



Low rates, assets inflate – Part II of II

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Since the Global Financial Crisis (GFC) in 2008, central bankers worldwide have pursued expansionary monetary settings to buoy tepid economic growth by cutting policy rates and buying government bonds. As a result, low interest rates have been a fact of life in large developed economies for the past decade – and counting. The prospect of sustainably low long-term “risk-free rates” of interest has driven required returns down, and boosted prices, in many financial asset classes. Yields on government and corporate bonds, and capitalization rates on real estate, have fallen. The same has not been true for the aggregate equity market...yet.

In Part I of this two-part whitepaper series, we considered the likely drivers of low interest rates that are currently being observed, particularly around demographics, indebtedness, technology, globalisation and the structure of the international monetary and financial system. We looked to Japan as an example of a major economy that may hold some lessons about the future for the rest of the world. Importantly, the ramifications of this potential future illustrates a very different world to that of the recent past. In short: there is a strong case to be made for interest rates remaining structurally lower for a protracted period of time.

In Part II, we consider the consequences of such a protracted low-rate environment on asset prices – in particular on equity prices. We observe that, notwithstanding a significant recent reduction in global interest rates, the market-implied required return for equities has remained relatively stable. Consequently, we believe the equity market offers investors attractive risk-adjusted returns on average. We also deduce that equity risk is being priced differently between certain geographies and sectors. This raises the prospect of attractive opportunities to generate alpha by investing in stocks both long and short. Finally, we consider what long run effects this low rate environment may have on our societies more broadly.

DISSECTING EXPECTED EQUITY RETURNS

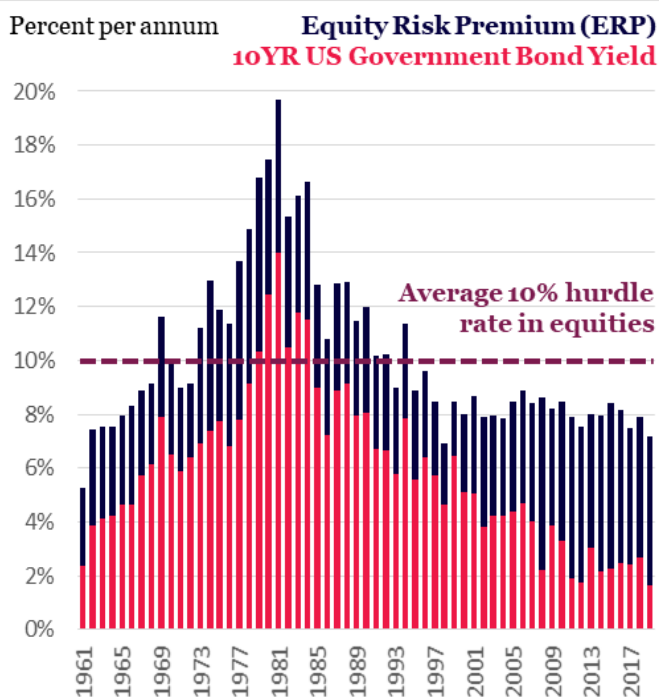
Fundamental valuation theory teaches that the intrinsic value of a stock is the present value of the expected future cash flows to shareholders (usually a growing stream of dividends), discounted at a rate to compensate for riskiness. This required, or expected, return is the “risk-free rate” expected to be earned from a riskless investment (such as a government bond), plus an “equity risk premium” (ERP) that investors demand to invest in risky equities.

The required return on equities is a critical input into equity valuation and, therefore, so too are its components. Higher risk-free rates and higher ERPs, all else equal, result in higher required equity returns and lower stock prices. And lower risk-free rates and ERPs result in lower required returns and higher stock prices. While this qualitative relationship is straightforward to establish, quantifying an appropriate expected return is much more difficult, even if only an estimate. The challenge is compounded by the uncertainty in determining both inputs.

Even though many argue that the risk-free rate should be readily observable as the interest rate on long-term government bonds, debate remains around whether to use current yields which are at extreme low levels historically, or a “normalized” level of interest rates consistent with the historical average. Discussion about the best method to determine the ERP is perpetual and inconclusive. Approaches include surveys and historical return data, and there are several different methodologies for each, all with limitations. The range of estimates produced can vary widely.

Instead of attempting to determine the correct expected return we invert the problem and deduce the required return being implied by the current market price of equities.

US Risk Free Rate & Equity Risk Premium



Source: NYU Stern (Aswath Damodaran); MGI

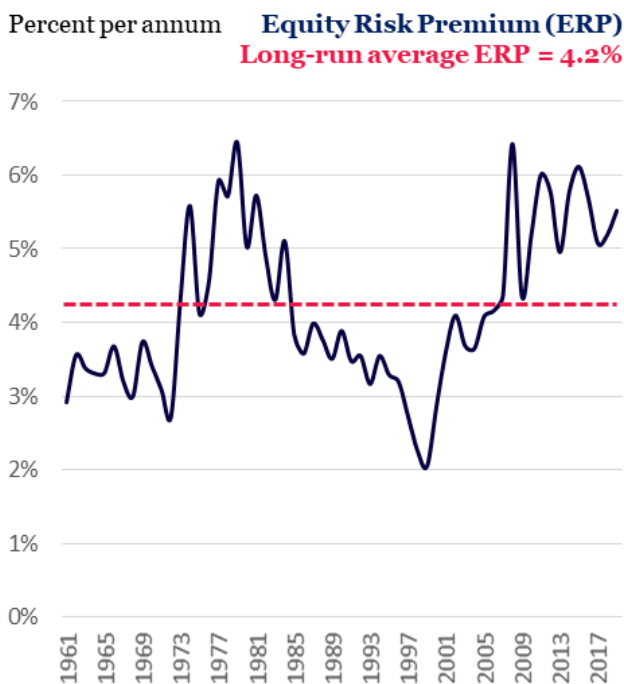
MARKET-WIDE IMPLIED EXPECTED RETURN ON EQUITIES APPEARS TOO HIGH

An application of this methodology by Professor Aswath Damodaran, of NYU’s Stern School of Business, produced an estimate of the market-implied expected return of the US equity market for every year since 1961. Using the 10-year U.S. government bond yield as a proxy for the risk-free rate, the market-implied ERP can be netted out at each year, as illustrated in the chart above.

We observe that expected returns, while averaging around 10 percent, varied meaningfully until the 2000s, rising in the 1970s with interest rates and inflation to a peak, then declining as interest rates fell and the stock market’s “tech bubble” expanded. Since then, expected returns have been remarkably stable, but interest rates have declined further to historically low levels and the implied ERP has increased to an historical peak.

It is not clear to us that such a high level of ERP is sustainable, especially when viewed in the context of influential economic and market factors. Established relationships between ERPs and interest rates, inflation, volatility and corporate bond spreads all appear to have broken down in the 2000s, and particularly since the financial crisis in 2008. Interestingly, GDP growth has only exhibited a small statistical correlation with ERP over time.

US Equity Risk Premium



Source: NYU Stern (Aswath Damodaran); MGI

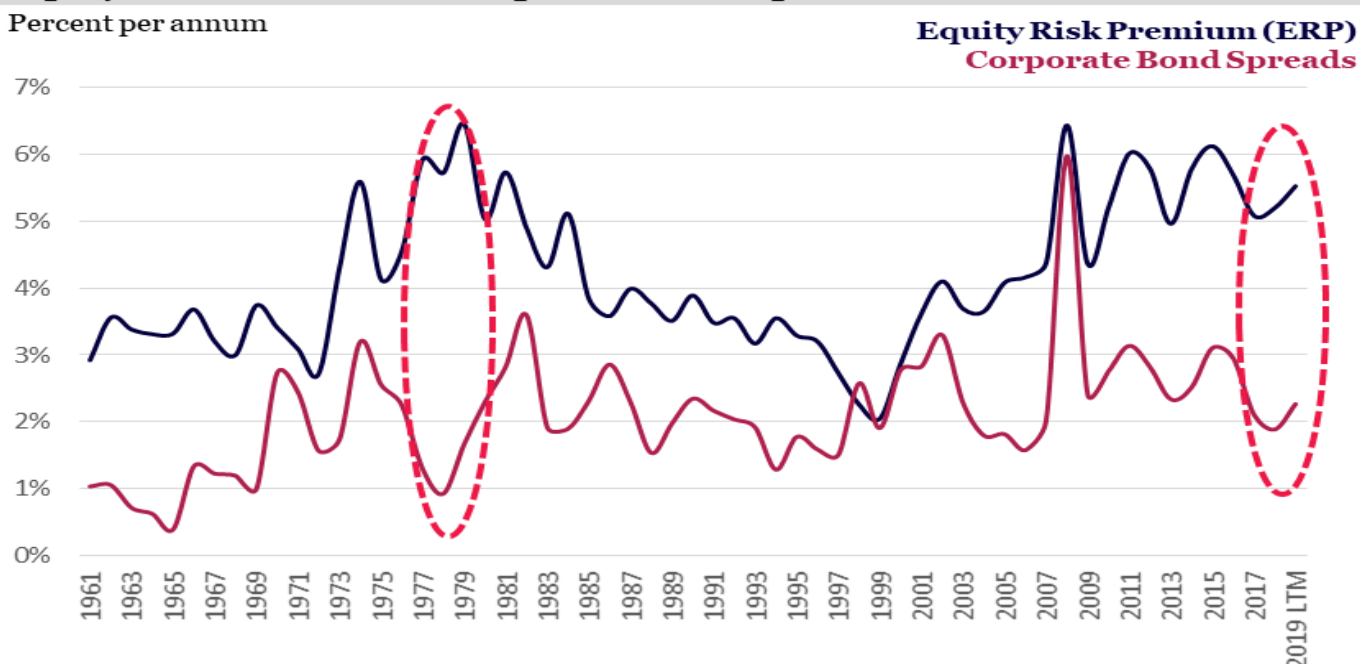
We believe it is instructive to compare the ERP with corporate bond spreads. Both are spreads over and above the risk-free rate for taking a particular variety of risk. Naturally, one would expect the premium for taking equity risk to be higher than that for taking corporate credit risk. After all, in a liquidation, corporate creditors have a claim on the business assets ahead of equityholders. But the question is: to what degree should these premia vary?

The ERP has typically been around 2.0 percent higher than the corporate bond spread (based on history going back to the 1960s, as illustrated in the chart below). And yet today, the ERP is approximately 3.3 percent higher than the corporate bond spread – a significant difference not observed since the late 1970s. Why does it make sense that equities are so much riskier than bonds today? Or does this represent an unsustainable mispricing (i.e. an opportunity)?

The reasons for an abnormally high ERP are not observable – though we can surmise, for whatever that is worth. Equity analysts and investors are taught from a young age not to reduce their assumed cost of equity when valuing businesses. The logic is as follows: businesses are valued based on long-term cash flows; and, therefore, equity cost assumptions should also be based on long-run interest rate and ERP levels. In other words, short term cycles should not influence long run assumptions. Of course, should interest rates step down for a protracted, multi-decade, period of time, such an approach would be flawed. Reducing one’s assumption for the cost of equity is also something one cannot afford to get wrong. Doing so would result in the overpayment of assets and long-term underperformance. At Montaka, for example, we continue to employ a minimum 10% assumed cost of equity in our valuation analysis – notwithstanding the implications we have uncovered in this whitepaper.

Our analysis in Part I has led us to the conclusion that interest rates could well remain low for a protracted period of time. We also believe that the ERP is much more likely to compress back to historical levels, than continue to expand further.

Equity Risk Premium vs Corporate Bond Spreads

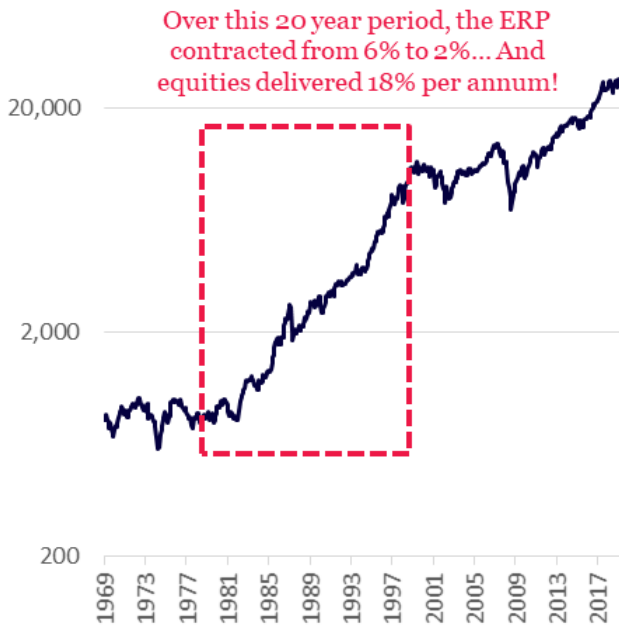


Source: NYU Stern (Aswath Damodaran); MGI; Moody’s

Indeed, the last time the ERP deviated from corporate bond spreads to this extent was in 1979. Over the subsequent two decades, the ERP compressed. The chart below shows how the Dow Jones Industrial Index performed over this particular two-decade period. We are not suggesting that equities will deliver an 18 percent per annum return for the next 20 years, but the observation certainly offers some food for thought.

Dow Jones Industrial Index

Index (log scale)



Source: Bloomberg

Building on the analysis above, we make three more nuanced observations with respect to the ERP level – and, therefore, the corresponding implications for equity prices.

1. We observe significant differences in implied ERPs across geographies;
2. We observe significant differences in implied ERPs across sectors; and
3. We believe the businesses we own today are undervalued. And indeed, these businesses are much more undervalued if interest rates remain lower for longer and ERPs compress.

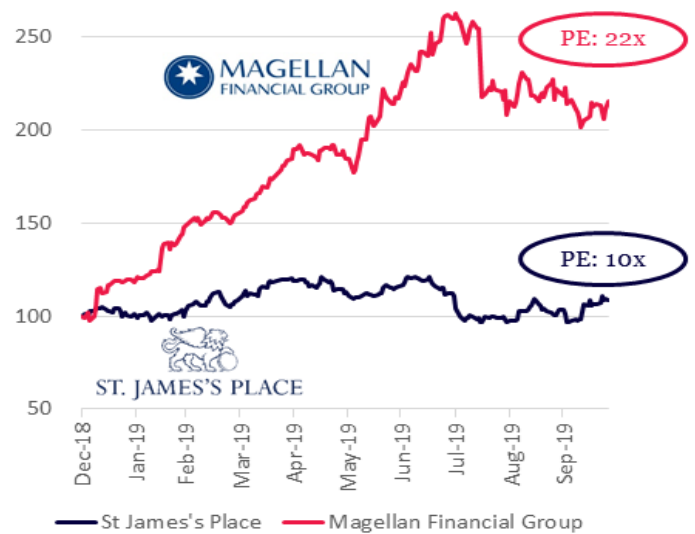
GEOGRAPHICAL DIFFERENCES IN ERP

We have observed ERP anomalies between companies in the same industry operating in different geographies, indicating that equity markets in different parts of the world are pricing similar equity risks differently.

For example, Magellan Financial Group (ASX: MFG) is one of Australia’s leading fund managers with around A\$90 billion of assets under management, or “AUM”. The business is driven by AUM which in turn is dependent on market movements (mainly global equities) and client flows. Magellan trades on a forward PE multiple of around 22x and AUM is forecast to grow in the low-double-digit range per annum over the next four years.

Share price performance YTD

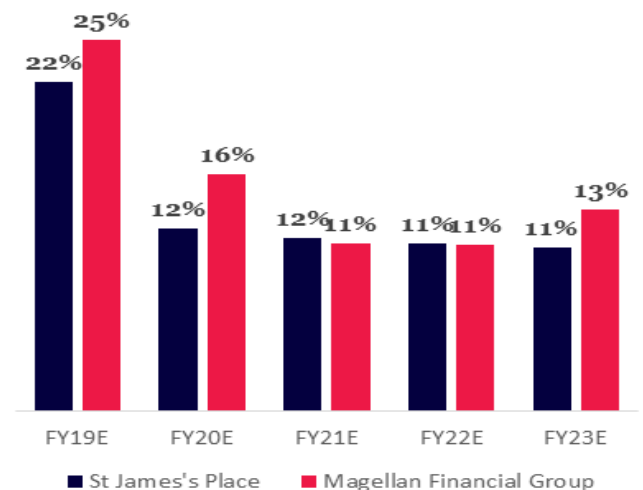
Index: 100 = 31 Dec 2018; 2020E PE



Source: MGI; Bloomberg

Forecast AUM growth

Per cent per annum



Source: MGI; Bloomberg

On the other side of the world, St James's Place (LSE: STJ) is the UK's largest wealth manager with over £110 billion of AUM. The key business drivers of St. James's Place are largely the same as those of Magellan's – AUM, client flows and market movements. St. James's flows are more consistent, and market exposures more diversified, however. So, we consider the inherent riskiness of St. James's to be relatively lower.

Over the next three to four years, St James's AUM is forecast to grow at a similar rate to that of Magellan. However, an expanding addressable market and share gains could sustain double-digit AUM growth at St. James's well into the next decade, which should outpace Magellan's long run rate of growth. Yet, St. James's stock trades on a forward PE of just 10x.

We think Magellan's large and surprising PE multiple premium over St. James's is reflective of a difference in the ERP and cost of equity between the Australian and UK equity markets today.

SECTORIAL DIFFERENCES IN ERP

We have also observed ERP anomalies across different sectors of the equity market. More specifically, stocks with long-term structural growth in some sectors are priced cheaply, and stocks of ex-growth companies in other sectors, like utilities and consumer staples, appear expensive. A comparison between The Kellogg Company (NYSE: K) and Alphabet (NASDAQ: GOOGL) illustrates this point.

The stock of The Kellogg Company, the iconic cereal-maker, trades on a forward PE multiple of around 15x. And yet, Kellogg's revenue is forecast to be almost flat

in the coming years – following several years of decline – and considerable reinvestment is required to sustain these sales. After all, consumers are replacing high-sugar packaged foods with healthier alternatives and private label competition continues to intensify. Profits are almost certain to erode in the future.

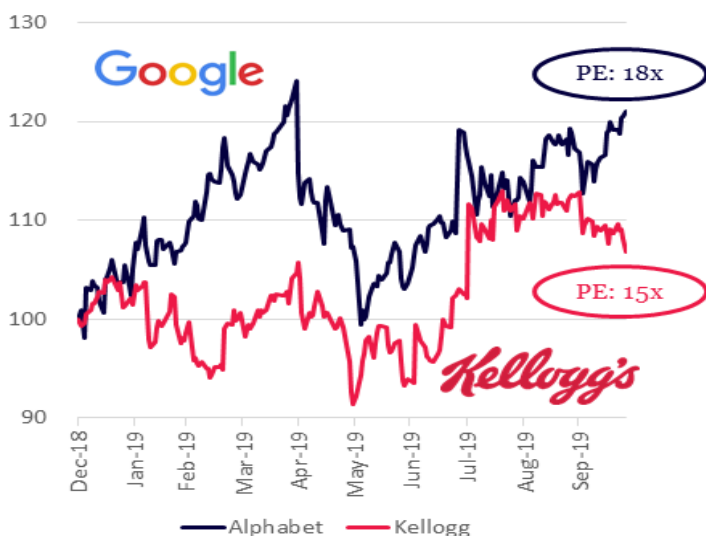
On the other hand, Alphabet's Google is the dominant internet search and online advertising platform in the world (outside of China) and its Google Cloud is a leading global cloud computing platform. These industries are experiencing strong, structural growth tailwinds underpinning forecast revenue growth rates of mid-teens per annum for Alphabet for the foreseeable future. Inherent scalability should mean that profit margins expand over time. On top of this, Alphabet has invested many billions of dollars into new ventures, like driverless cars and healthcare technology, that remain under development. These "real options" do not contribute positive profits today but will likely be worth staggering sums one day.

It would be reasonable to surmise that Alphabet's stock would trade at a significant premium to that of Kellogg's. Yet, the market values the two businesses similarly. Alphabet's stock currently trades just three multiple points above Kellogg's PE rating – approximately 18x compared to 15x – and they have regularly traded at the same multiple in recent months.

Taken in the context of the wildly different growth and profitability trajectories of these companies, this PE multiple discrepancy – or lack thereof – appears nonsensical. We think it is indicative of an unjustified difference in ERP and cost of equity between the consumer staples and information technology sectors.

Share price performance YTD

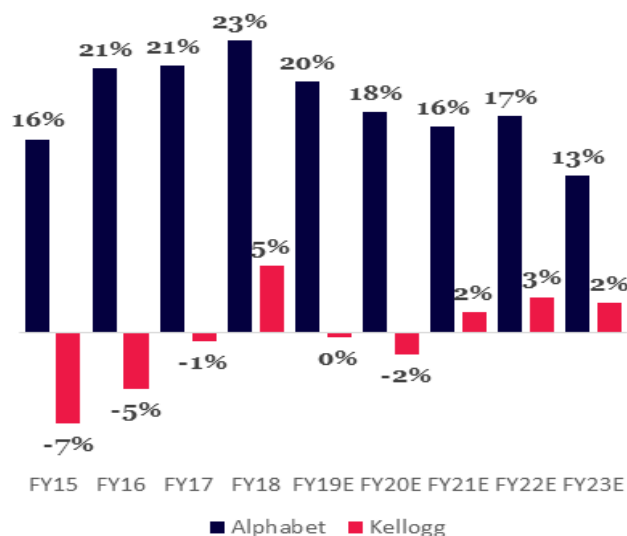
Index: 100 = 31 Dec 2018; 2020E PE



Source: MGI; Bloomberg

Revenue growth

Per cent per annum



Source: MGI; Bloomberg

IMPLICATIONS FOR MONTAKA’S PORTFOLIO HOLDINGS

In our Montaka funds we own some of the world’s highest-quality businesses, that are well-positioned in structurally growing industries, and that we believe are materially undervalued at their current stock prices. Three current and important holdings in our long portfolios are Vivendi (Euronext: VIV), Microsoft (NASDAQ: MSFT) and St. James’s Place (LSE: STJ). We believe these businesses will be worth considerably more in the future than they can be acquired for today.

The chart below shows the current share price of each of these stocks (blue bars) and our assessment of fair value in 12 months’ time for each (burgundy bars). To make our assessment of fair value we use a required return, or hurdle rate, for equities of 10% - higher than the market-implied cost of equity deduced above. On this basis the upside potential in these stocks ranges from 30% to 50%.

Yet if interest rates remain lower for a protracted period of time, then we believe there is a strong case for the hurdle rate to be lower, as outlined above. If this were to occur, then the upside in each position below is even higher.

For example, the pink bars in the chart below show the fair value of the same three stocks assessed at an 8% hurdle rate – which is still a healthy premium to the required returns being priced into other asset markets. In this case the upside potential has increased to range from 70% to 100%-plus.

If equity markets come to fully appreciate the new lower-for-longer interest rate paradigm that we believe is possible, then spectacular gains may lie ahead for our Montaka funds.

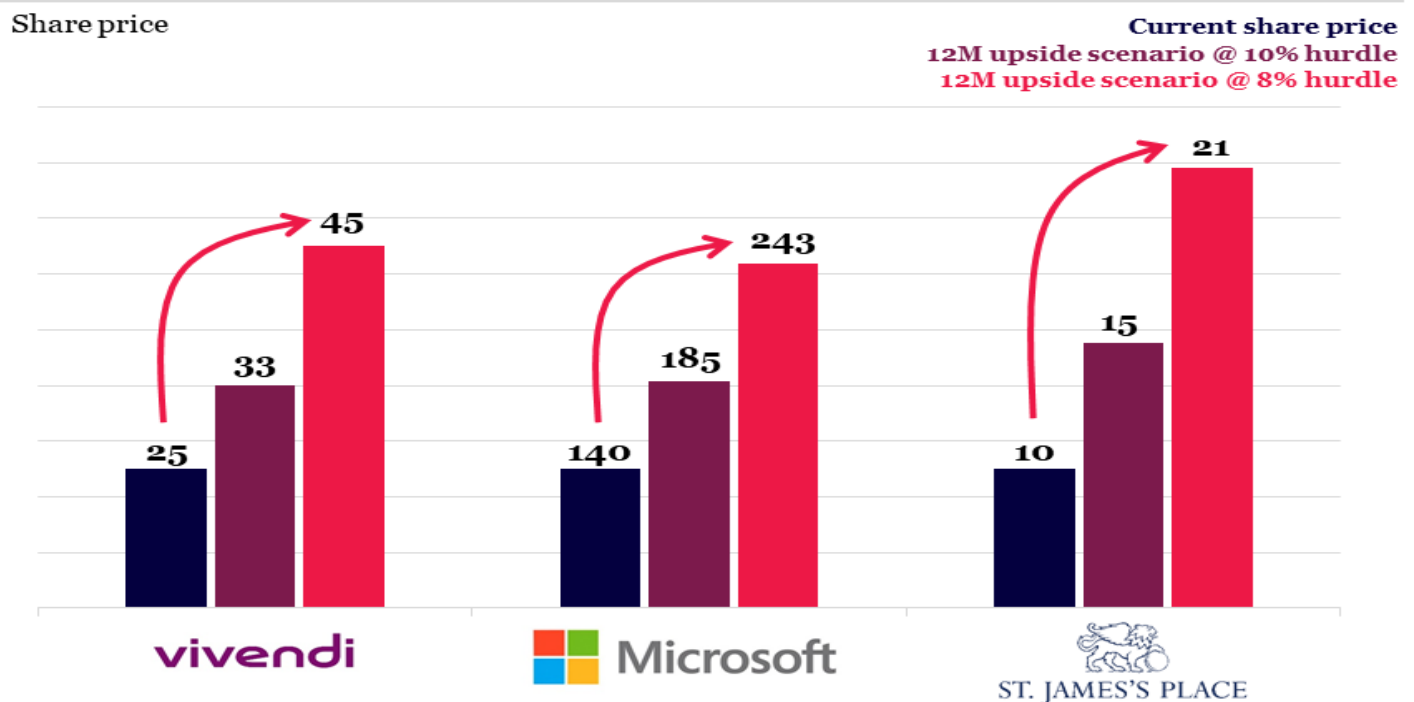
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In closing, a brief word on the implications of our analysis for societies more generally. A sustained period of very low interest rates will surely inflate assets. For asset-owners, this sounds wonderful. For those who do not currently own assets, this sounds nightmarish – as assets would likely become less affordable, the longer rates stayed low.

Furthermore, lower interest rates effectively result in a transfer of wealth from savers to borrowers. Once again, this is great news for existing asset owners who have levered their investments with borrowings. For savers, this scenario is again nightmarish. And interestingly, recent experience in Europe has shown that lower rates have perversely led to increased savings, not a reduction, as many might expect. The logic here is that savers feel like they need to save even more while interest rates are low. And this is obviously a drag on economic growth – which ironically, keeps rates even lower.

As a simple thought-experiment, one can take to the extreme how society might look if rates were to remain very low for a protracted period of time. Societies would likely split between those who own assets and those who do not. Extreme inequality would likely result. Populist governments would likely rise. Perhaps civil unrest as well. We will leave it to you to consider where this ultimately leads. Needless to say, we believe that the challenge of low interest rates could well be the defining challenge for the next generation of global leaders.

Equity valuation uplift from reduced hurdle rate



Source: MGI; Bloomberg

Do you want to get in touch with the team at Montgomery?

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