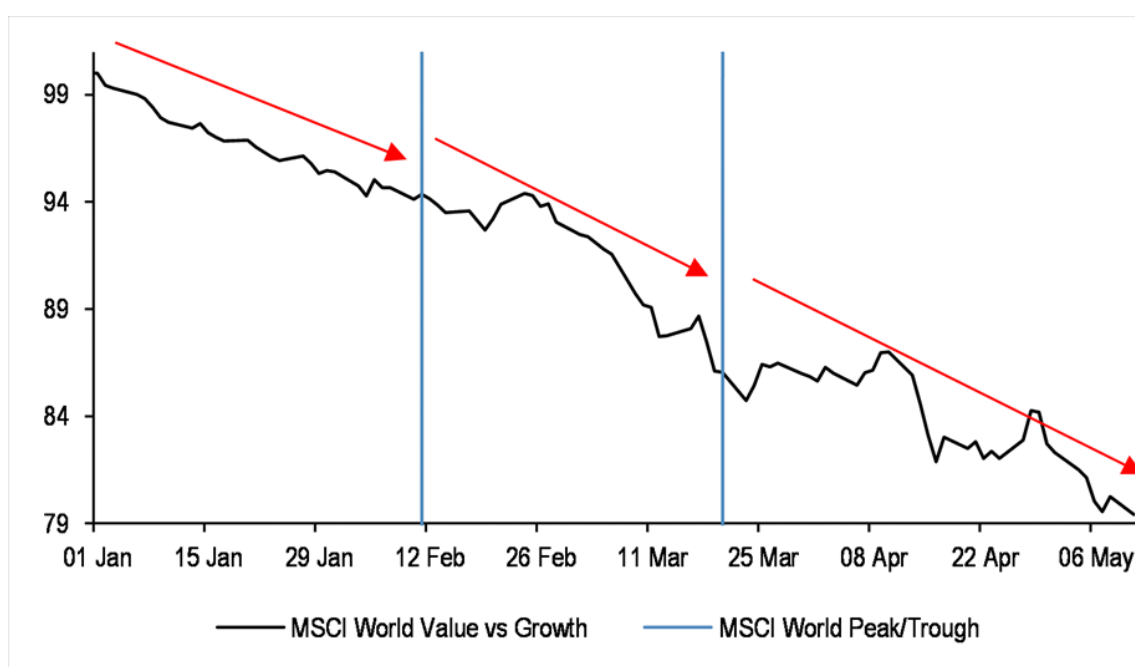




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Value investing and Covid-19 crisis did not mix well. Value has indeed been underperforming growth going into the market correction this year, continued to underperform during the crisis and still underperformed in the subsequent rebound. This is summarized in the below graph from JPMorgan.

Fortunately enough, investing is not about looking into the rear mirror. And here we remain convinced that the odds of an imminent rebound of value stocks are increasing.



Source: JPMorgan

The main reasons for our high conviction level into our investment approach are the following :

1) Reversal to the mean

The value spread, or the valuation gap between the most expensive stocks and the cheapest stocks in the main developed markets is at historical high. This is the same valuation excess last seen before the bursting of the Internet bubble. **If history is any guide, the higher the valuation spread, the higher the outperformance going forward of value stocks.** In other words, the more value underperforms its growth counterparts, the higher the expected future return. We agree humbly that this argument is hardly recomforting for existing value investors but it is what we call the law of (valuation) gravity of the financial markets.

2) An exaggeration of some of the argumentation in favour of growth investors

As value investors we are quite used to the arguments of technological disruption, the importance of intangibles not considered by many value investors and the concentration of market shares to a small number

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of winners. However, a closer look at these arguments makes us think that some of them are exaggerated. Value stocks are better, healthier, have high market shares and are more profitable than their reputation.

3) Inflation and higher interest rates will return.

One of the reasons value underperformed over the last decade are the low interest rates and the quantitative easing measures put in place by central banks. These were important to help our economies to normalize. We also believe that the exceptional measures currently being announced by governments and central banks are justified to kickstart economic activity after the lockdowns. This approach to throw liquidity at the wall till something sticks is however coming sooner or later at a price: debt, inflation and higher interest rates. Rising prices and higher interest rates in turn will benefit value stocks against their growth counterparts.

4) Business sentiment about to rebound from lows

As we pointed out in previous morning coffees, there has been historically a strong positive correlation between outperformance of value stocks and increasing business climate. PMIs are now at extreme lows. The Eurozone composite PMI for example has crashed from 52 points in February, to 30 in March and to an even more depressed 13 level in April. When China was coming out of the lockdown, the PMI quickly rebounded from its lows. We are convinced the same will happen in Europe over the coming weeks.

In the recent Netflix series "The last dance" featuring the career of Michael Jordan, he makes the following comment: "It is who I am. It is how I play the game. That is our mentality. If you do not want to play that way, don't play that way." This somehow resonates with us: **we are of course adapting the way we apply our investment philosophy in today's environment, but we stay true to the investment principles laid down by Benjamin Graham in the 1930's. This is who we are.**

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
May 22th, 2020

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