Discovery Global Value Equity Feeder Fund

Market background

The MSCI All Countries World Index (ACWI) Index declined by 1.1% in Q3. Though the broad equity benchmark was little changed overall, it was a volatile quarter in global markets.

On the positive side, data releases showed that several major economies – including the eurozone and the UK – had bounced back from their pandemic slowdowns more quickly than expected. In addition, corporate earnings were notably strong, as were some economic data releases, while hopes for continued stimulus in the US and China provided further fillips for markets at times during the quarter.

However, these tailwinds were counterbalanced by concern over the spread of the Delta variant of the coronavirus; worries about the impact on businesses of supply-chain bottlenecks, labour shortages, and sharply rising energy and raw-materials prices; inflation concerns more broadly; and indications that economic growth may be slowing, particularly in China. Beijing's moves to intervene in certain sectors, including education and technology, also rattled market confidence, as did news that a leading Chinese property company was at risk of collapsing under its debt burden. At the same time, uncertainty persisted over the timing of withdrawal of central-bank stimulus and future interest-rate hikes, with markets periodically buffeted as investors reacted to inconclusive signals from policymakers.

Having lagged in July and August due to the Delta variant and other cyclical concerns, value equities came back strongly in September on renewed optimism over the re-opening of economies, a return to normality in travel & leisure, and an outlook for higher interest rates.

Performance review

For the quarter, the Fund delivered a positive absolute return and underperformed the benchmark. As noted above, value equities lagged in July and August, but came back strongly in September.

To a certain extent, what happened in the past quarter was the mirror image of Q2. Back in April and May, value stocks, sectors and themes performed strongly on encouraging economic data, expectations of a pick-up in inflation and interest rates, and potential indications of the start of a period of sustained 'value' outperformance – only for concerns over the Delta variant and other cyclical worries to undo all of the outperformance of the previous two months. Those worries persisted for the first two months of the past quarter, only for another reversal towards the end of the period, leading to a very strong performance of value in September.

At the stock level, among the main detractors from relative returns in the quarter were several companies linked to the auto sector, which has been hampered by the global semiconductor chip shortage, with several major carmakers forced to curtail production in the quarter. Shares in TI Fluid Systems (which makes automotive fluid storage, carrying and delivery systems) and Continental (various auto parts, including tyres) suffered as a result. We expect the headwind from the chip shortage to fade in time.

The contributors to relative returns represented a diverse range of themes in the portfolio. There were significant contributions from two travel-related companies, aircraft engine maker Rolls-Royce and aircraft leasing company AerCap. Beyond the broader macro factors, Rolls-Royce's shares gained strongly in the period for several reasons, including striking a deal to sell a Spanish subsidiary in a move that will strengthen its balance sheet, winning a contract to upgrade the engines on US bombers, and the potential for small nuclear reactors which it builds to get the go-ahead in the UK. IT and outsourcing company Capita also contributed, with the market welcoming progress in its plan to strengthen its balance sheet and streamline its business via asset sales, which included the disposal of Capita's stake in Axelos in the quarter. UK bank NatWest was another contributor, after it reported a better-than-expected Q2 profits, its earnings boosted by the strong UK recovery and lower loan defaults than forecasted, as well as the more positive environment generally for banks given the rise in bond yields and interest-rate expectations. NatWest also announced plans to return cash to shareholders via dividends and share buybacks.

Portfolio activity

Significant purchases over the period included Facebook. This is a growing company, with a huge user base and sustainable competitive advantages, earning high returns on invested capital. Facebook is an owner-operated business, with the founder still running the company and with a very large stake in it. Facebook's user base is growing, as are ad prices and ads per user. These trends are persisting and it's not unreasonable to expect them to continue for the foreseeable future. However, regulation is a risk and has been a looming issue for some years, which goes partway to explaining Facebook's earnings multiple contraction over recent years, alongside the Cambridge Analytica scandal which surfaced in 2016. The margin of safety on this investment comes not only from valuation but also from the characteristics of the business and an aligned management team.

Significant sales included Brazilian electronic payment solutions provider Cielo. In 2010, the Central Bank of Brazil set out to de-regulate the payments industry, initially slowly, and then, starting in 2015, very aggressively. It essentially made it possible for any company, regardless of whether it held a banking license or not, to enter the payments industry. Our original thesis was that the worst that could happen was that competition would reduce the company's transaction processing margins to more or less what they were in mature economies, and that those margins would represent a viable earnings floor upon which to rely. But it has turned out that pricing pressures are so high that, despite operating in a fast-growing industry, this is a low-growth company with the potential for this erosion of earnings power to continue.

Outlook and strategy

As noted above, financial stocks were some of our strongest performers over the past one and three months, which unsurprisingly coincided with a rise in bond yields and interest-rate expectations in the UK, the US and elsewhere. What's interesting, though, is that despite recent outperformance (banks are Europe's top-performing sector year to date), the sector still trades very cheaply. European banks trade at a significant discount to the wider market on both a price-earnings (P/E) and price-to-book basis, with such a discount also markedly wider than the historic average. Indeed, banks are Europe's third-cheapest sector based on forward P/E ratios, after autos (an area of current interest for us) and miners and have yet to catch up with their relative earnings momentum. With the combination of higher shareholder returns, lower restructuring and legacy costs, and potentially a more beneficial interest-rate environment, there could still be plenty of money on the table for our financial stocks.

Speaking of the UK, that market remains extremely cheap relative to European, US and global indices, with the UK's P/E discount to European and global stocks at its widest for 16 years, and a growing dividend-yield gap to Europe and the US. This adds to our conviction in our UK overweight position.

Any update from us wouldn't be complete without some sort of value vs. growth comparison, and again it's not just us beating the value drum here. Research Affiliates put out a report last month entitled 'Did I miss the Value turn?' (to which we think the answer is a resounding 'no'), in which the authors conclude that value discounts (to the market, to growth etc.) have almost never been cheaper, that value stocks are the only asset class that remains cheap on an absolute level (able to deliver acceptable real returns) and that "we may never again see a better opportunity to buy value stocks". They also point out that all of value's recent underperformance has been driven by de-rating (i.e., the 'value of value'). Similarly, AQR's Cliff Asness observed in a recent webinar that "current value spreads … are at record levels", a differential that's been inflated by ever-higher prices for growth stocks. "When it walks like a bubble and quacks like a bubble, we'll eventually say it's a bubble," he said.

To conclude, the setup we have here is that value stocks still trade at extreme, multi-year lows relative to growth stocks and the broader market, at the same time as some of the key drivers of performance within our portfolios' value themes appear to be gaining momentum (re-opening, interest-rate outlook, perhaps inflation too). Our portfolio's c.50% discount to intrinsic value remains attractive in an historical context, while if we really do see a long term pick-up in inflation, it's instructive to look at what happened during the previous high-inflation era of the 1970s. And what did happen? Value stocks, at least in the US, trounced both the broader market, as well as the inflation index itself. Revisiting the question posed by Research Affiliates, there seem to be plenty of reasons to believe that the Value turn really hasn't been 'missed'; as we've commented before, the discipline of value investing is a marathon, not a sprint.

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