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Gresham House Asset Management (GHAM) Investment Strategy - 2016

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Alpha generation from investing in "value"companies – Time to be contrarian?

Summary

Value investing has been out of favour with investors for a number of years, effectively since the financial crisis. The material underperformance of "value" stocks versus "growth" companies is comparable to levels last seen at the peak of the TMT boom in 1999. We believe the bifurcation of valuations with investors focusing on growth and momentum companies suggests long-term returns from "value" style investments, which may be asset backed and overlooked, will significantly outperform the market in the longer-term.

Despite two years of near zero returns from UK and US equity indices, relatively high cyclically adjusted P/E ratios (CAPE) and valuations of private equity deals indicates medium term returns from equity indices are likely to be relatively poor. Investors will need to explore alternative asset classes or more focused specialist strategies to generate alpha over the medium to longer term.

It is well documented that within UK equities, smaller companies have proven to generate significant outperformance over the long term. UK Small-cap has performed relatively well over the last three years with the FTSE small-cap (ex IT) delivering a total return of 59.2% vs 24.2% for the All Share[1]. Empirical evidence (Dimson, E and Marsh P 2014.) confirms a focus on "value" smaller companies has generated significant outperformance and we believe continuing to focus on smaller companies will generate outperformance over the long-term.

Value investing - now a contrarian strategy

Despite outperforming over the long-term, value investing has been out of favour with investors with growth and momentum stocks having been in vogue for around five years. The chart below (fig.1) shows the underperformance of global value versus growth indices on a rolling 10 year basis. The underperformance is comparable today to the peak of the TMT bubble 16 years ago. This point represented a market peak from which the FTSE All Share declined 42%, however "value" companies actually increased in price such as Imperial Tobacco which increased by 161% over that period.[2] We believe 2016 could be the year we see value investment strategies and stocks return to favour.

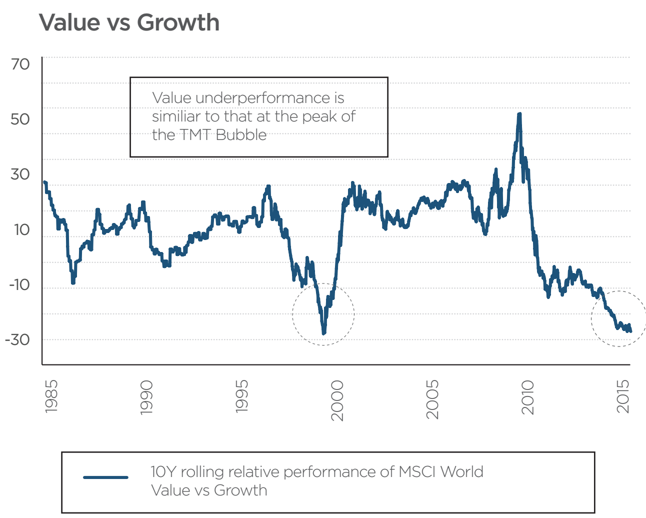

Fig.1 - MSCI World value vs growth - ten year rolling relative performance

[1] Bloomberg data, total return, 31st December 2012 - 31st December 2015.
[2] Bloomberg data, total return, March 2000 - March 2003.
[3] Bloomberg data screen, 12th January 2016, median average P/E multiple % dividend yield.

Current index valuations are relatively high - but areas of good investment value can be found

Although traditional valuation metrics do not look excessive they are at the upper end of the spectrum with average P/E multiples of 17.4x and a dividend yield of 2.5% for the FTSE small-cap index (ex. Investment Trusts)[3]. The extraordinary period of Quantitative easing following the financial crisis has resulted in an unprecedented low cost of capital which has helped drive corporate ROE and margins toward peak levels e.g cyclicals and defensives 40-year peak ROE of c.16-18%, with current levels at c.15%[3].

We believe the cyclically adjusted P/E of 13.3x for the FTSE All Share also suggests that returns are likely to be below the long term average of circa 4-5% real.

Further evidence that we are close to the end of another bull market cycle is provided by the average transaction multiples paid by Private Equity which has been increasing over the last five years and deals are now priced on average at 10.5x EBITDA with 5.4x Debt/EBITDA, similar to levels in 2006/2007(fig.2).

Private Equity Multiples

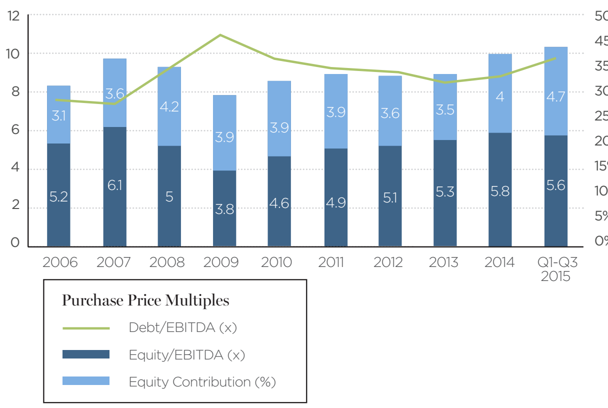

Fig.2 - Goldman Sachs UK Investment Club Presentation October 2015, S&P LBO as of September 30 2015

What does this mean for future Returns?

Current valuations would suggest medium-longer run returns will be below the long term average of c.4%-5% real and investors will need to cast a wider net including alternative and more illiquid asset classes or specialist strategies to achieve attractive returns.

Indices are an average and hide dispersions and, whilst areas of value do exist, investors need to do their research carefully and potentially adopt a contrarian investment strategy to generate superior returns. These areas could include the oil & gas services sector, retail services, or simply smaller, illiquid companies.

We also expect allocation into real assets to increase with investors attracted to the potential for long-term outperformance whilst owning investments backed by tangible assets that tend to be uncorrelated to traditional asset classes. Within this, we highlight timber as particularly attractive. The chart below (fig.3), compiled by GMO Woolley (an independent Asset Manager) is based on what current valuations imply for future returns, and shows forecast real returns of 4.8% p.a. for the timber asset class, (compared to international equities at 1.6% and emerging market debt at 2.8%). The unique characteristics of timber, including the biological growth and supply constraints, generate potential for significant outperformance.

Real Return Forecasts

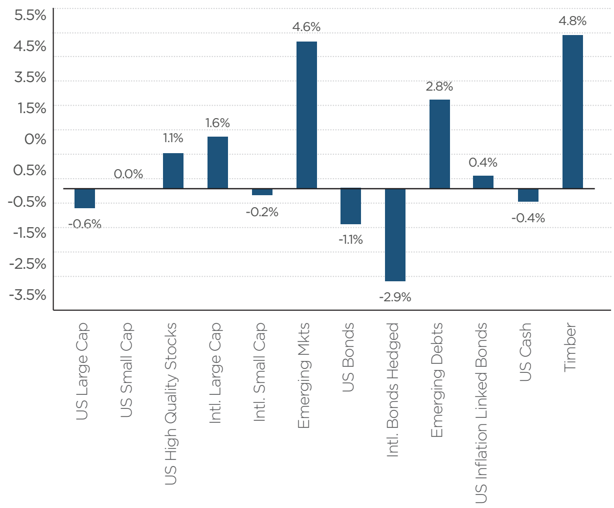

Fig. 3 7 year real return forecasts by asset class, GMO Wooley

Cyclicality and dispersion in valuations can present great opportunities for an alpha focussed investor to generate outperformance. A value investing style has historically generated long-term superior returns and there is evidence that even greater returns have been delivered through investing into smaller companies with value characteristics. Contrarian investing can be uncomfortable, however rewards have historically been significant.

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