Q1 2018

Sparinvest

Quarterly report

VALUE EQUITY

Uncertainty fueled volatility

Despite a stellar start to the year, global equity markets ended the first quarter with negative returns. Global markets stumbled heading into February, when stronger than anticipated wage growth in the U.S. caused bond yields to move upwards. Equity markets fell, as investors seemed concerned that rates might rise faster than the economy could withstand. Equity markets stabilized during February, only to be spooked in March by fears of a global trade war following U.S. tariff announcements.

Over the quarter, global developed markets (as measured by MSCI World) declined by 3.61 percent, European markets (MSCI Europe) fell by 4.30 percent, and global emerging markets (MSCI Emerging Markets) fell by 0.98 percent. Value stocks continued to lag growth stocks, particularly in the United States. This had some pronounced effects on the relative performances of our three strategies. Our global developed market funds slightly lagged MSCI World, but did better than the value index. Our European strategies did well against both MSCI Europe and MSCI Europe Value, while our global emerging market strategies lagged both MSCI EM and the value index.

The market declines coincided with very strong spikes in volatility, which we have not witnessed in a long time. That is clearly a change from the recent past, in which equity markets had continued to tick upwards in a stable manner. Increased volatility, however, cannot be too much of a surprise. We are now in the 10th year of recovery since the global financial crisis, there has been a long bull market, and equity valuations are somewhat lofty – albeit more so in some regions than others.

A few key factors are influencing markets. Global economic momentum is perhaps easing a little, but remains generally positive, and we still see fairly positive earnings growth, which can help drive equity returns. In some areas, valuations are arguably a little high, and we probably see more value in Europe and emerging markets. Meanwhile, quantitative easing is ending, and political risk is not low – not least due to the wild card - President Trump. Investors are weighing these factors, and they perhaps leave financial markets without clear momentum in the short term.

What to expect?

The unwinding of quantitative easing may be the biggest elephant in the room. It has been an unprecedented monetary experiment, which does appear to have worked – but it is difficult to know the nature and impact of its unwinding. Pulling back from it is a delicate balancing act: too fast, and it can clearly impact global growth; too slow, and it can help fuel inflation and asset bubbles, and lead to even more pain in the future. In any case, quantitative easing and ultra-low interest rates had extreme impacts on the nature of equity investing in recent years, many of which we have written about before. Under those conditions, and with periods where political risk was elevated, for many years a 'risk on, risk off' atmosphere dominated stock markets. It was not so much about selecting single stocks, but more about whether you were in or out of equity markets. Correlations between stocks were high, so rather than picking individual companies, much boiled down to picking the right sections of the markets. One popular example has been simply buying big blue-chip benchmark stocks and harvesting market beta. Now that quantitative easing is gradually unwinding and interest rates rising, uncertainty increases. What has worked in the past 10 years, will not necessarily work going forward.

Turning to the current state of the global economy, we see mixed signals. In March, the OECD raised the outlook for the global economy from its previous assessment. Global GDP growth is expected to reach 3.9 percent this year and next, which is more in line with long-term averages. Therefore, the global economy is in good shape, but some clouds are building on the horizon. A normalization of monetary policy will eventually lead to higher interest rates and could pose challenges to mortgages, loans, and high corporate and public debt. The OECD also share the common view that a normalization of monetary policies will bring more volatility and risks going forward, especially as stock market valuations are elevated. They argue for governments to step up structural reforms to ensure future growth as the medium-term growth outlook is still weaker than prior to the global financial crisis.

Donald Trump's activities add to the worries, and the first quarter could prove to be the start of a trade war. The entire episode has been disorderly. Despite opposition from some key advisors, Trump announced tariffs on steel and aluminum. This drew quick comment from around the world – including from the EU and Canada, whom Trump quickly decided to exempt from his tariffs, leaving China as the main target. Tariffs on USD 60 billion of Chinese imports target a range of products including components used in aeronautics, technology and energy. China responded by announcing new tariffs imported American meat, wine, fruit, nuts, ethanol and other products: arguably hitting some of those Americans who voted for Trump in the first place. It remains to be seen whether this could jeopardize some Republican seats in the upcoming midterm elections. In any case, the steps taken so far, and the confusion, are setbacks to smooth free trade, and stock markets have responded negatively. However, the end goal of Trump's actions are not always clear, and it may well be that not everything being said now will actually be implemented – so we should not assume a full-blown trade war is necessarily upon us.

Active/passive revisited

The return of market volatility and the quarterly losses have made more people ask themselves – and some have asked us - if the bull market has come to an end. We do not have the answer to that, but it certainly seems like the easy money to be made since stock markets bottomed out in 2009, has now been made. A substantial part of the returns since then was driven by valuation changes and many investors are of the opinion that markets are currently too expensive. Yet investors have piled money into equities, mostly into passive indexing strategies whose success seems to continue at present. We have touched upon this phenomenon and the active/passive debate before, but given the recent development, we think it makes sense to add a small comment.

We have said before that there are pros and cons to both passive and active investing and we are not trying to advocate one or the other. However, one of the differences is that while passive strategies offer market participation at a fraction of the cost of the typical actively managed fund they also mean that you give up any chance of outperformance. If you accept the premise that low interest rates and quantitative easing have pushed up equity prices, and that market returns going forward will be humble, flat, or even negative, then you might well think that many investors would now start to prefer active managers. They have the option to pick stocks that are reasonably valued and avoid the expensive parts of the market. However, statistics do not seem to suggest that the tide has turned yet.

In January, there was an interesting article in the Financial Times, stating that there are now more than 70 times more indexes in the world, than there are listed stocks, according to a survey by the Index Industry Association. So, not only is there a lot of money in passive investment strategies, but the list of indexes replicating various parts of the market has grown to be endless. We are not able to foresee what would happen if the trend changes and passive strategies see heavy outflows, but we think, that it could have huge implications for equity returns.

Meanwhile, we continue to follow a long-term value investment strategy, where we care more about the underlying fundamentals and valuations in our portfolio companies, rather than overall stock market trends. Although the recent market pullback has been a drag to short-term performance, it has given us an opportunity to lay the foundation for stronger future returns, and we have added a couple of new names to the portfolios, while other have been sold.

UPM

An example of positive stock selection is the Finnish paper producer UPM that we have been selling during the quarter. We invested in UPM in the summer of 2008, after its market cap had halved over the course of a year to around EUR 5.3 billion (enterprise value EUR 9.8 billion). Its EV/EBITDA multiple had declined from around eight times to around 6.5 times, as the company faced earnings pressure from rising pulp and oil prices as well as currency headwinds. Despite this, we thought that UPM was well placed given its market leadership, its position as a relative low cost producer, and its vertical integration. For example, the company had vast forest holdings that secured cheap pulp supply for its paper production. UPM also had a substantial financial stake in its own energy production, and owned part of an associated company Metsä Botnia. We concluded that these holdings, which it could choose to divest, were worth almost its entire market capitalization. Therefore, we felt the company would eventually ride out the headwinds, and in the meantime, there was strong asset backing.

After we invested, the operating environment took a turn for the worse. UPM was faced with a European economic crisis on an unprecedented scale. More importantly, we recognized that UPM's paper products faced a major structural headwind in the form of digitalization, but this turned out to be fiercer than we expected. From our point of view, UPM has responded in the right way to these challenges. Over the last

10 years, it has shrunk its productive assets by almost a quarter, reducing excess capacity and improving asset efficiency. At the same time, it has used the cash flows from its Finnish paper production to increase capacity in the growth markets of Asia, and it has shifted from plain paper towards higher value-added adhesive products. UPM also monetized several financial assets to re-position the company and restore its earnings power. Since our investment in 2008, UPM has generated almost EUR 800 million of free cash flow per annum. This translates to a free cash flow yield of almost 15 percent, if compared to the market capitalization at initial investment. During this transition, UPM has paid out roughly half its cash flows through dividends. In recent months the share price has reached multiple decade highs, as earnings are strong and its EV/EBITDA multiple has reached 9.0x again.

We decided to sell most of our shares and realized an annualized return of around 17 percent per annum over our holding period, compared to around 10 percent for MSCI World. This example perhaps illustrates a few things. The first is the obvious point that active stock pickers have the ability to exploit shifts in market valuations to enter and exit companies. They do not have to remain invested at any price, but can use buy and sell discipline to help generate competitive returns. Second, strong asset backing can provide some form of insurance if some of your earnings assumptions do not pan out as expected. 10 years ago, we thought the company was facing cyclical and structural headwinds, but we underestimated the structural headwinds – but the asset backing provided the company with the flexibility and resources to reposition itself. Third, although the new economy and internet stocks get most of the attention these days, in practice is can still be possible to generate decent equity returns by investing in old industries, and even in industries like paper, which face a structural decline. Strong cash flow generation and consolidation often help explain this, and UPM is no exception.

Outlook

We constantly evaluate this investment approach and our processes. One of the things we anticipate going forward is further bifurcation of investment styles. We have decided to engage more actively with our investments and get closer to management, so we have more influence. We have had a voting policy for many years, later followed by an engagement policy. Recently, we became signatories to the Danish Stewardship Code, which was a natural fit for us given the efforts we make in being responsible, active owners. You can read more on this in the Stewardship section of our website. This year we have decided to further refine our voting processes and policy, introduced more bespoke elements. We will write more on this in the future, but a clear focus is board quality. The aim is to encourage our holdings towards stronger governance – and as always, when companies do not meet our requirements, we will express our dissatisfaction through our voting, and through direct communication with the company. For example, we are tightening our requirements on the proportion of independent directors in the board. We are discouraging the practice of combining the roles of chairperson and CEO in one person. We are encouraging companies to improve gender diversity, which we see as a clear positive for governance and long-term corporate value. The first step, across developed and emerging markets, is to target the least diverse companies, by voting against companies who do not even have one female board member, but we will be encouraging all our holdings to push for higher standards. We look forward to elaborating more on this in future.

Recent market conditions have certainly been bumpy, and although the outlook for global growth continues to look positive, the first quarter of the year showed us how quickly attitudes to equities could change. We have already commented on some of the issues that can influence equity returns in the near future, but we have also made it clear that we offer more than just market exposure to our investors. We are not immune to overall market moves, and we are aware that measured over shorter horizons like a quarter or even a year, our inherent value bias can lead to returns that differ from those of the benchmark. However, our long-term outcomes will be more reliant on company specific events at our holdings, and we have shown historically that our active valuation-based approach to investing can provide solid relative returns as those stock specific drivers kick in. From this bottom-up standpoint, we remain optimistic. Many companies in the world today are several years into a recovery, enjoy record margins, speak of a bright outlook, and have high valuations – all of which can make an equity investor nervous. Yet it is always possible to find attractively priced companies facing short-term challenges. Often, those are the ones we often find interesting, and which will make it into our portfolios at times like this. We are convinced that our investment approach will be advantageous for our investors in the long run.

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