Value and quality for the road ahead

By Tom Carroll, Director

The events of October will no doubt be fresh in the minds of many investors as global markets sold off and investors started to question when the investment cycle will come to an end. This followed an exceptional period for the US market, which saw corporate profits rise by 40% over the past two years alone. Margins, return on capex and corporate profits as a share of GDP are above long-term historic averages or at all-time highs.

The market has been supported by the helpful tailwinds of tax cuts and low interest rates over recent years. Looking ahead to 2019 and beyond things are not looking straightforward, particularly as the Fed continues to normalise monetary policy.

For those in search of the best investment opportunities in today's challenging environment, it is important to pay close attention to valuations as the divergence between growth and value stocks in the US remains huge.

Take Netflix and Disney as examples. The former, a well-known growth stock, currently trades on 115x earnings, while Disney trades on 15x. However, what the valuations do not indicate is Disney's potential to challenge market leader Netflix. Fresh from its acquisition of 21st Century Fox, which includes video streaming service Hulu, Disney has ambitious plans to rival Netflix.

According to RBC, analysts estimate that Disney could end up spending close to $30bn annually. This would dwarf Netflix's $8bn budget for original content in 2018. What's more, Disney can draw on its existing pool of content, including its blockbuster films. We do not currently own either company but will be watching both with interest next year.

The polarised US market is creating fantastic opportunities for disciplined investors who are willing to take a medium to long-term view.

While the opportunities clearly lie amongst unloved US value stocks, it is important to incorporate a quality overlay.

There are risks associated with holding out on value stocks. This is why we screen for quality characteristics by focusing on companies with a dividend yield of at least 2%, which are able to pay out sustainable dividends over time. We also examine the management team's track record, their capital allocation decisions, the company's business model and the sustainability of returns.

The Sanlam FOUR US Dividend Fund has a low average valuation with high quality characteristics to provide it with a degree of downside protection in difficult market conditions.

The fund is first and foremost a value portfolio, currently trading at a 40% discount to the market, but the current 3.6% yield underscores our focus on quality. What's more, we believe that dividends will continue to make up a significant component of total returns, supported by US companies which are currently sitting on record cash levels.

In today's environment, it makes sense to hold quality undervalued US businesses, which can provide strong upside participation and even better downside protection. Given where we are in the cycle, we believe that value and quality will ultimately win out.

The fund invests geographically in a narrow range, there is an increased risk of volatility which may result in frequent rises and falls in the Fund's share price.