RMI INVESTMENT MANAGERS

Is it all gloom and doom and do opportunities exist for investors?

BY ADRIAN CLAYTON
Analyst, Northstar Asset Management

Is it all gloom and doom and do opportunities exist for investors? 'The stock market is filled with individuals who know the price of everything, but the value of nothing'.
- Philip Arthur Fisher (1907 to 2004)

Philip Arthur Fisher explores the concept of value versus price and contends that most 'investors' are privy to the price that assets trade at (information which is readily available) but few have any concept of what an asset is really worth.

With this in mind, we peer through the haze of noisy, unnerving markets and dire economic data to focus on the task of identifying valuable assets.

Quantitative modeling is critical in that it assists in identifying high impact opportunities. Often these require a reasonable period of time before revealing their 'true worth'. On this note, Buffett's words resonate deeply in our communication to you: 'If you are not willing to own a stock for 10 years, do not think about owning it for 10 minutes'.

Company profitability at its most basic level is driven by varying factors which include revenue growth, the costs of goods sold (from which we can calculate an operating margin), fixed costs such as debt repayments and then tax. These are aggregated at a market or index level.

In this exercise, we take two of these factors – revenue growth and operating margin - and in both cases, compare them to the P/E of individual markets. The objective here is not precision but purely to spot anomalies in markets, to assess whether certain markets and sectors look cheap against others.

The analysis involves the following:

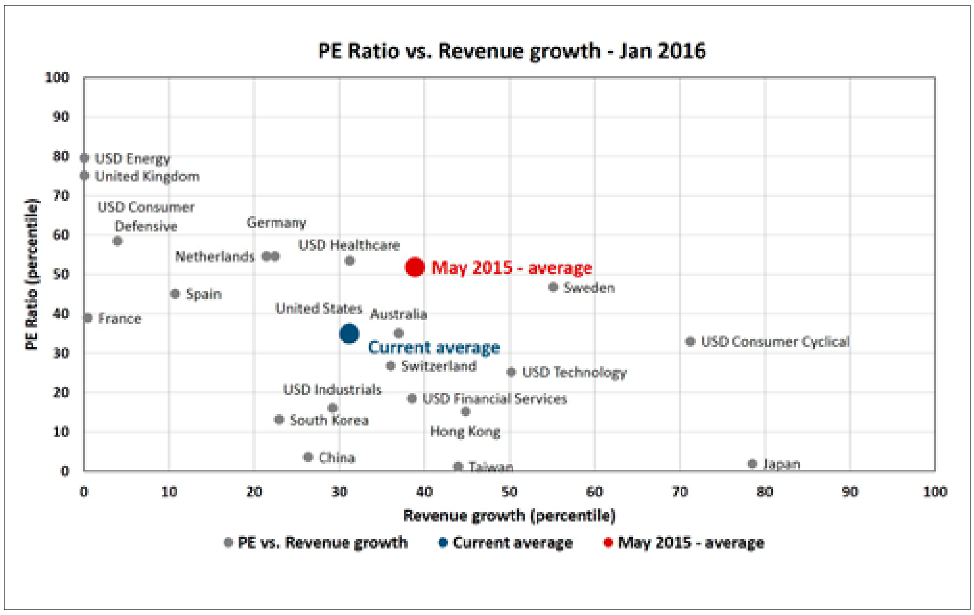
1. The P/E for each market is represented as a percentage of its long-term average P/E. This P/E percentage is plotted against the revenue growth of each market, also expressed as a percentage. (See graph)
2. We use the same approach as above, but instead of assessing the P/E to revenue, we look at the P/E to operating margins for markets.

What are we looking for?

1. Stocks are usually cheap when P/E's are at a low point (relative to history and revenue growth) and operating margins are at low points relative to their histories. This is the best time to own stocks as any normalization in revenues and operating margins leads to surging profit growth - it becomes a free ride.
2. Stocks are usually expensive when P/E's are at a high point (relative to history and revenue growth) and operating margins are at high levels relative to their histories. This is the worst time to own stocks.

Observations and comments:

1. Currently, with respect to P/Es versus revenue for the varying markets, we note the following:
a. Most markets trade below their long-term P/E levels – in mid-2015, most markets traded well above their long-term P/Es.
b. Markets are, in general, producing relatively low revenue growth compared to their histories. In 2015, growth rates were better than in 2016.
c. US Consumer Cyclicals and Japanese stocks are extreme revenue outliers (above average) and were in 2015 too, however, the largest outlier in terms of a P/E to revenue growth in 2015 was the Dutch market which has been de-rated in 2016. The Dutch example possibly demonstrates the dangers of chasing revenue.
d. US Energy, UK stocks and US Consumer Defensives are extreme revenue outliers (below average). These, together with Spain, were similarly positioned in 2015 but Spain has been severely de-rated. We believe the market is adopting a view that revenues will improve for energy stocks in time - for Consumer Defensives, this could be as a result of 'herding' or a flight to quality.
e. The Taiwanese, Korean, Chinese and Hong Kong markets all have below average revenue metrics and are extremely lowly rated relative to their past. Excluding other factors and purely at face value, these markets look to be offering real opportunities. We can testify to this as our company specific screens are also identifying opportunities in Asia.



2. Currently, if we look at markets from a P/E to operating margin perspective, we see the following:
a. Most markets trade above their long-term average operating margin levels and this concerns us. In 2015, the same picture existed, except P/Es were much higher for most of the markets – they have since de-rated.
b. Certain US sectors (Consumer Cyclical, Technology, Financial Services and Industrials) and developed markets look the most expensive in this regard.
c. Operating margins are almost at historically low levels for US Energy and the UK market. For energy this seems obvious as the oil price is so low - for the UK, the most likely reason is that many dual-listed miners are listed on the FTSE and mining margins are currently non-existent.
d. On this basis, the US market, as a whole, does not look that expensive.
e. Japan is a stand-out - operating margins are at historically high levels and we surmise this is due to exporters benefiting from a weak yen and Abenomics at work.

What do we take away from this analysis?

1. Revenue growth for many markets seems to be muted, but certain sectors and specific markets are being priced for improving revenue growth (P/E's are high). Should this revenue not emerge, it is likely that these markets will be severely de-rated. This could prove opportunistic with respect to finding high quality, valuable assets.
2. In general, operating margins for most markets are still high and real pressure will be forthcoming on profits if margins normalize. Many stocks could become 'value traps'.
3. High margins might be due to currency anomalies and monetary stimulus. If this is the case, high degrees of caution are warranted if QE is reversed or is even reduced.
4. Certain markets, particularly in Asia, are at low operating margin levels and their P/Es are also very low. Some of these markets are also far from peak revenue growth levels. Consequently, further analysis with stock specific screening is justified.

We hope this exercise has opened a window into the importance of creating a process of thinking that transcends the linear and encourages lateral concepts, which is precisely how we at Northstar Asset Management conceptualize our world. What it certainly does do is demonstrate that valuations should not be taken at face value - risks and rewards become less opaque when simple but powerful analytical templates are deployed that deconstruct the world into finer constituents.

Adrian Clayton, Analyst, joined Northstar Asset Management in 2012. He launched Alphen Asset Management in 2002 and has experience in managing one fund for more than 15 years.

NORTHSTAR