DIVAS ASSET MANAGEMENT AG

VALUE IS DEAD, LONG LIVE VALUE!

Marketing material for professional investors

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In the following paragraphs we would like to address the various preconceptions the market has established over the course of one of the most dramatic eras in socioeconomic history. In the last 11 years alone, we have witnessed, substantially negative yield curves, an implosion of commodity prices, a global superpower trade war with various sideshows and a global pandemic on a scale seldom witnessed. The fallout of these occurrences was exacerbated by exceptionally easy money, the creation of some USD3 trillion new products, all buying the same sensitivities (momentum – proxy for growth, yield and low volatility) a major drive from active to passive investments (ETFs), accompanied by a historic record net outflow from Eurozone equities into US equities (2008-2020) and a mind boggling inflow into global tech equities which extended into mid-2020 (USD73bn weekly cumulative inflow compared to the 10-year average of some USD5bn).

This finally culminated in the value implosion seen into mid-May 2020, which comfortably beat the one seen in the Great Financial Crisis (GFC) of 2008/09 (-3032 basis points versus growth, compared to -1824 basis points) completing the most extended (fourteen years) and pronounced (underperforming by some 130 percentage points) period of underperformance of value versus growth in history.

The new normal

An unintended consequence of this distorted eleven-year period was that the market bred a whole new generation across the entire value chain (Sell- and buy-side analysts, fund analysts, portfolio and fund managers, client advisors and CIOs), which controls global flows and is convinced that what was probably the biggest aberration in financial history since the great depression (the last 11 years) is the new normal and will last forever. Conventional wisdom has it that old economy Eurozone will never grow again and that interest rates will stay at zero forever. Below we try to illustrate why this is probably one of the biggest misconceptions of our time and how it is likely to unravel.

Growth to shift in favour of the Eurozone

A key driver of flows into US assets to the tune of USD8 trillion over the last 12 years was their superior growth profile compared to other geographies like Europe. Over that same period Europe suffered a USD2 trillion net outflow. Investments into US assets has been a one-way street since the GFC, as investors sought out safe haven status, strong corporate growth and innovation (technology), combined with a hawkish Fed that supported a strong USD backed by a strongly positive carry (moving from +50 basis points versus the 2-year Bund yield late 2014 to +350 basis points late 2018), i.e. as a European investor you got royally paid by the market to hedge your Euros into USD.

> **"Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."**
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> *John Maynard Keynes*

The invention of the iPhone in 2007 followed by the rapidly growing penetration of smart phones, combined with the internet of things strongly fostered such giants like Facebook, Amazon, Netflix, Google, Apple and Microsoft, which over the last 11 years accounted for the vast majority of the growth generated in the technology space. Those six stocks today account for a whopping 25% of the S&P and 44% of the NASDAQ.

The temporary earnings growth hit Eurozone value stocks have to absorb in 2020 (-33-50%, depending on the cyclicality of the business model), will see to it that Eurozone value stocks will, over the course of the next two years, enjoy an earnings growth of 50-100% to return to the levels of 2019. A level hard to beat by the growth space and therefore at the same time a key driver for flows out of growth into value.

Are Eurozone banks structurally challenged?

In mid-May, most Eurozone banks made new all-time lows or retested their 16 March 2020 lows, trading 25%-65% below the trough of the GFC. To put this into context: In their Q1 results

Eurozone banks guided for an average cost of risk (CoR or loan loss provisions) for 2020 of 90 basis points. This compares to peak 2009 credit losses of 140 basis points of loans. Excess capital over MDA (amount banks can return to shareholders in form of dividends or share buy-backs), plus 2020 pre-provision profits for the industry, average some 500 basis points of loans. This would allow the banks to cover 3-4 times the level of CoR experienced back in 2009. Put another way, even if you assumed double the guided credit losses were to occur, banks would still enjoy 320 basis points of MDA buffer, which they could use to return to shareholders. In view of the government-initiated back-up loan guarantee schemes, to the tune of EUR520bn for Germany, EUR400bn for Italy, EUR300bn for France and EUR120bn for Spain, such a scenario is anyway highly unlikely.

Put another way, the 500 basis points equity surplus Eurozone banks enjoy today is equivalent to the entirety of the equity quota the sector held back in 2009.

In my 34 years I have never come across a structurally challenged industry that at the same time had managed to build a record equity surplus.

To illustrate the current unmatched attractiveness of Eurozone banks, look at stocks like Société Générale and BNP Paribas trading at some 0.25x and 0.35x tangible book. Conventional wisdom has it that banks would never ever trade back at book again. However, only as recent as 2017, i.e. in the new world in which banks are perceived to be structurally challenged and therefore uninvestible, those stocks were trading at 1x and 1.1x tangible book.

To spin the wheel a bit further: have you ever considered the earnings enhancement our banks would enjoy from as little as 10% share buy-backs, trading at such huge discounts to tangible book? This would enhance the normalised 2022 earnings growth of our bank holdings by between 25% for BNP Paribas and 102% for Banco BPM, bringing the forward earnings multiples to between 2.7x for Société Générale and 4.8x for ING. All our banks have an equity surplus (MDA buffer) that would allow them to buy back a multiple of that.

More than 100% of the outperformance of growth over value is simply explained by growth turning most expensive ever!

In May 2020, Research Affiliates published a very timely and highly up-to-date (to March 2020) empirical analysis as to whether value was dead. Even though the study was conducted on US equities, the conclusions are likely to be even more salient to Eurozone stocks, since Europe has nothing comparable to the six key performance drivers of growth seen in the US (Tech exposure in Europe is 7% vs 26% in the US). The analysis basically splits the July 1963 to March 2020 period into two episodes. One from 1963 to 2007, a period the value factor delivered an average annual outperformance over growth of 6.1% and the last 13 years from 2007 to 2020 over which the value factor suffered an average annual underperformance, over growth, of 5.4%. The narrative that growth stocks post-2007 were both more profitable and had faster sales growth than pre-2007 were both disproved. ROE declined from 17% pre-2007 to 16% post-2007, while sales growth actually tumbled from 14% pre-2007 to 8% post-2007. However, what is even more remarkable is that the net delta of the change in ROE and sales growth of growth versus value (post-2007 versus pre-2007) yielded an annual net 1% benefit in favor of value, i.e. had valuations had any relevance over the last 13 years, value should have outperformed growth. The reason value has suffered a 50% drawdown over the last 13 years is fully explained by the collapse of relative valuations, i.e. value moved from the 23rd percentile (expensive) versus growth to the 100th percentile (cheapest-ever). A modest move to the historical 75th percentile, halfway between the cheapest-ever and the median valuation for value relative to growth, would imply a 53% relative performance for value over growth. To put this into context: back in 2009, where our strategy within 9 ½ months managed to generate an alpha of 115 percentage points, the eurozone value factor had outperformed growth by 27%.

Prerequisite for a sustainable rotation back into value

Historically, any sustainable out-performance of the value factor versus growth has always been driven by the combination of the following three factors: rising PMIs, stable to rising yields and rising oil prices.

April 2020 saw the low in Eurozone PMIs. The staged ramping of the

European economies should ensure a gradual ascent into year-end.

The major driver behind gradually declining rates since March 2015 has been the various Quantitative Easing (QE) programs. However, the aggressive deleveraging of very healthy economies like Germany and Switzerland has proved a further driver over the last couple of years. This shrinking supply, together with rising demand from pension funds and insurance companies, helped to constantly push rates lower. The huge combined fiscal stimulus from Eurozone countries to the tune of EUR2.5 trillion, equivalent to some 18% of Eurozone GDP, along with the hundreds of billions expected to be issued by European corporates, will increase supply and should help to balance the market. This, combined with the growth this massive stimuli entails and the associated rise in inflation expectations, should finally allow yields to normalise.

The global oil market is currently still some 10m boe/d oversupplied. The staged ramping of global economies, starting with energy intensive manufacturing and construction, should gradually ease that pain. Integrated oil companies (IOCs) globally have aggressively slashed their capex programs. Marginal cost of production of IOCs is around USD65 and, even for the Russians, a Brent crude oil price at current levels is not sustainable. The Saudi's and their Middle Eastern competitors would bankrupt themselves should prices stay at current depressed levels for an extended period of time. With Brent crude oil down 45% from its 2018 peak, there is a good chance, we will see oil prices gradually rise over the next 12-18 months.

With this, all factors are now in place for a sustainable rotation back into value. Growth shifting in favour of Europe has historically helped to accelerate that rotation, since it always went along with an economic recovery in Europe and major asset allocation shifts from US back into European equities. The associated US Dollar weakness helps to further strengthen flows into European assets. The majority of such assets returning, typically flows into European cyclicals and financials. Value outperformance versus growth tends to peak when PMIs reach 54. A long way to go from May's level of 31.9.

What has changed since 14 May 2020?

14 May 2020 seems to have been the watershed moment for any non-momentum asset. Following the initial sharp market sell-off in the first two weeks of May of some 7%, sensitivities on all asset categories experienced a major turning point. This coincided with the first weekly inflow into Eurozone equities in three years. On 14 May 2020 we saw a substantial intraday reversal in factors, with value reversing its morning weakness and momentum rapidly selling off in the afternoon. This despite negative news flow on renewed trade threats from President Trump and the situation in Hong Kong flaring up again. In the following weeks we saw the same pattern repeated, regardless of whether markets traded up, down or flat. In the morning the value factor underperformed or started with modest outperformance and then persistently recovered part of the under-performance or expanded into considerable outperformance over the course of the day. The machine that has a vested interest to defend the positioning of its USD3 trillion momentum products kept riding multiple intra-day assaults on the value factor, but consistently failed. The only day the momentum factor prevailed and the value factor closed on its intra-day low was month-end, where the window dressing of the momentum factor typically dominates. This is a pattern I last experienced in March 2009, the low of the GFC, which marked the start of the last major rotation back into value. Mid-May also seems to have coincided with weekly cumulative inflows into global tech equity and health care equity funds peaking out. This coincided with record cash positions, sentiment nearly as bearish as at the lows of the GFC, the European equity risk premium (ERP) reaching a new record high of some 10% (7% peak in March 2009) and a multi-year high of the Swiss franc.

With the pattern change seen prevailing since 14 May 2020, value should eventually start to display momentum characteristics and the machine will as unemotionally and frantically start buying value as it had sold value over the course of the preceding 14 years.

Such market rotations tend to unfold very fast, as could be seen in 2009, when the last such rotation happened and our program, within 9 ½ months returned 177%, with 115 percentage points of this being attributable to Alpha generation.

Currency Risk – Non-Base Currency Share Class: Non-based currency share classes may or may not be hedged to the base currency of the Fund. Changes in exchange rates will have an impact on the value of shares in the Fund which are not denominated in the base currency. Where hedging strategies are employed, they may not be fully effective.

Equity: Investments in equities may be subject to significant fluctuations in value.

Capital at risk: All financial investments involve an element of risk. Therefore, the value of the investment and the income thereof will vary and the initial investment amount cannot be guaranteed.