Income approaches as an alternative to expensive growth

Executive summary

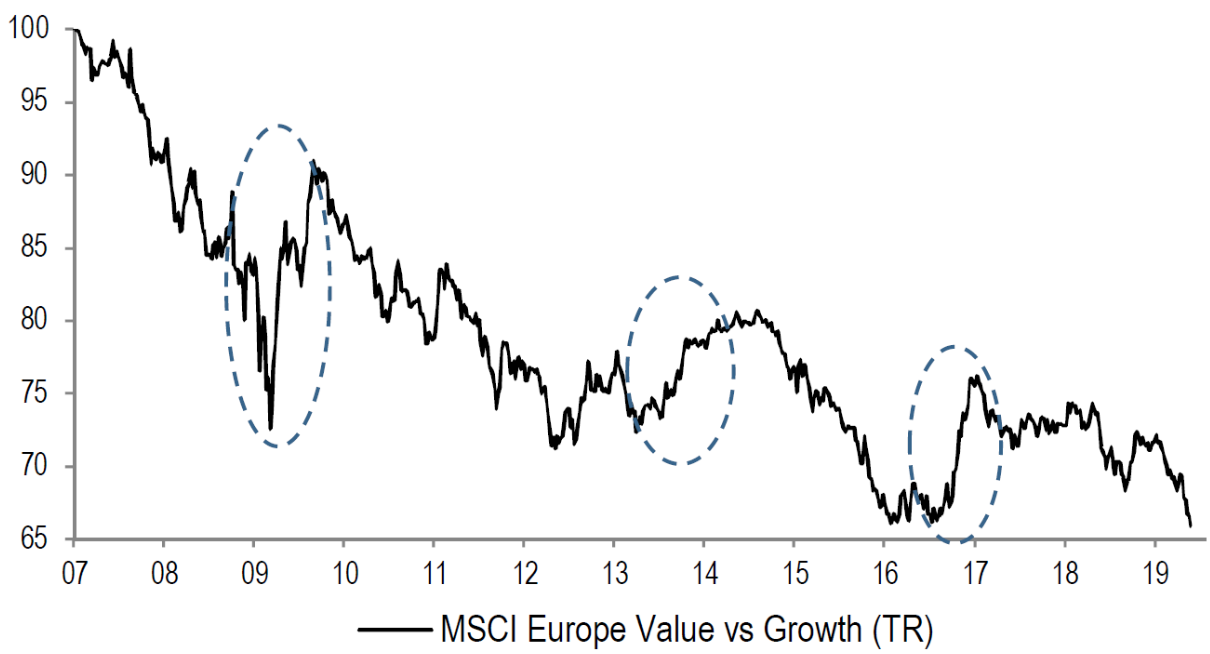
- There is a compelling case for an income approach within the current investment backdrop.
- Income stocks offer greater resilience than pure value stocks and are simultaneously much cheaper than growth stocks.
- We think value is about attractive entry points into compounding assets, not simply an optically cheap valuation.
- Disciplined investment processes with a strong valuation discipline stand a much better chance of outperforming than generic value-style baskets.

2019 has seen market outperformance of growth relative to value

Value has steadily underperformed growth in this cycle, with three value-relief rallies but no sustained value rebound (exhibit 1). The upward mean reversion of perceived value sectors has consistently disappointed for two reasons: a lack of macro tailwinds disproportionately hindering weaker companies and the increased prevalence of disruptive risk.

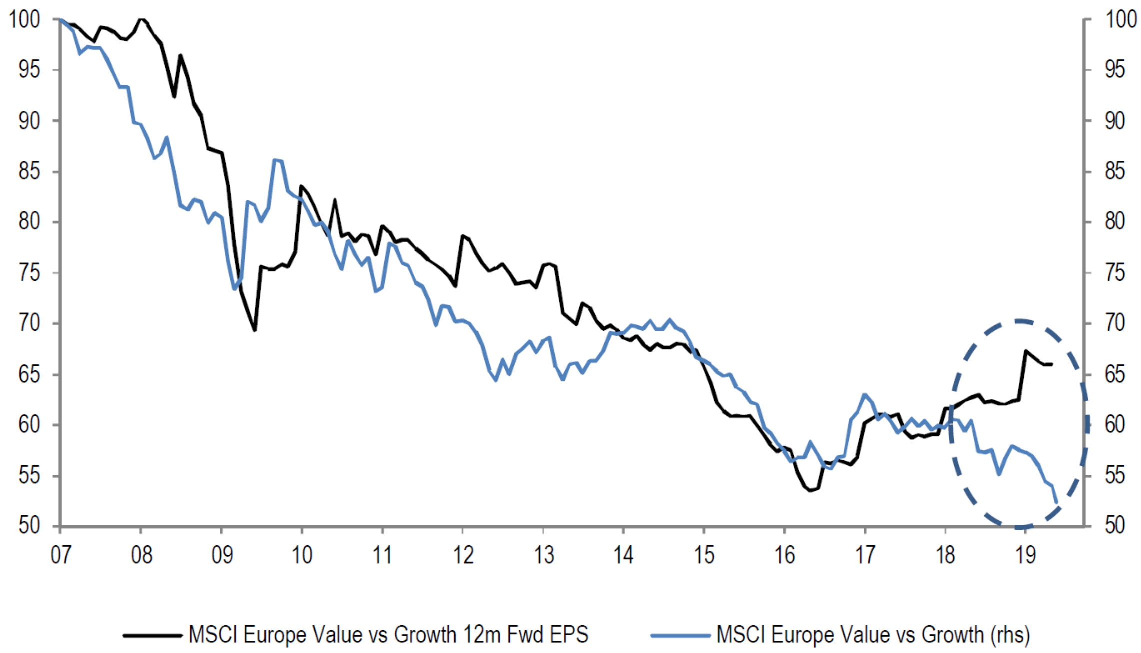
The strong year-to-date move in bond yields after the Fed pivot and a drop in eurozone medium-term inflation expectations has driven another leg down in value stocks relative to growth. Although growth stocks have delivered much stronger earnings progression following the crisis (exhibit 2), this period has also seen a dramatic re-rating of stocks perceived to be secure growth (exhibit 3). The underperformance of value stocks has also been marked against quality stocks not just growth ones.

Exhibit 1: In Europe, value has steadily underperformed growth since the global financial crisis



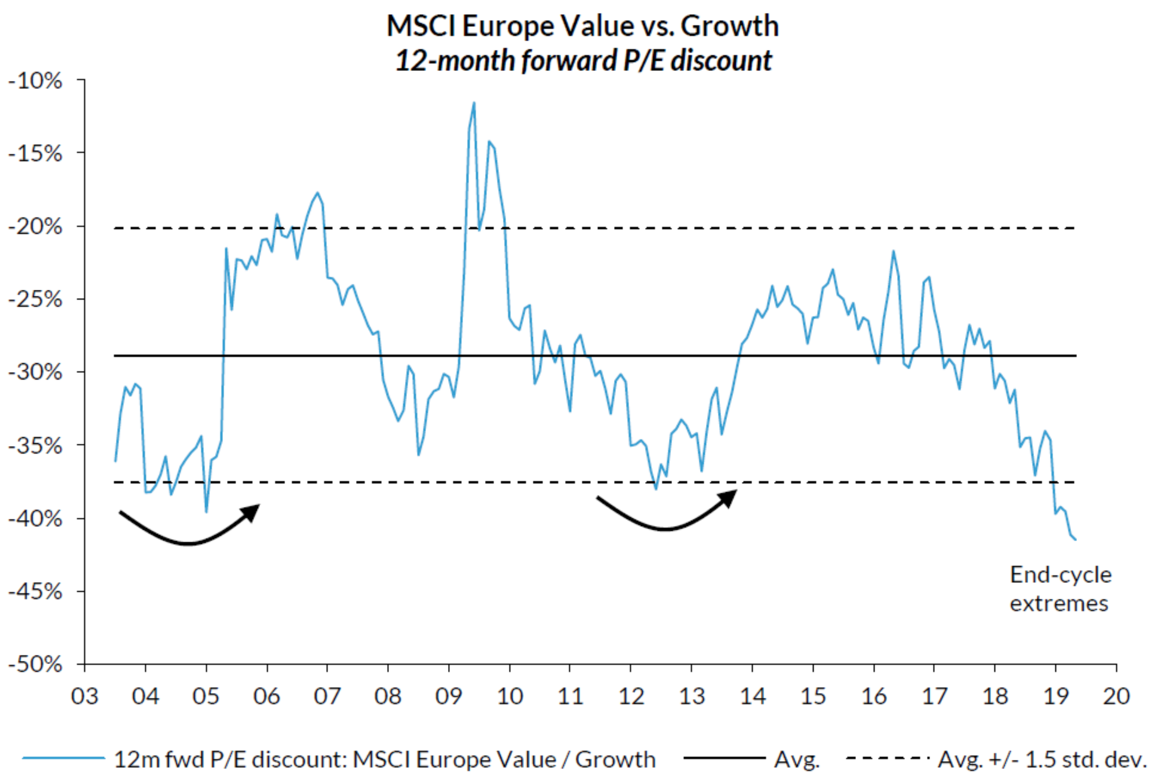
Source: Datastream; JP Morgan, May 2019.

Exhibit 2: The value sectors have consistently - and justifiably - disappointed on the earnings side



Source: Datastream; JP Morgan, May 2019.

Exhibit 3: The latest leg down in value versus growth has gone beyond recent extremes



Source: Datastream; Kepler Cheuvreux, June 2019.

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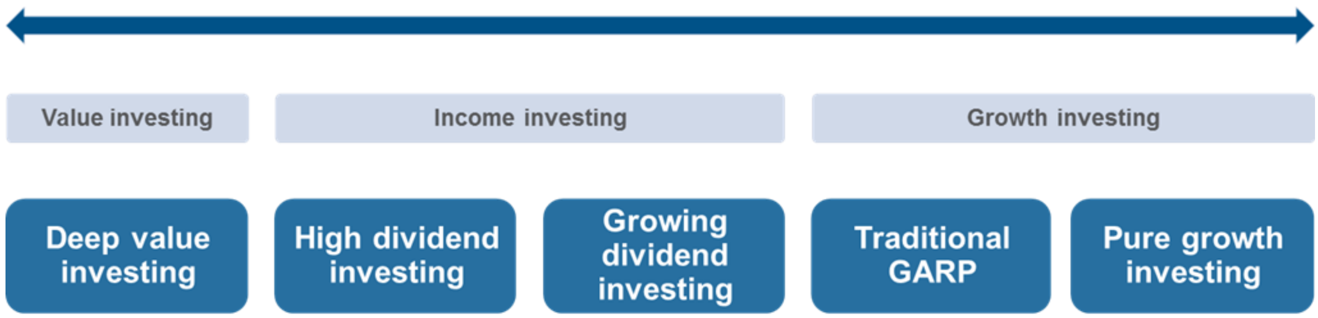
Income investing is a type of value investing

By definition, income investing is buying a portfolio that is cheaper than the index in terms of dividend yield. A portfolio targeting a yield above the overall index can only hold relatively few of the loved growth stocks. In our view, if a portfolio barbells too many very low yielding growth stocks balanced with very high dividend yield stocks, then more performance is lost with the high yield names than is gained from the growth ones.

Rather than two binary classifications of value and growth, we see a spectrum of investment styles that runs from deep value investing to pure growth investing (exhibit 4). Between the extremes of deep value investing and pure growth investing, we would add two further intermediate styles: income investing and GARP (growth at a reasonable price). Many of the traditional GARP stocks have re-rated in recent years to levels where we no longer consider their price reasonable. There are also two strands of income investing: high income which we see as close to deep value investing, and growing income which sits more towards the growth style.

With the current backdrop, we view an income-based approach as a better alternative to expensive growth. We see many of Europe's blue-chip stocks offering a compelling combination of attractive dividends and resilient earnings profiles.

Exhibit 4: How we see the investment style spectrum



Source: Polar Capital, June 2019.

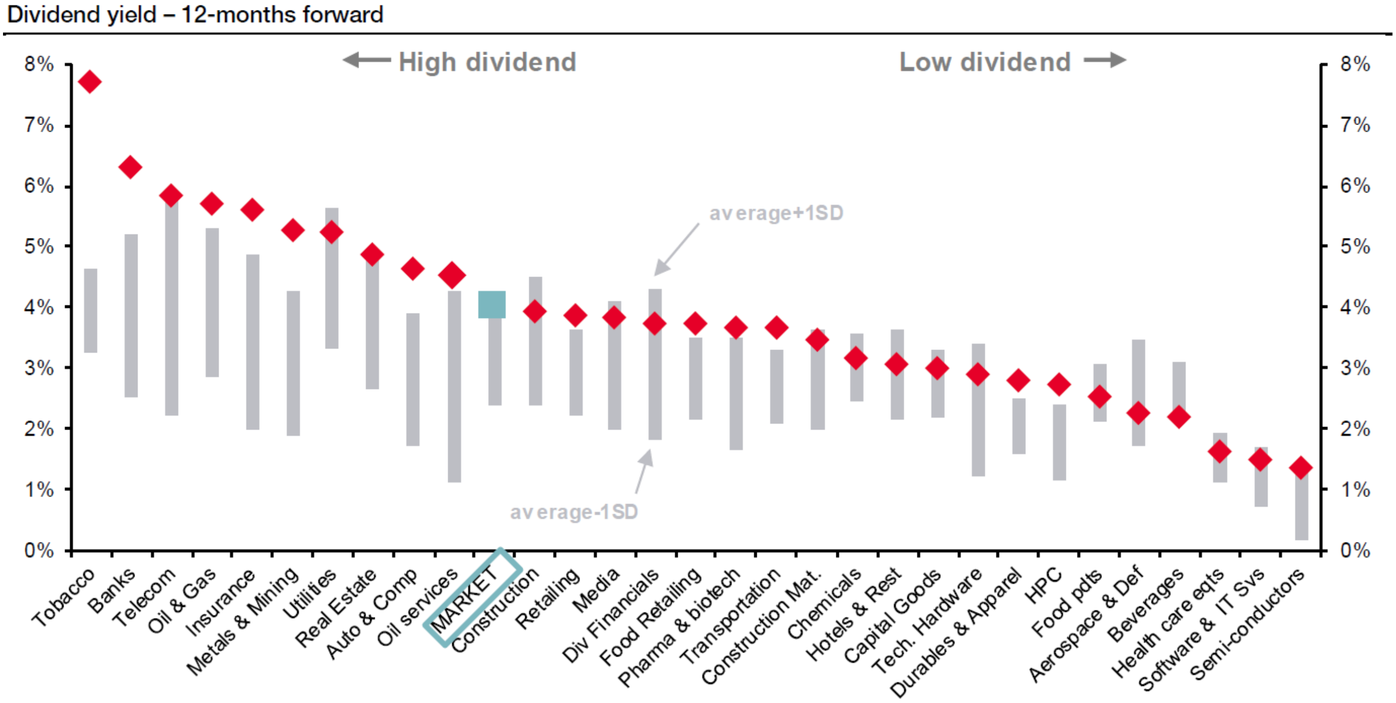
The dividend of value stocks is currently running at about twice the dividend of growth stocks (exhibit 5). Stocks like Nestlé now yield at least two percentage points below the level they did a decade ago. We see this in the UK with some equity income funds leaving the IA Income peer group as their preferred cohort of stocks re-rated to levels that breached the yield requirements.

Exhibit 5: The dividend yields of growth stocks have gradually re-rated since 2000

Source: Datastream; Barclays Strategy, June 2019.

Although income investing is a type of value investing, we would caution against using dividend yield to value stocks. Optical dividend yield is a relatively poor measure of valuation because it does not capture the sustainability of dividends or their future growth. Although we are blending dividend yielding stocks to hit a portfolio yield target, we use other methods to assess individual positions. We look for stocks that can deliver dividend yield plus earnings growth of 10%, which is an absolute compounding mindset. However, we use other conventional primary valuation metrics to assess current valuation. These are free cash flow yield, price-to-book value and a basic discount cash flow model. While many sectors currently offer dividend yields at the top of their historical ranges (exhibit 6), some of these will prove to be value traps. Some of the cheapest looking sectors in the market tend to combine both cyclical and disruptive risks. Autos, banks and media are all relatively sensitive to the economic growth cycle and face the disruptive effects of new technologies.

Exhibit 6: Many sectors offer dividend yields at the top of their historical ranges



Source: IBES, MSCI, Datastream, SG Cross Asset Research/ Equity Strategy, June 2019. Dividend yield—12-month forward dividend per share/ current price. Red—current, blue—market, grey high—historical average + 1 standard deviation, grey low—historical average—standard deviation. Historical average since 01/01/95.

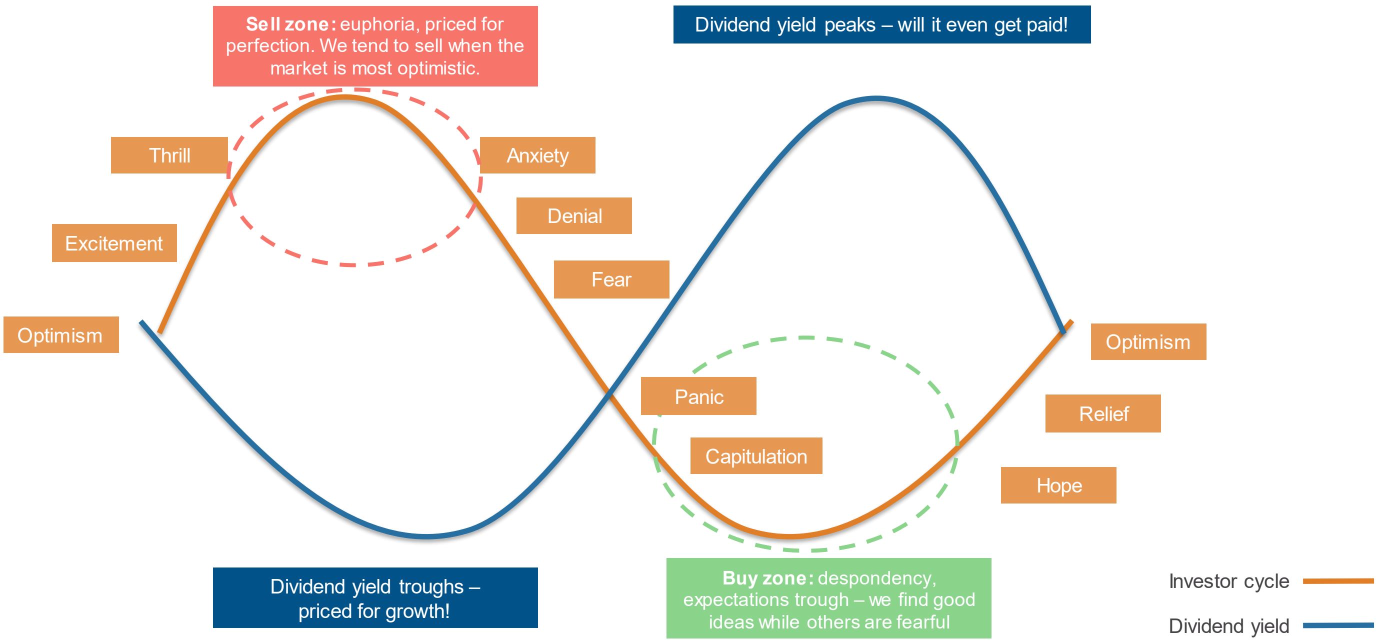
Our process is to buy good companies when they are out of favour

The one-line description of our investment approach is to buy good companies when they are out of favour, ie contrarian stock-picking. In effect, this combines elements of value (an attractive entry point) and growth (companies that deliver compound cash flow growth over time). Our process is built on the idea that the dividend yield of a stock is inversely correlated to the investor sentiment around a stock (exhibit 7). When stocks are loved and priced for perfection, they tend to have very low dividend yields. Similarly, when stocks are feared and investors are capitulating, their dividend yields will tend to peak.

It is much easier with hindsight to identify great entry points into stocks. In the moment, it is much harder *ex-ante* to decide if a stock is really good value or a value trap. A robust investment process is key to consistently getting this judgement call right. It is also clearly better to find these ideas over time and steadily rotate capital from more expensive stocks into cheaper ones.

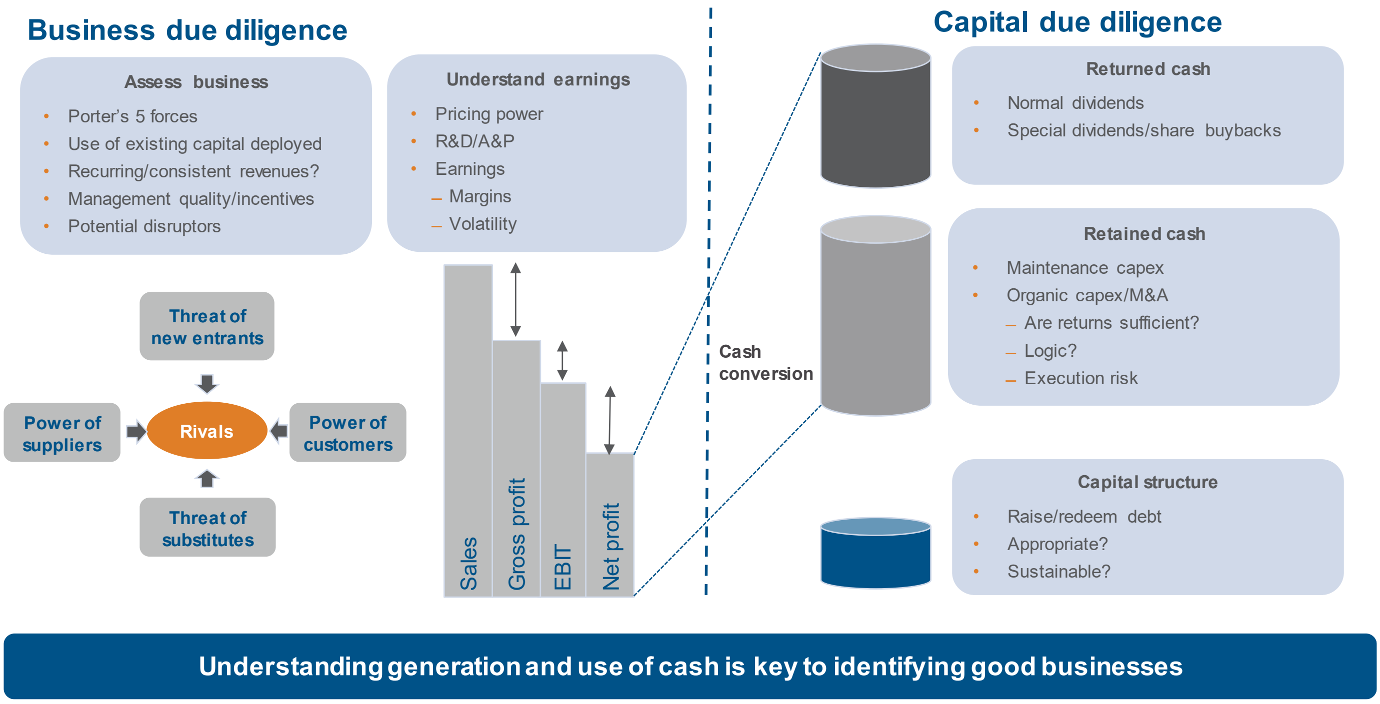
Different factors can push stocks below their fair intrinsic value, some of which we feel more able to exploit than others. It is important to have a clear investment approach to find genuinely cheap opportunities and avoid value traps (exhibit 8). For example, when a consensus macro top-down view is negative, this can create good entry points in solid companies which are resilient through near-term problems and then prosper afterwards. Often this takes 3-5 years to play out. When looking at out-of-favour stocks and trying to avoid value traps, we like to think in terms of whether there is a medium-term value anchor that can underpin upward mean reversion (technical speak for recovery). The first part of this is whether the company's basic business is necessary and not being materially disrupted or disintermediated. The second part is to consider what type of cycle is playing out if the problem is not structural. Ideally, we want a relatively simple business that it takes a longer investment time horizon than the market to exploit. We also use a through-cycle 10% return on equity threshold when screening for stocks to make sure we are buying companies that make good returns over the medium term. The 10% return on equity threshold is a proxy for quality – in other words, we do not equate value as meaning low quality.

Exhibit 7: The dividend yield of a stock tends to be inversely correlated to investor sentiment



Source: Polar Capital, June 2019.

Exhibit 8: To avoid value traps, we perform due diligence on the business and the use of capital



Source: Polar Capital, June 2019.

Where value in the market does not align with index and basket-type approaches

We frequently see investment strategists cite the performance of value and growth, as noted in our introduction. The relative moves in these types of basket provide an interesting insight into high-level, short-term shifts in style rotations. However, we are more sceptical that buying a bunch of optically cheap stocks in a value basket and hoping to catch a re-rating is a very robust way to value invest. We recently read a JP Morgan strategist note that provided a basket of growth and value stocks – these comprised 55 Europe ex-UK stocks of which we owned none in the growth bucket and only two in the value bucket. We need to look beyond these binary extremes to find attractively valued, compounding assets.

Looking at the MSCI Value and Income sector weightings (exhibit 9), we would focus on striking data points that support our view. For example, we think it is likely that a very low percentage of European financials will prove good growth stock ideas. However, we find it fairly unlikely that an optimum value portfolio of genuinely cheap stocks will be 35% weighted in financials. This is the nature of optical valuation approaches and therefore illustrates why we prefer an intrinsic value-based approach. In other words, to assess a view of true value we ask what the compounding rate of this asset is, the level of returns and risk of this asset. This is simply not captured by a P/E ratio. Having such a big single-sector weighting also makes it harder to diversify. We much prefer to pick stocks that are cheap for company or sector issues. Declaring whole sectors cheap and taking huge sector positions might produce great short-term results but is harder to replicate. As much as we can, we look to pick up risk premiums in stocks that can be diversified across our other holdings.

It is also why our process is driven by a watchlist of stocks that we know well and are constantly reviewing for attractive entry points. The short-term nature of markets frequently drives selloffs that provide excellent entry points. We describe this as contrarian, single-stock picking.

Exhibit 9: The MSCI Value and Growth index sector weights

	Sector	Value	Growth	Value-Growth
Value	Financials	35.1%	2.7%	32.4%
	Energy	13.3%	1.1%	12.2%
	Utilities	9.1%	0.6%	8.5%
	Comm Svcs	8.0%	2.8%	5.2%
	Materials	8.6%	6.4%	2.2%
	Real Estate	2.4%	0.5%	1.9%
Growth	Healthcare	5.9%	12.0%	-6.2%
	Cons Disc	8.1%	15.7%	-7.6%
	IT	0.9%	9.8%	-8.9%
	Industrials	5.1%	21.2%	-16.1%
	Cons Stap	3.5%	27.1%	-23.6%

Source: Datastream; Barclays, June 2019.

Europe includes some sectors that are persistent losers and some global growth stocks that are not cheaper than their peers in other regions. However, between these two extremes we do continue to see attractively valued opportunities.

Nick Davis
15 July 2019

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