M&G North American Value Fund

A compelling time for value investing in North America

April 2016

Fund Manager – Daniel White

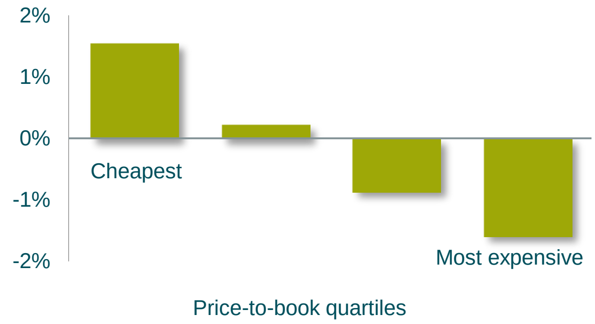
After a prolonged period of underperformance, 'value' as a style has returned to favour and has outperformed over the year to date. Daniel White, manager of the M&G North American Value Fund, believes this trend can continue and that value has further to go. Value stocks are trading at unprecedented discounts to 'growth' stocks, creating a wealth of opportunities sector-wide. With a combination of cheap stocks and robust fundamentals, the fund, he believes, is well positioned to capture the value tailwind.

Why value?

'Value investing', namely buying cheap, out-of-favour stocks, has tended to outperform the market over the long term. This value phenomenon is supported by empirical studies as well as our own analysis.

Our research shows that a value strategy investing in the cheapest quartile of the US market would have delivered an outperformance of 1-2% per annum over the medium to long term (see Figure 1). This is the cornerstone of our investment process.

Figure 1. Outperformance of value stocks



Source: M&G, Factset, 31 December 2015. Equal weighted, excluding negative price-to-book stocks. Average returns in excess of back-test universe on three-year annualised basis, since 31 December 1989.

Why value now?

Value appears to have returned to favour, as value stocks got off to a strong start in 2016, outperforming not only the broader market, but also growth stocks (see Figure 2). While we consider this to be encouraging, we believe value's outperformance can continue and this is potentially only the beginning of a style reversal.

In our opinion, there is plenty of scope for value to maintain this outperformance. We believe the prospects for value investing currently are very attractive.

Figure 2. Recent outperformance of value follows long period of underperformance

Source: Datastream, 31 March 2016. Relative returns calculated in US dollars. Russell 1000 Value Index vs Russell 1000 Growth Index. Geometric relative returns.

Value's outperformance over the year to date is extremely modest in comparison to its historic underperformance. Although the value style has shown the ability to deliver superior returns over the long term, value stocks have suffered from one of their longest and most severe periods of underperformance since 2007.

Heightened risk aversion has driven investors towards the perceived safety of 'growth' and 'quality' stocks. Record low interest rates have also encouraged investors to favour income-generating firms, which tend to be found among larger 'growth' companies with stable earnings. As a result, value has a long way to go before it has narrowed the gap with growth.

Moreover, value has seldom been cheaper, as Figure 3 shows. Stocks are trading at significant discounts to their more expensive peers. Even after the recent rebound, the gap between the cheapest part of the market and the most expensive has rarely been wider.

Value has only been cheaper on two occasions: during the height of the technology bubble and during the global financial crisis of 2008/09.

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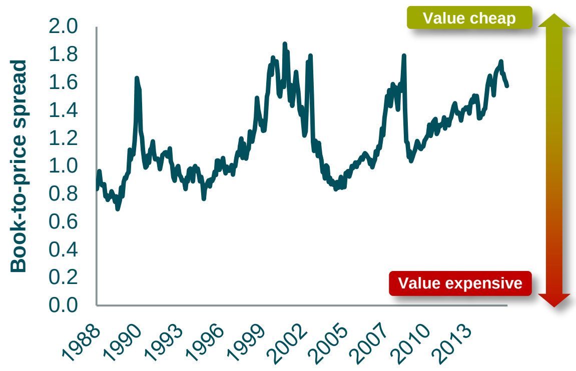
Figure 3. Value is cheap relative to history



Source: Bernstein, 31 March 2016. Book-to-price (B/P) spread is calculated as the percentage difference between the median B/P of the cheapest quintile and the overall market median B/P. Percentile vs long-term history.

What is even more encouraging, however, is the valuation dispersion within sectors. Opportunities are not just concentrated in a few select areas/sectors such as energy or financials – there is a wide dispersion of valuations within sectors too. Not only have investors crowded into defensive sectors, they have also favoured particular companies within each sector. As a result, attractive valuation opportunities can be found across a diverse range of sectors and in companies of different sizes.

Despite value's unprecedented cheapness, we would, however, caution against a broad-based shift to value. Investors must remain selective to identify genuinely mispriced stocks – some stocks, are caught in so-called 'value traps' and are cheap for a reason.

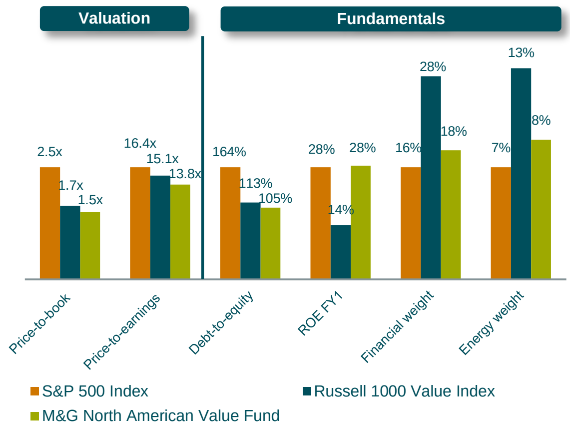
Why the M&G North American Value Fund?

We truly believe our investment process is differentiated. We aim to capture the value tailwind while attempting to mitigate the shortfalls associated with a traditional approach to value investing – namely volatility and value traps. Our approach, in our opinion, offers something above and beyond a passive value-management approach.

We believe the fund is currently well positioned to capture the valuation opportunities that exist in the market. The fund's differentiated approach combines strict valuation-focused screening with rigorous fundamental analysis to ensure the fund maintains a strong and consistent value bias without compromising on the fundamentals of the companies in the portfolio.

This is illustrated in Figure 4. The fund trades at a 41% discount to the broader market (as represented by the S&P 500 Index) and is cheaper than the Russell 1000 Value Index of value stocks. At the same time, the companies in the portfolio have robust fundamentals: they have the same level of return on equity as that of the S&P 500, as well as stronger balance sheets (as measured by lower debt-to-equity levels).

Figure 4. Strong value characteristics



Source: M&G, Factset, Bloomberg, 31 March 2016, price-to-book and price-to-earnings on 12-month forward basis.

The fund also offers a more diversified approach to the value style with a significantly lower exposure to financials and energy than the value index. This is because the fund has not achieved its significant value bias by focusing on structurally weak 'cheap' companies or cheap sectors. This diversified approach should ensure that returns are driven by the value style rather than a large sector or stock bet.

In our opinion, this combination of valuation screening and fundamental analysis represents an attractive proposition for investors who seek to invest in a US value strategy, yet are concerned about timing the value style. Due to the fund's diversified approach and lack of compromise on company fundamentals, the fund is not reliant on a recovery in the value style to outperform. On the other hand, if value outperforms, the significant value bias/valuation discount should enable us to capture the tailwind.

Opportunities for selective investors

We believe the outlook for a value investing strategy is compelling. Valuation opportunities can now be found in a wide range of sectors across the US market. In our view, this is a significant opportunity, and importantly, allows investors to construct a diversified portfolio. As such, we believe we are well positioned to capture the value tailwind, as and when the value style returns to favour.

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