want to keep playing the upside, but with more robust downside coverage, meaning the purchase of put protections.

"We are neutral to slightly underweight in equities, we are underweight bonds because we think bonds are expensive and what we do buy there is corporate paper, not sovereign debt. We tend to be defensive, so we focus on soft picks - quality cash flows, dividend enablers. We do not envisage another rate cut this year."

How to play with cash

Another banker said while opportunities are less than obvious, cash will erode in time, and as the economic cycle remains intact, there should be strategies in place to build a portfolio gradually, despite any headwinds from trade wars or other problems.

"Yes," said Montier, "safe haven assets or cash are troublesome due to such low returns. Focusing on the long term is necessary and in concert with valuation. Hence, we own about 42% of our unconstrained funds in equities, but far and away the biggest element of those equities is emerging market value stocks because they stand out as being so compelling. We have about 31% of the portfolio in alternatives, and that really is a reflection of the view that we share there that the cash rates are incredibly low and sitting on cash is not going to do you an awful lot of good. Alternatives we hold are really an attempt to deliver cash plus returns."

Saving for a sunnier day

"That said," he added, "we do have something like 17% in cash which we think of as dry powder, ready for us to buy assets at much more attractive levels of returns. To conclude, I have a lot of sympathy that cash is going to be a drag on the portfolio but I think you still want to own a reasonably large amount of it, or substitutes for it, at least because the long-only opportunity set is really quite challenging."

Building an alternatives portfolio

A guest questioned whether there was a danger in such a large slice of alternatives. "Alts tend towards a higher correlation in down markets, so how do you build your alternatives strategy?"

"You raise a very good point," said Montier. "The way we think about alternatives is to say that there are alternative ways of owning standard risk. There are two and a half core risks, depression which will crash cashflows and inflation, which will seriously damage fixed income. And the half a risk is liquidity. What does this mean to us? We think of alternatives as loading on those risks, and we take a wide view of these strategies, so some, for example, are alternative ways of owning equity-like risk, such as arbitrage, and put selling. We found for example, that the payoffs to put selling are remarkably uncorrelated with starting valuations in a way that equity returns are not. Another alternative is merger arbitrage, playing the risk of a merger falling apart, which has a duration of somewhere between 6 and 12 months; it is an equity-like risk, but of much shorter-term duration."

Shadowing alpha

"And at the other end of the alternatives spectrum, we have I think things that are much closer to the alpha players. So, the largest position we currently hold within the alternatives basket is the systematic global macro represented by Jason in the room here; we think that is a pretty uncorrelated source of alpha, and he has an incredibly impressive track record delivering returns with a very low correlation."

"Additionally, we currently have a number of relative value bets that are driven by the asset allocation views. So, we are long quality versus the S&P, we are long small value versus the S&P, unsurprisingly we tend to like international markets versus the S&P. All those are spread trades that we think of as carrying risk for sure because there is a path dependency as Jason mentioned in the context of SGM and its use of leverage, here there is path dependency as well which is uncomfortable for a value investor but which is, we think, a viable way of generating returns."

"There is more and more hacking of phones and the bank cannot necessarily completely reassure itself that such and such a call to or from a certain number is bona fide."

China – always a go-to discussion

The discussion turned to China, with Divecha answering on behalf of GMO. "We see the A and H share markets differently," he commented. "We think the H-shares are really expensive, especially some of the internet names like Tencent and Alibaba and others, even though we like these companies from a long-term point of view as businesses. But we like the A-share market and we are overweight there, although they have done well in 2019 so they're not quite as appealing."

"I also want to give my views on EM generally. We believe that you make more money in EM when things go from truly awful to merely bad than when they go from good to great. This means we tend to favour countries like Turkey, Russia and Taiwan, right now, and those three tend to be the biggest bets in our portfolio at this point. Turkey, Russia and Taiwan are trading at valuation discounts to broad EM, and the macro environments are either stable or improving."

Playing climate change for gain

The spotlight then shone on a GMO climate change strategy introduced two years ago. "This is not a do-good product which is designed to save planet earth," said Kim Mayer, "it is a product that is designed to make money because the earth is changing."

"Our founder Jeremy Grantham," Mayer continued, "has put a vast amount of his family fortune into the entirely altruistic and philanthropic Grantham Foundation for the Protection of the Environment. But he also urged us to devise a commercial strategy in this area. So we did, as we saw an important inflexion point in terms of the economies of renewable energy production versus the fossil fuel alternative, and the fact that you can build a broad universe of companies that already are mature enough to be generating good cash flows around clean energy, around energy efficiency, around batteries and storage, and then playing up and down the value of supply chain.

Mayer explained the strategy owns copper, lithium producers, the tech companies that are controlling the drive train of electric vehicles, but not further up the chain to the actual electric vehicle makers.

Solid, but perhaps not electrifying progress

"We think more and more investors are starting to come to grips with the idea of protecting their portfolios against climate change risk, so our idea is resonating with more and more people, resulting in huge interest. However, people are also still getting to grips with how they view this. Is it an ESG portfolio? Is it something else? As we address these questions, we are now seeing some good fund flows from early adopters such as endowments and foundations, as well as some family offices, especially driven by the younger generations. In short, it has been a little slow to take off, but we are moving in the right direction, through two different vehicles that invest in the strategy today, a UCITs vehicle and an institutional mutual fund that between them register USD200 million in AUM primarily in the US and Europe at this point and some early adoption out of Asia as well."

Anyone still out there? In financials?

A guest quizzed the room about the financial sector. Mayer reported that they like identifiable quality with low leverage, and in the US can today only find Bancorp, Wells Fargo and American Express. "What do those three have in common?" he pondered, rhetorically. "They have very sound underwriting practices and much better books of credit than their peers. They are trading at really cheap levels relative to their tangible book."

Divecha chipped in, adding that in the EM arena there are traditional banks and financial institutions that are very high-quality banks, as well as being well-run and conservative. "We tend to like financials because they tend to be cheap most of the time in the EM arena," he reported. "Accordingly, we are frequently overweight financials, but obviously, the risk is when you get some kind of a global financial crisis those are the ones which tend to take it on the chin first."

Passive and alpha state their claims

The discussion closed with the impression that value investing, asset allocation and alpha had made considerable progress in fighting back against the world of passive. Will passive and smart beta continue to win over investors in a world that is far less uni-directional than in the past decade during QE? Perhaps less so, despite the continuing momentum towards passive. But, for sure, the value and alpha hunters still hold on to their world view and are firmly of the belief that they will soon be proved right. ■

GMO's Four Decades of Value-Seeking Success

GMO describes itself as a partner in investing. The firm reports its investment teams are "grounded in a long-term, valuation-based investment philosophy", an approach GMO believes provides the best risk-adjusted returns.

The firm's literature explains that GMO has for more than 40 years partnered with a broad range of sophisticated institutions, financial intermediaries, and families to provide the investment expertise they need to meet their goals and fulfil their missions.

"Investing on behalf of our clients is GMO's sole focus," the company reports. "Across asset classes and around the world, our investment teams identify and exploit long-term opportunities and develop solutions that both anticipate and respond to client needs. GMO clients benefit from our diverse expertise, intellectual curiosity, and open culture of debate, as well as from our ability and willingness to take advantage of contrarian market opportunities. Clients also receive access to all of our industry-leading, insightful investment research and commentary."

GMO explains that the realisation of its value-based approach if effected through a collection of investment teams with focused specialities. GMO also highlights its commitment to ESG investing, reporting that ESG factors can have a meaningful impact on the long-term success of companies and countries. "Our investment teams incorporate them where we believe doing so will improve investment results."

The company is present in Boston, San Francisco, London, Amsterdam, Singapore and Sydney. Several key GMO executives were at the discussion GMO co-hosted with Hubbis. Their experts were:

James Montier, a member of GMO's Asset Allocation team. Prior to joining GMO in 2009, he was co-head of Global Strategy at Societe Generale. Montier is the author of several books including Behavioural Investing: A Practitioner's Guide to Applying Behavioural Finance; Value Investing: Tools and Techniques for Intelligent Investment; and The Little Book of Behavioural Investing. He is a visiting fellow at the University of Durham and a fellow of the Royal Society of Arts. He holds a BA in Economics from Portsmouth University and an MSc in Economics from Warwick University;

Jason Halliwell, the head of GMO's Systematic Global Macro team. He joined GMO Australia in September 1999 from Westpac Investment Management where he spent three years in research and development of quantitative tactical asset allocation methods. Halliwell has an honours degree in Commerce/Law from Queensland University and has completed postgraduate studies in Financial Mathematics at the University of Technology in Sydney. He is a CFA charter holder;

Arjun Divecha, the head of GMO's Emerging Markets Equity team and GMO Board member. Divecha continues to lead the team today and is widely considered among the pioneers of fundamentally based, quantitative portfolio management for institutional investors in the asset class;

Kim Mayer, oversees investor relations and is a research analyst within GMO's Focused Equity team. Previously at GMO, he was a member of the Global Equity team focusing on the Quality Strategy. Prior to joining GMO in 2006, he managed the U.S. fixed income syndicate desk at Morgan Stanley. Mr. Mayer earned his B.A. in History from Princeton University.