Cycle turns toward value investing as Mag 7 falters and rate cuts delayed: Barrow Hanley

By Perpetual Asset Management
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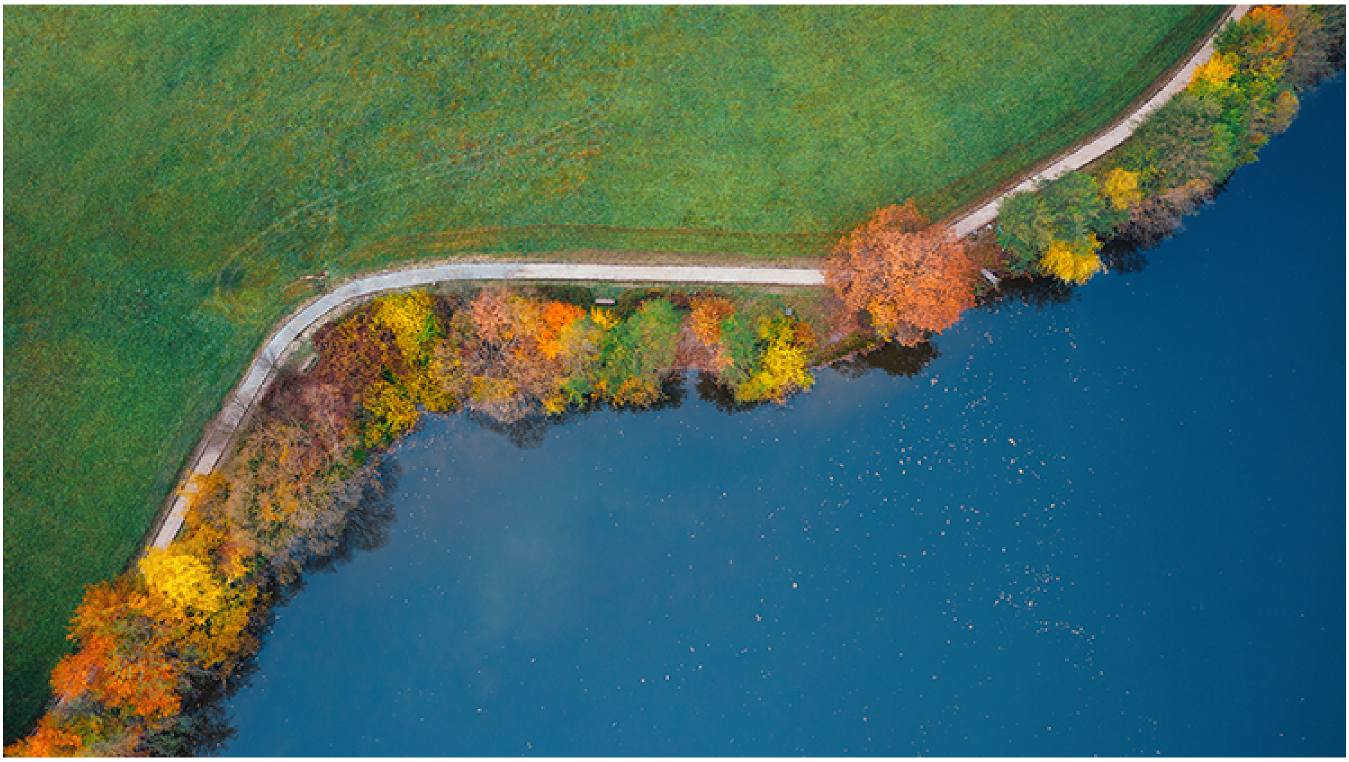

Bubble concerns? US rate cuts looking uncertain? It's time to think about a different strategy, argues Brad Kinkelaar, senior portfolio manager at US value investor Barrow Hanley

Reported by Perpetual senior equities investment specialist James Holt

- Investors turn cautious on rate cuts amid hot payroll data, stubborn inflation
- Conditions look increasingly favourable for value investors
- Find out about Barrow Hanley's global equities investment solutions

Over the past year we have seen one of the narrowest, one-way, momentum-driven markets in financial history.

The rise of the so-called "Magnificent Seven" tech stocks, driven partly by the rush to AI, caught the imagination of growth-oriented investors.

Federal Reserve chair Jerome Powell's promised multiple 2024 rate cuts added fuel to the valuation fire.

In 2023 these seven stocks returned between 48% and 237% compared with just 23% for the MSCI World.

But it also highlighted the irrational exuberance that sometimes carries equity prices to unsustainable valuations.

By the end of 2023 the Magnificent Seven represented a whopping 28.3% of the S&P500, even though they comprised just 16.8% of the index earnings.

By contrast financials were just 13.2% of the S&P500 despite contributing 21.6% of index earnings.

The top 10 stocks as a percentage of the S&P500 is now over 30%, a level not seen since the "Nifty Fifty" era of the early 1970s when investors overpaid for quality stocks.

Signs of a turn in sentiment

Now, however, there are signs investor sentiment might be turning.

The Wall Street Journal has downgraded the "Magnificent Seven" to the "Fab Four".

Investors have turned cautious on US rate cut expectations amid strong payroll data and stubborn inflation.

This month Minneapolis Fed Reserve president Neel Kashkari said a continued sideways inflation trend "would make me question whether we needed to do those rate cuts at all".

That view doesn't surprise Brad Kinkelaar, senior managing director and equity portfolio manager with US value investor Barrow Hanley (distributed in Australia by Perpetual Group).

“Everybody decided we’re not going into recession, we’re going to have Goldilocks economies all over the world and central banks cutting rates for the perfect landing,” says Kinkelaar.

“Everybody bought into that and so we ended up with a very focused market.

“Then in February people started recognising, well maybe we’re not going to get as many rates cuts as we expected.

“Maybe inflation is not going to come down as much as we expected. Maybe the ongoing assumptions were incorrect.

“Just in that little shift, we can see conditions changing to suit value investing.”

Time to reconsider value

It should come as no surprise that the performance of any value manager who is true to label would be struggling relative to these distorted index performances.

We aren’t narrow-value investors. We invest broadly across the entire market, including cyclical and defensive global value stocks

“We are traditional, value investors,” says Kinkelaar.

“We’re low P/E, low price-to-book, high dividend yield. We look for good companies that are out of favour for reasons we can identify – and which are selling at a discount to intrinsic value.

“At the same time our research leads us to value names with better-quality metrics such as better operating margins, higher ROEs and better EPS growth.

“The combination of below-average market valuation and above-average quality is what really drives long-term alpha.

“We’re very consistent in what we do and how we do it and how we build portfolios.

“We are not momentum investors, we are contrarian investors doing the exact opposite of what’s working in the marketplace.

"That’s a core philosophy which we strongly believe will outperform the broad market over the long term.

“While we can own any stock in the world at the right price, we don’t break the rules to own expensive mega tech at any price – even if it makes our relative index returns look better in the short term.

“Our long-term clients have stuck with Barrow through many cycles precisely because we provide them with the valuation discipline we promised them.”

The market outlook

“We’re now in the longest-running growth cycle in our lives,” says Kinkelaar.

“Do we know when that’s going to turn? No, but we see signs when conditions look favourable and now is one of those very favourable times.”

Just three months after the markets went “all-in” on the goldilocks scenario, there are problems emerging.

Inflation isn’t falling as fast as many would have hoped and the economy has remained resilient.

Financial conditions have eased dramatically as the stock market has risen.

Bond markets, which were predicting six rate cuts are now predicting only three.

It is a reminder that consensus trades often don’t come true.

“Every year for the last three years the consensus trade entering the year ended up being dead wrong,” argues Kinkelaar.

“The consensus trade for this year was soft landing, lower rates, Goldilocks scenarios and now everyone is second guessing that.

“At the end of 2020, the consensus trade was global recovery from Covid and energy was uninvestable. Yes we did get a global Covid recovery for two years, but the world index was flat. And energy was up over 100%.

“At the end of 2021, the consensus was big tech was immune to increasing rates.

“What happened in 2022? US 10-year bond yields went from 1.5% to 4.2% and Nasdaq went down by a third, (as shown in the chart below)”.

Consensus predictions	Actual outcomes
Late 2020 expectation for 2021: Global recovery from covid and energy uninvestable	2021: Recovery but world index was flat; energy up over 100%
Late 2021: Big tech will be immune to rising rates	2022: NASDAQ down 33%
Late 2022: Recession on the way	2023: No recession

Late 2023: Up to six rate cuts on the way	2024: Rate cut expectations falling

“We don’t have a crystal ball, but we do know narrow, momentum-driven markets like 1972 and 2000 don’t last.

“Both those markets ended with spectacular corrections, despite the fact many of the top-10 stocks in each of those periods generated significant cashflows at the time.

“Even among the highest quality growth companies excessive valuations often end in severe corrections.

Opportunities in value investing

US based Barrow Hanley has been a global leader in value investing for more than 43 years.

A long-term value investor, Barrow Hanley has stable leadership, a strong investment centric culture and depth of experience in periods of heightened volatility and uncertainty.

The Barrow Hanley Global Share Fund – distributed in Australia through Perpetual Group – aims to materially outperform benchmarks and peers over the medium and long term by generating attractive asymmetrical returns from participating in up markets while protecting in down markets.

It’s an all-cap strategy designed to exploit the widest opportunity set and greatest market inefficiencies.

Launched in 2010, the strategy now manages more than $US 8 billion in assets , typically including 50 to 70 stocks with a minimum market cap of $US1 billion

Although value is often perceived to be risk averse it is worth noting that one of our positions, **Vertiv Holdings**, rose 491% in the year ended March 31 – far more than any of the Magnificent Seven stocks.

Barrow Hanley also owned **Rheinmettal** (+97.4%) and a host of other strong performers.

These stocks were held because their valuations were reasonable at the time of ownership.

Positions are always sized commensurate with risk. The portfolio remains positioned in a range of stocks portfolio managers believe have the potential to grow strongly over time.

Kinkelaar points to China as an example

“The fundamentals are actually pretty good in China except for real estate.

“China tech is not fast growing like US tech but look at Ali Baba or Baidu – they both grew revenue 7-8 per cent this year and earnings at double digits. They’ve got huge cash on the balance sheet, huge cash generation. “

While US tech continues to trade at multi-decade-high multiples, Alibaba and Baidu trade at mid-single-digit price to EBIDTA.

“We’re starting to see green shoots in China, but nobody’s talking about it. You’ve got domestic travel back up to all-time highs, restaurants businesses is at highs, movie theatres at highs.

“Right now China is not a popular place to be and valuations there are around 20 year lows but these are the opportunities that value investors make a living on – when nobody else wants to touch it, not when everyone is chasing it.”

About Barrow Hanley

Barrow Hanley is a global leader in value investing, managing assets for clients for more than 40 years.

Barrow Hanley Global Share Fund aims to provide investors with long-term capital growth through investment in quality global shares.

Rated "Highly Recommended" by Zenith, "Recommended" by Lonsec and with a Morningstar Medallist rating of "Gold", the investment team focuses on finding value in all the right places.

Find out more here.

Barrow Hanley is distributed by Perpetual Group in Australia.

Contact a Perpetual account manager

The product disclosure statement (PDS) for the Fund, issued by PIML, should be considered before deciding whether to acquire or hold units in the Fund. The PDS, including for the Active ETF, issued by PIML, and each of the Active ETF's other periodic and continuous disclosure announcements lodged with the ASX, should be considered before deciding whether to acquire or hold units the ETMF. The respective PDS and Target Market Determination for the Fund and Active ETF, issued by PIML, can be obtained by calling 1800 022 033 or visiting our website www.perpetual.com.au.

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