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MARKET DRAWDOWNS

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As the profit cycle matures, we are increasingly being asked how long-term investors should best position themselves should the economic backdrop and equity markets become more challenging.

There is a widely held belief – one we don't subscribe to - that when the backdrop becomes more challenging, investors should shift out of higher multiple growth stocks towards lower multiple value stocks. This belief is based on the presumption that low multiples provide added defense when times are tough.

Unfortunately, the reality is more complicated, with little evidence supporting the claim that multiples are a powerful defense against worsening conditions.

In fact, our analysis of performance through downturns finds stable and rising cashflows are the most crucial line of defense during a market downturn. We find stocks that can continue to grow their cashflows during periods of tough economic conditions not only preserve more value during a market downturn, they also provide higher risk adjusted returns on a through-the-cycle basis.

When we pull apart market returns across geographies, sectors, styles and stocks, we find performance of the underlying cashflows is most often the critical input into the total return that investors receive, particularly when it can be delivered largely irrespective of market conditions.

The importance of earnings on shareholder returns

As we can see from the **Exhibit 1** of the S&P 500 index below, absolute share price performance of the index (blue line) is very closely correlated to the trajectory of earnings (brown line), over both the short term and through a full investment cycle.

Even in the most cyclical of sectors, where the inherent volatility of earnings should be well understood and widely anticipated, investors still seem reluctant to look beyond the regular deviations from the long-term trend in earnings. Investors mark-to-market near term changes in earnings and are less willing to look through periods of earnings volatility. This fact is illustrated in **Exhibit 2** which is an example of the typical earnings and price behavior of companies operating in the notoriously cyclical shipping sector.

The close relationship between earnings and share prices also transcends styles and sectors. For example, the uncomfortable truth is that the long-term performance differential between value and growth styles is almost entirely explained by the difference in earnings performance between the two.

As shown by **Exhibit 3**, since 2003 the S&P 500 Value Index has returned an annual price return of 6.9% vs annualised earnings growth of 5.6%, whereas the growth index has returned 9.2% annualised over the same timeframe based on a 9.1% annualised increase in earnings. The 33% improvement in returns to growth over value could be explained by the difference in earnings and has little to do with valuation.

Taking a long-term view on one style over the other is really a call on the potential difference in earnings outcomes between the two styles and not, as is commonly believed, a call on valuation.

Interestingly, and linking back to our original point, the Growth index was also more defensive during the GFC-led downturn. As can be seen form Exhibit 4 below, in the three years from 30 June 2007 to 30 June 2010, the S&P 500 Growth Index lost 24.7% of its value and earnings declined -1.3%. The value index in contrast lost 40.7% of its value over the period and earnings declined -19.8%.

Both styles suffered similar de-rating over the period, but the superior earnings power of the S&P 500 Growth Index

Exhibit 1. S&P 500 Index (1Yr Forward EPS vs Index Price - 2003 to 2018)

Source: Bloomberg Finance L.P. as at 13 June 2018

Exhibit 2. AP Moller-Maersk (1Yr Forward EPS vs Share price - 2005- 2108)

Source: Bloomberg Finance L.P. as at 13 July 2018 cushioned investors against the worst of the GFC fallout, **Exhibit 4**. The trajectory and stability of earnings really is the key differentiator when it comes to risk adjusted returns and defensive strategies.

The very close relationship between share prices and profits speaks to the market inefficiency that the AMP Capital Global Companies Fund seeks to exploit. It is clear shares price to near term fundamentals rather than attempt to price to longer term outcomes, which can provide long-term investors such as ourselves with a clear and meaningful investable advantage.

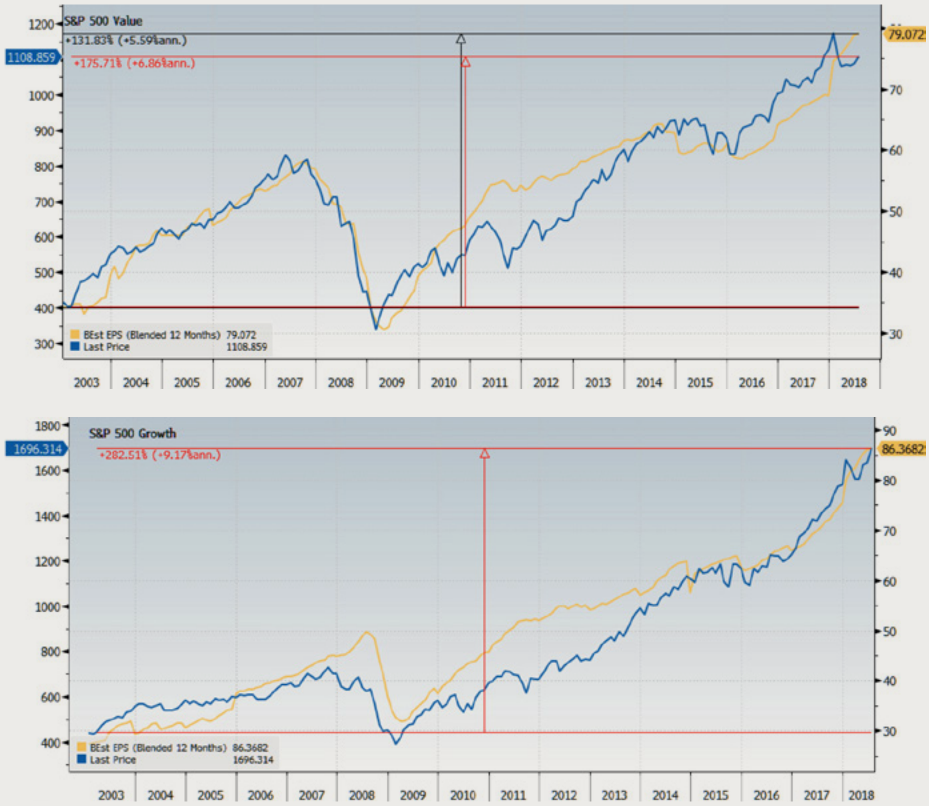
If we can identify companies that can genuinely sustain or improve their economic returns over the long term and combine that with structural, rather than cyclical, pathways to growth, we will reap the rewards from the long-term compounding of those cash flows. These kinds of companies should provide positive and stable earnings trajectories over our five-year timeframe and throughout all stages of the economic cycle, helping investors to preserve value when times are tough and grow value when conditions are more favourable.

This is why we believe that fundamentals, not valuations, explain the vast majority of total shareholder returns (and risks) over the long run.

Conclusions

- Markets mark-to-market in the short term and are inefficient in the long run. This is our exploitable edge.
- Earnings matter more than multiples over the long run and particularly during a downturn.
- The impact from the compounding of cash flows outweighs the potential impact from valuations over the medium to long term.
- Low multiples do not necessarily offer protection in a downturn, earnings and cashflows generally do.
- Consistent and stable cashflow growth is an important cushion to protect and preserve value through a downturn.
- Combining structural growth with high or improving returns is the root cause of stable and expanding cashflows - it is the first line of defence in a downturn.

Exhibit 3. Style performance: Value vs Growth (2003 to 2018)



Source: Bloomberg Finance L.P. as at 13 July 2018

Exhibit 4. SPX Growth and Value Index - 3 years from June 2007 to June 2010

Source: Bloomberg Finance L.P. as at 25 July 2018

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