DIVAS EUROZONE VALUE

Monthly Report December 2020

Marketing material for professional investors

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Market environment

Other than the sharp one-day sell-off seen in the third week of December, triggered by news of a mutated COVID-19 strain in the UK, which is much more transmissible than others known so far, Eurozone equity markets largely moved sideways over the month.

On 10 December the ECB increased the Pandemic Emergency Purchase Program (PEPP) by EUR500 billion to EUR1.85 trillion and extended it by nine months to at least the end of March 2022. Reinvestments will be made until at least the end of 2023. The favourable TLTRO-III bank lending terms were extended by 12 months to June 2022.

The ECB's mid-December announcement to limit the bank's pay-out ratio to the lower of 15% of earnings or 0.2% of risk weighted assets (RWA) to the end of September 2021, triggered some profit taking in Eurozone banks, following the stunning performance seen in November.

On 24 December the EC and the UK finally managed to agree on a Brexit deal that should allow for an orderly transition. Both parliaments will still have to sign off on this agreement.

Forward inflation expectations rose 4 basis points to 1.26% while the 10-year Bund yield remained unchanged at minus 57 basis points. The Swiss Franc appreciated 26 basis points to 1.0812, having failed for the fourth time to break the all-important technical resistance at 1.0850.

The commodity complex continued to rally, driven by the persistent V-shaped recovery in global manufacturing and construction. Brent crude oil jumped 8% on the unprecedented production discipline of OPEC+ and further OECD commercial inventory drawdowns. Nickel appreciated 4% and iron ore spiked 18%, as strong demand in China continued to reduce inventories. Other than crude oil, all major industrial commodities are now in deficit.

The December Markit Eurozone Composite PMI spiked to 49.8 versus 45.3 previously, mainly driven by the rapid recovery seen in the Markit Eurozone Services PMI to 47.3 versus 41.7 previously and an expected reading of 42. The Markit Germany Manufacturing PMI jumped to a new high of 58.6, as the global V-shaped recovery continued to unfold. The December Markit US Manufacturing PMI rose to 57.1 from 56.5 previously. Conversely, the December Caixin China Manufacturing PMI softened to 53, following its rapid ascent during the preceding months.

Performance

In December, the MSCI EMU Index rose 1.97%. The fund's euro I-shares appreciated 2.11%, outperforming the MSCI EMU Index (net dividends reinvested) by 14 basis points.

Performance contributors

- ArcelorMittal outperformed the market by 21%, as continued strong demand from China pushed steel and iron ore prices 15% and 18% higher respectively.
- Volkswagen pref. outperformed the market by 6% as CEO Herbert Diess won the backing of the board for the planned major restructuring.
- Technip outperformed the market by 6% on announcing a major project win in December.
- Covestro outperformed the market by 6%, as the company, for the third time in a row, positively preannounced. The company now expects a FY2020 EBITDA of EUR1.44-1.5 billion versus EUR1.2 billion previously and free operational cash flow of EUR400-550 million versus EUR0-300 million previously. Current spot product spreads suggest a significant >EUR1 billion EBITDA tailwind year-on-year into FY2021.

Performance detractors

- UniCredit underperformed the market by 13%, as its CEO Jean Pierre Mustier, in disagreement with his board with regards to the acquisition of Banca Monte dei Paschi di Siena, handed in his resignation. Even though he was instrumental in the major restructuring of UniCredit, his job, after four very successful years, is now done and his departure at the end of April 2021 will not change the future course of the bank. This is reflected in the fact that there were admittedly numerous analyst recommendation downgrades on the stock, but with consensus forward earnings expectations remaining unchanged.
- ABN AMRO Bank and ING underperformed the market by 9% and 8% respectively. Since those

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banks have by far the largest capital surplus among European banks and were therefore expected to pay the highest 2021 dividend yield, the proposal by the ECB that Eurozone banks should only pay out the lower of 15% of earnings or 0.2% of RWA until the end of September 2021, disproportionately hit those banks. Since they have a whopping capital surplus of 100% and 50% of their respective market cap., they can nevertheless easily afford to pay a 7-8% dividend yield in FY2021.

Positioning

In December, the fund switched Airbus, up 39% since purchase in June 2020 and having outperformed the market by 22%, into Telefonica. Furthermore, it reduced its position in Banco Santander and ArcelorMittal to increase its holdings in UniCredit, ABN AMRO Bank, Volkswagen pref. and ING.

Outlook

In September 2020, a variant of the COVID-19 strain emerged in southeast England. Preliminary analyses suggest it is 56-70% more transmissible than other circulating strains, thus contributing to a spike in cases in the UK. Researchers have found no evidence that this mutation causes more severe illness. The extent to which COVID-19 may evolve to escape immunity induced by infection or vaccination is currently not known. However, drug makers including BioNTech, AstraZeneca and CureVac don't believe that their vaccine's efficacy will be affected.

The ECB's announcement mid-December to limit the banks' pay-out ratio for 2019/20 profits to the lower of 15% of earnings or 0.2% of RWA to the end of September 2021, was interpreted by the market to limit the banks' dividend paying capability and share buy-back potential in 2021. The fact that the ECB set a hard deadline for this restriction to expire at the end of September 2021, makes it easy for our banks to pay an interim dividend this spring and subsequently in Q4 pay a final dividend for 2021 to disperse a very generous total dividend in 2021 yielding 7-8% for our holdings. Since our banks are desperate to get rid of their huge capital surplus, which is equivalent to between 45% and 100%+ of their respective outstanding market cap., and artificially badly depresses their ROEs, there is a high probability that, come the end of September, they will announce meaningful share buy-back programs.

Over the course of the last 11 years some USD 3 trillion worth of new machine-driven products were created. These are mostly absolute-return products, which sell themselves under the attribute of highly differentiated intellectual properties, but factually perform the exact same process, display identical momentum sensitivities and are therefore highly correlated. Over that period this momentum sensitivity was the proxy for growth, yield and low volatility sensitivities.

I have already touched on this topic in the past, stating that, once the rotation unfolds, this momentum sensitivity would no longer be represented by growth, yield and low volatility factors but by value factors. Because of this shift, momentum strategies will not cease to exist, but will evolve to buy the value factor. From conversations with clients, I realised that this concept was so alien to their thinking that they struggled to grasp the ramifications of it. A consequence of this is that the old incredibly powerful momentum "perpetuum mobile" will transition to henceforth chase value factor sensitivities. Put another way, the familiar set of stocks that in the past protected investors on the downside (losing less than the market) while powering ahead in rising markets (gaining more than the market) will cease to give investors that pleasure and will start to display diametrically opposite features. This will eventually push investors out of their comfort zone and force them to buy the very stocks they learned to hate over the course of the last 11 years.

With worries about a no-deal Brexit after 4 ½ years finally out of the way, the door has been pushed wide open for US investors to finally return to Eurozone value stocks, having deserted the space over the last 11 years.

Even though we have, since mid-March, generated an Alpha of 2391 basis points, the value factor has even underperformed the blend benchmark by 45 basis points, i.e., the rotation is only just starting and the incremental 50-100% Alpha we generated during the last rotation in 2009, is still up for grabs.

NAV: EUR 96.92
ISIN I shares: LU1975716835
Valor I shares: 47229643

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