It's so easy with hindsight!

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As with anything in life, it's so easy in hindsight. Now it's only fair, to myself, to caveat the following commentary as one swallow hardly makes a summer but for now, at least, things look to be aligning with an article I wrote last quarter, European valuations: apocalyptic or opportunity?

I'll also be whole-heartedly honest and say that it's a terrible trait of Portfolio Managers to remind you of our successes whilst managing complete amnesia when it's not quite panned out as we expected.

Now, what have we supposedly got so right that I felt I had to write about it? In August, I wrote a piece entitled 'European valuations: apocalyptic or opportunity?' in which I attacked the herding mentality of markets and the anchoring to bond-proxy or 'growth-at-any-price' stocks as they've been termed. This was being driven by low interest rates and negative bond yields which had not only distorted valuations, but also deceived the rational investor who was becoming comfortable paying 20x price-earnings (plus) for businesses he or she could have bought three or four years ago for 15x. It could possibly have been growing quicker at the time as well but I'm not about to delve into the specifics of that in this piece.

What's our philosophy?

We talk about 'margin of safety' in the way we invest. Sure, quality, as with most fund management houses, is at the core of our process and we speak about intellectual property, pricing power and competitive advantage alongside Porter's five forces[1]. These are a given but valuation has categorically been the hardest part of our job over the last few years as central bank policy continues to defy logic, pushing yields ever lower and asset prices ever higher.

So what's changed? From our perspective, and the portfolio, not very much at all - we are continuing to do exactly what we've done for the past several years. The market, however, has decided that valuation now matters. Why now is a difficult question to answer but the rhetoric has definitely changed. My initial thought was, much like Brexit, that a Trump victory would have driven a similar risk-off trade and flight back to the relative safety of the bond-proxy but I was completely wrong. The rotation that had begun to swing from quality to value (banks and cyclicals) has continued, as has the confirmatory noise around this trade (the herd is fickle). Selecting a few examples, I put together the following information for a client presentation which is a reminder of what's been happening across some of the quality names post third quarter results.

[1] Porter's five forces: existing competition, supplier power, buyer power, new entry threat, substitution threat.

What has earnings season told us……

"no longer deems it achievable to reach the 10% operating profit growth set in February 2016"
(-42% year-to-date (YTD))

"we suffered from a weak quarter in Brazil driven by a challenging consumer environment"
(-10% YTD)

"the outlook for sales growth has reduced to 0-1%, from 1-3% previously"
(priced for perfection fell 26% YTD and trades on 24x)

"organic revenue growth came in below Q3 expectations although we remain confident in meeting our full-year expectations"
(-20% and on an astronomical 33x)

A second modest downgrade of sales growth to 3.5% coupled with a 30 basis point reduction in margin wasn't well received.
(-12% and still on 26x this year)

It's worth saying at this point that the quality trade isn't linear and the sell-off has been driven by a diverse set of third-quarter results so I would be careful putting 'all things quality' into the same bucket. Novo Nordisk and Essilor, for example, have downgraded their outlooks, which isn't the case across the board.

How have we performed, and how will we react?

We haven't been immune from the rotation out of quality, although this hasn't been driven by any particular change in company outlook. In terms of our holdings; Kerry Group (-12% YTD) trades on a price-earnings (P/E) ratio of 19x but delivered 3.2% volume growth (prices feel as if there is a raw material pass-through) and a 70 basis points uplift in operating margin. Heineken (-8% YTD) trades on 18x and saw organic volume growth at their half-year of 4.3% and operating margin rise 1.3%. In other names, we have taken profits more recently, before the sell-off, such as Adidas, Unilever and Givaudan and have a smaller position in Glanbia. We were therefore cautiously positioned in quality entering the rotation.

The bigger question is: when do you jump back in? The answer is: you don't jump. Sitting on the sidelines watching this start to unravel is the most comfortable seat in the house and in time we will get the opportunity to add quality businesses to the portfolio at the right price. Trying to time the bottom is not something we would feel comfortable attempting. A far less risky approach is the one we take: incrementally adding to things we own where we feel the share price has overreacted to the fundamentals.

Financials are back in vogue!

So where is allocation going? Well, financials are back on the radar and, as I noted previously, we didn't need the catalyst of higher interest rates to drive this change in sentiment and allocation. Over the last quarter, the European banking sector is up 13% although this hides a multitude of sins. Putting our cards on the table we have been long quality financials for some time and have got to the stage of exiting Swedbank on valuation grounds. Some of our peers are just getting round to owning financials, or they don't own any at all, so there will be some interesting conversations taking place on the merits of owning financials I would have thought.

We have a big relative allocation to financials (see below) in the portfolio's top 10 positions[2]. In relative terms, 17% of the portfolio is in banks and insurers and most in the top 10 have achieved these heady heights through performance alone, not because we've added to the positions. For example, UBS is up 22% quarter-to-date (it has a lot of US$ exposure), DNB 19%, Allianz 19%, ING 18% and Svenska Handelsbanken (a more modest 7%, but 17% YTD). There is a big distinction between quality, and the rest, across the financials space so being firmly at the quality end has been a big beneficiary to our performance year-to-date.

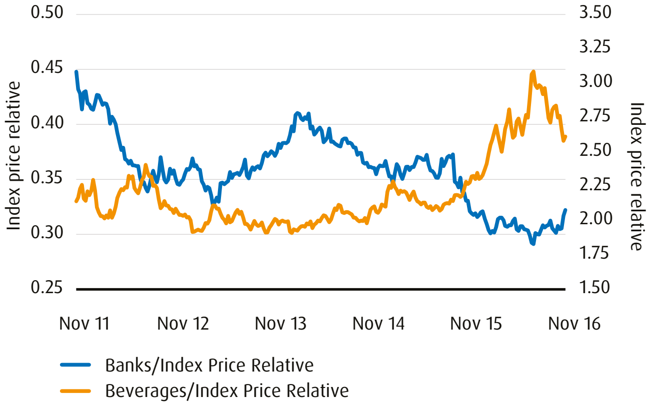
Top 10 holdings	Relative weight %
Swatch Group	2.9
SAP	2.9
Publicis Groupe	2.8
CRH	2.6
DNB	2.6
Allianz	2.6
ING	2.5
Air Liquide	2.5
Svenska Handelsbanken	2.5
UBS	2.4
Total	**26.3**

[2] European Growth and Income Fund

Continued

What next?

The answer is, as with my opening caveat, one swallow doesn't make a summer. The aim of my last piece wasn't about being clever it was to remind you about valuations and what you pay for a company builds in a margin of safety. This isn't rocket science, it's simple fund management, that had been brushed aside in the pursuit of growth and yield. Does the below shift continue? Who knows, but it has a long way to run before valuations start to look more acceptable, although some like Novo Nordisk have got there faster than I expected. We will therefore continue to chart the same course but it's worth noting that we see more opportunities today to own quality businesses at better valuations, although there are more downgrades to come.



Source: Berenberg, Bloomberg as at 04.11.2016

We always start with the premise of protecting shareholder capital and while we have underperformed this year (although this gap has narrowed dramatically over the last quarter) we take comfort in the fact that we feel these decisions will turn out to be right for our clients. Over the next three to five years, having that microscopic focus on valuations will, in our opinion, prove to be the right decision but as ever, only time will tell.

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