

January 2017

Europe 2017: value, large-caps & liquidity

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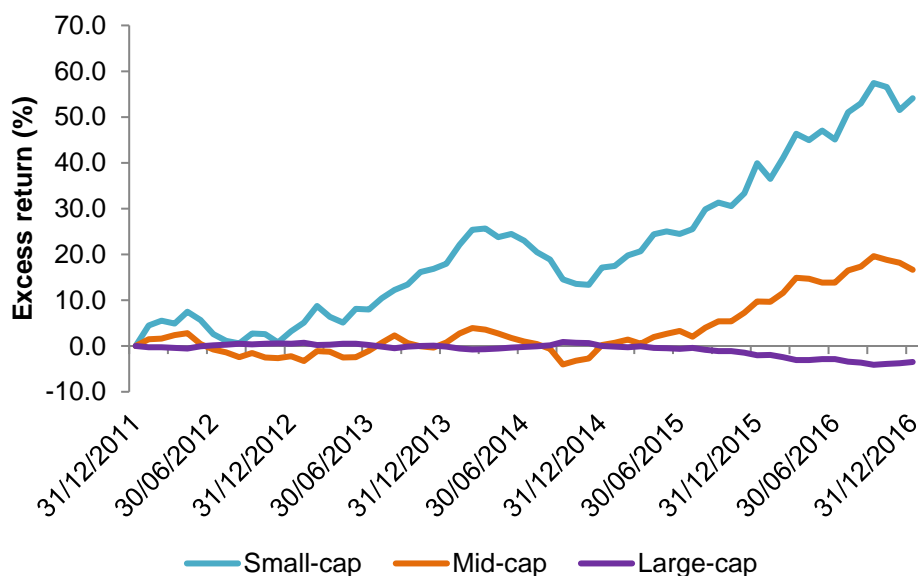
2016 was the first year that value stocks outperformed growth in Europe since 2009. Since the onset of large-scale quantitative easing in the US and Europe one of the simplest ways in which active managers could outperform was investing in quality growth as a style. As yields have fallen, the future earnings of quality growth companies – which are longer in duration than value areas – become more valuable in the present, which results in significant multiple expansion.

This has driven the outperformance of growth over value since the financial crisis. As value companies typically exhibit shorter duration earnings and cashflows, they have not had the same multiple expansion enjoyed by companies in sectors such as consumer staples and healthcare. The Neptune European Opportunities Fund moved to a value bias in late 2012, dragging on some of our medium-term numbers. However, we believe we finally reached an inflection point for value in 2016, with all value sectors – including financials, materials and energy – contributing to the Fund's outperformance of the Index. This saw the Fund return 29.1% in 2016 as a whole, versus the benchmark return of 19.7%.

Has the small-cap cycle turned?

We have often talked about a reliance on quality growth amongst many European managers, but there has been another route to outperformance – overweighting small and mid-caps. Small and mid-cap stocks have significantly outperformed over the last 5 years as investors have chased growth and liquidity has been plentiful.

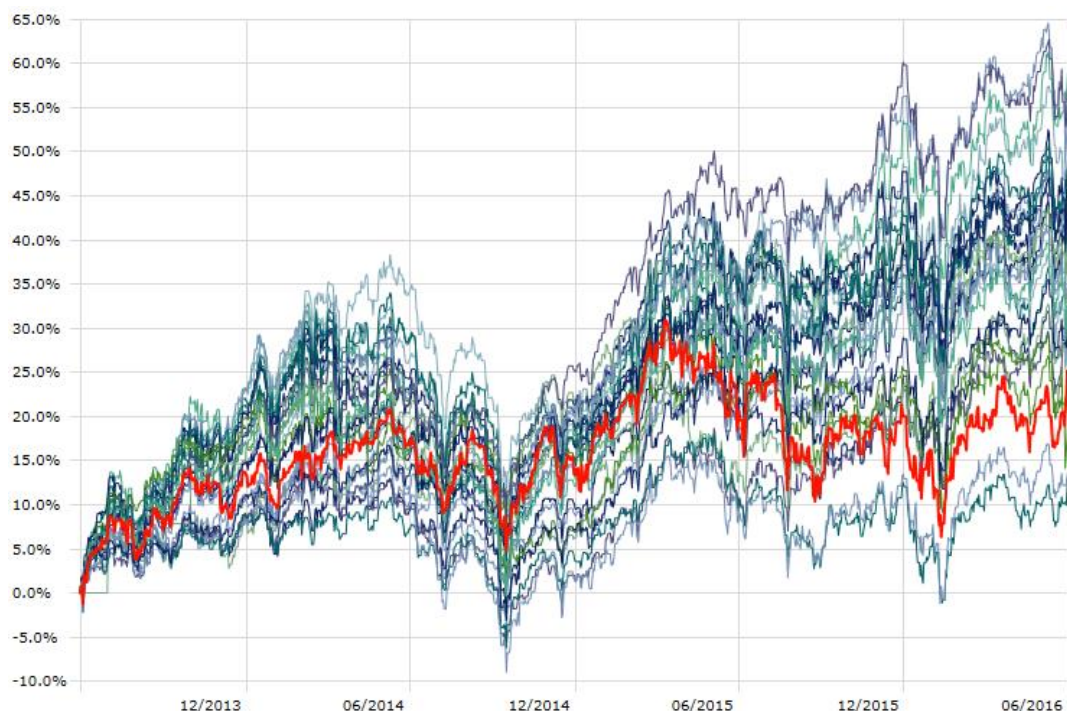
The performance of small, mid and large-caps versus the MSCI Europe ex UK Index



Source: Morningstar Direct, five years to 31.12.16. The graph shows the relative performance of the MSCI Europe ex UK Small, MSCI Europe ex UK Mid and MSCI Europe ex UK Large indices versus the MSCI Europe ex UK Index, in pound sterling.

Small-caps have outperformed the Index return by 55% over the last five years. Given that only 1.3% of the Index is made up of small-cap stocks, this has offered an easy route to outperformance for many managers: 24 out of 28 European small and mid-cap focused funds have outperformed the wider Index in the three years to the 30 June 2016. However, in the second half of 2016, only 21% of these funds outperformed.

European small and mid-cap focused funds versus the MSCI Europe ex UK Index (red line)



Source: Morningstar Direct, as at 30 June 2016, in pound sterling.

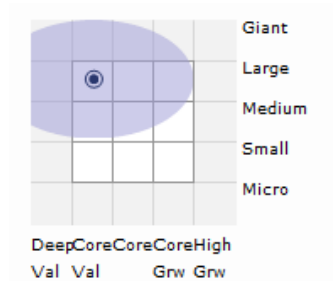
The return of large-caps?

As well as value returning to the fore in the second half of 2016, large-caps also halted their five years of underperformance. We believe this is because value stocks are typically large-caps, especially in Europe. Stocks that endured a tough five years included big Eurozone banks such as BNP Paribas, oil giants like Total and large chemical companies, including BASF.

Many investors think that value's inflection point at the end of June was related to Brexit. However, we believe it was actually related to the ECB and the BoJ abandoning further moves into negative interest rate territory. Global yields started stabilising and trending higher. History has proven that value outperforms when there is a stable or rising cost of capital, which is the environment we believe we are in now.

We believe this will also lead to a continued outperformance from large-cap stocks, given the association of market-caps and valuations in Europe. As a result, the Neptune European Opportunities Fund – as well as having a value bias – is also overweight large-caps versus its peers, as shown below.

Neptune European Opportunities Fund style map & market-cap



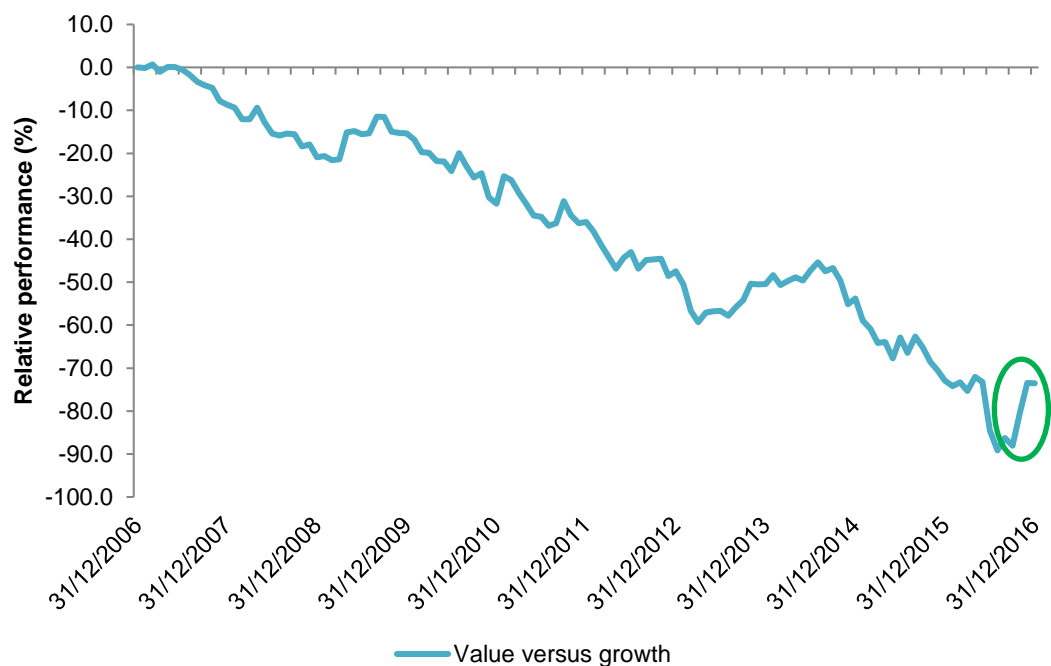
	Av. market-cap	P/fE	P/B
Neptune European Opportunities	£28.2bn	14.9	0.9
IA Europe ex UK sector average	£19.5bn	16.8	1.9

Source: Morningstar Direct & Neptune, January 2016.

Outlook

Despite the uptick in the performance of value and large-caps respectively, there is still a long way to go in reversing their recent underperformance. Large-caps underperformed small-caps by more than 50% over the last five years and the outperformance of value in 2016 has barely made a dent when the last ten years are taken into consideration.

MSCI Europe ex UK Value versus MSCI Europe ex UK Growth over the last decade



Source: Morningstar Direct, as at 31.12.16.

H117 volatility

Although we have a positive outlook for Europe in 2017, there are of course risks to this view which, typically, are primarily political. Although not our base case, the possibility of the election of Geert Wilders in the Netherlands and Marine Le Pen in France in the first half of this year will likely cause some short-term uncertainty and market volatility. However, as we saw in 2016, high political risk did not disrupt value's outperformance – quite the reverse – it increased it.

In an environment of a rising cost of capital, it is important that investors understand the liquidity of their portfolios. Given the large-cap bias of the Neptune European Opportunities Fund, scenario analysis suggests that our entire portfolio could be liquidated within three days, should it be warranted. Of course, this is very unlikely to ever be required, but it highlights that liquidity risk is low in the portfolio. In contrast, significant market volatility would mean that it could be very hard to exit significant positions in less liquid small and mid-cap stocks. Liquidity therefore may become more relevant to investors in coming years.

Conclusion

Since the 1920s, value has outperformed growth 70% of the time. However, it is falling interest rates and thus falling yields and falling discount rates, that is kryptonite for value stocks. Since 2008, interest rates have fallen to historic lows, with interest rate futures pricing in a 0.5% rate in Europe as far out as 2050 in some instances. However, we believe that era has now passed, with rates now stabilised and – in the US for example – trending upwards. Although we do not expect sharp rises, we do expect a stable and gently rising trend to be the new norm for global yields.

We believe this environment will be favourable for value and the predominantly large-cap occupants of this space. Given the electoral battles ongoing in Europe in the first half of 2017, we also expect large-caps to provide a liquidity buffer should we encounter any short-term volatility.

Important Information

Investment risks

Neptune funds may have a high volatility rating and past performance and forecasts are not a guide to future performance. These are Neptune's views and as such this document is deemed to be impartial research. We do not undertake to advise you as to any change of Neptune's views. The value of an investment and any income from it can fall as well as rise as a result of market and currency fluctuations and your clients may not get back the original amount invested. References to specific securities or sectors are for illustration purposes only and should not be taken as a solicitation to buy or sell these securities. Neptune funds are not tied to replicating a benchmark and holdings can therefore vary from those in the index quoted. For this reason the comparison index should be used for reference only. Neptune does not give investment advice and only provides information on Neptune products. Please refer to the prospectuses for further details.