MARTIN CURRIE AUSTRALIA VALUE EQUITY

APRIL 2022

For institutional, professional and wholesale investors only

THE TIDE CONTINUES TO TURN FOR THE VALUE-GROWTH DYNAMIC

As the economic reopening gathers momentum, the Value style is witnessing a swing from performance headwinds to tailwinds. The time is now to capitalise on this thematic.

Reece Birtles

Chief Investment Officer
Martin Currie Australia

Introduction

The Value investment style has faced material performance headwinds for a prolonged period, as evidenced in the long run of relative underperformance of Value-style market indices, both domestically in Australia and globally.

These headwinds had been driven by a combination of factors including benign global inflation rates, sub-trend economic growth, and historically low monetary policy settings. This has supported increasingly high valuations across certain segments of the market, particularly in technology and other Growth-style sectors.

We have been talking about the inevitable rebound in Value performance for more than 12 months as economies recover from the COVID-19 downturn, and why investors should be positioned in quality Australian Value stocks.

As the economic reopening gathers momentum, as predicted, the tide has continued to turn in favour of Value performance, and over recent months Growth stocks have seen a severe price reversion.

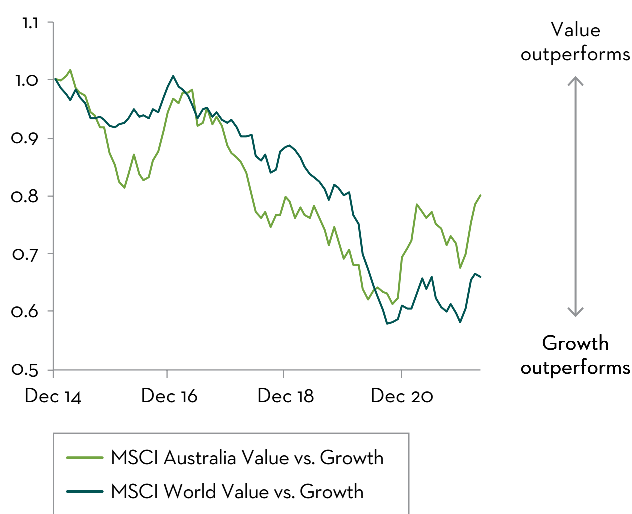
In the following paper, we discuss:

- The backdrop to the recent performance upswing for Value;
- The drivers that support a continuation of the performance reversion;
- Why Australia, in particular, represents a meaningful opportunity to take advantage of this theme; and
- Why now, more than ever, is the time to invest in Value.

Value's relative performance has bottomed...

Since 3Q 2021, we have seen a meaningful reversal of the relative performance between Value and Growth. While it is naturally extremely challenging to accurately call the bottom of a cycle, it appears that the performance tide has now turned, both locally and globally.

Relative performance of MSCI Style indices



Past performance is not a guide to future returns.

Source: Martin Currie Australia, Bloomberg, MSCI. As of 31 March 2022.

The shift in relative performance has correlated closely with strengthening momentum behind the reopening of global economies, as COVID-19 restrictions have been progressively eased and borders have begun to reopen. This has been associated with an acceleration of key inflation measures, as well as expectations for the normalisation of extremely loose monetary policy settings.

As the economic reopening gathers momentum, as predicted, the tide has continued to turn in favour of Value performance, and over recent months Growth stocks have seen a severe price reversion.

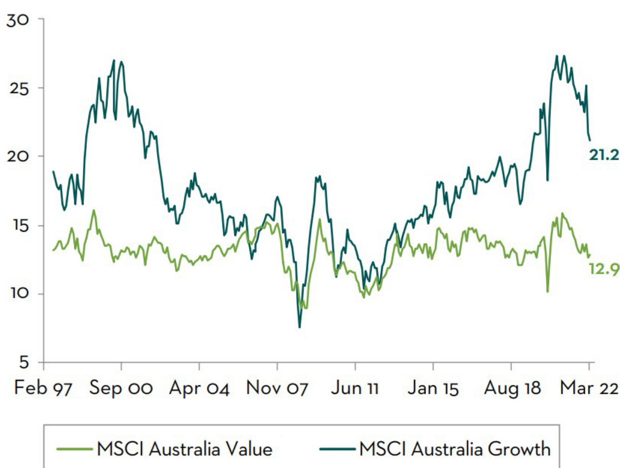
Growth P/E ratios not supported by earnings

It is interesting to note that the rate of EPS growth for Value and Growth style stocks had been relatively consistent over time. This highlights that the most recent divergence in performance for the two investment styles has been primarily driven by inflated prices being paid for Growth stock exposures in recent years, rather than fund flows supporting more profitable companies. This has resulted in the significant expansion of P/E multiples for Growth stocks.

Notably, we have seen another instance of this trend occur in the late 1990s with the dotcom bubble, which was associated with a rapid rise in technology stock valuations fuelled by widespread investment in internet-based companies. As the below chart shows, this led to a significant stretching of Growth stock P/E multiples, which subsequently sharply de-rated when the bubble burst in the early 2000s, helping to spark a strong reversion in relative Value performance.

Technology stocks are once again at the forefront of the current Growth stock multiple expansion. While the sample set of these occurrences is obviously small, this does highlight the potential danger of investing in such a high-risk momentum play, as well as the upside for Value should a normalisation subsequently occur.

P/E ratios of MSCI Australia style indices (NTM)



Past performance is not a guide to future returns.

Source: Martin Currie Australia, FactSet; as of 31 March 2022.

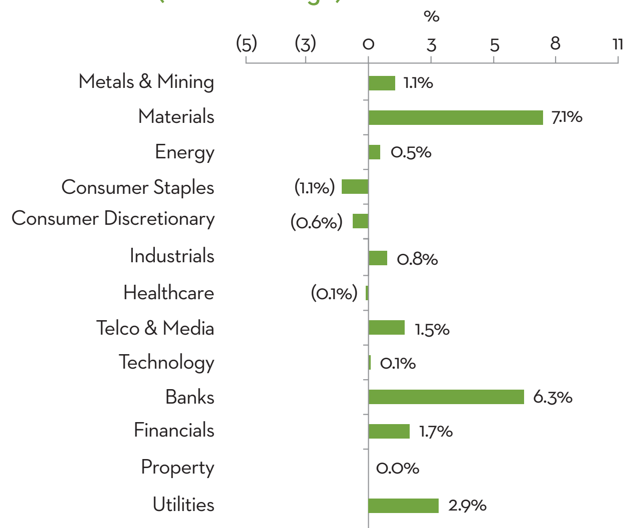
NTM: next twelve months.

Value rewarded at recent reporting season

During the recent February 2022 domestic reporting season, we saw quite meaningful broker EPS revisions across stocks trading on high valuation multiples – i.e., the typical Growth-style exposures. The notable P/E expansions had increased the level of 'risk' baked into these Growth names and these revisions resulted in quite significant de-rates for Growth stocks. This has exacerbated the severity of the performance unwind that we have seen playing out through the year-to-date.

Conversely, stocks trading on lower multiples, typically Value-style exposures such as commodities, energy, and financials stocks, saw more upward EPS revisions, and thus a more promising price reaction through reporting season.

EPS revision (median change)



Past performance is not a guide to future returns.

Source: Martin Currie Australia, FactSet; as of 28 February 2022. Data for the S&P/ASX 200 Index. Calculated using the weighted average of broker consensus forecasts of each holding -because of this, the returns quoted are estimated figures and are therefore not guaranteed.

Follow on Revisions: the average change in broker consensus next 12-month (NTM) forecasts after companies have reported their results.

Value spreads remain attractive despite uptick

Even accounting for the recent uptick in Value performance, we see ongoing material upside for the Value style.

Our proprietary methodology shows that the fair value gap between the most attractive Value-style stocks and the broader market, or what we call the 'Value Spread', remains at a notably stretched level versus history.

Despite the sharp reversion of relative performance, the spread remains the widest it has been since early 2012, highlighting that as the spread narrows, the return opportunity that our model estimates is still very significant. This further shows the extent the P/E expansion across Growth-style stocks have to unwind, and highlights the magnitude of the upside scenario that we see for Value stocks looking forward.

MCA Value spread

Past performance is not a guide to future returns.

Source: Martin Currie Australia, FactSet; as of 31 March 2022. Data calculated for the representative Martin Currie Australia Value Equity account relative to the S&P/ASX 200.

Inflationary forces provide Value tailwind

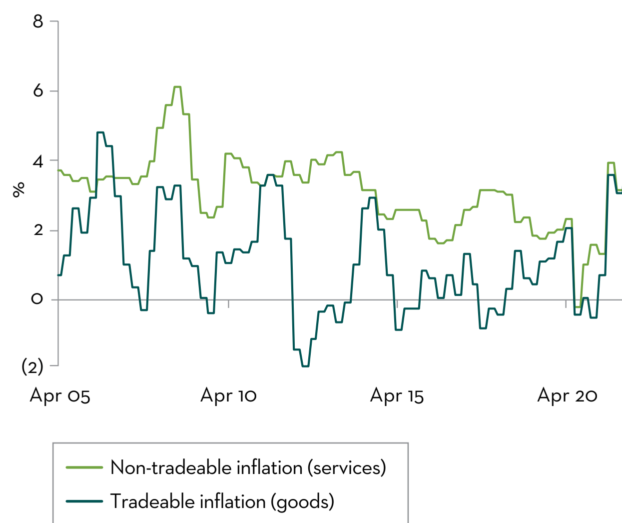
Following a prolonged period of challenged growth, exacerbated by strict COVID-19 restrictions, global economies have now begun to reopen in earnest. This has been associated with a material inflationary spike with Consumer Price Index (CPI) prints across major economies pushing to the strongest levels seen since the recovery from the GFC.

While the inflationary spike itself has been significant, importantly beneath the headline strength we are also now seeing a reconfiguration of the underlying drivers of inflation. A clear dynamic over the past decade has been that non-tradeables (services) inflation has been stronger than tradeables (goods) inflation.

This strong demand for services had meant that many Growth-style companies were able to maintain quite healthy earnings while their input costs fell, supporting the outperformance over the typical Value-style companies levered to tradeables inflation.

The recent inflationary spike that we have seen has reflected a swing back to tradeables inflation, with increasing goods and commodities prices helping to generate momentum behind the move. Increasing goods costs with relatively static input costs will help to create a beneficial environment for Value stocks such as resources companies and other goods producers, strengthening the tailwind for Value's relative outperformance going forward.

Australian inflation: tradable vs non-tradable



Past performance is not a guide to future returns.

Source: Martin Currie Australia, FactSet; as of 31 March 2022.

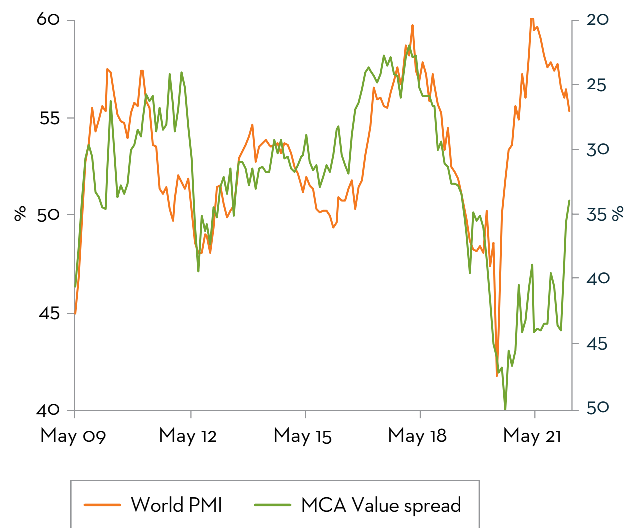
Economic factors create solid Value backdrop

Value stocks have historically shown a strong performance correlation with strengthening economic growth and movements in bond yields. These factors have clearly provided a headwind for Value in recent years, with pandemic-induced lockdowns driving a global economic slowdown and inciting an extreme monetary policy response from central banks.

As restrictions continue to be eased, measures of global growth, such as the World Purchasing Managers Index (PMI), are reflecting a rapid economic recovery, driving a material spike in inflation and raising expectations of monetary policy tightening through 2022. We believe that these conditions will provide a supportive backdrop for the continued outperformance of Value stocks going forward.

The sharpness of the recovery from COVID-19 lockdowns around the globe has seen a significant spike in the World PMI, without an equivalent narrowing of Value spreads. This enduring gap further highlights the significant opportunity that Value exposures represent as the global economy continues to reopen. Value style stocks remain cheap relative to the broader market despite the period of outperformance through the year-to-date.

World PMI and the MCA Value Spread (inverted)



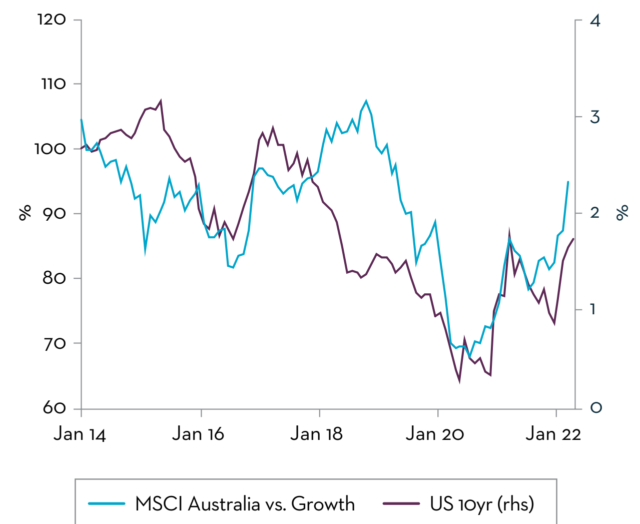
Past performance is not a guide to future returns.

Source: Martin Currie Australia, FactSet; as of 31 March 2022.

Value Spread calculated for the representative Martin Currie Australia Value Equity account relative to the S&P/ASX 200.

Rising yields have historically shown a strong correlation with positive Value style returns and a narrowing of the Value spread. Yields had been trending lower since the GFC as monetary policy settings were progressively loosened in an effort to spark growth. While central banks are naturally being quite cautious, monetary policy settings are beginning to normalise around the globe, and forecasts for major economies suggest that rates will continue to rise, which will push bond yields higher and should therefore provide a tailwind for relative Value performance.

Relative performance of MSCI style indices and US bonds



Past performance is not guide to future returns.
The investment vehicles shown may have different risk profiles and a direct comparison may not be appropriate.

Source: Martin Currie Australia, FactSet; as of 31 March 2022.

Australia presents a compelling Value opportunity

Within this improving thematic for Value, we believe that the Australian market is particularly well-placed to outperform in an improving economic environment, relative to the US or other global market equivalents.

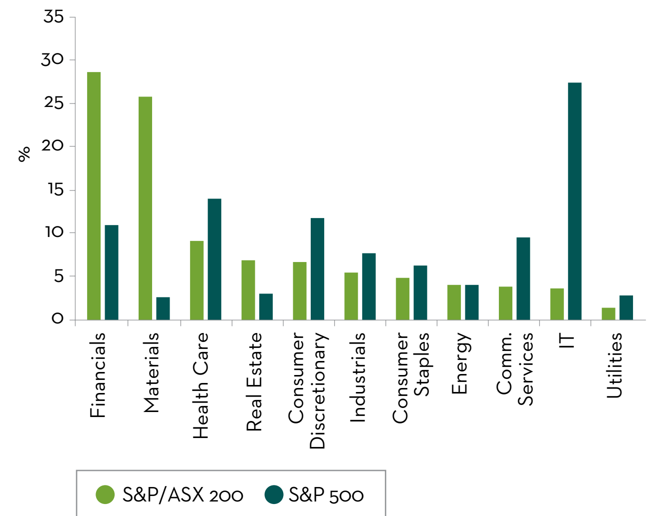
The Australian equity market is notably Value-tilted, with a large weighting to very high-quality financials, which will benefit from rising interest rates, and materials/resources, which will benefit from supply chain limitations/disruptions and growing momentum behind the global push toward Net Zero.

Conversely, the US market is more leveraged to the tech-led Growth thematic, with major technology stocks such as **Apple** and **Amazon** making up more than a quarter of the total market capitalisation of the S&P500 index and representing 8 of its top 10 constituents by weight[1].

While there are of course Value stock opportunities within the US market, the large concentration in Growth-style names trading on significant multiples highlights the better positioning of the Australian market as an opportunity to capitalise on the rotation to Value.

We would note that thematic influences associated with these differences have already driven a clear performance dispersion between the two markets over the year to date, with Australia's greater Value-orientation supporting outperformance relative to the US and other global markets. With growing momentum behind the rotation back to Value, we see meaningful opportunity for this relative outperformance to continue.

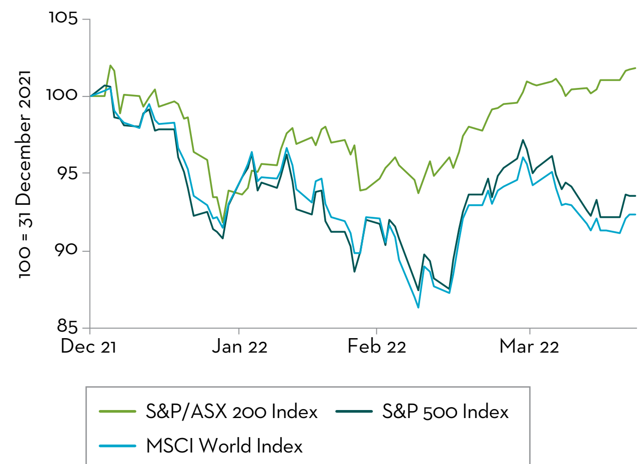
Australian vs US sector weights



Past performance is not a guide to future returns.

Source: Martin Currie Australia, Bloomberg; as of 31 March 2022.

Index cumulative returns this year



Past performance is not a guide to future returns.

Source: Martin Currie Australia, Bloomberg; as of 21 April 2022.

The time for Value is now

The economic tide is turning, and Australia presents a particularly compelling opportunity to capitalise on this trend given the market's strong Value orientation. Extremely high valuations across Growth stocks have highlighted the degree of downside risk associated with these exposures, and while the performance reversion has already been sharp, there is notable scope for this to persist.

The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.

[1]Source: Martin Currie Australia, Bloomberg; as of 31 March 2022.

Martin Currie Australia Value Equity

The Martin Currie Australia (MCA) Value Equity strategy provides investors with a diversified exposure to our highest conviction stock ideas with Valuation potential, while balancing risks through our focus on Quality and Direction.

Our stock selection, driven by our proprietary fundamental analysis process, is positioned to benefit from a continuation of the rotation to Value. Our Australian focus provides the opportunity to benefit from the geographic advantage within this thematic environment.

Select examples of our top Australian Value opportunities

Our overweight position in oil and gas producer **Woodside Petroleum** (WPL) was initiated in 2017 in response to oil prices trading below our view of long-term normal, which was not reflected in the market's thinking. We have subsequently increased our overweight positioning reflecting the company's exposure to the energy transition, expanding project pipeline, and upside associated with the merger with BHP's oil and gas business.

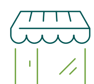
We maintain a high conviction overweight allocation to **South32** (S32), a diversified metals and mining company. The company offers attractive and well-diversified exposure to commodities such as aluminium, which we see as key for the energy transition push. We consider S32's asset base to have high cash generation capacity which provides a material return opportunity for shareholders. The stock has been very strong in recent months, supported by broad commodity price strength, but on balance of the remaining opportunities we still see further upside for S32 going forward.

We have been expanding our overweight allocation to global engineering, advisory and project management services company **Worley** (WOR) since late 2020, given the company's beneficial exposure to the capex required to achieve the energy transition to Net Zero emissions by 2050, as well as increasing capex in its traditional businesses of oil and gas, chemicals and resources.

Although television networks have seen a significant decline in audience and advertising dollars, growth in new Broadcaster video on demand (BVOD) platforms has reversed audience and revenue declines. **Nine Entertainment** (NEC) are continuing to pivot their business in a way that will help the structural declines in the publishing business along with creating growth in digital subscriptions and advertising. We believe that the market is yet to fully value the shift from "old media" to growth business and the stabilisation of the more structurally challenged parts of the business.

Australia and New Zealand Banking Group (ANZ) remains the best valued Australian bank with a solid cost-out story to evolve, and a favourable business banking skew. A mix of initial reinvestment and Board focus should ultimately see this management team deliver the cost savings needed to improve earnings. The business banking skew should see growth return in 2022 whilst bad and doubtful debts remain subdued. This is partly built into valuations, but we expect to see further upside for ANZ versus peers.

We believe that the quality and earnings stability of **Medibank Private** (MPL), Australia's largest health provider, together with growth opportunities from diversification and consolidation, are being undervalued. We expect MPL to outperform private health insurance industry peers due to its superior ability to manage costs and innovate, whilst finding new sources of growth as the company pursues a broader role in healthcare.



Retail REITs were significantly sold down during the height of COVID-19 social restrictions; however, the retail sector has been bouncing back with tenant demand for leasing improving. Whilst **Vicinity Centres** (VCX) share price has started to recover, it is still trading well below pre-COVID levels and at a very large discount to Net Asset Value. As retail sales and foot traffic further recovers, we expect the discount to reduce over time. Recent asset transactions in the retail property sector further point to the valuation upside for VCX.

The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.

Select examples of our top Australian Value opportunities (cont.)

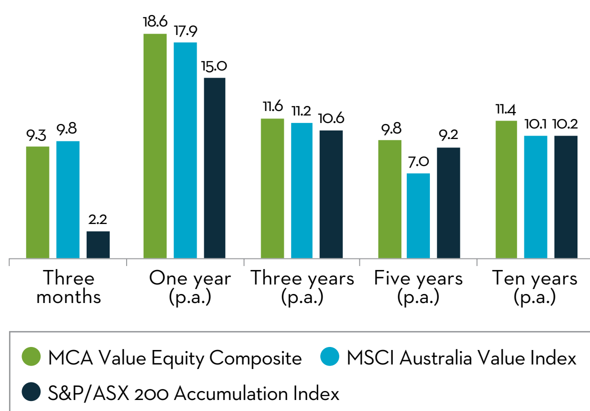
We initiated an overweight allocation to diversified global insurer **QBE Insurance Group** (QBE) in December 2021 reflecting a strong Valuation signal on the stock, which had notably underperformed global peers despite solid underwriting discipline and reserving practices. Recent company results have highlighted that the business recovery is well underway, which we believe will be supportive of expanding margins, driving upgrades to consensus and providing share price support.

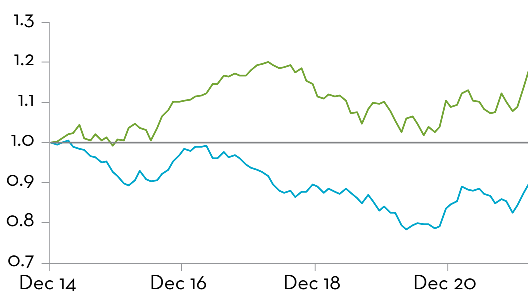
Insignia (IFL) is a focused player in the financial intermediary space that operates a low-cost carrier model. IFL remains a turnaround story and doubled down on the synergy extraction via the MLC deal. Delivering on these cost savings is the key to the value opportunity, as this should more than offset core platform business decline from margin contraction and set the group up for the future of advice delivery. This creates greater execution risk, but also a larger prize and better industry structure that we believe is being under-estimated by the market.

Alumina (AWC) is a leading Australian resource company and one of the world's largest, lowest cost alumina (the feedstock for aluminium smelting) producers through its joint venture with Alcoa. We see it as a high-quality company, with valuation support, and increasing margins as demand for Aluminium, and therefore Alumina, increases with global decarbonisation. The high alumina price currently reflects supply disruption from the Russia/Ukraine conflict, further enhancing AWC's near term earnings.

Critically, as our long-term performance demonstrates, our balanced approach ensures that we also provide investors with genuine protection through periods where our investment style faces thematic headwinds.

Performance (%)





Past performance is not a guide to future returns.

Source: Martin Currie Australia; as of 31 March 2022.

Martin Currie Australia (MCA) claims compliance with the Global Investment Performance Standards (GIPS®). The Australia Value Equity composite (EQ_06) contains fully discretionary Australian Equity accounts containing diversified portfolios of Australian equity securities with a "value" investment style bias. For purposes of compliance with the GIPS®, the Firm is defined as Martin Currie Australia ("MCA") formerly Legg Mason Australian Equities (LMAE), and comprises all assets managed or advised on a discretionary or non-discretionary basis. MCA is a division of Franklin Templeton Australia Limited (FTAL), which is a part of Franklin Resources, Inc. MCAs predecessor firm for GIPS® purposes, was FTAL, which was known as Legg Mason Asset Management Australia Limited (LMAMAL) prior to 1 October 2021. The MCA team has and continues to manage the Australian domestic equities portfolio of FTAL. The Australian Dollar is the currency used to express performance. Returns are presented gross of investment management fees, custody fees, administration fees, tax and net of trading expenses, and include the reinvestment of distribution income. Returns are presented net of non-reclaimable withholding taxes. GIPS Reports and/or the firm's list of and description of composites and limited distribution pooled funds and list of broad distribution pooled funds can be obtained by contacting info@martincurrie.com. Inception date: 1 December 2006.

GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.

The performance record noted above is clear representation of the strategy's performance over the period shown. Performance information showing five years (or since inception) in complete 12 month periods is available upon request. Please refer to the end of this document for important disclosures.

The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.

Important information

This information is issued and approved by Martin Currie Investment Management Limited ('MCIM'), authorised and regulated by the Financial Conduct Authority. It does not constitute investment advice. Market and currency movements may cause the capital value of shares, and the income from them, to fall as well as rise and you may get back less than you invested.

The information contained in this document has been compiled with considerable care to ensure its accuracy. However, no representation or warranty, express or implied, is made to its accuracy or completeness. Martin Currie has procured any research or analysis contained in this document for its own use. It is provided to you only incidentally and any opinions expressed are subject to change without notice.

This document may not be distributed to third parties. It is confidential and intended only for the recipient. The recipient may not photocopy, transmit or otherwise share this [document], or any part of it, with any other person without the express written permission of Martin Currie Investment Management Limited.

This document is intended only for a wholesale, institutional or otherwise professional audience. Martin Currie Investment Management Limited does not intend for this document to be issued to any other audience and it should not be made available to any person who does not meet this criteria. Martin Currie accepts no responsibility for dissemination of this document to a person who does not fit this criteria.

The document does not form the basis of, nor should it be relied upon in connection with, any subsequent contract or agreement. It does not constitute, and may not be used for the purpose of, an offer or invitation to subscribe for or otherwise acquire shares in any of the products mentioned.

Past performance is not a guide to future returns.

The distribution of specific products is restricted in certain jurisdictions, investors should be aware of these restrictions before requesting further specific information.

The views expressed are opinions of the portfolio managers as of the date of this document and are subject to change based on market and other conditions and may differ from other portfolio managers or of the firm as a whole. These opinions are not intended to be a forecast of future events, research, a guarantee of future results or investment advice.

Some of the information provided in this document has been compiled using data from a representative account. This account has been chosen on the basis it is an existing account managed by Martin Currie, within the strategy referred to in this document. Representative accounts for each strategy have been chosen on the basis that they are the longest running account for the strategy. This data has been provided as an illustration only, the figures should not be relied upon as an indication of future performance. The data provided for this account may be different to other accounts following the same strategy. The information should not be considered as comprehensive and additional information and disclosure should be sought.

The information provided should not be considered a recommendation to purchase or sell any particular strategy/ fund/security. It should not be assumed that any of the security transactions discussed here were or will prove to be profitable.

Risk warnings – Investors should also be aware of the following risk factors which may be applicable to the strategy shown in this document.

- Investing in foreign markets introduces a risk where adverse movements in currency exchange rates could result in a decrease in the value of your investment.
- This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the strategy's value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
- The strategy may invest in derivatives (index futures) to obtain, increase or reduce exposure to underlying assets. The use of derivatives may restrict potential gains and may result in greater fluctuations of returns for the portfolio. Certain types of derivatives may become difficult to purchase or sell in such market conditions.

For wholesale investors in Australia

Any distribution of this material in Australia is by Martin Currie Australia ('MCA'). Martin Currie Australia is a division of Franklin Templeton Australia Limited (FTAL), (ABN 76 004 835 849). Franklin Templeton Australia Limited is a wholly owned subsidiary of Franklin Resources, Inc., and holds an Australian Financial Services Licence (AFSL No. 240827) issued pursuant to the Corporations Act 2001.

MARTIN CURRIE

Martin Currie Investment Management Limited, registered in Scotland (no SC066107), Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ES

Tel: (44) 131 229 5252 Fax: (44) 131 228 5959 **www.martincurrie.com**

Authorised and regulated by the Financial Conduct Authority. Please note that calls to the above number and any other communications may be recorded.

© 2022 Martin Currie Investment Management Limited.