Future cash flow

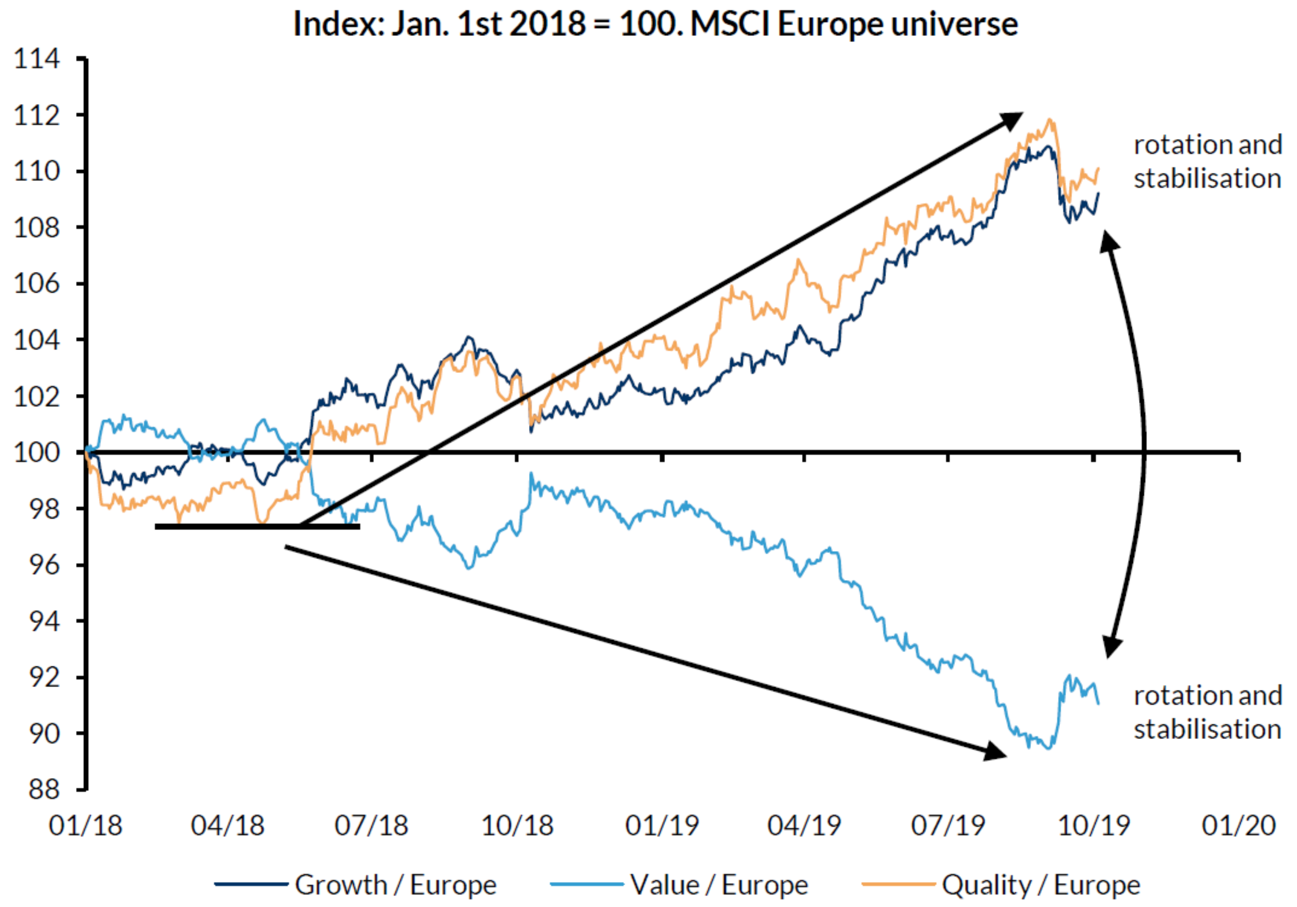
Executive summary

- Low valuation multiples have been a poor predictor of value in the past decade
- We favour an approach that seeks attractive free cash flows avoiding disrupted subsectors
- We see income investing as a compelling alternative to expensive growth

The case for free cash flow value opportunities

The challenges of value investing over the past decade are well understood. Low valuation multiples have consistently failed to act as signals of upcoming mean reversion opportunities. The quant screen approach of sifting out low P/Es or low price-to-book stocks has tended to produce stocks affected by both technological disruption and financial repression (weak recovery with very low inflation). On the flipside, scarce growth stocks have re-rated to ever higher multiples, which has become even more extreme in 2019 (see Exhibit 1). This means even episodes of value outperforming have tended to be short and sharp tactical bounces. Market timing is key to benefitting from these bounces, rendering value less successful as a buy and hold strategy. With many eurozone banks trading on just 0.4x book value, we may be near another similar bounce (albeit our view remains that the fundamentals for banks are poor and that low-quality banks are likely to prove value traps).

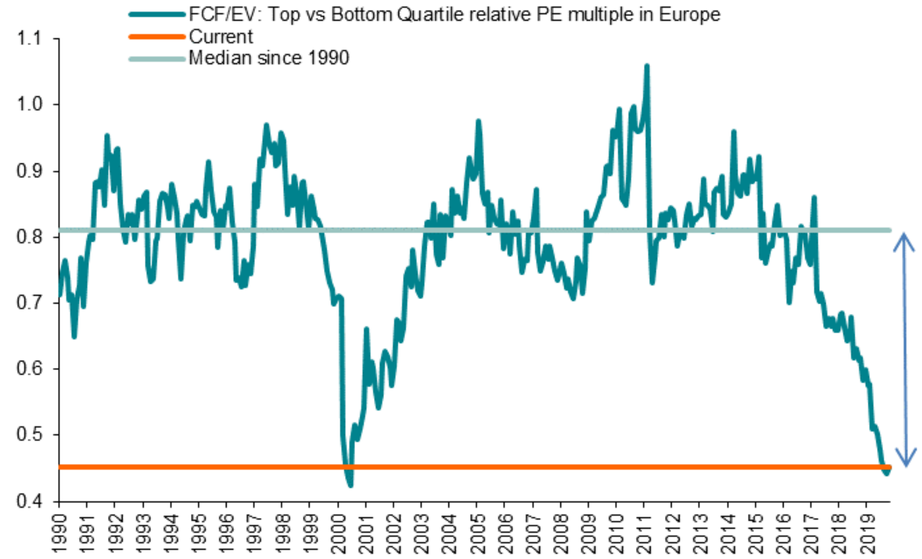
Exhibit 1: Style divergences have shown signs of reversing in recent weeks



Source: Datastream & Kepler Cheuvreux, October 2019.

For those looking for an alternative to expensive growth stocks, we believe investors should focus on free cash flow yields as a value factor and filter out the most blatantly disrupted sectors. We always like free cash flow yield as a valuation metric but the reason for this insight piece is instead to highlight how attractive the free cash flow factor currently is relative to history (Exhibit 2). After a long period of growth outperforming, which we believe has stretched too far, low bond yields are acting as a screen for investors who are losing valuation discipline to hide behind.

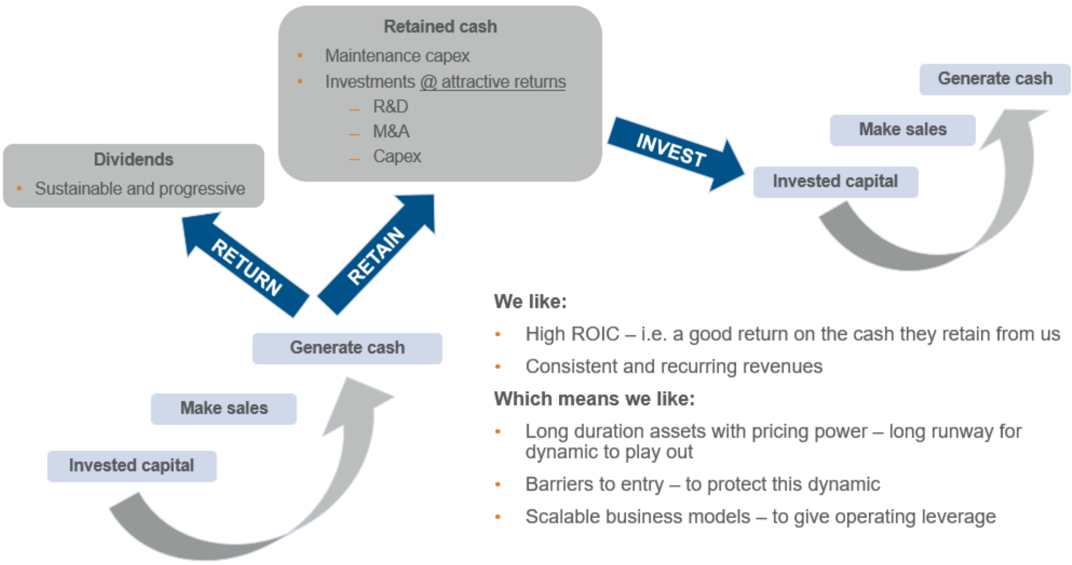
Exhibit 2: High FCF yield stocks in Europe have reached TMT bubble relative cheapness



Source: Exane BNP Paribas estimates, October 2019.
Note: Relative P/E valuation – high free cash flow versus low free cash flow quintile stocks.

We like free cash flow yield as a valuation metric for empirical reasons (the data supports its credibility) and reasons specific to our strategy (dividends are better underpinned where free cash flow is strong). We typically consider free cash flow yields below 4% to be too expensive. Strong free cash flow is attractive for a variety of reasons. First, good free cash flow coverage of dividends gives increased confidence that the current payout is sustainable (the key to successful income investing). Beyond that, it increases the resilience and flexibility of a company to shocks, either allowing the company to pay down debt or respond to capex spend opportunities. We spend considerable amounts of time understanding companies' capital allocation approach (Exhibit 3). If management are doing sensible things with their marginal use of capital, then strong free cash flow is both an indicator of current cheapness and a driver of future growth at good returns on capital.

Exhibit 3: Due diligence around capital allocation is key to sustainable dividends



Source: Polar Capital, September 2019.

Free cash flow factors look cheap in most regions

Looking at data from Bernstein Research, free cash flow factors are looking cheap in all regions (Exhibits 4 and 5) with the exception of Japan. We would note that this holds at a global level, with Europe looking particularly cheap on this basis. The data in these exhibits also highlights what we already know, that growth is very expensive relative to its own history. This is consistent with free cash flow factors historically performing strongest in slowdown and recession phases and weakest during expansion phases. Given the cycle will transition from late cycle expansion to slowdown sooner or later, we think free cash flow factors are well positioned from both a valuation and cycle timing standpoint.

Exhibit 4: Factor valuation summary (12-month forward P/Es)

Factor z-score	World	Europe	US	JP	AXJ	EM	UK
Composite Value - 12m FWD PE	-1.30	-2.33	-1.69	-1.25	-2.15	-1.60	-1.45
12m FWD PE - 12m FWD PE	-0.66	-1.80	-0.98	-0.20	-1.84	-0.83	-1.36
Price to Book - 12m FWD PE	-1.62	-1.55	-0.98	-0.99	-1.94	-1.43	-1.45
DY - 12m FWD PE	-0.71	-1.95	-0.91	-1.33	-1.89	-1.58	-1.56
ROE - 12m FWD PE	1.21	2.25	-0.05	1.20	0.66	0.51	0.46
Composite Growth - 12m FWD PE	1.20	4.02	-0.51	2.97	1.93		
LTG - 12m FWD PE	0.53	1.91	-0.15	1.39	2.02	1.46	2.33
Internal Growth - 12m FWD PE	1.93	2.49	-0.87	0.86	2.00		
FY0FY3 - 12m FWD PE	0.64	1.39	0.74	-0.25	1.78		
Momentum - 12m FWD PE	0.88	0.89	1.17	0.47	-0.25	-0.50	1.31
Low Vol - 12m FWD PE	0.31	0.68	2.84	-1.02	-1.52	-0.85	1.26
FCF Yield - 12m FWD PE	-1.68	-2.23	-1.74	1.41	-1.18	-0.98	-0.37
Low Leverage - 12m FWD PE	0.43	1.70	-0.01	1.39	2.02		0.69
Size - 12m FWD PE	0.03	-0.76	-0.15	-0.37	0.98	0.49	-1.01
Residual Value - 12m FWD PE	-1.05	-1.71	-1.44	-1.17	-1.97	-0.89	-0.76
As of: 04/10/2019							

Source: Factset, MSCI & Bernstein Research, October 2019.
Note: Z-scores compared to the full history since 1990 showing how many standard deviations vs. historic average.

Exhibit 5: Factor valuation summary (price to book)

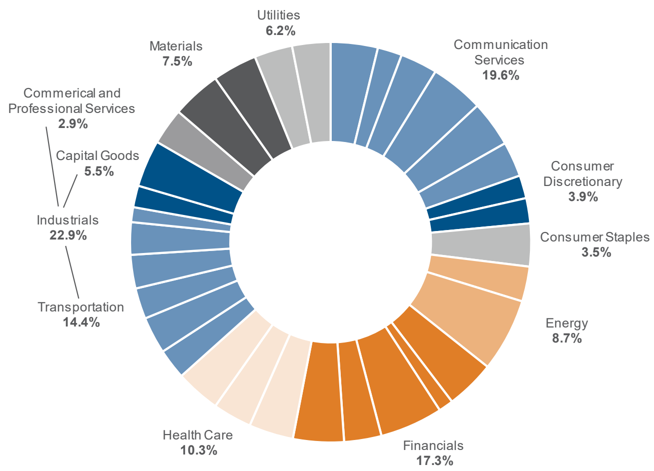
Factor z-score	World	Europe	US	JP	AXJ	EM	UK
Composite Value - PBK	-1.88	-1.84	-2.04	-2.17	-1.80	-1.50	-1.56
12m FWD PE - PBK	-1.50	-1.40	-1.33	-1.75	-1.37	-1.29	-1.16
Price to Book - PBK	-2.00	-1.79	-1.81	-1.93	-1.64	-0.53	-1.06
DY - PBK	-2.04	-1.23	-1.48	-1.94	-1.61	-1.88	-1.42
ROE - PBK	2.15	2.36	0.63	1.48	-0.34	-0.81	2.48
Composite Growth - PBK	2.30	2.24	-0.06	5.09	-0.15		
LTG - PBK	1.65	1.75	0.14	2.36	1.00	0.37	0.60
Internal Growth - PBK	3.16	2.90	-0.10	1.09	-0.74		
FY0FY3 - PBK	2.82	0.80	1.19	0.25	1.96		
Momentum - PBK	1.33	1.38	1.98	0.21	-0.63	-0.59	2.75
Low Vol - PBK	-0.88	-0.13	-0.22	-1.44	-1.65	-1.33	1.21
FCF Yield - PBK	-2.58	-2.34	1.34	1.43	-0.84	-0.80	-0.13
Low Leverage - PBK	-2.16	-0.65	-1.31	2.44	1.42		1.10
Size - PBK	-0.09	0.25	-0.86	-0.30	0.06	-0.50	0.24
Residual Value - PBK	-1.40	-1.54	-1.65	-0.21	-1.23	-0.74	-1.58
As of: 04/10/2019							

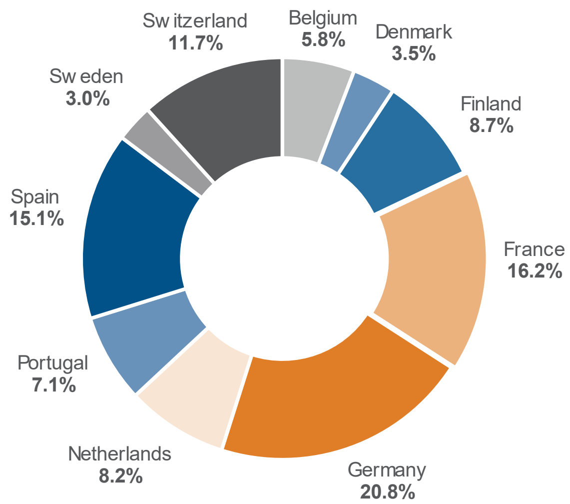
Source: Factset, MSCI & Bernstein Research, October 2019.
Note: Z-scores compared to the full history since 1990 showing how many standard deviations vs. historic average.

We see good European dividend-paying stocks as the standout opportunity across asset classes

We see Europe's large-cap defensive dividend payers as the outstanding opportunity across asset classes. Our Fund's historical yield currently stands at 4.5%, generated from a diversified portfolio of stocks by both country and sector (Exhibit 6). Europe is an excellent index for income investing: the region has relatively low trend growth and an abundance of mature, cash-generative businesses. When we look at our top ten at the end of September (Exhibit 7), we see a collection of resilient businesses that deliver steady earnings growth over the medium term in most macro environments at attractive valuations. We believe that late cycle, these types of company are very attractive.

Exhibit 6: Our portfolio yield is diversified by sector and country





Source: Bloomberg & Polar Capital, October 2019.

Exhibit 7: Valuation characteristics of our top-10 holdings

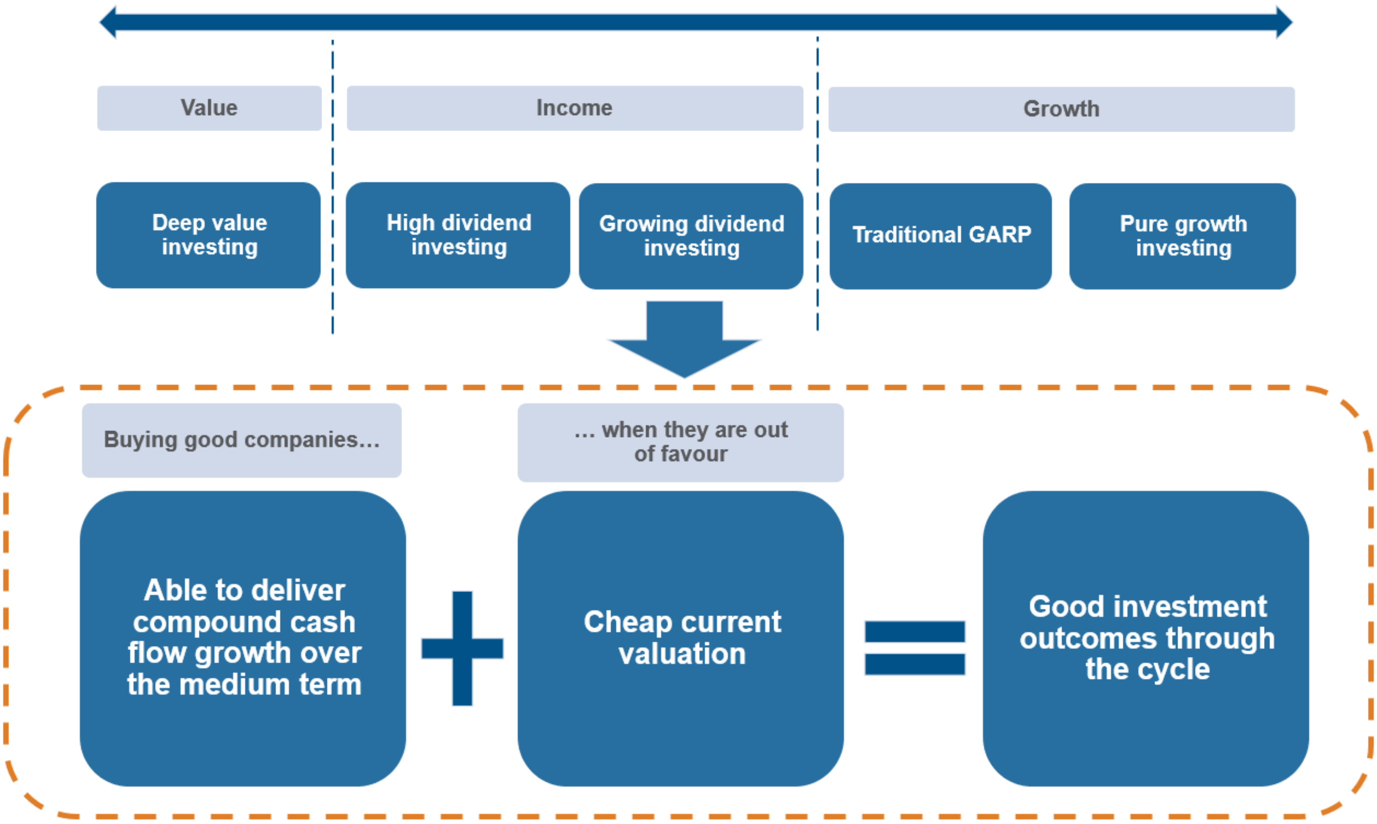
Top 10 Positions	P/E	ROE	FCF Yield	Dividend Yield	Beta
Total	9.4	11%	7.2%	6.1%	1.0
Roche	14.3	42%	6.4%	3.2%	1.0
Sanofi	13.1	13%	6.1%	4.0%	0.9
Siemens	13.6	12%	6.0%	4.0%	1.1
Bayer	8.7	12%	6.6%	4.6%	1.1
BASF	14.6	10%	3.7%	5.0%	1.2
Deutsche Telekom	14.2	15%	5.0%	4.9%	0.7
Zurich Insurance	12.8	13%	7.9%	5.5%	0.9
Orange	13.4	9%	3.7%	5.1%	0.7
Inditex	23.4	26%	5.5%	3.9%	1.0

Source: Bloomberg & Polar Capital, October 2019.

Conclusion

Our investment philosophy is based on the fact that a successful medium-term investment outcome is driven by both an attractive starting valuation and an ability to deliver compound cash-flow growth over the medium term. We describe this as “buying good companies when they are out of favour”. We prefer to think of investment styles as a spectrum rather than a binary choice between growth and value (Exhibit 8). In an environment potentially moving towards slowdown and recession, we see dividends and free cash flow yields as compelling alternatives to growth.

Exhibit 8: Income approaches as an alternative to growth



Source: Polar Capital, September 2019.

Nick Davis

22 October 2019

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