When growth is hard to come by, as it has been in the past five years, investors generally flock to the safety of companies with predictable earnings. This behaviour often leads to a multitude of other companies being heavily undervalued.

If the economy continues to improve, as we expect, cyclical areas of the market should do well. In addition, investors are likely to begin demanding more upside potential from stocks, which should be a favourable environment for fund managers who can unlock value.

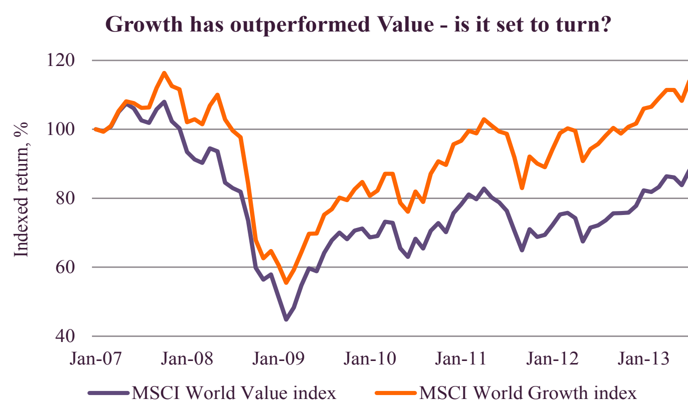
Economic View

C. Hoare & Co.
PRIVATE BANKERS SINCE 1672

Time to find value in the market

The economic environment over the last five years has been extremely challenging for companies as well as equity investors. Fear and uncertainty made companies understandably cautious, with their managers keeping a tight lid on capital expenditure and strengthening balance sheets in the process. Such prudent business strategies resulted in generally modest earnings growth.

Investors also demonstrated their risk aversion by favouring companies with more predictable earnings. As shown in the following chart, growth stocks have outperformed value stocks since 2007. If, however, the economy continues to improve, we believe investors will gain in confidence, paving the way for the cheaper, more cyclical areas of the market to recover.



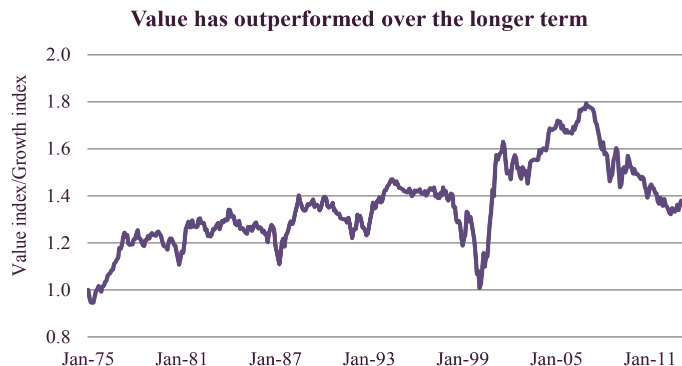
Source: Bloomberg, as at 31st July 2013

A cyclical rotation

Looking at how our portfolios are currently positioned, we have above-average exposure to cyclical stocks, such as those in the consumer discretionary and financial sectors, as well as small and medium size companies in general. Moreover, we believe the funds that are best suited to take advantage of the improving landscape will be those run by active managers, who will be able to spot opportunities in a rapidly changing environment.

Fund management firms have a variety of labels to describe such a style, such as recovery, special situations, turnarounds or simply undervalued assets. What they all have in common is that the fund manager looks to identify stocks that are lowly priced on profit or balance sheet measures and, crucially, have a catalyst for this value to be realised. In other words, they look for what will make the market recognise the cheapness of the stock.

As can be seen in the following chart, the value investment style has outperformed growth investing over the long term, even with the recent underperformance mentioned earlier.

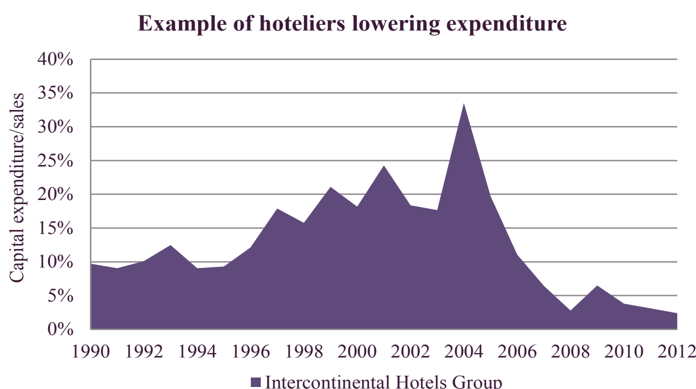


Source: Bloomberg, as at 31st July 2013

Value opportunities

For a company to be a good value opportunity, it often needs to have gone through a bad patch. Consider for example a company's management that takes a successful business model and, through overconfidence, invests too heavily. As a result, the return on capital falls, eventually to below the cost of capital, and shareholders demand change to remedy the situation. This creates a potentially great opportunity for value investors, as it often leads to a newer, more profitable business model.

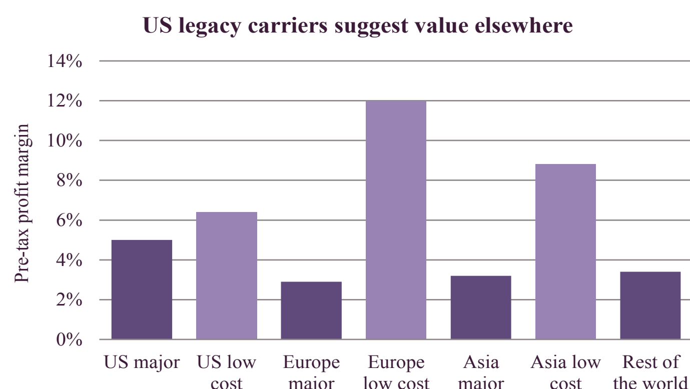
This occurred in the hotel industry, which over the last decade has seen a move away from owning hotels to a focus on hotel management and franchising, with the property owned by others. It allowed a large return of capital to shareholders, and left the companies highly profitable.



Source: Bloomberg, as at 31st July 2013

We may see a similar approach adopted by the cruise ship industry, where management wisdom has been that demand will continue to grow, justifying an ever greater number of ships with each addition to the fleet delivering lower profitability levels. A more intensive framework for justifying capital expenditure could improve cashflow markedly. That could be a catalyst for a rise in the share price.

We could also point to the airline industry, where companies have been famously volatile and spendthrift with shareholder capital. However, the bankruptcy process that the traditional US network carriers have been through in recent years has allowed them to reduce legacy costs, improve their fleet costs with older, cheaper aircraft, and introduce that bugbear of travellers, ancillary charges for items like luggage. As a result, their profitability is now close to that of low cost carriers.

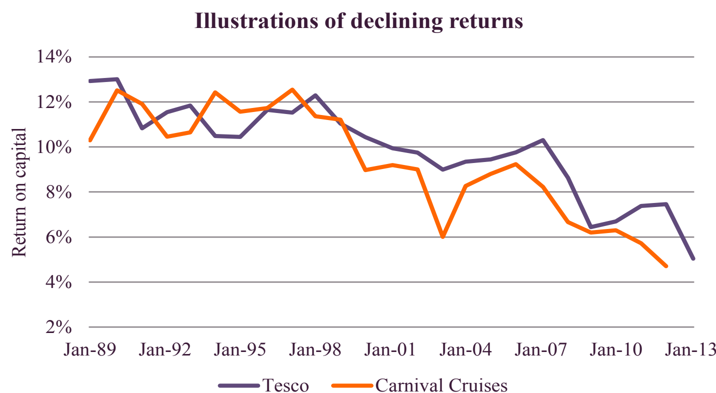


Source: Deutsche Bank, as at 31st July 2013

Legacy carriers in Europe may be able to copy some of these approaches, but the low cost carriers still have growth opportunities, for example in Italy.

Change is also evident in the retail food industry, where some companies have overinvested, for instance building hypermarkets to ramp up sales of electricals and other non-food goods. However, with internet purchasing more prevalent, the expansion of new space is now set to slow.

In addition, various food retailers have tried to expand overseas with generally modest success. The buying synergies have not been realised, and with best practice in terms of logistics and customer data now well known, local management have tended to trump recently arrived expatriates. As a result, retail food companies are adopting a more intensive return on capital framework, which we believe is a value opportunity.



Source: Bloomberg, as at 31st July 2013

Beware of value traps

Investors looking for value need to watch out for traps. Infrastructure gives us good examples, such as the La Cuidad Real airport in the middle of the Spanish countryside. Opened in 2009, it cost €1.1 billion to build, and is now for sale for a snippet at just €600 million. On face value, it looks a bargain, but is an airport in the middle of nowhere with no scheduled flights or even private planes using it cheap at even that price?

Another example would be a computer or mobile phone manufacturer with falling sales and a valuation lower than previous years. The trap here is that obsolescence is more likely than recovery. Value investing solely on the basis of sharp recent share price falls is not always wise.

Identifying the catalyst for change

The final element of value investing is deciding whether the catalyst for change within a company is actually imminent. We are confident in consumer sectors, and some of the examples cited. Our view is that as economic recovery becomes more established on both sides of the Atlantic, investors will be more comfortable with risk and require more upside potential from their investments.

For some companies, the operational gearing they can generate in a recovery will see them perform well, but for others, where progress has made parts of the business model obsolete, growth will be harder to achieve. In some cases, shareholders will demand a strategy to improve returns, and value investing will be a component of market gains in the years ahead. As mentioned, this will play to the strengths of active, value style fund managers. We continue to adjust portfolios to ensure suitable exposure to these themes.

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Image credit: http://www.123rf.com/image id 7059069/A close-up of a key moving towards the key hole /jgroup

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