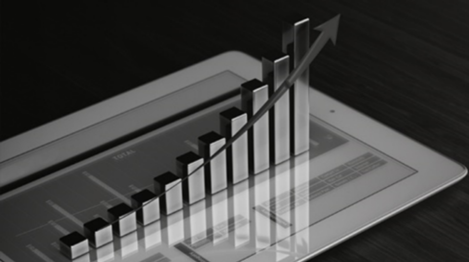

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Funds and Solutions

SPOTLIGHT – EQUITIES

January 2022

Rotation impacting our portfolios – our views

The rapid and strong increase in real interest rates has led to a clear dispersion in capital markets. Long-dated bonds as well as growth companies with earnings development priced far into the future lost massively in value, while commodities (especially energy) and value shares in general were able to gain. However, our philosophy is based on our conviction that longer term the dominant driver of share prices is the underlying growth trajectory of a company. The main question right now for the short term is, how far the valuation dispersion of different market segments will be narrowed down and is there a better earnings growth trajectory for so called value stocks.

The valuation dispersion

There is a clear risk, that some growth stocks, that have expanded their valuation multiples in the last 2 years will correct to the pre-COVID period, while most of that has happened already. The most affected area is the non-profitable tech segment in the US, which is correcting already heavily since summer last year. Also, stocks pushed up by popular thematic baskets and ETFs have corrected already and are further at risk if the business models are not rock solid and cash flows are far out in the future.

On the other side the question is if there is any reason why energy and banks stocks for example should be on much higher multiples than in the pre-COVID period? We do not think so, as structural trends are in most cases very similar to that period before COVID-19. From a valuation perspective, it is important to bear in mind that many stocks from the Energy or Commodities sector – in other words core representatives of the value camp – are already back at the valuation levels that we saw before the start of the pandemic. From here on, valuation is thus unlikely to provide as strong tailwinds as it did recently.

The earnings growth differential

The value camp which is performing right now can be clustered into three different areas:

1) Financials
2) Commodities & Energy
3) Re-Opening stocks like Travel & Leisure

Most of the companies out of the first two areas did not show any or low earnings growth over the last ten years, as their business models have been structurally challenged. We are having a hard time identifying any structural changes within these sectors that would set them up for significant and sustainable earnings growth. Furthermore, energy and banks have already seen a quite significant recovery of earnings growth over the last year. If the economy is opening up after the Omicron wave, Travel & Leisure companies will for sure benefit for a while, but also the overall economy will be affected positively by consumers, companies and governments spending more. This will be beneficial for the more cyclical end of our portfolio in consumer discretionary, industrials and semis. On the other side, is there a risk that some of the strongly growing companies will see a period of growth rates decelerating? We believe that most companies in our portfolios are growing at rates which

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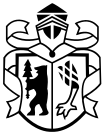


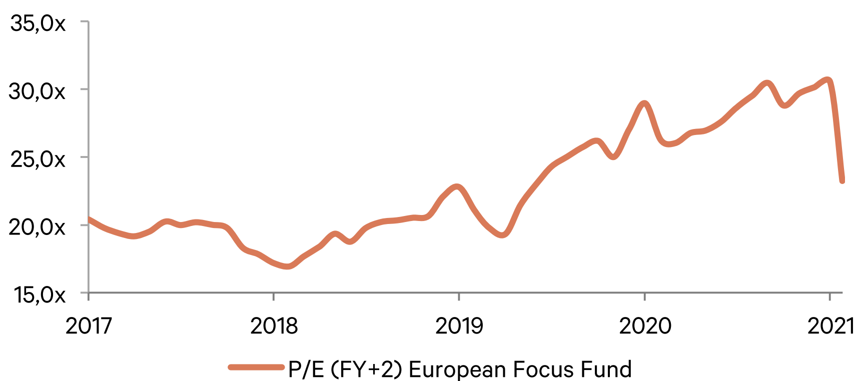
they have achieved also pre COVID. Some have accelerated their growth rates as they benefited from the lockdown economy. In these cases, it has to be monitored and analysed if it is sustainable and driven by a structural change of end market demand and/or company specific changes.

This begs the question, how long will the current rotation last? In a historical context the current selloff of the winners of the last years is far advanced. This observation is based on the performance patterns of the growth strategies our lead portfolio managers have been managing for almost 2 decades. We see the following long-term arguments for our portfolios:

Even in an environment of rising inflation/interest rates, what drives long-term outperformance doesn't change. It is down to whether business models work well, whether they are future-proof and whether profits will grow. There are many examples found even when we look into periods with rate hikes over a longer timeframe like in the years 2003-2007.

Strikingly, the valuations of our portfolios are also back at pre-COVID levels. This gives us confidence, that going forward the valuation headwind we faced should slow down, allowing the continued strong earnings growth of our companies to drive future performance. Our portfolios have been adding strong alpha since inception but also since March 2020, when the COVID-19 crisis began, despite the valuation compression and performance losses recently, as our holdings had a far better earnings trajectory.

Fig. 1: Portfolio valuation data European Focus Fund (P/E FY+2): back to pre COVID levels



Source: Berenberg, Bloomberg, 24.01.2022.

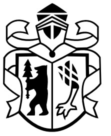
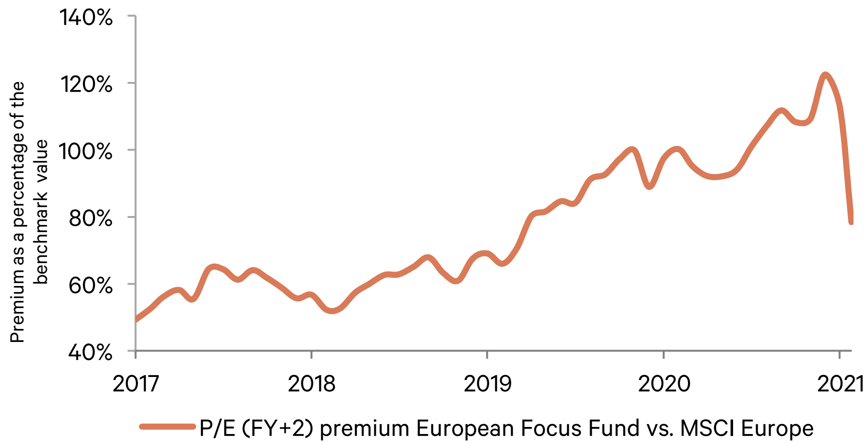


Fig. 2: Portfolio valuation data European Focus Fund vs. MSCI Europe



Source: Berenberg, Bloomberg, 24.01.2022

Stable and nearer term cash flows become more important. Discipline on valuation is important but needs to be considered in the context of growth and quality. The Berenberg European Focus Fund for example has an average PE 2023E ratio of 26.6x, the earnings growth is expected to be mid-teens and the companies are on average highly cash generative and have better balance sheets.

Fig. 3: Valuation overview European Focus Fund

	Valuation P/E 2023	Revenue growth (2022-24E)	Earnings growth (2022-24E)	Valuation vs. earnings growth	RoE (last FY)	Net debt/ EBTDA (last FY)
European Focus	26.6x	10.4%	13.9%	1.9	26.9%	1.1x
MSCI Europe	14.0x	2.5%	6.4%	2.2	12.2%	3.1x

Source: Berenberg. Bloomberg, 25.01.2022

Most affected by rising interest rates are highly leveraged companies, unprofitable companies, hyped segments/themes. We generally do not invest in companies that are not profitable. In fact, we look for highly cash generative business models. This is also why our holdings tend to have a very low leverage.

Companies that have grown far above their pre-COVID trends are at-risk for-profit deceleration. We have to monitor these cases even more closely.

Selling structurally growing quality companies and tactically entering structurally challenged companies just for the sake of rotation has never been a good decision. As we manage growth quality approaches for a long time already, we have seen similar events many times and we are aware on the usual pattern.

The companies in our portfolio are investing heavily in future growth, therefore their growth prospects should be much better than the average of the market.

Our portfolios can always adapt to a changing environment within the remits of our approach, by becoming more cyclical or defensive depending on the opportunities in individual stocks.

We therefore feel well positioned for the future with our investment approach based on companies with structural growth drivers, high barriers to entry, outstanding management teams and excellent balance sheets.

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