

Full, but not bursting

“Donald Trump has used his Twitter account to threaten a nuclear first strike on Iran and to promote the rich, smooth taste of Bud Ice.

A 3.20am tweet from the president-elect read: “New Iran deal under Trump is drop ‘Islamic’ government or nuclear weapons targeted on Tehran! 5.5% ABV Bud Ice is cool and refreshing!”

– From *The Daily Mash*.

It may be one of the more powerful contra-indicators in finance. The attendance at SocGen’s annual investment conference in London is widely tracked for the signals it may be sending about market confidence. Last year the conference was packed to the rafters with supposed ‘perma-bears’ – and FTSE, along with many other stock markets, enjoyed an excellent year. This year, the conference – which took place last week – was full, but not bursting. In the words of David McCreadie at Hobart Capital Markets,

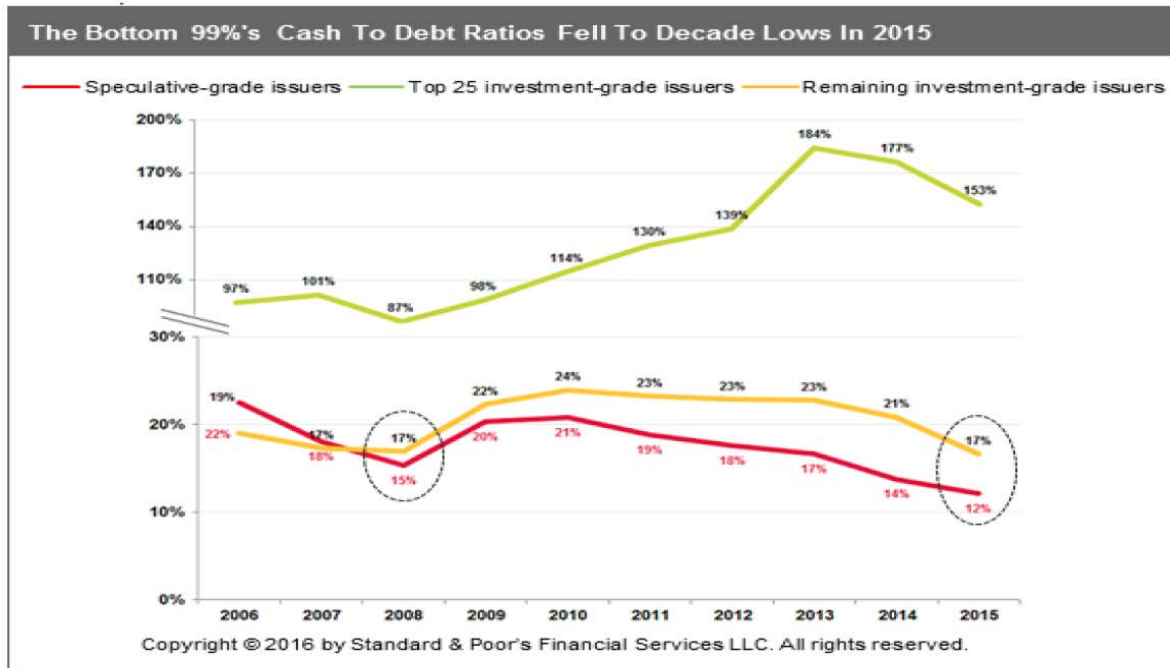
“That nicely sums up the stage of acceptance the market has reached with current equity levels.”

While many of those Britons who wish to Remain in the EU are still stuck in the Denial stage of the Kübler-Ross grief cycle, many asset managers – in the face of a continued bull market for stocks – have clearly moved on to the Acceptance phase.

But for investors of an inquiring or somewhat sceptical hue, SocGen’s various speakers provided plenty of food for thought.

We are constantly told, for example, about the cash piles that US companies have hoarded around the world. As Andrew Laphorne points out, these cash piles may be somewhat more concentrated than we have been led to believe:

CASH IS HELD BY THE LARGEST 25 COMPANIES. THE REMAINING 99% OF US COMPANIES HAVE HISTORICALLY LOW CASH RATIOS



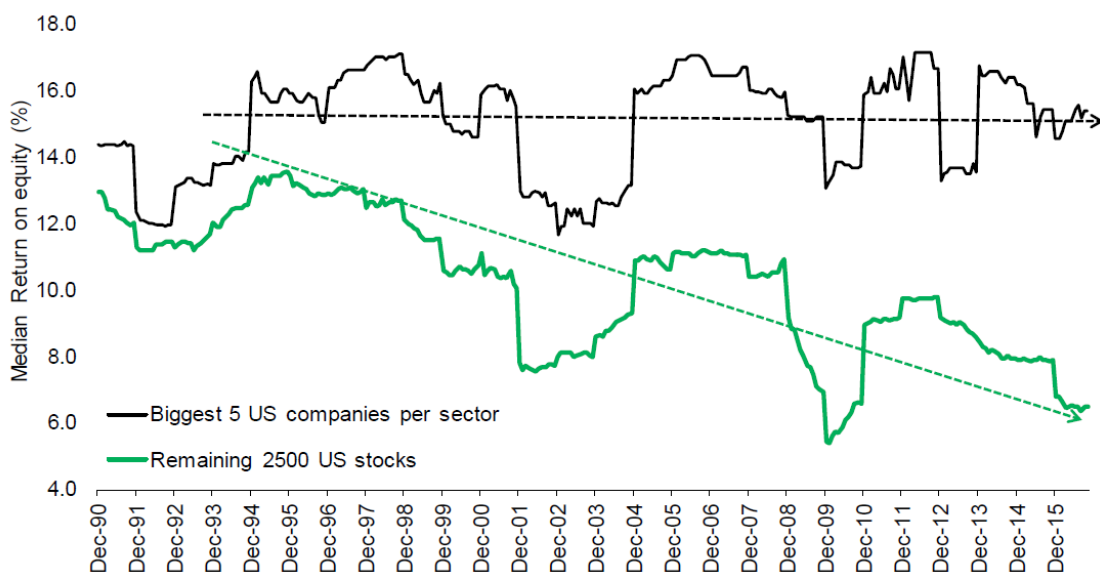
Source: Standard & Poors

While the largest 25 US companies may be rolling in cash, the remaining 99% of corporate North America barely has any.

It's a similar story of concentration when it comes to corporate profitability:

US CORPORATE INEQUALITY...

The biggest US companies remain very profitable, the rest are struggling



Source: SG Cross Asset Research/Equity Quant. Factset

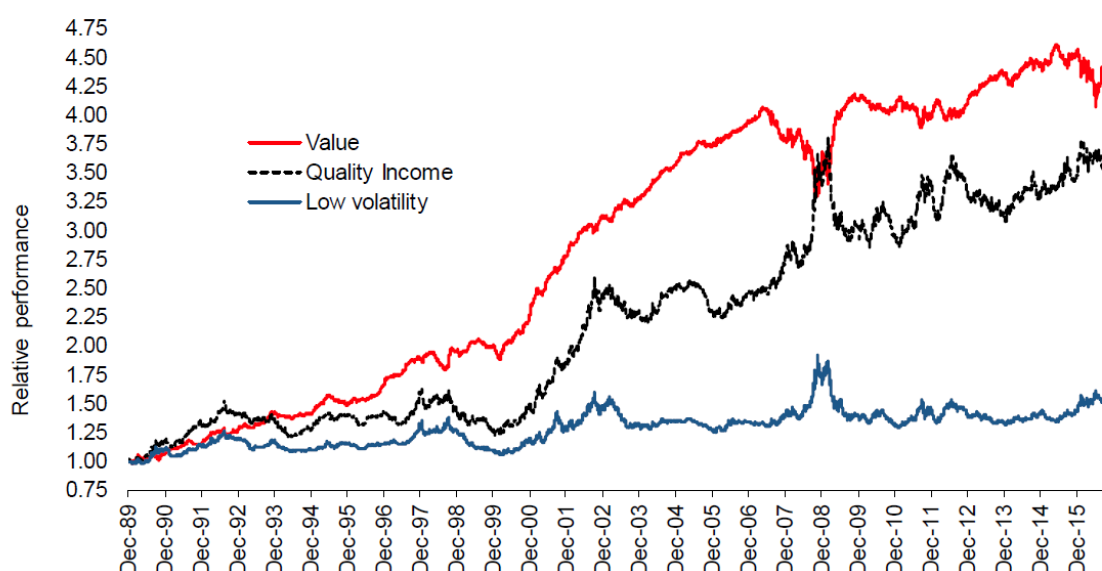
While the largest five US companies in each business sector are enjoying relatively high returns on equity, the trend in profitability for the remaining 2,500 stocks has been deteriorating for the past two decades. In other words, US market breadth is extremely concentrated, and the health of the overall market has been obscured by the performance of a handful of mega-cap companies now sporting premium multiples.

As value managers we were particularly interested to hear Andrew Lapthorne’s take on the growth versus value debate. His take: value stocks **were** in a bear market, but have started to recover strongly over recent months. ‘Growth’ stocks, however, or what SocGen refer to as ‘High Quality’ stocks, now enjoy record valuations, as expressed in 12 month median p/e ratios. Given the acute concentration of profitability and cash hoarding displayed by the handful of US market leaders, investors searching for a margin of safety may wish to be somewhat more discerning in 2017.

For us, Andrew Lapthorne’s stand-out chart was the one that follows:

IN THE LONG RUN VALUE INVESTING IS WHAT MATTERS

Relative performance of a global Value, Quality Income and Low Volatility Portfolio



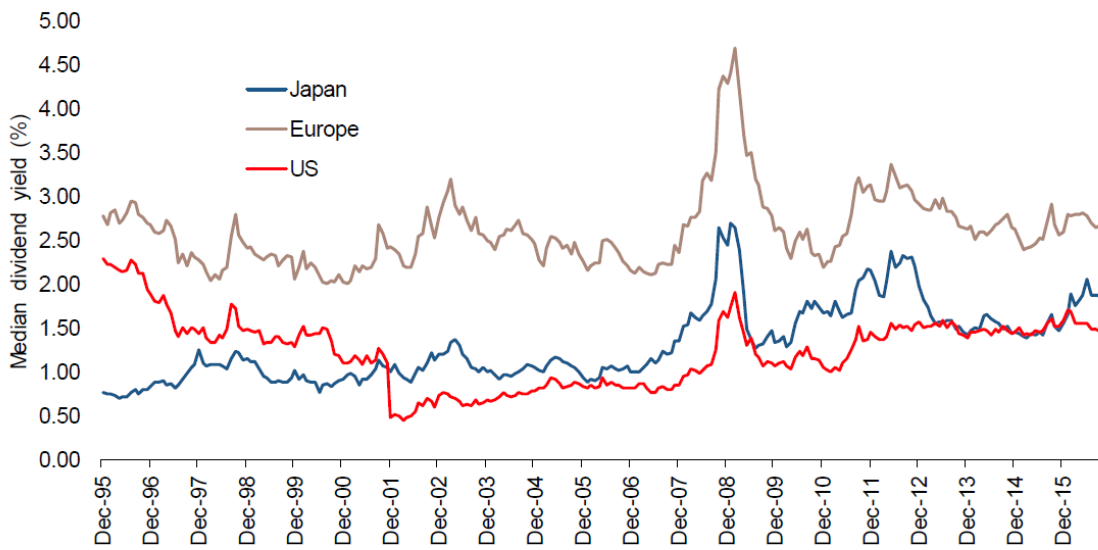
Source: SG Cross Asset Research/Equity Quant, FTSE, I/B/E/S, FactSet

From a style perspective, on SocGen’s analysis of markets since 1990, value as a strategy outperforms everything else, and certainly outperforms both ‘Quality Income’ and the particularly disappointing-looking ‘Low volatility’ strategy. Which is not to say that value doesn’t incur drawdowns – but rather that the longer term performance of value justifies the commitment to the strategy, warts and all.

What may surprise many investors, particularly those looking for income, is the extent to which the Japanese market now appears on the radar. As the following chart makes clear, the average Japanese dividend yield is now above that of the US:

AVERAGE JAPAN DIVIDEND YIELD IS ABOVE THE US

Median dividend yield by region

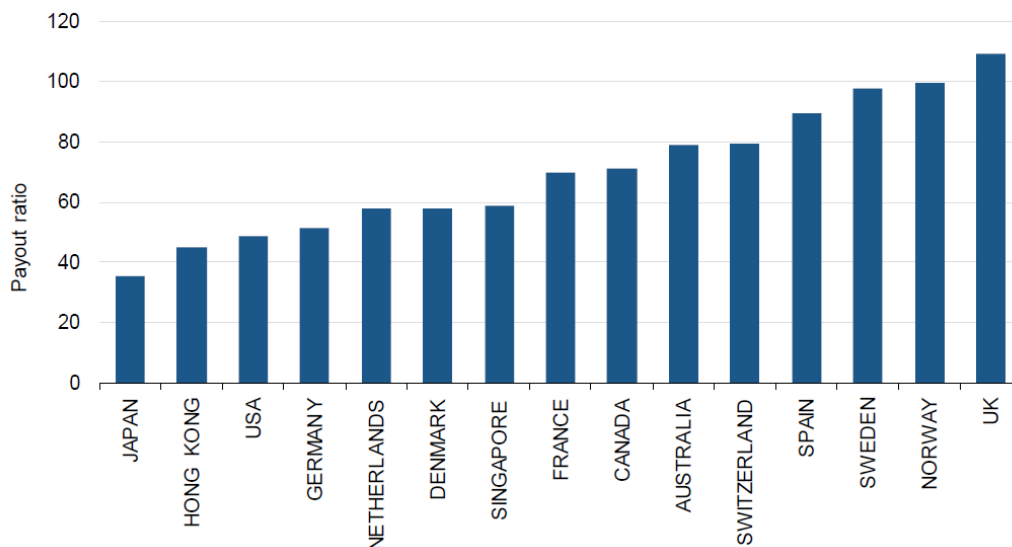


Source: SG Cross Asset Research/Equity Quant, FTSE, I/B/E/S, FactSet

Another intriguing aspect of the Japanese market is that while dividend payout ratios are low relative to international peers, they are rising quite strongly. Those in the UK, by contrast, appear unsustainably high, at a time when dividend cover looks somewhat fragile:

JAPAN HAS THE LOWEST PAYOUT RATIO

Dividend payout ratios by region



Source: SG Cross Asset Research/Equity Quant, FTSE, I/B/E/S, FactSet

As an example of the latter, Glaxo SmithKline, popular amongst equity income funds, made £1.9 billion in cash from operations for 2015 – but paid out £3.8 billion in dividends. No

company can continue to pay out to shareholders more than it makes by way of profit, indefinitely.

The Japanese stock market is at the other extreme. Having endured a more than two decade deflationary recession, Japanese corporate balance sheets are now the strongest in the world. The Japanese government is encouraging better capital allocation. Stock buy-backs are now accelerating, and unlike US debt-fuelled buy-backs, Japanese stock buy-backs can be funded out of cash. Japanese dividends are also being raised relentlessly.

In addition, Japanese stocks are benefiting from capital flows, too. As John Seagram of CLSA puts it, there is now a new 'High Roller' club buying Japanese stocks. To be a member, you need to commit to buying at least ¥4 trillion worth of stock annually. The Bank of Japan is a founder member, currently buying ¥6 trillion in ETFs each year. Corporate Japan will have bought back approximately ¥6 trillion in stock in 2016. The Government Pension Investment Fund, GPIF, the largest pension fund in the world, has raised its equity target weight to 25%, which is consistent with buying ¥5 trillion of stock. And Japanese private investors, in part through NISA portfolios, were on track last year to buying an annualised ¥4 trillion. That totals ¥21 trillion – or more than 5% of the Topix free float. For the first time in years, the Japanese stock market now has strong domestic support.

So it may not be too much of a surprise to learn that Japan represents the single largest country exposure in our unconstrained global value fund.

Many Asian stock markets look inexpensive by comparison with their western cousins. Asia, however, has in many cases better demographics (younger populations), healthier banks, and realistically superior prospects for longer term economic growth. Western markets, on the other hand, and notably the US, have valuations that look full, if not necessarily bursting. Yet. The combination of highly attractive bottom-up valuation and superior growth prospects is not a common one. 'Asian value' offers something comparatively rare in modern investment markets: a genuine margin of safety.

Tim Price is co-manager of the [VT Price Value Portfolio](#) and author of 'Investing through the Looking Glass: a rational guide to irrational financial markets'.

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