Focus on change – the search for equity alpha

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COMPANY FUNDAMENTALS ULTIMATELY DRIVE STOCK PRICES

There is no single theory that adequately accounts for market movements. Technical forces and investor sentiment often dictate near-term market behaviour. However, there is strong evidence suggesting that fundamentals do ultimately reassert and determine asset values over the long term, a view that has been widely accepted since the 1960s.

Evidence for long-term rationality comes from various sources. Studies by McKinsey Global Institute (2005)[1] of the UK and US stock markets revealed that long-term growth and returns on capital remained remarkably consistent between 1970 and 2000, despite periods of deep recession and strong economic growth. For instance, the median return on equity for all US companies stayed around 12% to 15%, and long-term GDP growth in the US has hovered near 3% since 1945.[1] Meanwhile, the inflation-adjusted cost of equity remained fairly stable at around 7%.

McKinsey then used this data to estimate intrinsic price/earnings ratios for the UK and UK stock markets and compared compared their estimates with actual values. They found that the US and UK stock markets had generally been fairly priced, never straying far from their intrinsic price/earnings valuations. Apart from high-inflation periods in the late 1970s and early 1980s, market PE ratios in the US and UK remained about 15. Moreover, during periods when there was significant deviation, stocks did eventually fall back in line with economic fundamentals within about three years.

Work by Dimson, Marsh and Staunton[2] in the early 2000s supports these findings. Their "DMS Global Indices" measured the long-term performance of equities, fixed income, bills, inflation, currencies, risk premia and maturity premia in 20 countries around the world from 1900 to 2000. They then interrogated this unique bank of data to answer contemporary questions on investment, finance and regulation. Among their findings, they established the consistency of long-term returns on capital and growth, providing evidence that, over the long term, markets are rational.

FUNDAMENTALS PRICE INEFFICIENTLY AT TIMES OF CHANGE

'Rationality' theory argues that investors make logical investment decisions based on analysis of a company's future cashflow, and that markets allocate capital efficiently.

In practice, short-term discrepancies between share prices and their intrinsic values often occur, owing to technical factors, sentiment and the time it takes for rational investors to identify and correct the mispricing. This tends to be most prevalent when fundamentals are undergoing or facing the prospect of significant change. However, history shows that significant disparities arise infrequently and tend to correct relatively quickly, indeed, often precipitously.

There are numerous examples in history of market inefficiency: Tulipomania (1634 – 1637), the British Railway Mania bubble (1840s) and Black Monday (1987), to name just a few. A more recent case is the dot.com bubble of the late 1990s, when investors became carried away with the potential of web technology and e-commerce. Many stocks, notably in the technology sector, soared to unprecedentedly high valuations. This was despite the fact that the dot.com business model was largely unproven with no clear path to monetisation. In early 2002, the market crashed spectacularly as fundamentals reasserted (Figure 1).

Figure 1: Irrationality – the dot.com bubble

Sources: Standard Life Investments, Datastream

The causes of short-term irrationality

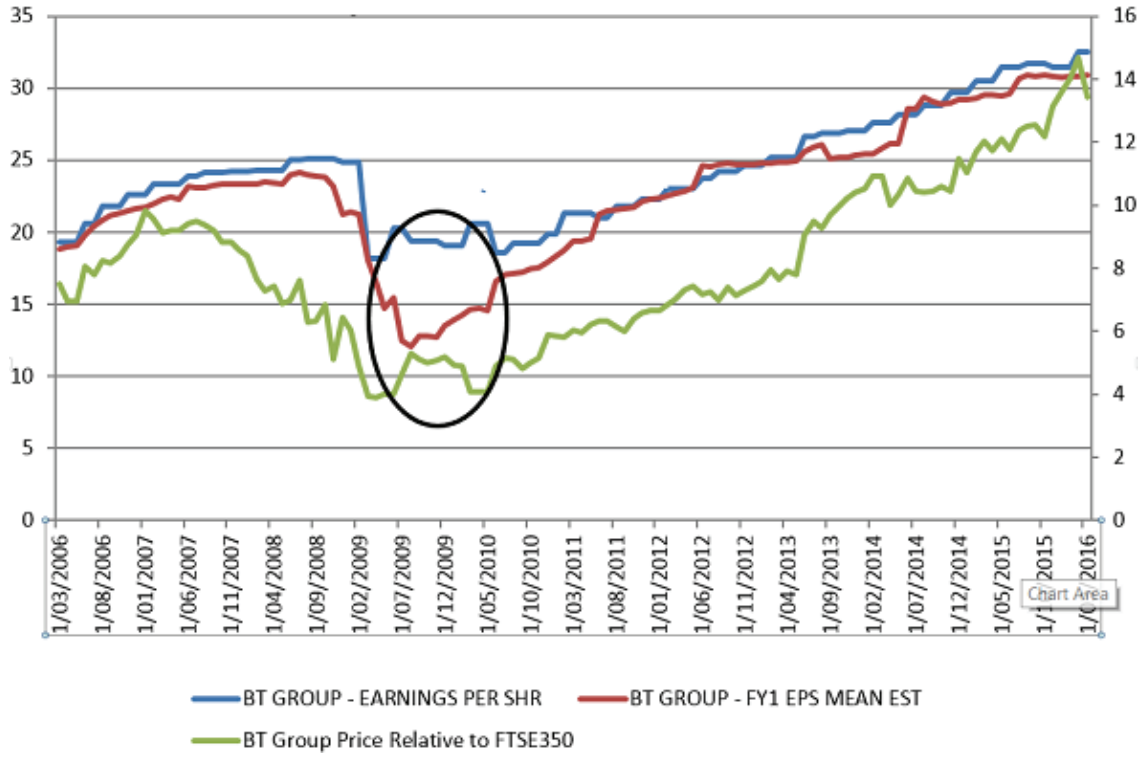
Behavioural finance theory offers valuable insights to help explain what drives markets, particularly over the short-term.

One phenomenon that is well-documented and readily observed is herding, the tendency for individuals to mimic the actions (rational or irrational) of a larger group. At its root may be social pressure to conform and/or the misplaced belief that so many others are unlikely to be wrong. The dot.com bubble discussed above provides a classic example. Herding was also at play in the late 1970s when stock valuations fell below intrinsic value as investors collectively became overly cautious about inflation.

Anchoring is another feature that can cause valuations to stray from fundamentals. Faced with change, investors may cling doggedly to entrenched views about an asset, based on outdated information. They resist changing their beliefs, even as contradictory evidence mounts.

Consensus company earnings forecasts commonly reflect irrational behaviour. Responding to changing stock fundamentals, market analysts will typically amend their numbers by modest increments in the initial stages, each seemingly fearful of stepping too far out of kilter with the peer group. As a result, consensus estimates characteristically lag reported results at times when fundamentals are undergoing meaningful change (Figure 2).

Figure 2: Analyst revisions tend to be lagging indicators – BT Group
Consensus estimates characteristically lag reported results at times when fundamentals are undergoing meaningful change.



Sources: Standard Life Investments, Datastream, as at March 2016

Behavioural studies also reveal an instinctive aversion to uncertainty. In financial markets, this may cause investors to shy away from the unknown, structurally mispricing positive change. Herding, anchoring and other such behaviours can lead to material market mispricing which, once it corrects, inevitably leaves the unwary badly bruised. Conversely, however, these behaviours can offer valuable opportunities for rational investors whose investment decisions are guided by long-term fundamentals.

DIFFERENT FUNDAMENTAL FACTORS MATTER IN DIFFERENT CIRCUMSTANCES OR AT DIFFERENT STAGES OF THE INVESTMENT CYCLE

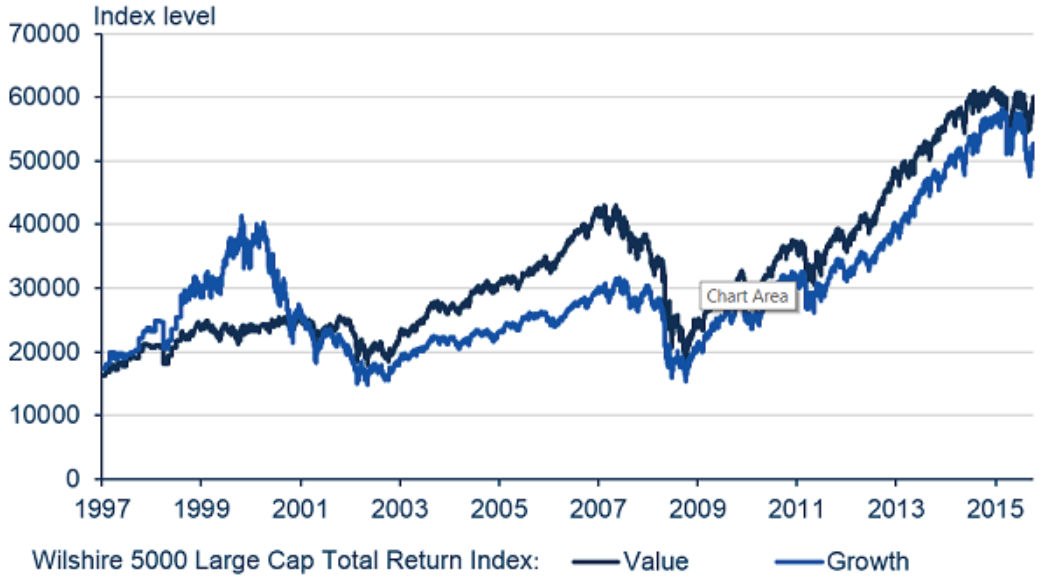
The factors driving markets do not remain constant – rather they vary according to prevailing economic or political circumstances. This constant state of flux magnifies the incidence of exploitable pricing anomalies. Focusing on change can help identify, understand and exploit market influences and the dynamics behind them. Change is a persistent feature of markets and can offer the greatest potential for outperformance, as it can accommodate any and all stages of the economic cycle, regardless of the prevailing market drivers.

Growth versus value investing

By contrast, alternative approaches like growth and momentum investing are unlikely to be rewarded during times of economic slowdown, or when markets are volatile. Momentum investing typically relies on the premise that securities that have recently performed well will continue to do so, while those that have not will continue to lag. However, as well as incurring substantial trading costs, it can be difficult to predict when a run might end.

Similarly, followers of Warren Buffet will testify to the merits of value investing. However, it can take a great deal of time – often years – for the market to recognise that a particular security is underpriced. At other times, assets that appear cheap continue to decline as their fundamentals worsen, ensnaring the investor in a value trap.

Figure 3: Cyclicality of growth and value stocks



Sources: Datastream, Standard Life Investments (as at March 2016)

Instruments of change: politics

There is ample evidence to show how market drivers can vary over time. In the aftermath of the credit and stock market collapse of the early 1990s, Japan languished amid a combination of mutually reinforcing problems, including its ageing population, ongoing corporate and household deleveraging, entrenched deflation, massive public sector debt and a reluctance to undertake structural reforms. For two decades, successive governments tried and failed to stimulate growth, while investors despaired of ever seeing the degree of change required to restore the country's fortunes.

The arrival in 2012 of Prime Minister Shinzo Abe heralded a new era of optimism. Abenomics represents the most concerted and radical effort yet to revive growth and stimulate inflation, combining monetary and fiscal stimulus with aggressive structural reforms. Much remains to be done, but improvements in corporate profitability, business investment and consumer confidence are evident, and the deflationary battle lines have at last been breached. Consequently, the investment climate has become tangibly more upbeat.

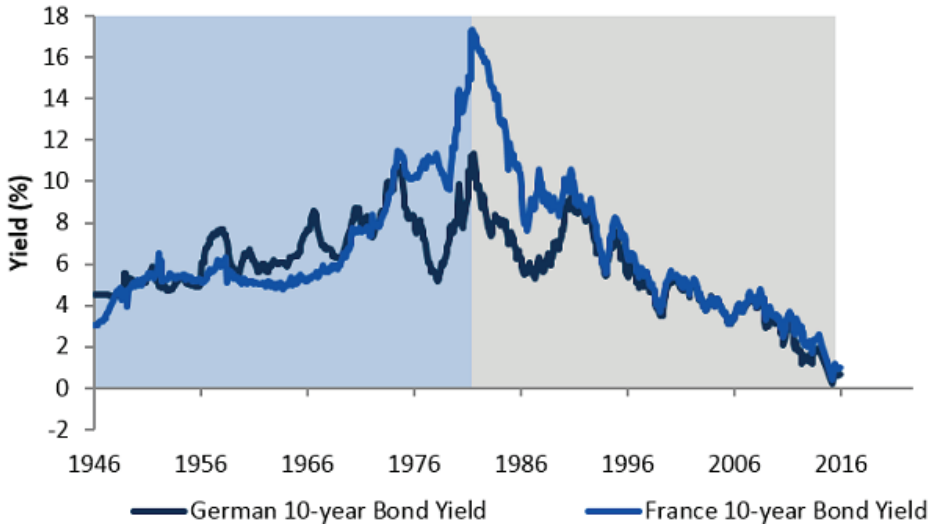
Instruments of change: the monetary cycle

The factors influencing markets can take many years to change – not just through a short business cycle but across several cycles. For example, during the past few years, global interest rates have hovered around 200 to 300 basis points below their 1998 to 2008 average, with the disparity being even more pronounced in the UK and core Eurozone countries (Figures 4 and 5).

Figure 4: Historic long-term UK gilt yield

Sources: Standard Life Investments, Datastream (as at 31 December 2015)

Figure 5: Historic 10-year French and German government bond yields



Sources: Standard Life Investments, Datastream (as at 31 December 2015)

A focus on change indicates a variety of economic and political drivers that have created this low interest rate environment. Scarring from the financial crisis and prolonged private sector deleveraging have boosted savings, weighed on consumer demand and inflation, trends reinforced by monetary and fiscal policy mistakes. At the same time, the US recovery has not translated into stronger growth in the rest of the world (largely owing to structural and other constraints in the Eurozone), boosting the dollar and fuelling demand for yield. Productivity growth, already in decline before the financial crisis, has further deteriorated, exacerbated by the drought in capital investment. Through both accident and design, central banks and regulators have been pursuing policies that reduce real interest rates and long-term return premia, enhancing demand for all income-yielding assets and thereby supressing rates.

Identifying the triggers for change

A focus on change requires the investor to consider what changes might prompt the market to change its mind and contemplate higher rates. In this case, economic growth and tighter capacity should ultimately drive up inflation and a cyclical upswing. At the same time, investors should look for signs that governments are showing greater commitment to structural reform in order to boost productivity.

By identifying and monitoring the underlying drivers, it is possible to ready portfolios to benefit when these changes ultimately materialise.

SUMMARY AND CONCLUSION

Asset prices are ultimately driven by fundamentals and markets are inefficient at pricing in changes in fundamentals. By identifying, analysing and understanding the key drivers, it is possible to exploit inefficiencies and deliver value.

At the same time, the factors driving markets are prone to change over time. This argues for an approach that does not favour any particular investment style (i.e. growth or value). Rather, by focusing on change, it is possible to outperform irrespective of where economies are at in the cycle.

Change is pervasive, whether at the macro, sector or stock level. Geopolitical upheaval, industry consolidation, technology disruption and so on all have potential to shake out a new set of winners and losers.

ENDNOTES

1. Koller.T, Goedhart. M, Wessels.D, 2005,Measuring and Managing the Value of Companies, Hoboken, New Jersey: John Wiley & Sons,
2. Dimson.E, Marsh. P, Stauton. M, 2003, Global Evidence on the Equity Risk Premium, London, Journal of Applied Corporate Finance, Vol 15, No 4, pages 27-34