

Discovery Global Value Equity Feeder Fund

Market background

Global equities gained in Q2 for the fifth consecutive quarter, buoyed by solid growth as major economies continued to recover, generally encouraging earnings, government stimulus and continued vaccine rollouts in the developed world – along with indications that the latter are proving effective in limiting further coronavirus outbreaks and hospitalisations. This was in contrast to poorer countries, where vaccines are much less available, COVID cases are spiking in many instances and health systems are under increasing strain. Having risen strongly since the final months of 2020, some major equity indices touched record highs in Q2.

After market-leading gains for value equities, and for cyclical sectors more generally, in Q1 – continuing the pattern since Q4 2020 – the ‘pro-inflation’ trade reversed sharply in June after the US Federal Reserve (Fed) hinted at possible future interest-rate hikes in response to indications that price pressures may be becoming more persistent and signs that the US job market had healed sufficiently to merit a change in policy stance. This weighed in particular on cyclical sectors such as financials, autoparts and travel, with the latter additionally impacted by concern over the COVID ‘Delta variant’ and the likely continuation of restrictions on cross-border movement. Growth stocks generally outperformed towards quarter-end, particularly the shares of some of the ‘big tech’ companies that have previously dominated stock-market performance.

Performance review

For the quarter, the portfolio delivered a negative absolute return and underperformed the benchmark.

At the macro level, the underperformance largely reflected the fact that value equities lagged growth stocks – having led the market since last autumn – as the shift in tone by US policymakers caused a reversal in stock-market leadership. Overall, we continue to see considerable room for value to outperform after a long period of relative weakness, and we still regard value stocks as extremely cheap relative to all other equity factors and the market generally.

At the stock level, the main detractors from relative returns included several companies exposed to travel, one of the COVID-related themes we have been allocating to and which has been an important contributor to relative returns in recent quarters. Airline easyJet and aircraft leasing company AerCap detracted from relative returns in Q2 as the spread of the Delta COVID variant looked likely to delay the resumption of air travel. We maintain our positive long-term view on these companies and continue to see value in them. Pharma company McKesson also detracted. Its shares were volatile and under pressure in the quarter as the resolution of the long-standing opioid litigation drew closer. Ultimately, a conclusion will remove a costly drag on the shares, but the prospect of a multibillion-dollar settlement creates uncertainty that the market dislikes.

The primary contributors to relative returns in the quarter included US commercial foodservice equipment manufacturer Welbilt, which performed well in the quarter as a bidding war broke out between Middleby, with an all-stock offer, and Ali Group with a rival cash bid. American Express performed well too, although there was no significant news. This was likely driven by the expectation that a recovery in consumer spending and travel will benefit the business going forward. In addition, AmEx has increased marketing spend, which hopefully then will translate into more cards in circulation, and higher profits down the line.

Portfolio activity

Significant purchases over the period included British American Tobacco (BATS) and Chinese baked goods company Dali Foods. Sales volumes for traditional cigarettes have been collapsing in the tobacco industry and the rise of next-generation products has changed the competitive landscape, lowering the barriers to entry and forcing tobacco companies to increase their investments in marketing and R&D. All of this has eroded margins, but BATS has more exposure to emerging markets, where the decline in users of combustibles is less steep. In addition, the company's double-digit free-cashflow yield, combined with increasing certainty on next-gen product profitability, all make for an attractive forward return. Dali Foods shares have derated as growth has slowed in recent years, and the balance sheet has become more inefficient. The market has lost patience as new products like soy milk have disappointed. However, there are reasons to believe that this could just be a dip. The company has had a good history of innovation and continues to launch new products. There is also a structural tailwind in Chinese snack consumption. In the long run, it is likely that short-shelf-life bread and soy milk will grow. If the company hits Dali's own targets, group revenues could double. Given seemingly sensible management and a clearly articulated strategy, the risk-reward appears favourable.

During the period we sold out of DXC Technology, Grafton, SKF and Tapestry as they reached our estimate of fair value.

Outlook and strategy

Global markets have recognised that an economic recovery is under way and stocks are being repriced higher. We continue to regard the opportunity in the value segment as attractive. It still trades cheaply in absolute terms, relative to its history, and especially versus the rest of the market and other investing styles, with growth and quality factors still very expensive on a long-term view.

Value tends to correlate with pro-cyclical macro variables, for example GDP growth, inflation or rising interest rate expectations – all of which we have seen of late to varying degrees. And value is one of the few styles that can outperform in this kind of pro-growth environment, particularly when compared to where the market and certain sectors and styles are trading today.

When considering the recent rally, it is also worth remembering just how long value has been in the doldrums. While there has been a recovery in value names of late, on a historical view it is barely a blip on the screen in terms of the kind of underperformance that value had suffered, whether this is looked at on a 1, 3, 5, or 10-year view. This leaves a lot of runway for value in terms of potential future performance.

Of course, selectivity is key and there is a case for looking at value in a more dynamic way than it has been traditionally – including with a recognition that it can coexist with growth. Think in terms of ‘hybrid companies’, those which display both growth and value characteristics: the combination of low valuation with growth is one of the highest predictors of high future returns and therefore a worthy addition to those seeking value in the current market environment.

So, despite some calls to the contrary, there is no reason to suggest that we are nearing the end of a value recovery given the supportive macro indicators of late and when considering the longer-term picture. In addition, for all the concerns inflation has caused market participants, it tends to correlate with value outperformance and could provide an additional tailwind.

We think it is therefore worth looking at those sectors and businesses that tend to do well in a pro-inflationary environment – for example, the money-centre banks, both in the US and the UK, select energy stocks and some of the more cyclical sectors such as housing, construction and other industrials. These businesses tend to do a better job of passing on inflation through pricing, or through higher profit margins, than some other sectors of the market.

However, value does not necessarily have to just correlate to cyclical businesses and industries. There will be instances where the more staple-like businesses, healthcare or consumer staples themselves, should rightfully fall onto a value investor’s radar. We will continue to seek to move nimbly between value styles as they present opportunities in the market.

DISCLAIMER:

Discovery Life Investment Services Pty (Ltd): Registration number 2007/005969/07, branded as Discovery Invest, is an authorised financial services provider. Product rules and terms and conditions apply.

The views and opinions expressed in this article are for information purposes only and should not be seen as advice as defined in the Financial Advisory and Intermediary Services Act. Discovery shall not be liable for any actions taken by any person based on the correctness of this information. For full details on the products, benefits and any conditions, please refer to the relevant fact file. For tailored financial advice, please contact your financial adviser.

For the full CIS disclosure and risk statement, go to:

CIS disclosure:

<http://www.discovery.co.za/assets/discoverycoza/corporate/cis-disclosure.pdf>

Risk disclosure:

<http://www.discovery.co.za/assets/discoverycoza/corporate/risk-disclosure.pdf>