UNIGESTION

Avoiding overvaluation in “low-risk” approaches

October 2016

Since 2012, the least-risky stocks and sectors have delivered significant outperformance compared to cyclicals and the riskiest stocks. This has led to a large expansion of multiples for stocks within low-risk sectors. These shares are now trading at relatively high valuation levels, leaving them potentially at risk of mean reversion. As a result, passive low-risk strategies are now more exposed to the most expensive names and sectors. We believe that active risk management is the answer. It is possible to construct a risk-managed equity portfolio that avoids the overvaluation danger that is now arguably inherent in passive “low-risk” equity approaches – and to do so without sacrificing performance.

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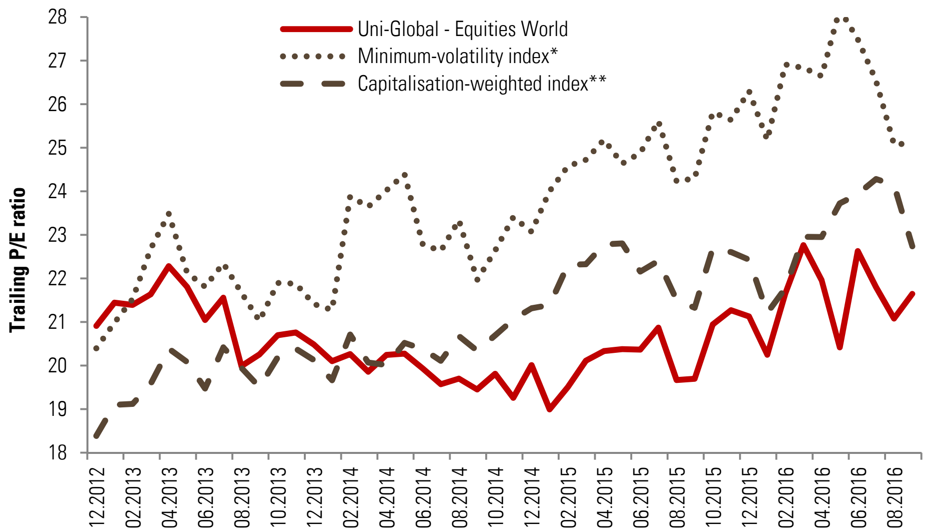
Not all low-risk assets are created equal

High valuations present a potential asymmetrical risk for portfolios. When overvaluation starts to correct – which it is likely to do at some point as multiple expansion has been driven by central banks’ unconventional monetary policy – it will have a big influence on the risk profile of equity portfolios. Unigestion has been monitoring the increasingly expensive valuations. In the middle of 2013, we decided to take action to control the valuation of our active risk-managed portfolios in order to avoid the most expensive stocks.

In Figure 1 below we show that from early 2012 the valuation of a passive “minimum volatility” strategy (dotted line), as measured by the trailing price/earnings (P/E) ratio, has risen significantly. So too has the valuation of the market-capitalisation-weighted index (dashed line). What is also evident is that passive minimum volatility has been persistently more highly valued than the cap-weighted index. The valuation of our own global risk-managed approach is shown below too (solid line). Thanks to our 360° risk-managed approach, it has remained much more reasonably valued over the period.

Since early 2012, the valuations of global passive minimum-volatility approaches have risen significantly.

Figure 1: Comparing valuations



As at 30 September 2016. *MSCI AC World Minimum Volatility; **MSCI AC World. To compute the P/E ratios of the different portfolios, we simply calculate the weighted average of P/E ratios of underlying holdings. We exclude from the calculation outliers: stocks with negative earnings or a P/E ratio over 200. Past performance is no indication of future performance. Please see the Important Information at the end of this document. Source: Unigestion, Bloomberg

Based on the calculated P/E on each portfolio we can calculate the P/E variation over a time period. Thus, we can isolate the contribution that multiple expansion has made to the total performance of a portfolio. The remainder is the performance from earnings growth, which is backed by fundamentals.

What causes multiple expansion?

Generally, multiple expansion (rising stock prices without a commensurate increase in earnings) is caused by market speculation that a stock or a group of stocks will generate greater earnings in the future but where these earnings have not yet materialised. This was the case during the technology bubble of 1999.

What we see today are assets that were already reasonably valued that have become a lot more expensive. We believe this has arisen from the dual effects of central banks providing ample, cheap liquidity, which supports assets prices; at the same time, fixed income securities are offering low to negative yields. From a cash-flow perspective, dividends from stocks are more attractive than coupons from government bonds.

One of the ways of looking at stock valuations is from the perspective of the Fed model, which states that, in equilibrium, earnings per share would be equal to the long-term yield of government bonds. At the time of writing (6 October 2016), the yield on 10-year US bonds was 1.70%, being held down by unconventional central bank activity. This implies a P/E of 58 for US stocks according to the Fed model, which is well above the current P/E of the S&P 500 Index of 23.3.

Although this suggests that the market may have further to run, it also indicates that there is significant valuation risk in the market for passive investors. If we look at the history of market valuations over the past 20 years, the market P/E has only been higher during the late 1990s. This is a risk issue, and so we believe investors need a risk solution.

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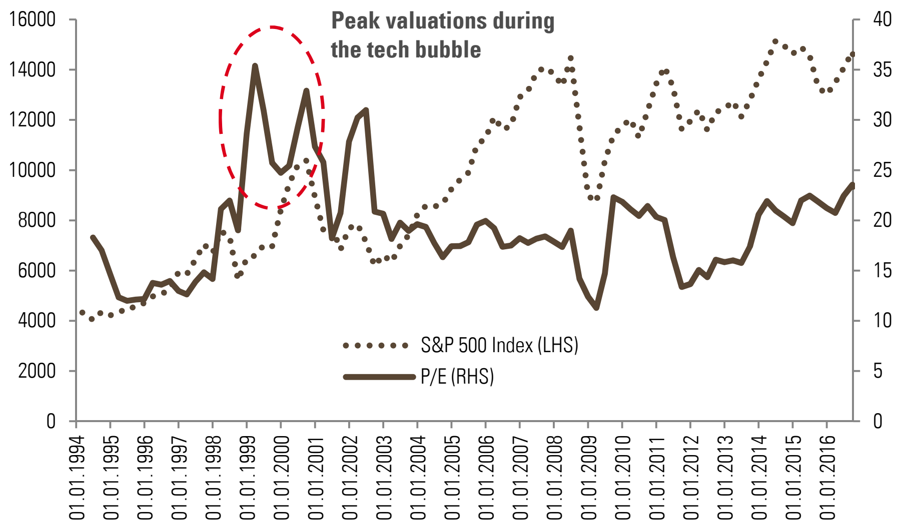
Figure 2: Comparing valuations



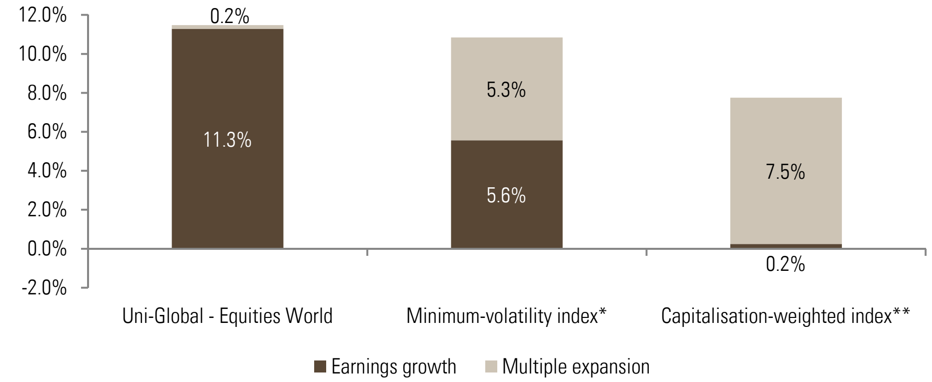
Source: Unigestion, Bloomberg. As at 6 October 2016.

As Alan Greenspan put it in his memoirs: "The decline of real (inflation-adjusted) long-term interest rates that has occurred in the last two decades has been associated with rising price-to-earnings ratios for stocks, real estate, and in fact all income-earnings assets."

Investigating the performance of equities

Looking at performance of global equities since the end of 2012, it is evident that the minimum-volatility index has been driven by the expansion of multiples. In contrast, the performance of the Uni-Global Equities World strategy was driven significantly more by earnings growth. The cap-weighted index was driven almost entirely by multiple expansion.

Figure 3: Splitting out performance in global equities: speculation vs fundamentals

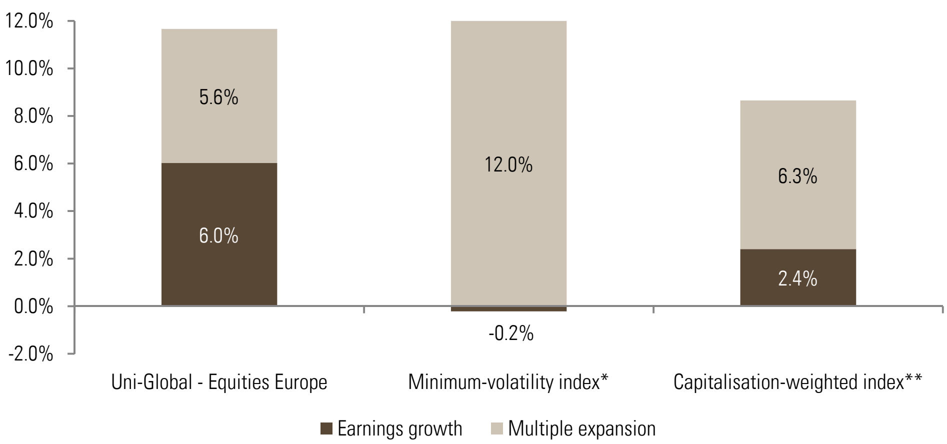


Performance split between earnings growth and multiple expansion from 31 December 2012 to 30 September 2016, annualised returns, gross of fees. *MSCI AC World Minimum Volatility, total returns (net); **MSCI AC World, total returns (net). Past performance is no indication of future performance. Please see the Important Information at the end of this document.

Source: Unigestion, Bloomberg.

We carried out the same analysis on individual equity markets to gauge whether this phenomenon applied in specific regions, and found similar results across major developed regions, though in different proportions. The same exercise applied to European equities illustrates particularly starkly just how much multiple expansion has been responsible for the performance of the passive low-volatility index.

Figure 4: Splitting out performance in European equities



Performance split between earnings growth and multiple expansion from 31 December 2012 to 30 September 2016, annualised returns, gross of fees. Past performance is no indication of future performance. Please see the Important Information at the end of this document. *MSCI Europe Minimum Volatility, total returns (net); **MSCI Europe, total returns (net).

Source: Unigestion, Bloomberg.

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What does this mean for equity investors?

Eight years since the financial crisis, investors may well be asking themselves how long this bull market can continue. We think that caution needs to be taken in areas of the market where valuations have become excessive. As we have set out above, index and passive low-volatility approaches currently offer little or weak risk management. Our 360° risk-managed approach has successfully protected our investors from the rising levels of valuations in low-risk equities. Looking ahead, we think that taking an active risk approach when investing in equities is more important than ever.

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