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Australian Equities Growth
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A TALE OF TWO STYLES

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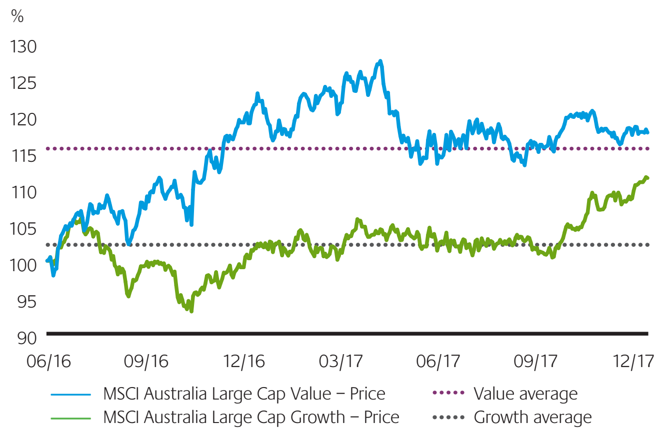
"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity" – Charles Dickens

And so it has been for value and growth investors, respectively. Value investors have seen their portfolios soar, while growth stocks have languished. In this paper we look at some of the drivers behind recent market moves, including the effect of rising interest rates, earnings disappointments and the subsequent de-rating of growth stocks.

Key points

- Conditions in 2017 normalised after a 'perfect storm' in 2016.
- Active growth managers focused on high quality stocks typically fared the worst.
- Downtrodden valuations provided a good entry point into high quality, high growth companies.
- Academic studies and our own analysis suggests that the benefits to growth and quality stocks are longer term in nature.
- A more positive 2017 and outlook for 2018 demonstrates the importance of sticking to a philosophy and process through the difficult times.

Chart 1: Growth vs Value Price Index



Source: Factset, CFSGAM. Data from 30 June 2016 to 31 December 2017.

While it might be tempting to join the crowd and abandon out-of-favour stocks, we believe that now is the time to be re-investing in quality growth stocks. Academic studies, and our own experience and analysis, suggest that there are attractive benefits to investing in these growth stocks over the longer term. But of course there are periods when they underperform over the short term.

We highlight the valuation opportunities this can create and why 2018 may be an attractive opportunity to access the longer term benefits of exposure to quality growth stocks.

What happened?

In the absence of irrational exuberance or pessimism in the markets, a 20% divergence in performance between growth and value stocks in the 12 months to the end of March 2017 can be difficult to fathom; so what happened?

The primary reason behind the underperformance of growth stocks seems to have been the rise in bond yields. As shown in Chart 2, bond yields started to rise in the second half of 2016, on the back of rising inflation expectations and improving confidence in the global economic growth outlook.

Rising bond yields negatively affected the valuation of long duration growth stocks, while improving economic growth was seen by the market as being beneficial to the earnings outlook for cyclical value stocks. This appears to have driven the relative performance of growth and value stocks over the second half of 2016. Notwithstanding a small decline in the Australian 10 year bond yield for 1H17, the lagged negative impact persisted for much of 2017.

It is important to put the market's reaction into perspective. Bond yields are actually only back at around levels that they were at the end of 2015 (2.8% at end-2015 vs. 2.6% at end-2017). In our discounted cash flow assumptions, we have consistently assumed discount rates above the current yields. As a result, we believe there are a number of growth stocks trading at compelling valuations, given the market's apparent overreaction.

Chart 2: Australia Benchmark Bond 10 year yield

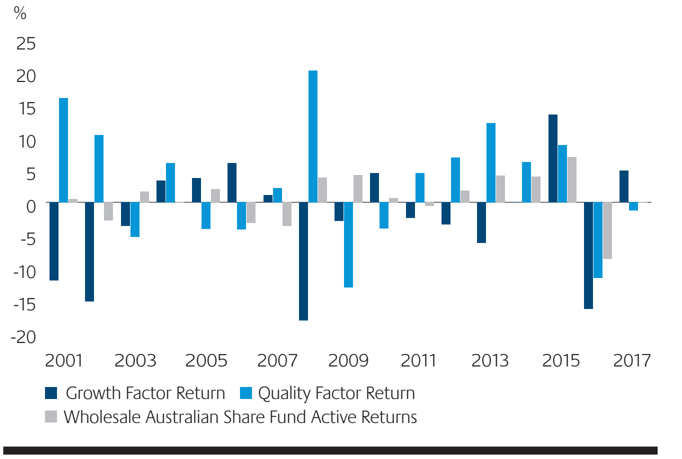
Source: Factset, CFSGAM. Data shown 30 June 2016 to 31 December 2017.

A perfect storm

In addition to growth and value factors, a number of high quality companies have markedly underperformed their low quality counterparts since the start of 2016. This has further weighed on active fund manager performance, given their general preference for investing in high quality companies.

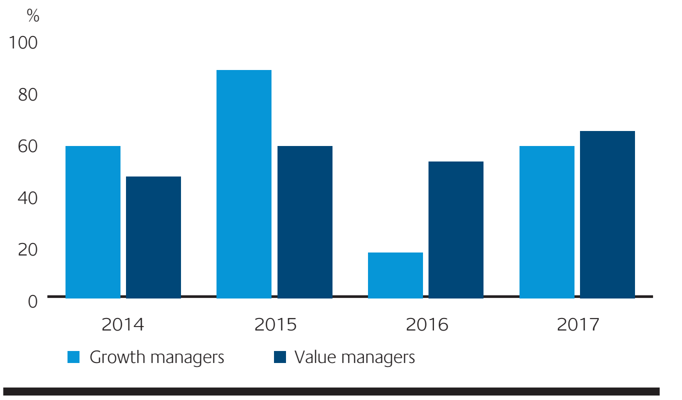
Chart 3 clearly shows what a tough 2016 it was for an approach that targets both growth and quality companies. Over the last 16 years, it has been rare for both high growth and high quality companies to struggle at the same time – let alone underperform by double digit returns as they both did in 2016; the perfect storm for growth and quality investors.

Chart 3: Growth and quality factor returns[1]



As shown in Chart 4, during 2016, only 18% of Australian equity managers with a growth sub-style in the eVestment Australian Equity Shares universe managed to outperform, whereas 53% of managers with a value sub-style outperformed. A very different result from the previous year, when 88% of the 'growth' managers outperformed their benchmark index.

Chart 4: Percentage of active managers outperforming by investment style



Source: eVestment, CFSGAM.

The Australian Share Fund was not immune to these headwinds, with returns -8.7% behind the benchmark in the 12 months to 31 December 2016. In the subsequent 12 months, when quality growth stocks recovered, the Fund reversed this performance deficit to finish the year slightly ahead of its benchmark.

During 2017 it was pleasing to see growth and quality factors recovering some lost ground, and gathering momentum heading into early 2018.

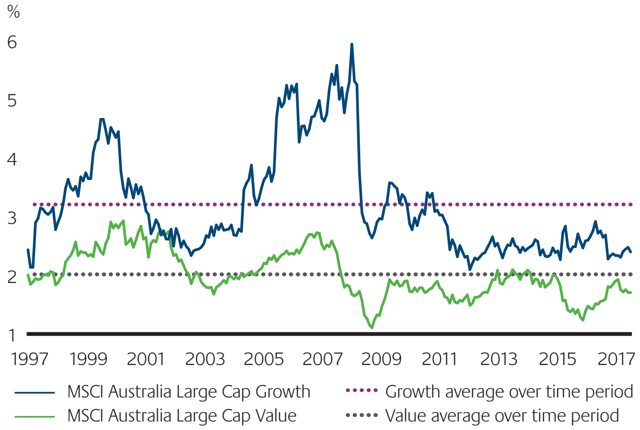
[1] The highest growth companies in the S&P/ASX 300 and the lowest growth companies in the same universe across a range of growth metrics, and the highest quality companies in the S&P/ASX 300 and the lowest quality companies in the same universe across a range of growth metrics.

Why now for growth and quality companies

There are two metrics we believe investors should consider.

Firstly, there is the difference in valuations between growth and value stocks in Australia today. As shown in Chart 5, growth stocks are cheap by recent historical standards[2], with many growth stocks trading at multi-year lows. The gap in the valuation between the MSCI Australia Growth and MSCI Australia Value has narrowed markedly in the last 12 months. Over June/July last year, this valuation gap rose to its widest level since February 2011 suggesting that the market was attaching quite a premium to growth over value. It was also in the top third of valuation gaps between growth and value seen over the past 20 years. Over the next 10 months, however, as interest yields started to spike upwards, that gap started to fall significantly. Other than two months in 2014, the gap in April 2017 was the lowest level since the end of 2002. Given these metrics, buying growth stocks in Australia today would appear to represent a sound long-term investment.

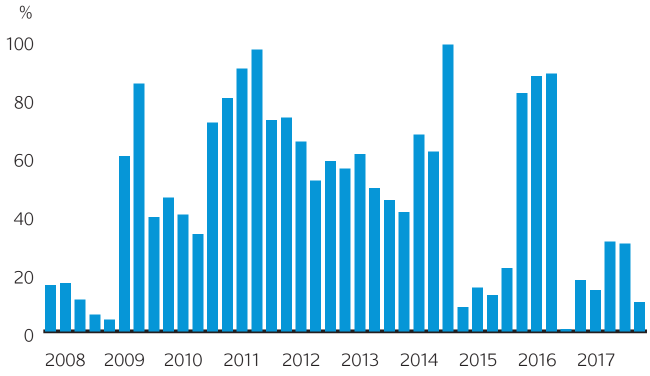
Chart 5: Growth vs value stock price to book



Not only do we believe that buying growth stocks today is a sound long-term strategy, we also advocate buying into higher growth/higher quality stocks over their lower growth/lower quality counterparts.

As shown in Chart 6 below, quality growth stocks are more attractively priced on a risk-adjusted basis than they have been for many years. Rarely over the last 10 years has the valuation gap, as measured by P/E spreads, between high quality growth stocks and low quality growth stocks been as low as it is today[3].

Chart 6: Valuation spread between high growth/quality companies and low growth/quality companies



This gap was even lower in September 2016, when most investors were rushing into low quality value stocks and offloading the higher growth/higher quality counterparts. While the valuation differential has recovered a little since then, the risks associated with stronger quality/growth stocks have eased post the greater certainty that came through. Today we are still looking at a substantial discount to the premium that these quality/growth stocks have traditionally been trading at, while the degree of outlook certainty is higher.

"We have confidence that both the domestic economy and Australian companies are more resilient than they are being given credit for. Incomes are growing steadily, if slowly, and there are many areas of opportunity beyond the miners and the banks – such as infrastructure, tourism, education, agriculture and healthcare. These are areas of the market with companies that are successfully competing on the global stage."

David Wilson, Deputy Head of Australian Equities, Growth

[2] As measured by price to book ratio, last 12 months. 20 years to 31 December 2017.
[3] Source: Realindex. Ten years to 31 December 2017.

What does this mean for a quality growth approach?

The wide valuation spreads in Australia and other developed global markets suggests that a period of growth-factor outperformance may be on the horizon, particularly when combined with quality factors. The process of any growth-spread reversion is unlikely to be linear and without disruption, so investors should always keep front of mind their investment time horizon and tolerance to risk.

During times of uncertainty, investors tend to be reluctant to purchase shares that have suffered large drawdowns, regardless of how attractively valued they have become. This can present opportunities for bottom-up investors. We take a long-term view towards our investment decisions and our Funds' investment philosophies and processes remain unchanged. Our stock selection continues to be driven from the bottom-up and we will not make portfolio tilts, for example towards the very cheap and poor quality stocks, based on prevailing market conditions.

Our Funds' investment focus on quality companies with strong balance sheets and attractive earnings potential has been proven over a number of investment cycles – as shown in Chart 7 – and supported by a number of academic studies over time. We therefore remain confident that, over the long term, our Funds will outperform their benchmarks. Indeed we may well be looking back in three to five years observing what a great time 2018 was to get into quality growth stocks.

"While it's been a challenging time for many actively managed growth funds, including our own, I believe the sustained divergence in performance has created mispricing opportunities in a number of high quality growth stocks, providing opportunities for disciplined investors."

**Dushko Bajic,
Head of Australian
Equities, Growth**

The academic research supporting our philosophy

The academic research supporting our philosophy extends back to 1968, when Ball and Brown were the first to identify a relationship between accounting information and US stock returns. Prior to then, the existing academic research had observed that both the income of firms and stock prices tended to move together – the conclusion being that they were influenced primarily by economy-wide or market-wide effects. Ball and Brown, however, focused on accounting information unique to an individual firm and examined the impact on its individual stock price.

In their 1968 study, they found evidence that:

- stock returns trending up over the year for companies that ultimately report positive (in the top half) earnings results – across three earnings variables (including EPS);
- stock returns trending down for companies that report negative (in bottom half) earnings results – across the same 3 earnings variables; and
- stock returns across the total sample lying in between the two halves.

Subsequent studies have found explanatory power between earnings and stock returns across a variety of markets outside the US and across Europe and Asia[4].

Later studies have further examined the additional explanatory power in extending the explanatory variables beyond earnings levels to include:

- earnings change (Easton and Harris, 1991); and
- levels and changes in EPS, ROI and ROE (Maditinos, Sevic, Chatzoglou and Theriou, 2007). Relevant to our philosophy, the authors conclude the "need for either a combined use of these measures or the adoption of other strategic managerial tools for performance measurement to explain stock market returns."

A similar conclusion is reached by Balachandran and Mohanram (2010), who distinguish between the different sources of earnings growth. They correctly observe (again consistent with our philosophy) that firms can still increase accounting earnings while potentially destroying shareholder value.

"If returns to shareholders are a function of growth in the economic profitability of the firm, then incorporating a superior measure of economic profitability can potentially improve the ability to explain stock returns."

[4] Germany (Booth, Broussard and Loistl – 1997); Germany, Norway and the UK (King and Langli – 1998); Korea and the Philippines (Graham and King – 2000) and China (Chen, Chen and Su – 2001).

Balachandrum and Mohanram adopt a residual income (RI) measure, which incorporates a charge for the opportunity cost of capital employed. In our approach, we tend to focus on Return on Invested Capital (ROIC), but both measures are similar in that they will only be attractive if management is effectively applying shareholder capital to create shareholder value.

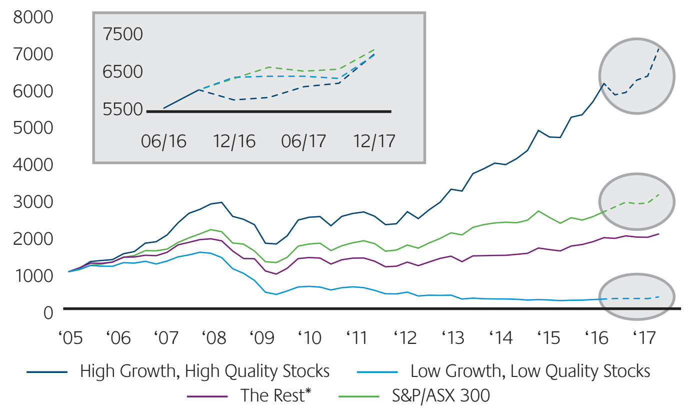
The accumulation of these academic studies reinforces our philosophy and process of seeking not only companies with earnings growth potential, but also those that are sourcing their earnings growth from value-adding activities (in our case positive ROIC) rather than value-destroying investments.

We have drawn on the above academic insights to conduct our own analysis to look at the longer term performance of companies with both higher growth potential and above-average ROI. We initially focussed on the MSCI World universe and found that:

- stock returns trend up most powerfully (+10.7%pa) if they are BOTH in the top half of EPS Growth and ROIC (currently around a quarter of the MSCI World universe);
- stock returns were weakest (+3.1%pa) for those stocks that are in BOTH the bottom half of EPS Growth and ROIC (also around a quarter of the MSCI World universe);
- stock returns were benchmark-like (+7.7%) for the rest (the remaining half of the MSCI World universe).

Most encouragingly for the Australian Equities Growth team, however, is the stronger outperformance potential of above average quality growth stock stocks in the S&P/ASX 300 universe, as illustrated in Chart 7.

Chart 7: High growth, high quality stocks have outperfomed



Source: Factset, S&P/ASX. Data from end 2005 to end 2017.

Note: High growth stocks are those in the top half of stocks in the S&P/ASX 300 by EPS growth over three years (FY2 over LTM), low growth stocks are those in the bottom half.

High quality stocks are those in the top half of stocks in the S&P/ASX 300 by ROIC (LTM), low quality stocks are those in the bottom half.

*The rest are the remaining half of the stocks that are neither in the top half of both growth and quality nor the bottom half of both growth and quality.

Similar to our findings in the MSCI World universe, we find that

- stock returns trend up most powerfully (+15.5%pa) for those stocks that are in BOTH the top half of EPS Growth and ROIC (currently around a quarter of the ASX 300 stocks);
- stock returns were weakest (-8.1%pa) for those stocks (again around a quarter of the ASX 300) that are in BOTH the bottom half of EPS Growth and ROIC; and
- stock returns were mediocre (+5.3%) for the rest (the remaining half of the ASX 300 universe).

Notwithstanding the longer term benefits of quality growth stocks, however, Chart 7 also shows that high growth, high quality stocks also struggled in Australia over 2016/2017. Having peaked in September 2016 they have under-performed both their poor growth, poor quality peers and the Index over the subsequent 12 months.

While our approach has been developed and refined over time by a team of experienced market investors, it is reassuring to see that our investment philosophy is supported by academic research across many geographies. Our relatively straightforward factor-return charts also reassure us that our investment process is capable of generating superior returns over the longer term – even though market conditions may not always favour our approach over the short term. For example, in the year to 31 May 2017 the Australian Share Fund was -9.3% behind its benchmark. By 28 Feb 2018, the 12 month excess return had swung around to be +5.7% ahead of the benchmark. This turnaround in performance demonstrates our conviction in quality growth stocks, and the importance of sticking to our philosophy and process, through the best of times and the worst of times.

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