Janus Henderson
INVESTORS

MARKET GPS

EQUITY PERSPECTIVES

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CONTENTS

OUR EQUITY CAPABILITIES

JANUS HENDERSON PROVIDES AN ACTIVE APPROACH TO EQUITY INVESTING. THE EQUITIES PLATFORM IS SHAPED BY THE BELIEF THAT FUNDAMENTAL RESEARCH IS THE FOUNDATION FOR DELIVERING LONG-TERM, MARKET-LEADING RISK-ADJUSTED RETURNS.

Independent thought and unique viewpoints are central to this approach and result in portfolios that are meaningfully different to an index. Each team expresses their individual, high-conviction ideas through processes that have evolved to suit their specific areas of the market and within robust risk control frameworks.

While operating with independence, the equities teams benefit from collaboration and shared research that provide a source of portfolio ideas. The culture encourages intellectual challenge and stimulating debate to test – and ultimately strengthen – investment thinking. The success of ideas is measured by overall client outcomes with the aim to deliver consistent, long-term risk-adjusted excess returns over benchmarks and peers regardless of the investment landscape. This effort is supported by award-winning, proprietary portfolio construction technology and a cultural emphasis on the client promise.

The equity teams, led by Co-Heads of Equities **Alex Crooke** and **George Maris**, include 165 investment professionals, responsible for US$171.1bn in assets under management[1]. The teams include those with a global perspective, those with a regional focus – US, Europe, Asia Pacific and Emerging Markets – and those invested in specialist sectors. A range of growth, value and absolute return styles are employed.

GLOBAL EQUITIES

- **GLOBAL** US- & UK-based teams, multiple regions and styles
- **GLOBAL INCOME** multiple regions and styles

REGIONAL EQUITIES

- **US** multiple styles
- **EUROPE / UK** multiple styles
- **ASIA PACIFIC** multiple regions and styles
- **EMERGING MARKETS** multiple regions

SPECIALITY EQUITIES

- **GLOBAL TECHNOLOGY**
- **GLOBAL LIFE SCIENCES / BIOTECH**
- **GLOBAL PROPERTY**
- **GLOBAL SUSTAINABLE**
- **GLOBAL NATURAL RESOURCES**
- **ABSOLUTE RETURN**

[1] Source: Janus Henderson, as at 30 June 2020.

Fundamental research: The analysis of information that contributes to the valuation of a security, such as a company's earnings or the evaluation of its management team, as well as wider economic factors. This contrasts with technical analysis, which is centred on idiosyncrasies within financial markets, such as detecting seasonal patterns.

LOOKING PAST ELECTION VOLATILITY

Source: Getty Images

Director of Research **Matt Peron** says that while the 2020 U.S. presidential race could create volatility for stocks, such pullbacks are often based on fear, not long-term fundamentals.

KEY TAKEAWAYS

- The 2020 U.S. election comes at a pivotal time, with the trajectory of the COVID-19 pandemic still unknown and the economic outlook uncertain.
- As such, U.S. stocks could experience increased volatility in the coming months as markets digest both a complicated macroeconomic backdrop and potential changes in Washington, D.C.
- But election-related pullbacks often have more to do with fear than actual policy and could create opportunities to invest in high-quality companies at attractive valuations.

With the 2020 U.S. presidential election fast approaching, markets are weighing the probability of a Democratic or Republican win and the resulting impact on stocks. Since 1960, the S&P 500® Index has enjoyed positive returns in the months leading up to a presidential election 80% of the time and typically gone on to deliver gains in the 12 months following – with little differentiation between which party proves the victor (see table below). To no surprise, the COVID-19 pandemic has complicated matters for 2020, with U.S. stocks cratering early in the year as the outbreak spread, then rebounding as central banks unleashed massive stimulus and economic lockdowns eased. With the pandemic's trajectory still unknown, the election comes at a pivotal time, but the policies that result in the months and years following the vote may be less disruptive than feared.

STOCK PERFORMANCE DURING U.S. PRESIDENTIAL ELECTIONS

The S&P 500 has typically delivered gains in the months leading up to an election and in the 12 months following.

					S&P 500 Index Election Year Returns	
Election Year	President Elected	Democrat/ Republican	Senate	House	Before Election Day (Dec 31 - Oct 31)	Following 12 Months (Oct 31 - Oct 31)
1960	Kennedy	D	D	D	-10.9%	28.5%
1964	Johnson	D	D	D	13.1%	8.9%
1968	Nixon	R	D	D	7.2%	-6.0%
1972	Nixon	R	D	D	9.3%	-2.9%
1976	Carter	D	D	D	14.1%	-10.3%
1980	Reagan	R	D	D	18.1%	-4.4%
1984	Reagan	R	R	D	0.7%	14.3%
1988	G.H.W. Bush	R	D	D	12.9%	22.0%
1992	Clinton	D	D	D	0.4%	11.7%
1996	Clinton	D	R	R	14.5%	29.7%
2000	G.W. Bush	R	R	R	-2.7%	-25.9%
2004	G.W. Bush	R	R	R	1.6%	6.8%
2008	Obama	D	D	D	-34.0%	7.0%
2012	Obama	D	D	R	12.3%	24.4%
2016	Trump	R	R	R	4.0%	21.1%
Average Return					4.0%	8.3%
Average Gain in Up Years					9.0%	17.4%
Average Loss in Down Years					-15.9%	-9.9%
% Up Years					80%	67%
% Down Years					20%	33%

Source: Bloomberg, September 2020, Janus Henderson Investors. Past performance is not a guide to future performance.

LOOKING PAST ELECTION VOLATILITY (cont.)

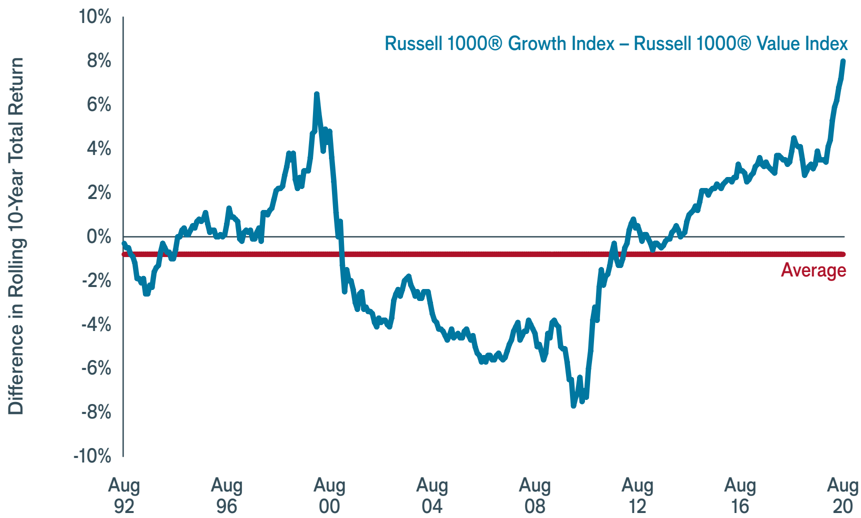
A CROWDED MACROECONOMIC BACKDROP

To be sure, we have already seen some equities trade up and down on polling data. During the summer, so-called "blue" stocks – equities of companies that might benefit should Democratic nominee Joe Biden win – rallied as the former vice president enjoyed a significant lead in polls.[1] But the global pandemic and resulting economic slump has muddied the backdrop. Take the health care sector. Both President Trump and Biden have discussed introducing significant reforms to the U.S. medical system, including policies that would curb prescription drug prices. In the past, such proposals have weighed on health care equities during election periods, as we saw in 2016.[2] But this year, the sector – specifically, biotechnology stocks – has outpaced the broader market, as the industry rises to the challenge of developing vaccines and treatments for the virus that causes COVID-19.[3]

Massive stimulus unleashed by the Federal Reserve in response to the pandemic has been another dominating force. With the 10-year Treasury yield now near record lows, fast-growing companies – many of which offer digital platforms that have experienced soaring demand in a socially distanced world – have seen the value of their future earnings and cash flow rise. At the same time, the dramatic slump in the global economy has weighed on companies whose prospects are tied to the economic outlook. As such, the difference in returns between these companies has been abnormally wide and could persist until economic growth improves or rates rise, regardless of the election outcome (see chart below).

GROWTH OUTPERFORMS VALUE

In another sign of the year's trends, fast-growing companies (growth equities) have outperformed more economically cyclical firms (value stocks) by an unprecedented margin.



Source: Bloomberg, data are monthly from 31/12/1990 to 31/8/2020. Past performance is not a guide to future performance.

LOOKING PAST ELECTION VOLATILITY

[1] https://www.cnn.com/2020/09/02/investing/joe-biden-stock-market-donald-trump/index.html

[2] Bloomberg. Data reflect returns for S&P 500 Health Care sector from 31/12/2015 to 31/10/2016.

[3] Bloomberg. Data reflect year-to-date total return for Nasdaq Biotechnology Index and S&P 500 Index as of 10 September 2020.

LOOKING PAST ELECTION VOLATILITY (cont.)

CAMPAIGN PROMISES VS. LEGISLATION

Restoring economic growth is likely to be a White House priority no matter who wins the election. But the two candidates would take different approaches to that goal. Trump, for one, has proposed deferring payroll taxes, lowering the top capital gains tax rate and maintaining the corporate tax rate at 21% (lowered from as much as 35% under the Tax Cuts and Jobs Act of 2017). Biden, on the other hand, says he would increase spending on infrastructure, funded by a higher corporate tax rate (28%) and bigger tax bills for wealthy households. Trump is also expected to continue pursuing industry-friendly regulations for fossil fuels and banks, while Biden has proposed making big investments in green energy and expanding government-run health care.

At first blush, these proposals might suggest that certain sectors, such as energy and finance, would do well under a Trump administration, while renewables and select industrials would thrive under a Biden presidency. But long term, the impact could be more nuanced and will certainly depend on policy details. Consider energy: Biden has a goal of eliminating carbon emissions from electric power generation by 2035, part of a roughly US$2 trillion clean energy plan that would also speed adoption of electric vehicles and improve the energy efficiency of buildings. Overall, such initiatives could be seen as a negative for oil and gas companies. But in our view, it wouldn't spell the end of these industries. On the contrary, we think oil and gas would remain key players in a decades-long energy transition and that the value of pipelines, refineries and other existing carbon assets could actually increase if investment in fossil fuels slows.

It's also important to remember that whoever wins the White House will need the support of Congress to turn campaign proposals into reality. Even if Democrats achieve a so-called "blue wave" – winning the presidency and gaining a majority in Congress – significant changes to Senate voting rules may have to be made in order to pass transformative legislation. Thus, while incremental reform could be achieved quickly, bigger overhauls would be slower to come, if at all.

SHORT-TERM VOLATILITY, LONG-TERM OPPORTUNITY

Nevertheless, markets fear the unknown and could become more unsettled as Election Day draws near. An unclear – or contested – outcome on November 3 could also roil stocks. But investors should bear in mind that these swings usually are short-lived. On the night of Trump's 2016 victory, futures contracts for the S&P 500 plunged 5%, hitting a daily downside limit. The next day, the index finished the trading session with gains.[4] When the Affordable Care Act (ACA) was being debated in 2009, stocks of some of the largest managed care companies in the U.S. traded at less than 6x forward earnings (an estimate of a company's earnings for upcoming periods) on worries that profitability and revenues would suffer.[5] But the ACA ended up being a growth opportunity for the industry, as more than 20 million new individuals gained coverage under the legislation, with 100% covered by private sector plans. Today, the group's average valuation is 15x forward earnings.[6]

This type of fear trade – one divorced from fundamentals – can create attractive opportunities to invest in companies with strong balance sheets and innovative products and services. Such firms could thrive long after an election is decided and potentially benefit investors who look past the volatility and stay focused on bottom-up analysis.

LOOKING PAST ELECTION VOLATILITY

[4] https://www.reuters.com/article/usa-stocks/us-stocks-futures-slide-as-trump-wins-u-s-presidential-election-idUSL1N1DA10L, Bloomberg. Data as of 9/11/2016.

[5] Bloomberg, data for UnitedHealth Group and Anthem as of 31 March 2009.

[6] Bloomberg, data for S&P 500 Managed Health Care sub-sector as of 10 September 2020.

THE HIGHLY RATIONAL – AND SOMETIMES SLIGHTLY LESS RATIONAL – WORLD OF TECH INVESTING

Source: Getty Images

Portfolio Manager **Denny Fish** argues that a long view is essential for maximising the opportunity presented by the forces driving the transition to a digital global economy.

KEY TAKEAWAYS

- While many investors have pointed at recent volatility to call for sector rotation or a shift to value stocks, we believe some of the most promising growth opportunities remain in tech and Internet-focused communications stocks.
- We sit on the cusp of the Fourth Industrial Revolution where a greater share of economic profits may shift toward digital rents as artificial intelligence, the cloud and increased connectivity improve efficiencies across the entire economy.
- Volatility is inherent in equity markets, but we believe in seeking to identify resilient companies with consistent cash flow generation and those which are levered to the themes defining the Fourth Industrial Revolution.

Tech stocks just can't keep out of the spotlight: first, by outpacing broader equities over much of the past couple of years, then with a swift early September sell-off. The relentless upward march in technology prices and valuations we have witnessed has brought many a prognostication on why we need to see a "sector rotation" or witness a "regime change from growth to value."

To be clear, that may very well happen, and we respect the potential. We are not numb to the power of shorter-term market movements, particularly given what can be perceived as near-term extremes. But we believe we are on the cusp of the Fourth Industrial Revolution as economic profits get redistributed to digital rents and away from many legacy industries. Importantly, while many technology stocks have seen significant price appreciation, several market-leading tech and internet-focused communications companies offer some of the soundest fundamentals and best long-term growth across all equity sectors, which has led to strong financial performance. We continue to believe this development could continue on a multi-year basis.

ROOTED IN FUNDAMENTALS

Our view has been that tech's solid fundamentals have been in place for several years and that only lately have investors truly begun to grasp the magnitude of this opportunity. Growth stocks are among the longest-duration assets (companies with a revenue stream that occurs over a long period of time). This is especially true for the tech companies leveraged to the secular themes of artificial intelligence (AI), cloud computing and the Internet of Things (IoT). These complementary forces are the underpinnings of a digital global economy that has been years in the making.

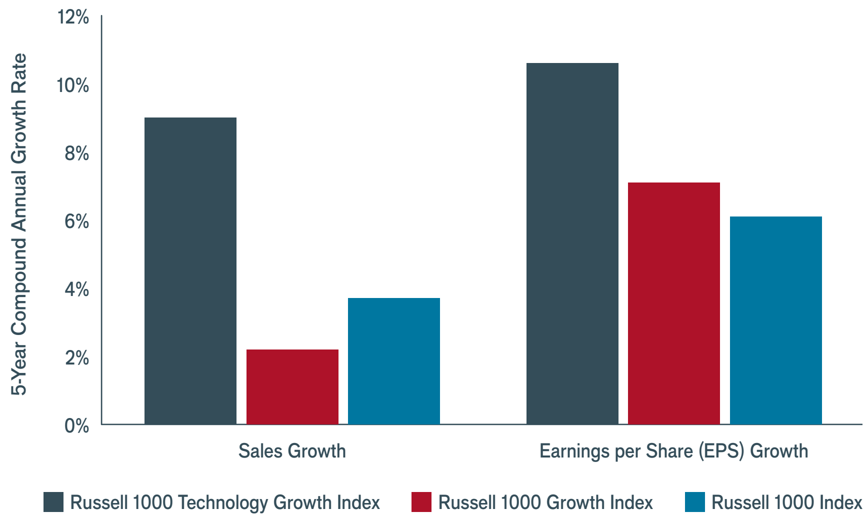
The luster of tech's growth profile increased during the 2019 economic slowdown and again this year as many tech offerings helped businesses and households navigate the disruptions caused by the COVID-19 pandemic. Also helping large tech and internet companies weather the early-year sell-off were perceived defensive characteristics given their resilient business models and strong balance sheets.

This context is necessary to put current valuations in perspective. Inherent within growth stocks is the expectation that promising companies' earnings will ultimately grow into today's share price. This phenomenon is magnified by the current pall hanging over the global economy as stocks that have demonstrably delivered growth are in demand.

THE HIGHLY RATIONAL – AND SOMETIMES SLIGHTLY LESS RATIONAL – WORLD OF TECH INVESTING (cont.)

GROWTH TECH EARNING ITS KEEP

The larger share commanded by higher-growth tech names in both the large-cap growth and broader large-cap indices has increased materially; these commanding positions are being fueled by unrivaled sales and earnings growth.



Source: Bloomberg, annual data as of 31 December 2019. The Russell 1000 Index comprises more than 90% of the total market capitalization of all listed stocks in the U.S. equity market. The Russell 1000 Growth Index measures the growth segment of the index, including firms whose share prices have higher price-to-book ratios and higher forecast earnings growth rates. The Russell 1000 Technology Growth Index is made up of Technology companies that fall into the Growth segment. **Compound annual growth rate (CAGR)** is the rate of return that would be required for an investment to grow from its beginning balance to its ending balance, assuming the profits were reinvested at the end of each year of the investment's lifespan. Past performance is not a guide to future performance.

As tech and internet stocks prices rose over much of this year, they commanded a higher portion of the growth equities universe. While growth indices' tilt toward tech raised some eyebrows, mega-cap companies' contribution to index earnings and cash flow growth has even exceeded the pace at which their share of several benchmarks has risen.

THE POWER OF THE FOURTH INDUSTRIAL REVOLUTION

This year's powerful run by tech stocks has drawn unflattering comparisons to the dot-com bubble of 20 years ago. However, in our opinion, there is a major difference: in contrast to that era, tech companies today seem to be delivering important efficiencies to companies and value to consumers.

Many of these benefits are being powered by the technologies that we consider the building blocks of the Fourth Industrial Revolution. Similar to the role played by steam and semiconductors during previous waves of innovation, data is the catalyst for this period. Information collected through IoT-enabled devices or user information on the internet is processed in the cloud – often through AI-driven algorithms – and used to make more informed business decisions. While these elements have been in place for a while, they were acutely called into action during this year's economic slowdown as companies scrambled to maintain access to customers and ensure back-office operations functioned optimally. In this respect, the digitization of the enterprise has been pushed forward – by years in some cases.

THE HIGHLY RATIONAL – AND SOMETIMES SLIGHTLY LESS RATIONAL – WORLD OF TECH INVESTING (cont.)

Tech stocks have also risen on the recognition that the total addressable market of many of their offerings has likely increased. Entire cohorts of consumers who had heretofore been hesitant to interact with the digital economy had little choice but to increase their engagement during extended lockdowns. This is most evident in rising e-commerce activity, remote learning and work as well as online entertainment.

As data is the currency of the Fourth Industrial Revolution, this increased activity has likely reinforced the competitive positions of the large internet platforms that have already invested in the technologies necessary to synthesize information gleaned from rising usage into actionable business intelligence. And while this year marked an acceleration, it is our view that we are still in the early innings of this digital shift. We expect the deployment of 5G infrastructure over the coming years to help keep the momentum going.

UNFORCED ERRORS

Just as many investors were late to recognize the opportunity presented by the large tech platforms driving these long-term themes, they also committed the oft-repeated mistake of approaching the sector as a homogenous entity. It's not. The later stages of the recent tech rally have shown evidence of indiscriminate buying, with little differentiation made between stocks leveraged to long-term drivers and those of legacy tech companies likely destined to see once-lucrative end markets wither. One-size-fits-all investment strategies only exacerbate the matter.

Despite the leading role played by tech in transforming the global economy, appropriate due diligence remains an essential part of the investment process. In our view, several swaths of the sector should be avoided, either due to negative transformation headwinds in the case of legacy companies or – for more speculative names – little visible path to profitability. Instead, an investor's focus should remain on identifying capable management teams, understanding unit economics and – with an eye toward future growth – exploring business adjacencies complementary to a company's core offering.

A PLACE FOR OPTIONALITY

Given the dynamic nature of technology and innovation, many of today's smaller enterprises could meaningfully contribute to the sector's future growth. Yet, given their wider range of potential outcomes, their investment risk is high. There is potentially a place for such companies in a tech portfolio, but they must be sized appropriately. We categorize companies capable of delivering high rates of earnings growth as displaying optionality.

Not only should risk be dispersed among stocks exhibiting optionality, but we believe that as evidenced by September's market volatility, it's prudent for investors to counterbalance "optional" stocks with a robust allocation toward more established companies with resilient business models. Tech investors find themselves in a unique position today given that many resilient, mega-cap stocks exhibit their own optionality thanks to the strength of the data collection and analysis, which may give them a leg-up in identifying and delivering new digital solutions.

THE HIGHLY RATIONAL – AND SOMETIMES SLIGHTLY LESS RATIONAL – WORLD OF TECH INVESTING

Price to book ratio: A financial ratio that is calculated by dividing a company's market value (share price) by the book value of its equity (value of the company's assets on its balance sheet). A P/B value of less than 1 can indicate a potentially undervalued company or a declining business. The higher the P/B ratio, the higher the premium the market is willing to pay.

GLOBAL REAL ESTATE – COMING TO THE END OF THE ABNORMAL?

Source: Getty Images

Global real estate Portfolio Managers, **Guy Barnard, Tim Gibson** and **Greg Kuhl** address misperceptions investors may have about real estate post-COVID-19 and explain why the team believes it remains an attractive and relevant asset class.

KEY TAKEAWAYS

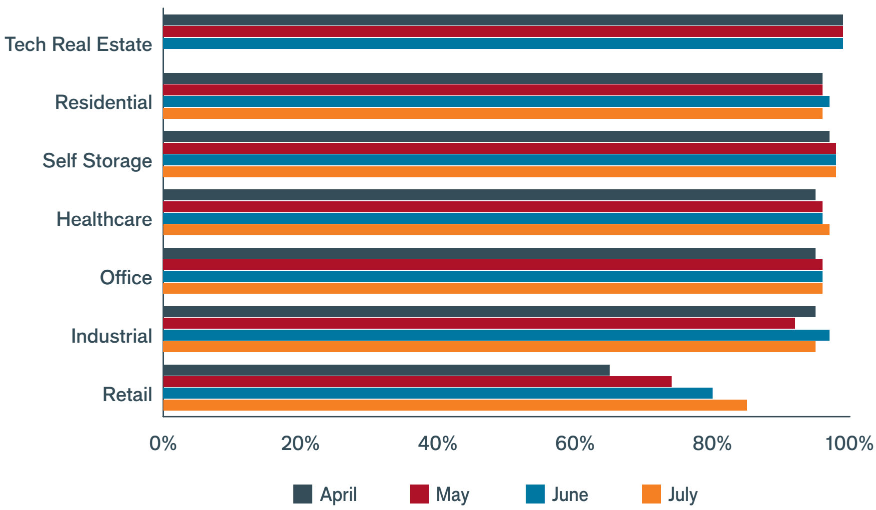
- Common perceptions around rent collection have been wrong, with multi-year contracts providing resilience.
- Share prices for many listed companies are trading below their net asset value, with increasing evidence of a disconnect between REIT and direct property valuations emerging in many sectors.
- The team believes normality will return and, as such, this is a period to selectively capture attractive opportunities.

Real estate equities have been one of the weakest performing sectors year-to-date as investors have perceived that tenants will struggle to pay rent, and in turn, landlords will struggle to pay dividends.[1]

The reality however is somewhat different to this view. Rent collection and operational performance among most sectors with contractual leases has so far been incredibly resilient. There have been notable exceptions in sectors such as retail and hotels, which found themselves most impacted by COVID-19. From April through July 2020, the weighted average contractual rent collection for US-listed real estate investment trusts (REITs) was 94% excluding the retail sector. As for retail, while still weak, the sector has seen a marked improvement in rent collections as stores have been allowed to reopen. In Europe and Asia, we have seen similar trends, with rent collection numbers varying depending on local individual market conditions and the response from governments to the pandemic.

WITH THE EXCEPTION OF RETAIL, US REIT RENT COLLECTION REMAINS HIGH

US REIT April to July, rent collection by sector: weighted average ex Retail 94%



Source: Janus Henderson Investors, company filings and commentary as of 31 August 2020. Collections reflect weighted averages based on FTSE EPRA NAREIT North America Index weights. Percentages listed within chart are average collection over the four months. Only properties with contractual leases are included.

GLOBAL REAL ESTATE – COMING TO THE END OF THE ABNORMAL? (cont.)

WHY HAVE WE SEEN RESILIENCE IN RENT COLLECTIONS?

Many real estate companies are in an enviable position of having multi-year lease contracts, which the vast majority of tenants have honoured. We believe this provides listed real estate companies a distinct advantage over other equity sectors given the higher degree of visibility in forecasting next year's earnings. This has also led to dividend cuts being the exception rather than the rule.

HOW ARE CURRENT VALUATIONS FOR REAL ESTATE EQUITIES LOOKING?

The further relaxation in monetary policy across the globe implies that the 'lower for longer' environment may continue for some time to come, meaning the search for income among investors is expected to remain strong. We believe this will continue to support the demand for listed real estate. More interestingly, global real estate equities currently look cheap relative to many other asset classes. A key metric for the valuation of the sector is the level at which listed property companies trade relative to the private market value of underlying property owned by the companies (their net asset value or NAV).

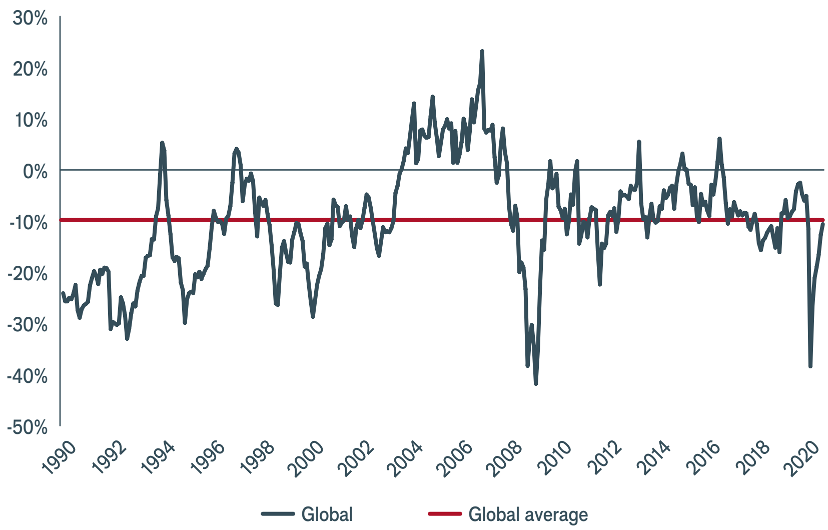
Share prices for many listed companies are trading below their NAV (see chart below) and in some sectors, such as office, discounts of 25% already appear to reflect a significant degree of uncertainty.

It is also noteworthy that REITs continue to offer an attractive dividend yield relative to many other asset classes. Dividend growth has also typically matched or outpaced inflation over the longer term.[2]

This means in times of market weakness, investors have benefited from dividend growth while waiting for valuations in the sector to improve.

PROPERTY COMPANIES ARE TRADING AT WIDE DISCOUNTS TO NET ASSET VALUE

Global property markets premium/(discount) to NAV.



Source: Refinitiv Datastream, UBS estimates monthly data from Jan 1990 to August 2020. Global average excludes emerging markets.

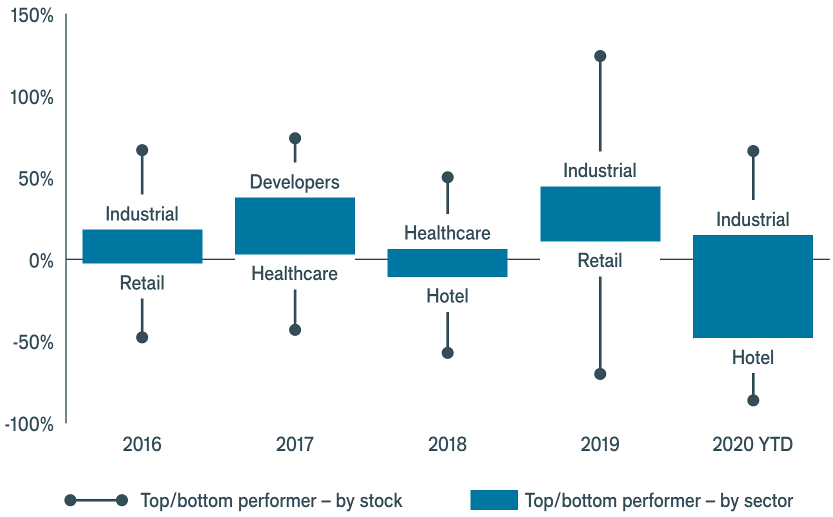
A discount between the share price a company trades at and its Net Asset Value (assets minus liabilities) means the market is pricing in uncertainty. This discount will typically reduce if prospects are considered to improve.

GLOBAL REAL ESTATE – COMING TO THE END OF THE ABNORMAL? (cont.)

BUT, THE DEVIL IS IN THE DETAIL

The dispersion (distribution) of returns in the real estate sector has rarely been wider, underlining the need for selectivity. Listed REITs in some sectors, particularly those which have been largely unaffected by COVID-19 such as data centres, cell towers and industrials, have posted strong absolute returns year-to-date (to 31 August), while retail, office, and hotel have suffered significantly. The chart shows the best- and worst-performing stocks in the FTSE EPRA Nareit Developed Index each year since 2016 (line with dots at each end) and the gap between the best and worst performing sector for each year (blue rectangle).

DISPERSION OF RETURNS BY SECTOR IS WIDENING



Source: Bloomberg, Janus Henderson Investors, as of 31 August 2020. Stock and sector returns refer to the FTSE EPRA Nareit Developed Index.

ARE CURRENT VALUATIONS FOR LISTED REAL ESTATE REASONABLE?

We think that the old adage that equity markets act like a voting system in the short term, and a weighting system in the long term probably has some truth to it. While news flow, perceptions and emotions may influence prices in the short run, prices in the long run will factor in the fundamentals of companies, e.g. earnings, cash flow and growth.

We still believe that the long-term ‘winners and losers’ in real estate – driven by changes in demographics, lifestyles and technological disruption – remain the same, and that current pricing does not fully reflect the future growth to come in areas with structural drivers of demand.

GLOBAL REAL ESTATE – COMING TO THE END OF THE ABNORMAL? (cont.)

WHERE ARE THE MOST ATTRACTIVE INVESTMENT OPPORTUNITIES?

As the passing months have seen countries and populations adapt to the pandemic, many of us will increasingly long for a return to the way things used to be. The good news is that for many property companies, not much has changed with cash flows and dividends having held up much better than many expected.

While we claim no expertise in any field outside of property, we believe the unprecedented global resources being directed towards vaccines, treatments, and testing as well as the progress that is being made will mean the virus has an expiration date. When the threat of viral infection is minimised, will most people remain averse to airplane travel, sending children to school, collaborating with colleagues in the office, frequenting restaurants and bars, and attending sporting events, the theatre, museums, and cultural attractions offered by big cities? While the virus will surely bring lasting change, in our view, our existence will eventually return to something more normal rather than the abnormal we have known for the most part of 2020.

As such, when taking a longer-term view, we are beginning to see selective opportunities in cheap but not broken sectors that are looking more and more mispriced, including offices, healthcare and hotels. These sectors have borne the brunt of a lot of bad news recently, but as things slowly return to normal and outlooks improve, valuations and pricing are likely to move in tandem. We are already seeing some early signs of potential opportunistic investments in the private real estate market where the number of buy/sell agreements has improved dramatically with this figure down only 17% year-on-year for July compared with -74% in April and early May[3]. An increase in private market property transactions could be highlighting some very large discounts currently available in selected listed REIT sectors – opportunities that we are actively monitoring and, where appropriate, looking to take advantage of.

GLOBAL REAL ESTATE – COMING TO THE END OF THE ABNORMAL?

[1] Source: Bloomberg, from 31 December 2019 to 23 September 2020.

[2] Source: NAREIT (National Association of Real Estate Investment Trusts). REIT dividends have outpaced inflation as measured by the consumer price index in all but two of the last twenty years to 2018.

[3] Source: CBRE Deal Flow, July 2020.

The **FTSE EPRA Nareit North America Index** is designed to track the performance of listed real estate companies and REITs in North American markets (US and Canada). By making the index constituents free float adjusted (where the weight of each stock in the index depends on its market value), liquidity, size and revenue screened, the series is suitable for use as the basis for investment products, such as derivatives and Exchange Traded Funds (ETFs).

The **FTSE EPRA Nareit Developed Index** is a free-float adjusted, market capitalisation-weighted index designed to track the performance of listed real estate companies in developed countries worldwide. Constituents of the Index are screened on liquidity, size and revenue.

Weighted average is an average resulting from the multiplication of each component by a factor reflecting its importance. eg by index weight.

Dividend yield is the income received on an investment relative to its price, expressed as a percentage.

BUSINESS MODEL INVESTING: OPPORTUNITY AMID CRISIS

Source: Getty Images

US equities Portfolio Manager **Nick Schommer** discusses the importance of durable, competitively advantaged business models amid a disrupted economic environment.

KEY TAKEAWAYS

- The durability of individual company business models in North America has become increasingly important amid the economic circumstances brought on by the COVID-19 pandemic.
- While most businesses have been tested severely and unexpectedly, opportunities have emerged amid the crisis.
- Importantly, identifying competitively advantaged business models may reduce the risk of permanent capital loss that, in our view, should be a primary concern for long-term investors.

Market shocks and economic uncertainty can bring the importance of business models sharply into focus. This certainly proved to be true earlier this year in North America as companies were forced to cope with a near-total shutdown of the economy. The disrupted economic environment has exposed clear differences in businesses and their long-term viability. Our belief is that by uncovering misunderstood, undervalued and underappreciated business models, investors may reduce the potential for permanent capital loss and increase the probability of long-term gains.

CRISIS AND OPPORTUNITY

The pandemic-induced economic environment has tested business models in ways we've never seen. The service economy – businesses that historically tend to do well during recessions – has been particularly impacted. Though the economy has begun to reopen, companies typically resistant to cyclicality have seen demand delayed or destroyed: medical procedures have been postponed, concert and sporting event attendance has been canceled, and travel has been significantly curtailed, among many other impacts. Nonexistent and/or severely decreased revenue for these businesses is something that no one would have predicted, and markets have reacted in rather unanticipated ways, with historical precedent an unreliable guide.

Leveraged companies (that rely, to some extent, on debt to finance their operations) were punished disproportionately (and somewhat indiscriminately) during the initial pandemic-related market volatility. Extremely low interest rates and Federal Reserve (Fed) support allowed many companies feeling the strain of impaired balance sheets to raise debt and equity capital. As markets have begun to discern between those companies that did and did not impair capital, we have seen certain high-quality companies with a degree of leverage rebound strongly. Thus, the ability to understand businesses that were financially suited to weather the environment and emerge in a position of strength has been critical.

Perhaps the most notable effect has come as a result of widespread digitization of the economy, a theme firmly in place prior to the pandemic that has accelerated markedly as a result. Because of digital disruption, competitive advantages have been magnified for companies able to not only function but also thrive in the midst of crisis. This gulf can be seen in the tremendous performance discrepancy between growth and value stocks, mainly due to the dominance of a handful of large-cap technology stocks. While certain technology companies have been the primary beneficiaries, strong business models on the correct side of digital disruption can be found across the economy. These are companies in less obvious areas that, nonetheless, stand to come out stronger on the other side of the recession.

BUSINESS MODEL INVESTING: OPPORTUNITY AMID CRISIS
(cont.)

"BECAUSE OF DIGITAL DISRUPTION, COMPETITIVE ADVANTAGES HAVE BEEN MAGNIFIED FOR COMPANIES ABLE TO NOT ONLY FUNCTION BUT ALSO THRIVE IN THE MIDST OF THE CRISIS."

Volatility at levels seen in markets this year can offer opportunity for those with the ability to buy durable business models with a long-term time horizon. We have seen opportunities in stocks whose business models continued to perform (or improve) but the stock price lagged significantly, typically as a result of financial leverage. Companies whose businesses had clearly been hurt by the sudden stop in the economy but whose stocks were punished much more than we deemed warranted also presented opportunities.

RISK AS THE PERMANENT LOSS OF CAPITAL

We prefer to define risk in an absolute sense as the permanent loss of capital because it becomes difficult to achieve the goal of long-term capital appreciation when one has permanently impaired capital in an investment. Permanent loss of capital can arise when the terminal value of a business is impaired, for instance, when a company is at risk of becoming obsolete, such as a brick and mortar retailer or a company heavily tied to fossil fuels. Again, widespread digitization has exposed many business models that are at risk of obsolescence.

Capital can also be impaired when a company is forced to issue additional stock to address liquidity or leverage concerns, diluting the value of existing shares. The pandemic has set off a boom in equity issuance, yet some companies have been able to avoid these offerings by maintaining strong balance sheets and stable cash flows.

To guard against the risk of permanent capital loss, we believe it is essential for investors to know what they own. It is important to understand and invest in durable business models, companies that can sustainably generate attractive returns, in order to capture the value of compounding growth over time. It is also crucial to focus on valuation, buying companies at a significant discount to estimated fair value with the goal of fully realizing that value during the investor's ownership. Ideally, an investment achieves both the objectives of compounding growth and value realization due to the strength of its business model.

As we have seen, the pandemic has presented a set of unique economic challenges that have exposed certain business models and created opportunity for others. This year has confirmed our view that a focus on durable business models and avoidance of a permanent loss of capital can be powerful tools in an investment process focused on the long term.

IS IT TIME FOR THE EUROPEAN RENAISSANCE?

Source: Getty Images

John Bennett, Director of European Equities, explains the potential turning point in markets that could propel European equities to compete with the long-running and seemingly invincible US bull market.

KEY TAKEAWAYS

- The global response to the COVID-19 pandemic may act as a catalyst for inflation in Europe as politicians promise billions of euros in recovery money and seek to reduce the huge debt burden faced.
- Although we do not believe that inflation is imminent in the near term, we do believe it is important to question the factors that have led to the decade-long run of US growth and bonds.
- Other factors, including the rise of environmental, social and governance (ESG) considerations and the dominant role Asia is expected to play in the 21st Century, offer Europe potential impetus to outperform the US.

For years now, momentum has propelled US growth stocks higher and higher still, with hefty valuations to match soaring share prices. Meanwhile, value managers have been lying face down in a darkened room for a decade, waiting to be fired. Now, we believe they should feel confident enough to emerge, blinking into the light and say, "good morning Europe".

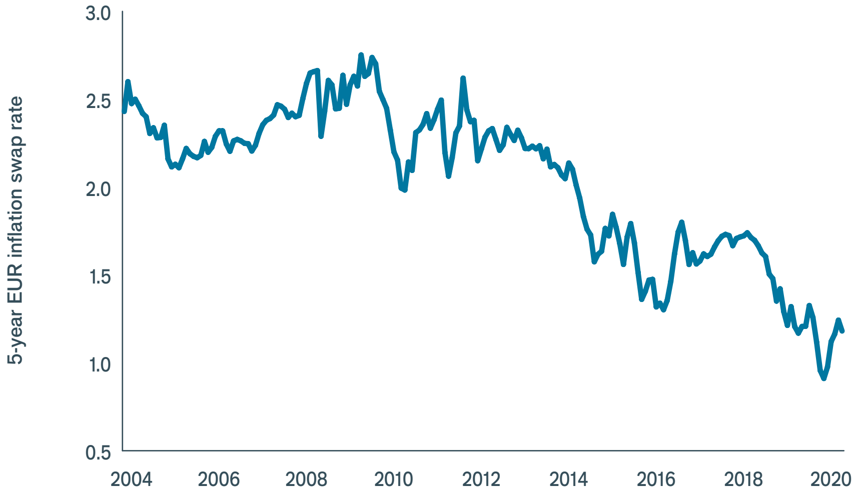
It would be foolish to suggest that allocating to US growth for the past decade was a mistake. On the contrary, we have watched from the side lines as the Nasdaq and tech stocks hit record highs time and time again, giving investors no reason to turn their backs on such phenomenal momentum. Since quantitative easing (QE) began, following the Great Financial Crisis of 2008, the world of equities has belonged to the US and to growth stocks as well as bond proxies. This ultimately led to years of underperformance by the value cohort. However, we believe that the sands are already shifting and the quite astonishing bull market in momentum stocks is potentially on its last legs. It is not just because many European stocks are cyclicals, nor simply because Europe is 'cheaper' on basic valuation metrics, such as price-to-earnings ratios. Rather, we believe that a catalyst has been identified: COVID-19.

COVID-19: A CATALYST FOR INFLATION?

To be more precise, we believe that the global response to the COVID-19 pandemic may act as a catalyst for inflation in Europe. The pandemic has given politicians the air cover to take control of the levers, wrestling them away from central banks. With those levers, we believe that politicians will set about creating inflation. Why? The world is facing a colossal debt burden that politicians would be thrilled to see diminished by the effects of inflation. A coordinated response to the COVID-19 pandemic offers this opportunity.

IS IT TIME FOR THE EUROPEAN RENAISSANCE?
(cont.)

LONG-TERM EUROPEAN INFLATION EXPECTATIONS HAVE BEEN FALLING



Source: Bloomberg, data from 30 April 2004 to 11 September 2020. Daily mid-price swap rate used. Note: The 5-year EUR inflation swap rate is a common measure used by central banks and dealers to assess the market's future inflation expectations.

The European response to the pandemic has commanded 'helicopter money' with central banks seeking to boost the economy with cash straight into people's pockets: £10 vouchers to the public to 'eat out to help out' and above-inflation wage increases for key workers in the UK alone. In May 2020, the European Union (EU) unveiled a 'Next Generation EU' recovery package to the tune of €750bn.[1] That is to say that we will see direct transfers from the frugal North, led by Germany, to the spendthrift South, including Italy and Spain. It is fair to say that this magnitude of direct money transfer would have never been considered without the pandemic and, yet, we would not be surprised to see more of the same to come. The return of inflation is crucial to all of this: if we are correct in our thinking and inflation returns, we believe that Europe and other value cohorts may begin to compete with the US.

However, it is important to say that we do not forecast inflation today, tomorrow or even this year. What we are saying is that there is a danger of 'the unthinkable' happening – that is, a return of inflation – while the world is currently calmed and sitting comfortably in deflation and disinflation. And while bond managers might think us mad – 'just look at the shape of the yield curve!' – we believe it is time to, at least, question what has been the winning trade for the past 10 years.

IS IT TIME FOR THE EUROPEAN RENAISSANCE?
(cont.)

GEOPOLITICAL SUPPORT

Another catalyst for Europe is at the geopolitical level. Europe is, for want of a better phrase, 'having a good pandemic' while some may argue that the US is having a disaster. This reflects much more than political personalities, although some may argue that this could be a major contributing factor. It also reinforces our view that we are witnessing the end of the American century and the beginning of the Asian century. To contextualise this, the nineteenth century was dominated by Europe and British Imperial reign, which was soon to be overtaken by America in the twentieth century. Today, Asia is on the rise. By 2040, it has been forecast to generate more than 50% of world GDP and could account for nearly 40% of global consumption.[2] In our opinion, Europe is much better placed to capitalise from the rising Asian century than the US.

WINNING THE GREEN RACE

We must also consider that a new competition is underway: the green race. The winners have been declared in the tech race and, while the US has reigned supreme on this occasion, we believe that Europe is well placed to be leaders in the ESG space. The EU has put a great emphasis on sustainability, with the Green Recovery Fund devoting nearly €550bn to green projects. This is the greatest climate pledge ever made and reflects the EU's desire to maintain momentum and to propel its position as leader in all matters ESG. The US, on the other hand, has taken to ESG matters more slowly.

It is our belief that markets are approaching a major turning point and that the 'buy growth stocks and forget about it' investing style is perhaps, finally, facing a genuine challenge. One of the features of our investment philosophy, and therefore the stocks we favour, is strong balance sheets and cash generation. This can sometimes appear old fashioned, not least during the love affair of recent years with 'disruptors' and other cash-absorbing adventures. Perhaps old-fashioned financial tenets tend to prove their worth at times such as this. We believe that the COVID-19 pandemic will come to be seen as having ushered in a different political zeitgeist and, with it, hope for some of the traditional value sectors in the stock market. It may even mean the unthinkable: that 'value Europe' now has the potential to outperform 'growth US'. Perish the thought.

IS IT TIME FOR THE EUROPEAN RENAISSANCE?

[1] Communicated from the European Commission to the European Parliament in Brussels on 27 May 2020.

[2] McKinsey Global Institute discussion paper: Asia's future is now, as at 14 July 2019.

Glossary of terms

Bond proxy: An investment product that replicates the performance of a bond but that is not a bond. This term can be used to describe equities, such as consumer staples and utilities, which often display 'safe' and predictable returns that are similar to bonds but may have higher yields than the bond market.

Price-to-earnings (P/E): A popular ratio used to value a company's shares. It is calculated by dividing the current share price by its earnings per share. In general, a high P/E ratio indicates that investors expect strong earnings growth in the future, although a (temporary) collapse in earnings can also lead to a high P/E ratio.

Yield Curve: A graph that plots the yields of similar quality bonds against their maturities. In a normal/upward sloping yield curve, longer maturity bond yields are higher than short-term bond yields. A yield curve can signal market expectations about a country's economic direction.

IS NOW THE TIME FOR DEFENSIVE VALUE?

Source: Getty Images

Portfolio Manager **Justin Tugman** discusses factors that may point to a leadership change from growth to value stocks. He also explores the potential a defensive value-based approach offers investors concerned with ongoing market volatility and lofty stock valuations.

KEY TAKEAWAYS

- Growth stocks have experienced an historically long run of outperformance versus their value counterparts, a trend that has continued despite an economic environment disrupted by the COVID-19 pandemic.
- Several factors lead us to believe that a leadership change may be forthcoming.
- For investors concerned with ongoing market volatility and lofty stock valuations, a more defensive approach, with a focus on seeking to mitigate downside risk, may be a prudent strategy.

Growth stocks, which have seen a long-running advantage over their value counterparts, have somewhat unexpectedly continued to outperform during the difficult economic environment brought on by the COVID-19 pandemic. This is evidenced by the Russell 3000® Growth Index outperforming the Russell 3000® Value Index by over 31% this year (through 8 September 2020). Among other factors, a tremendous amount of monetary and fiscal stimulus has been supportive for growth stocks and has likely enticed investors to take on greater risk. This resilience in a difficult environment (in which one may typically expect companies with more defensive attributes to be in demand) and the long-running outperformance posted by growth stocks may cause investors to question: "Why follow a value-based approach now?" The answer will likely come down to an investor's views on current stock valuations and the potential for continued market volatility in the future. If these raise concerns, a strategy incorporating defensive value stocks may well be timely.

VALUE AND GROWTH – ALTERNATING HISTORICAL LEADERSHIP

We are currently in the longest period of growth outperformance against value since the 1970s. The Russell 3000 Growth Index has beaten the Russell 3000 Value Index by 227% since 6 June 2007 (through 8 September 2020). Although the current outperformance has been particularly persistent, value and growth investing tend to be cyclical. Despite the recent long run of growth leadership, a value-oriented strategy has recurrently outperformed over extended periods. Following the late '90s tech bubble, for instance, the market experienced a phase of value outperformance lasting over seven years, during which the Russell 3000 Value Index outperformed the Russell 3000 Growth Index by 133% (March 2000 through June 2007).

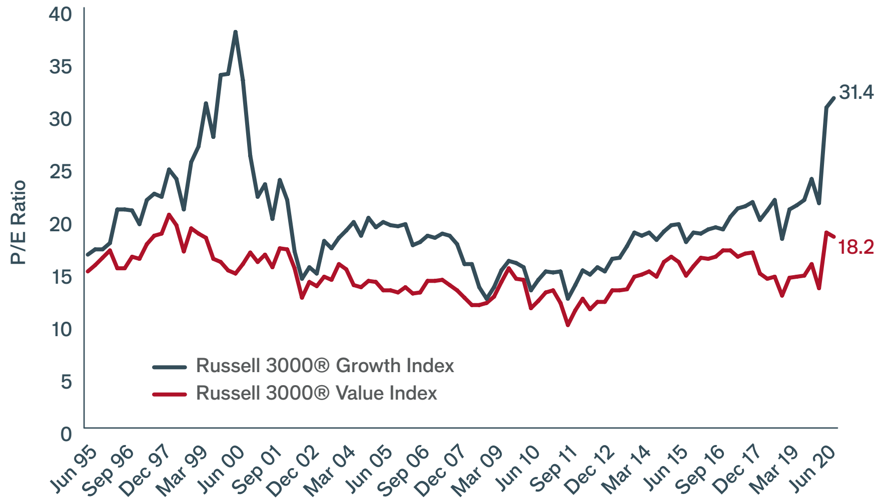
Mean reversion is a powerful market mechanism that is trending in value's favor as growth has experienced an extended leadership run. Many investors today perceive value to be perpetually out of favor and, thus, expect the future to resemble the recent past. While growth could certainly continue to outperform, we think that it may be timely for certain investors to begin moving to value and away from growth.

IS NOW THE TIME FOR DEFENSIVE VALUE? (cont.)

EXTREME RELATIVE VALUATIONS

In addition to extended outperformance, the difference (or 'spread') between the valuation of growth and value stocks on a relative basis has expanded to near all-time highs, approaching levels, again, last seen during the late '90s tech bubble, as shown in the chart below. While the market appears willing to pay a substantial premium for growth, long-term value investors, such as ourselves, have to examine whether the cost of these stocks is justified. In many cases, in order to rationalize current valuations, overvalued stocks would have to grow at tremendous rates over an extended period of time, which, to us seems unlikely. While this trend could continue, history indicates that the spreads between valuations typically compress.

SPREAD BETWEEN GROWTH AND VALUE REACHES EXTREME LEVELS



Source: Bloomberg. Price to Earnings (P/E) ratio, blended 12 months, 6/30/95 – 9/8/20, quarterly data. P/E ratio is used to value a company's shares. It is calculated by dividing the current share price by its earnings per share. In general, a high P/E ratio indicates that investors expect strong earnings growth in the future.

IS NOW THE TIME FOR DEFENSIVE VALUE? (cont.)

WHY CONSIDER DEFENSIVE VALUE NOW?

Being conscious of valuation by not overpaying for an asset can provide a cushion of support for an investor. However, value investing does not come without risks, which is why we believe a defensive-value strategy focused on finding high-quality stocks (as opposed to buying anything that appears cheap) is particularly important. The first cornerstone of a defensive-value approach is that the company must be out of favor and attractively priced relative to the market or relative to its competitors: it must be a good value. Second, and more importantly, the stock must have defensive-quality characteristics such as a strong balance sheet, durable competitive advantage and a strong management team. As opposed to other value-based strategies, a defensive-value approach puts a significant premium on investing in businesses that, while potentially challenged in the near term, have strong long-term prospects. We term these companies “survivors” as this defense-first approach may help them weather difficult economic environments.

Generally speaking, during periods of heightened risk, a defensive investment strategy affords investors the opportunity to stay invested in the market while partly mitigating downside risk. We believe it is essential to stick to a disciplined investment process that, at its core, selectively identifies companies with defensive attributes and attractive upside potential. Given the valuation levels and performance gaps we currently see in the market, this approach may be timely.

IS NOW THE TIME FOR DEFENSIVE VALUE?

The **Russell 3000® Growth Index** measures the performance of the growth sector of the broad US equity market.

The **Russell 3000® Value Index** measures the performance of US equity stocks in the value sector of the market.

Janus Henderson
INVESTORS

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