Three reasons why there's still value in Quality stocks

By Clyde Roussow, Co-Head of Quality, Investec Asset Management

We have experienced a modest cyclical rebound in a world of sluggish growth.

Opec's agreement to cut output for the first time since 2008, and Donald Trump's US election victory with the anticipation of fiscal stimulus have triggered a normalisation in inflation expectations, with rising rates and steepening yield curves in the US.

In turn, this also gave rise to a shift in global equity markets which resulted in rotation away from defensive yielding sectors like utilities, telecoms, healthcare and consumer staples in favour of lower quality 'cheap', leveraged, capital-intensive and more cyclical sectors, notably banks, materials, energy and consumer discretionary.

'Quality' performed as expected in this 'risk-on' environment, and has recovered so far this year as these companies have yet again shown their resilience, and as the reflation trade has begun to falter.

'Quality' companies, in terms of our analysis, are those which are cash-generative, able to sustain high returns on invested capital, and have typically low sensitivity to the economic and market cycle.

While macro-economic and thematic opportunities and threats are carefully considered, this is done at the individual company level in our assessment of the long-term strength of a company's business model and the sustainability of its competitive advantage.

In the context of today's macro-economic backdrop, the question for investors is how sustainable is the risk-on trade, and are quality companies still well-placed to provide long-term outperformance?

Below we give three reasons for our view that the relevance of Quality companies remains firmly intact for investors.

First, we address the consensus views for the coming year which point to stronger growth and reflation which has led to higher rate expectations and steepening yield curves.

Our view is that we are experiencing a modest cyclical rebound within a secular world of sluggish growth.

Looking to the US, we believe timely tax reform and infrastructure spending may be difficult to achieve, particularly on the back of the recent failure to repeal Obamacare, and that uncertainty still exists in the face of anti-globalisation and anti-free trade sentiment.

CLYDE ROUSSOW
Investec Asset Management

It remains to be seen how the US government intends to fund their fiscal packages from an already highly leveraged position, and it is worth contemplating whether any rise in borrowing costs will hinder growth before fiscal stimulus arrives, if it in fact arrives.

From a global perspective, a major complication in the argument for reflation is that it relies on the rebound of the US and Chinese economies.

We think the sustainability of the growth currently being delivered by two of the largest drivers of the world engine is questionable.

In the US, the only real growth has come from consumption fuelled by a strong job market.

In China, growth appears to have been boosted by a significant increase in debt.

Higher interest rates do not support either driver.

Other macroeconomic issues which may weigh on markets over the course of 2017 include political uncertainty in Europe, European bank stability, and commodity price volatility.

Secondly, we do not believe the current market environment has significantly changed the fundamentals of the stocks in our portfolios, the majority of which continue to perform well and have beaten expectations in their latest results.

The market rotation resulted in Quality companies de-rating, meaning that the perceived view in 2016 that 'quality' was expensive has become even less of an issue now.

Our stocks are cheaper now as well as more robust in terms of quality metrics than six months ago, in both absolute and relative terms.

We continue to believe long-term structural growth is more important than macroeconomic-driven short-term cyclical growth.

Therefore, we will continue to focus on those individual companies that we believe are still able to generate cash and reinvest that cash for growth at high returns.

sumer staples and health care sectors despite lower exposure to any short-term cyclical recovery (and have been selectively adding to positions on short-term weakness here), we are also finding attractive opportunities in other areas of the market, in particular technology and financials (excluding banks).

Because of this, and the underlying diversification of the individual companies we hold, our relatively concentrated portfolio maintains a range of exposures and is well positioned for uncertain markets.

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Finally, it could be argued that on a relative basis the biggest risk for quality is a sustained cyclical market rally because, whilst this should benefit equities in general, cheaper, more cyclical and economically sensitive lower quality stocks would likely benefit more.

We look to diversification to reduce reliance on any one market trend or sector, however.

For example, we not only continue to find attractive opportunities in the con-

Against the current macroeconomic backdrop we believe that the global economic recovery remains uncertain, and, under these circumstances, we believe that the relevance of Quality companies remains decisively in place for investors.

Fundamentally, we believe nothing has changed in terms of how quality companies could provide long-term outperformance, and we have used the recent volatility to increase our stock positions where we have high conviction. ■