

## US equities: The time for value?

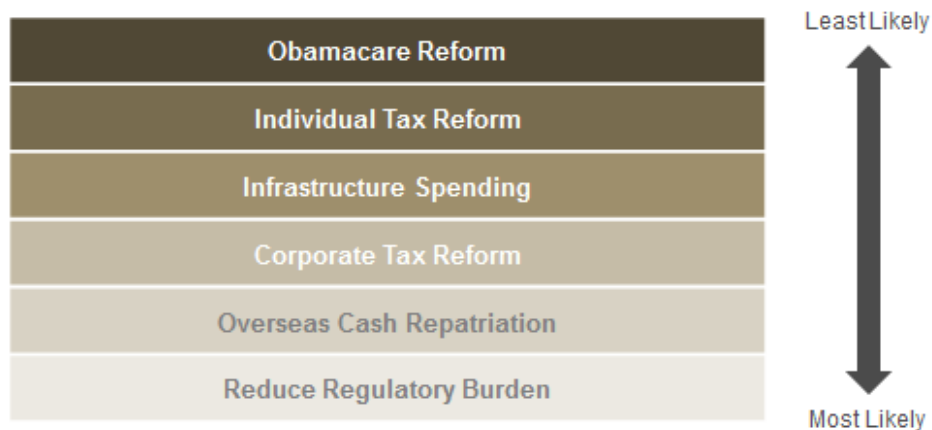
*Value investors should embrace market uncertainty as it creates opportunities to get great companies at fair prices, says John Bailer, US equity income manager at The Boston Company Asset Management<sup>1</sup>.*

There are growth companies investors believe will expand forevermore, which is unrealistic, he says. Instead, as a value investor, he invests in companies where expectations are low. This can be for a number of reasons: maybe the company has not been meeting its earnings expectations, or has difficulties with senior staff. "We are looking for those companies where there's some change taking place, such as shifts in management, or rationalisation of the business. These types of changes can affect the momentum of a business, and if the market does not realise it then the stock will represent good value."

### Embracing uncertainty

In the US, Bailer says the election of Donald Trump as President has brought some uncertainty into the market. Investors are reacting to whether they think his policies are going to be enacted or not and therefore whether they think the US will stay in a deflationary environment or get reflation?

### The most dramatic policy changes in decades



*But They Are All Pro Growth, Pro Business*

Source: TBCAM April 2017

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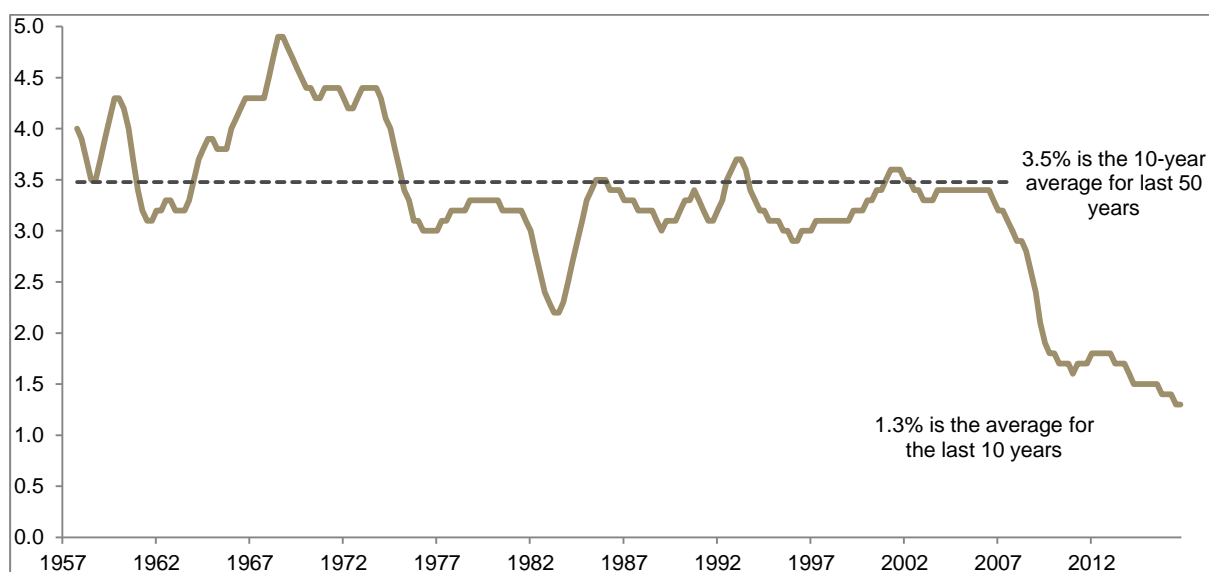


“There are some early signs of inflation coming back into the market and in the event this becomes more established our income-orientated portfolio should be well insulated as we own financial companies that should benefit from inflation and interest rate rises.

“If the repeal of Obamacare gets a second chance and the house approves it then the likelihood of all the other policies panning out improves. All of the potential reforms are pro-growth and pro-business and should therefore be pro-GDP growth and pro S&P 500 earnings per share growth if they get passed.”

Bailer says investors are positioning in stocks that are economically insensitive. This is due to the 10-year average of US GDP, which is much lower than was seen in the 50 years prior to the financial crisis. “You have to ask, are we going to see 1% GDP growth forever? Is that the new normal, or were the previous 50 years normal?”

### 10-year rolling average US GDP



Source: Bloomberg, Bureau of Economic Analysis. As of 12/31/2016. For illustrative purposes only. Some information contained herein has been obtained from third party sources that are believed to be reliable, but the information has not been independently verified by TBCAM. TBCAM makes no representations as to the accuracy or the completeness of such information.

He adds: “I believe the market is imbalanced – very low interest rates for longer and the associated search for income has made bond prices very expensive and stocks that act like bonds have become very expensive as well.”

### Value vs. growth

Looking at the history of growth versus value Bailer pointed out that during the dot-com era, growth stocks outperformed, and the gap between price-to-book ratios of growth versus value peaked at historic highs of 13.4 in 2000.

After the tech bubble burst, investors fled to value stocks. But by March 2009, valuations across the market were compressed, with the difference between the most and least expensive stocks about 3.9 on a price-to-book basis, making growth stocks attractive relative to value, he says. Amid stagnation, investors sought stocks with secular growth stories, such as Amazon, Google and Facebook. Importantly, after seven years of secular stagnation, the valuation gap approached tech-bubble levels and peaked at a price-to-book difference of 12.1 in March 2016.

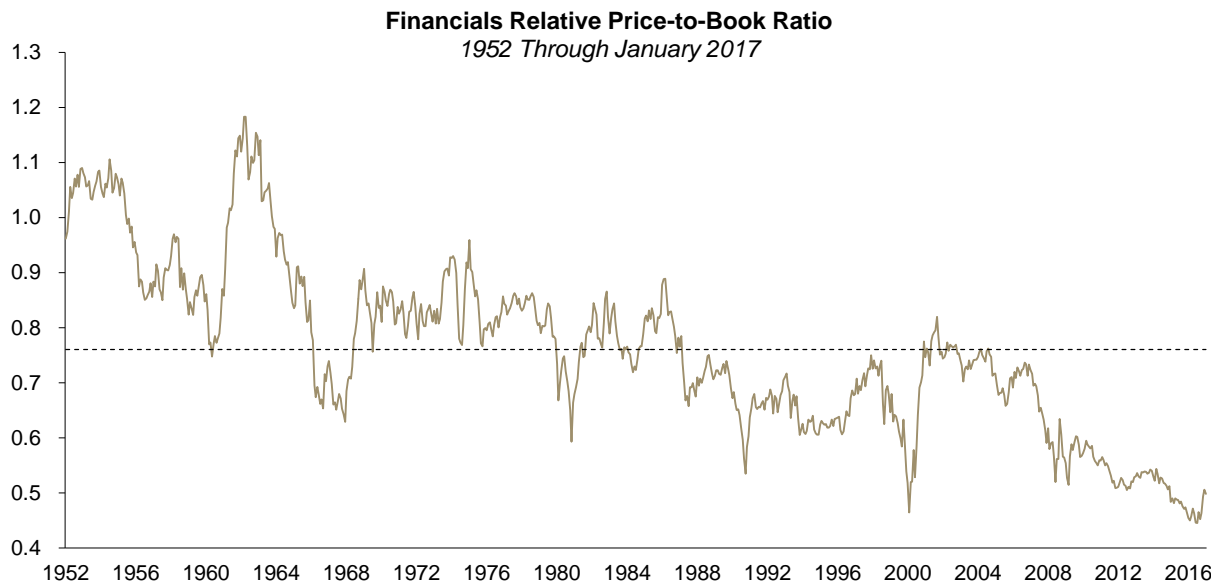
“We believe this outside dispersion sets the stage for the next rotation back to value stocks. In fact, 2016 was the first year since early 2010 when value outperformed growth. Even in traditional value



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sectors, dispersion is wide. Investors have bid up prices in bond-proxy sectors, like utilities, while avoiding sectors maligned during the post-financial crisis recession, like financials.

“For example, in July 2016, we were able to buy financials with higher dividend yields and significantly better expected three-year dividend growth rates at meaningful price-to-earnings and price-to-book discounts relative to utilities. Outside the bond-proxy sectors, we are finding attractive opportunities that offer healthy dividends, compelling valuations and business improvement catalysts.”



Source: Corporate Reports, Empirical Research Partners Analysis, National Bureau of Economic Research. As of January 2017. For illustrative purposes only. Some information contained herein has been obtained from third party sources that are believed to be reliable, but the information has not been independently verified by TBCAM. TBCAM makes no representations as to the accuracy or the completeness of such information. [19656]

### Behind banks

Bailer is bullish on financials but recognises there's still a large population of investors who hold a negative view on the sector. “Perhaps that's understandable given the long-lasting impact of the global financial crisis almost a decade ago. But by holding that view those investors are precluding themselves from owning stocks whose dividends – in our view – are going to experience strong growth over the next few years.”

He says balance sheets in the financial services sector are as good as he's ever seen them. In July 2016, all of the US banks required to take the Federal Reserve's 'severe adverse scenario' test passed with a tier 1 leverage ratio of 4% or higher.

Meanwhile US banks have been “extremely conservative” in their lending policy. Far from over-extending themselves, they have generated some of the best loans on their books over the past eight years, he says.



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