Talking Point
Healthly value

QEP Investment Team

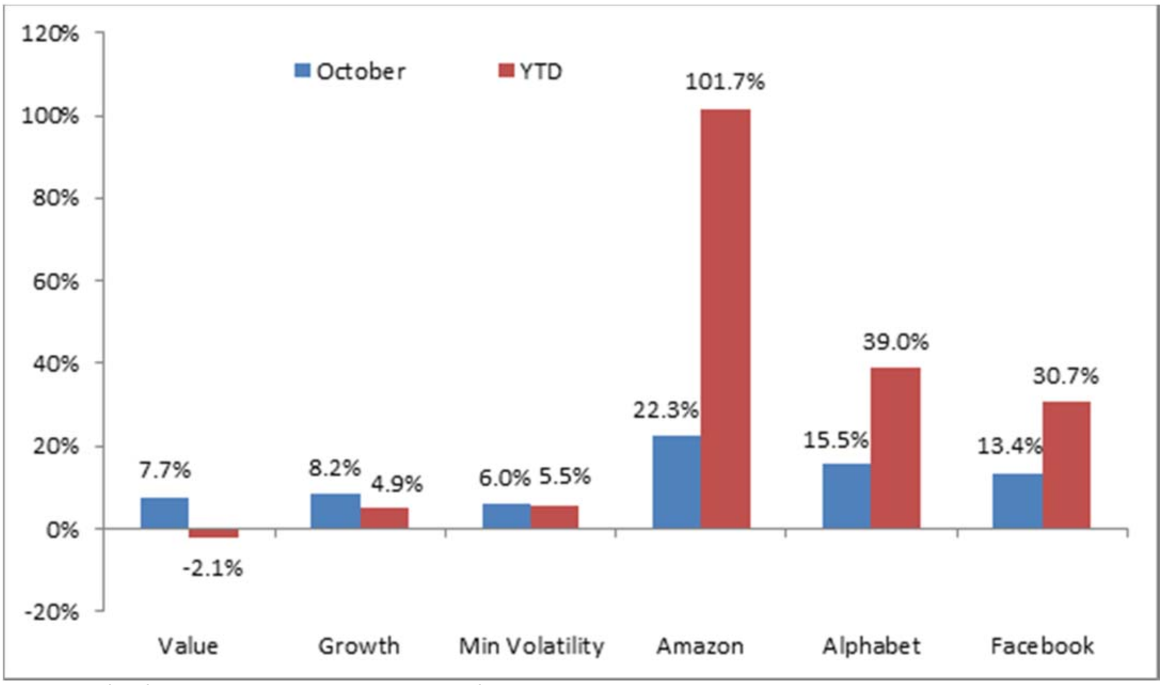
Global equities rallied strongly in October, rising 7.9%, recouping some of Q3's losses. The market recovery has enabled global equities to creep back into positive territory for 2015 with the MSCI World Index now up 1.4%. Emerging Markets also rallied by 7.1% but they remain well adrift year to date, down 9.4%. Resource stocks led the rally in October with both energy and materials rising by over 11%, but like Emerging Markets their returns are significantly negative year to date (-13.6% and -9.8% respectively).

Against this backdrop, the main themes we are currently thinking about are:

1. What is the outlook for Value stocks?
2. The healthcare sector continues to exhibit extreme behaviour.

What is the outlook for Value stocks?

Value stocks showed some signs of life in the first half of October and for a while we were quite excited that the one-directional Growth / Momentum market we have witnessed over the last five years might be turning. However, in the second half of the month mega cap, high multiple Growth stocks, for example Amazon, Alphabet (former Google) and Facebook, all started to rise strongly. By the end of the month the Value/Growth race had closed up and as measured by the MSCI indices Growth had slightly outperformed Value, helped by these mega cap, high multiple stocks.



Source: Schroders, FactSet, MSCI. As at 31 October 2015.

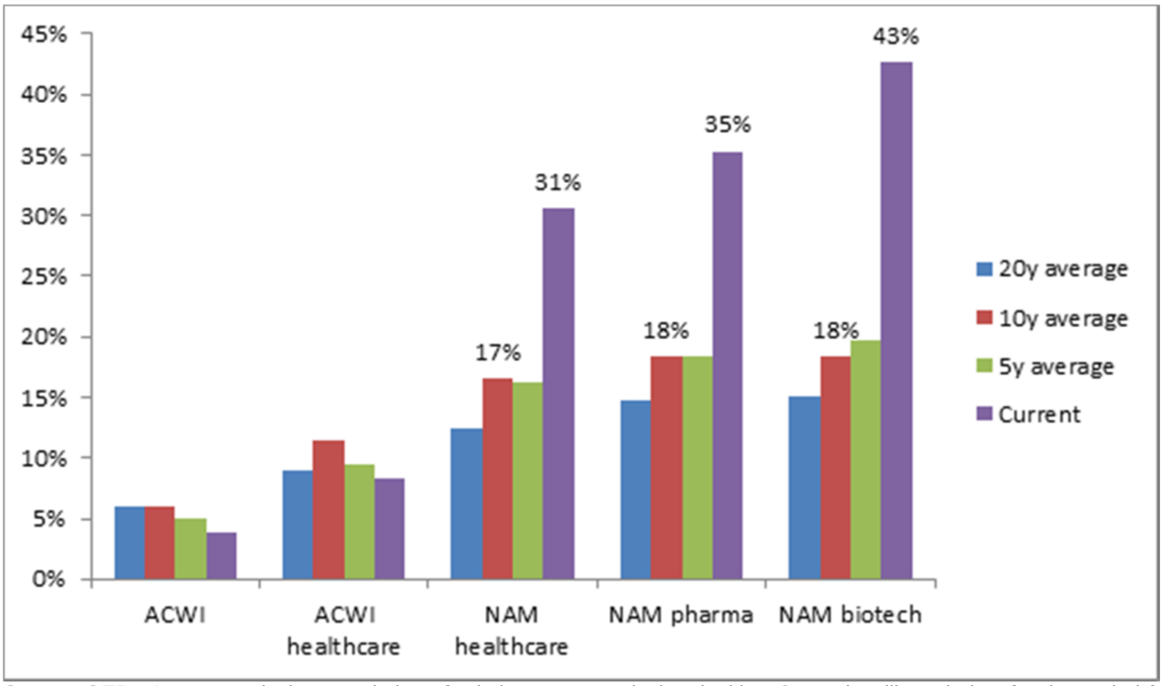
While timing movements between style characteristics is tricky, we offer three current thoughts on the relative outlook for Value stocks;

1. Investing in Value is not just a risky trade on resources and Emerging Markets. We believe investors can now build a varied portfolio of Value stocks which includes significant exposure to high quality stocks in out-of-favour areas such as industrials, technology, financials and telecoms.
2. Another interesting theme is that the group of anointed Growth winners is getting smaller; the more speculative Growth stocks did not join in the October rally and were actually quite weak. Our long-short strategies such as Global Value Plus have benefited from shorting these weaker, over-priced business models. After years of it being relatively 'easy' to be a Growth investor today it is becoming increasingly hazardous, while Value, as noted above, now offers a broader pallet of opportunities. However, in the short term a concentrated 'Nifty-Fifty-like' market of this diminishing group of winners remains likely.
3. Interestingly some of our clients who are able to take a longer-term, more forward-looking view have been asking us about allocating more to Value. The thinking is that, while they may not get the timing exactly right, they are now getting well-compensated to invest in Value stocks.

The healthcare sector continues to exhibit extreme behaviour

We discussed biotechnology stocks last month and continue to be intrigued by the ongoing unusual behaviour of the whole healthcare sector in North America. This seems to be a region-specific phenomenon which would support the view that short-term investors are driving returns, the result being that the sector jumps up and down in a manner unrelated to the broader market. Sometimes sector performance is driven by the returns on just one stock, namely Valeant which fell 47.5% in October. The chart below shows that on average over the last ten years North American healthcare stocks have had a correlation with each other of around 17-18%. This correlation has nearly doubled recently to over 31% for the sector as a whole, and to 35% for pharma and 43% for biotech.

Average pairwise relative return correlation 1995 – 2015



Source: QEP. Average pairwise correlation of relative returns calculated with a 3-month rolling window for the period from 01 January 1995 to 16 October 2015. ACWI refers to MSCI All Country World indices; NAM refers to North America. Stock universe consists of index constituents for the ACWI and ACWI healthcare indices, and mega to mid size stocks for the NAM healthcare, pharma and biotech industries.

Taking advantage of volatility

Market volatility continues to create opportunities, particularly for our approach which combines fundamentally-based stock selection criteria (Value and Quality) with daily evaluation of opportunities to rebalance portfolios. As noted above, the healthcare sector is one such area which has been through a period of extreme optimism and is now seeing the impact of being a crowded area where high correlations pull down some stocks more than fundamentals justify. We have taken advantage of this and topped up some of our favoured positions in temporarily ‘cold’ stocks which we estimate are likely to mean revert. Conversely, consumer staples were somewhat 'hot' and we have trimmed positions here.

Within financials we continue to trim insurance and top up banks; US banks look particularly out-of-favour after the non-rate rise and this represents a very good buying opportunity. Elsewhere, bank valuations in Europe and the UK are now very depressed - typically well below tangible book value - and it looks like you are getting paid to take positions here. We continue to think that established technology and telecoms stocks represent another area of value opportunity, but as yet this position has yet to pay off. Regionally, Japan offers plenty of value lower down the market cap scale and we have selectively increased exposure across a broad range of sectors.