The HUB

NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

Putting purpose into value investing

Funding future liabilities and beating an index should be the aim when hunting for undervalued companies

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Key takeaways:

- Value investors should ignore indices and look for companies that can return 50% to investors over three years.
- To avoid mean reversion, investors should look for opportunities that arise across the business cycle in the form of undervalued earnings growth, undervalued assets, or undervalued dividends.
- Price moves often morph into sector or stock narratives that can stray far from the underlying economic reality. It is important to ally fundamental research and macro analysis to understand cycles and where unsustainable narratives may reside.

Much of the active management world focuses on beating the index. Beat the index and you get a big tick in the box from clients and the media.

But relative value strategies do not necessarily meet investors' needs. Institutional investors align their investments to match cashflow requirements, and even great relative performance does not necessarily tick that box during a long duration bear market.

So how can investors better match long-term liabilities?

Trading time for value

Vaughan Nelson sees the answer in simple terms: find companies that have the potential to return 50% to investors over three years regardless of the forthcoming economic environment.

Of course, execution is not as simple as the philosophy, and there are several components to this approach. The first is to echew relative valuation measures. While the rest of the market is caught up in media narratives about interest rates, inflation and meme stocks, the focus is resolutely on discounted cashflow.

"We are simply looking for attractive, idiosyncratic stock returns," says Chris Wallis, chief executive officer of Vaughan Nelson Investment Management, an affiliate of Natixis Investment Managers. "We only look at relative value as confirmation of our discounted cashflow analyses."

Returns are derived from one of three research areas: finding companies with undervalued earnings growth, undervalued assets or undervalued dividend yields. After that, you wait.

Wallis says: "We trade time for value. A longer time horizon allows us to exploit short-term volatility and poor short-term price discovery."

Exploiting the three key value categories

First, undervalued earnings growth. Sometimes the market has not considered a company's ability to continue investing for extended periods of time. The management team may have a particularly strong, but unrecognised, capital allocation track record, earning the same to higher returns on redeployed earnings and understanding that returning excess cash to shareholders is sometimes better than reinvestment.

Unearthing undervalued assets is essentially traditional deep value. It could be a cyclically-oriented company coming off a cyclical bottom, or a company refinancing its balance sheet or going through another type of structural change. There is an inflection point and suddenly free cashflow improves. Once the inflection point has been passed and value is realised, it's time to exit. Wallis says: "That's the beauty of having three distinct alpha streams – they each exploit one factor and prevent us from holding stocks too long and getting hit by mean reversion as other factors become more dominant."

The third category, undervalued dividends, is defined as the market insufficiently valuing a high and secure dividend yield of at least 10%. To qualify as undervalued, the balance sheet must not be depleted to pay the dividend, industry dynamics are stable, and the majority of the expected return comes from the dividend.

The bulk of the Vaughan Nelson portfolio falls into the undervalued growth category. "Undervalued growth is the most efficient way of compounding capital," says Wallis. Before the financial crisis, undervalued dividends were a significant component, but most value in that factor has since been exploited.

How macro plays a role in value investing

Although the main focus is on discovering hidden value at individual companies, Vaughan Nelson believes investors cannot ignore macro-economic information. "One of our differentiators is our macro work, which distinguishes us from most value managers," says Wallis.

It is particularly important to understand where we are in the economic and credit cycles and where the bubbles reside. Wallis says: "We don't like market narratives, they are not built on reality." To steer away from them requires a macro lens allied to stock research.

Vaughan Nelson's macro-economic framework aims to predict when there will be economic accelerations or slowdowns in service and manufacturing, inflation, and employment across more than 20 countries. The framework has proved reliable for 6-12 month lead times, for economic decelerations and 1-3 month lead times for accelerations Wallis says.

"There are only two ways to influence the direction of risk assets – a surprise change in the growth environment or inflation," he says. "The rest is white noise."

In general, macro forecasts do not drive Vaughan Nelson's portfolios. "It's more that we establish where we think there is future value and then ask whether there is anything in the macro that prevents that value from being realised," says Wallis.

Very occasionally, the macro environment is outright hostile, as in the lead-up to the financial crisis. Wallis says: "We did a lot of macro work in 2000 and realised that the private sector was not finished leveraging up, so policy would work normally. However, by 2006 we were scared to death because we saw that the financial system and housing had created a perverse set of incentives driving mortgage and credit derivatives." Vaughan Nelson realised that the era of leveraging was over and a systemic crisis was at hand.

That kind of crisis typically leads to nationalisation of the banking system and a lack of liquidity would affect all prices. To date, that has been the only time that macro has driven Vaughan Nelson's portfolio construction. "However, the intrinsic value of companies not reliant on easy credit was intact, and we could still own some of them, knowing that their fundamental value would eventually be recognised," Wallis adds.

Assessing the current macro environment

What of the current macro environment and its impact on value investing?

Vaughan Nelson sees a broad global recession possibly linked to a sovereign debt crisis. "We are going to have a good old-fashioned business cycle with credit deterioration, and potentially a cleansing of the sovereign balance sheet through inflation and a recession," says Wallis.

He believes we are in a "normal" economic cycle. This cycle may influence at the margin what Vaughan Nelson decides to own, but well-managed companies don't rely on cheap money and they will survive recession intact.

In fact, opportunities are rife. The current deglobalisation process, for example, worries many investors as global supply chains break down. However, as part of this process, new chains must be created. Countries across the world are restricting the export of chips, upgrading their digital infrastructure, and rushing to create national infrastructure champions.

As they do, companies selling capital equipment and infrastructure services will benefit. As Wallis says: "Wherever there's a loser, there's a winner."

Creating teams who find value that others miss

Seeking hidden value across a wide universe of global companies requires personnel who are seasoned, skilled and engaged in all aspects of the work.

Wallis says: "Everyone is a generalist here, even the portfolio managers do primary research." The skills required are wide-ranging. "If you invest in Japan you need to understand the culture and that means speaking the language. We have people with fluency in foreign languages so we can not only digest information, but better assess how management and the local culture can influence the outcome of the investment thesis.

All of Vaughan Nelson's portfolio managers have between 16 and 30 years' experience. "We don't hire people out of school as a rule and even our new research analysts have more than 10 years' experience."

That does not have to be investing experience – it could be in industry, banking, consulting or elsewhere. "The overriding aim is to maintain a team that has the capabilities to generate ideas and unearth value that others miss," Wallis concludes.

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