Dodge & Cox®
Worldwide Funds

Podcast Transcript

The Case for Active Value Investing

JANUARY 2020

Scot Hoffman: Welcome to Dodge & Cox Investment Perspectives, where we take a close look at key themes in our investment portfolios. I'm Scot Hoffman in Communications. Today we are exploring the broad theme of active value investing across U.S. and Global equities. Charles Pohl, Chairman and Chief Investment Officer of Dodge & Cox, and Diana Strandberg, Senior Vice President and Director of International Equity, have joined us. Charles and Diana are members of the Dodge & Cox U.S. and Global Equity Investment Committees. They will talk about why the fundamentals support the Committee's collective belief that now is an opportune time to be an active value investor. Welcome, Charles and Diana.

Charles Pohl: Thank you, Scot.

Diana Strandberg: Thanks, Scot.

Scot Hoffman: Charles, let's start with you. Our Global Industry Analysts focus on finding under-appreciated companies through our bottom-up stock selection process, so it's really rare that you hear Dodge & Cox talk about what's going on in the market overall. What are our Equity Investment Committees seeing when you take that step back?

Charles Pohl: Well, it's a pretty extraordinary time. If you look over the long span of history, since 1926 we've had three periods where value stocks have underperformed growth stocks for ten-year rolling periods. And those were the Great Depression, the Internet bubble, and then, more recently, value has significantly underperformed growth over the last decade. And so this is a pretty extraordinary phenomenon. It's very meaningful to us because valuation plays a big role in our bottom-up analysis of companies. We're known as a value manager. And so this has been quite a strong headwind for us. But what we see right now are fairly extraordinary spreads, both domestically and internationally, in the valuations between stocks that are perceived as value stocks and those that are perceived as growth stocks. Like I said, you know, we see this both internationally and domestically. We see it across the board in different segments of the market.

Scot Hoffman: Diana, what's really driving this valuation disparity?

Diana Strandberg: So it is important to look under the hood of value and growth because they mean very different things, depending on where in the world we're looking. In the U.S., value/growth captures a lot of, but not all of, what's really driving these wide valuation disparities. Interest rates actually tell a much more powerful story in the U.S. market, where you see a group of companies that are beneficiaries of low interest rates—and they are at an 80% premium—to the group that are victims of low interest rates. And that spread is almost three standard deviations wide or in the 99th percentile on a 24-year span of time. Internationally, value/growth really does capture the wide disparities that we're seeing in the market, where growth is at an 85% premium to value, over three standard deviations wide, and again in the 99th percentile. Growth in the U.S. is really much more around technology and Internet companies. Growth internationally is around companies that are viewed as safe havens in an uncertain global world. Consumer Staples is the biggest overweight in the international growth benchmark, for example. So we think that it's really important to be able to look at the world on a bottom-up basis so that you can start to see what's going on under the surface that's really driving what we consider to be extraordinary opportunities to lean in to value internationally and these companies that are suffering from low interest rates in the U.S.

Scot Hoffman: So there are differences between how value and growth are perceived in the U.S. versus outside the U.S. Could you explain that to us?

Charles Pohl: Yes, it is really important to understand the details of all of these situations, because you can make these sweeping statements like I opened with but the devil is in the details. And at the end of the day, you have to own individual stocks. So it's one of the reasons we remain very focused on our bottom-up research. If you look at what's going on domestically and internationally, as Diana referenced, it's a little different inside and outside the U.S. Part of it is, as Diana mentioned, due to what constitutes a growth stock outside the U.S. and inside the U.S. Outside the U.S., technology is a much smaller weighting in the indices and so there's actually not as many technology stocks to be in the growth side of the index. But the biggest disparity we see is within the U.S., the disparity between value and growth in terms of valuation is actually smaller than the disparity between companies that are sensitive beneficiaries of rising interest rates and those that are beneficiaries of falling interest rates. And historically, these two groups of stocks have traded roughly in the same valuation range. And then post-2010, they've moved out to increasingly wide spreads, and we see that as being investors looking really for bond substitutes. And the areas where the sectors that are viewed as bond substitutes tend to be Utilities, REITs, and the Consumer Staples. Interestingly, Utilities are actually mostly in the value indices and so are many of the REITs and the Consumer Staples stocks as well. So these are tagged as value stocks but we think relative to their fundamentals, the valuations are inflated. On the other side of the ledger, companies that benefit from rising rates, the Financials and some of the Industrials, some of the energy stocks, and these are almost all categorized as value stocks and they are selling now at extraordinary discounts relative to the marketplace.

Scot Hoffman: What's going on in Europe and elsewhere outside the U.S?

Charles Pohl: The situation in Europe is a little bit different. As Diana mentioned, it's more about the discrepancy between companies that are viewed as safe havens and those that are viewed as more risky.

Diana Strandberg: And unlike the U.S. growth benchmark, the international growth benchmark is led by Consumer Staples. And so you really do have this view about safe havens in an uncertain world. The irony now, we think, is that the valuation disparities are so wide that the concerns people have, we think, are more than baked into the low valuations we're seeing in value or the low interest rate victims' group, that you don't actually need the better outcomes, higher rates, for example, or a strong economy, for the returns to be attractive from here when investing in the companies in those cohorts.

Scot Hoffman: So the Dodge & Cox Worldwide Funds are overweight Financials and Energy—the victims, as you've described them. Charles, what are we seeing in certain financial services companies that others may be missing?

Charles Pohl: Well, I think post-2008 the banks have gone through quite an evolution, the U.S. banks. And not only are their valuations at multi-decade lows, but they've gone through a period of extensive restructuring. They've raised their capital ratios very substantially; they've raised their liquidity ratios very substantially. Credit costs have improved enormously and are now extremely low and non-performing loans are quite low. We also in the past have always seen a period of rapid loan growth precede credit issues, and loan growth post-2008 for the U.S. banks has been very restrained. So we don't really see looming credit issues for the banks. They have restructured themselves to a reasonable level of profitability. Valuations are low. A lot of costs post-financial crisis relating to litigation and fines and various regulatory issues have been dealt with and so those are now also in the rear-view mirror. And so we see relatively a good set of fundamentals going forward from here, combined with the exceptionally low valuations.

Diana Strandberg: You also have capital returns, so U.S. banks have been returning through dividends and importantly and increasingly through share repurchases, with the permission of the regulators after stringent stress tests.

Scot Hoffman: So why do we think U.S. banks are inexpensive today, given that earnings are at cyclical highs and there may be tailwinds actually already baked in? What's driving these valuations?

Charles Pohl: Well, I think there's an overhang of concern that dates from 2008 that has always been lurking in the back of the market's mind that you could have another credit crisis of some sort, although, as I pointed out, with very restrained loan growth in that period, we don't really see that, the kind of excesses that might lead to another credit crisis. And with the capital liquidity ratio so strong among the major banks, we don't think that they're as vulnerable, even if you did have a credit issue. There are concerns that the economy may be slowing, but I think the biggest thing that has hung over their heads is the very low level of interest rates, and that makes it difficult for the banks in a few different ways. One, it is harmful to the net interest margins of a number of banks. Two, it signals the flat yield curve that you had last summer and the low rates I think were manifestations of a concern that the economy might be weaker and that might lead to increased credit costs. And then the other thing is not even really something that affects the banks so much but it affects the other companies in the index, and it affects some of the whole value growth dynamic as well—is that when you lower interest rates, the value of earnings out in the distant future becomes higher relative to a company that has earnings in the current period. So lower interest rates tend to inflate the multiples of stocks that already have high P.E. ratios that are discounting a rapid rate of growth in earnings. Because those earnings are far out in the future, you have a lower discount rate applied to them and so they become more valuable. And the banks are trading at low multiples so they don't benefit from that the same way that, say, you know, a high-tech growth company might benefit from that. So that's been a drag on them, a drag on value stocks in general.

Scot Hoffman: Diana, let's turn to Europe. The case with European Financials is quite different from the U.S. Would you talk us through that?

Diana Strandberg: Well, in contrast to the U.S., where earnings have really recovered for U.S. financials, European Financials earnings have crept up but really have not recovered. And in fact, investors are worried that these are broken businesses, given low rates, given sluggish growth, and you see that expressed in absolute and relative valuations that are back at global financial crisis levels on a variety of metrics. But here's what's going on with the actual businesses. So the perception is they're broken businesses and the reality is similar to the U.S. financials: they have significantly repaired their balance sheets with double or triple the capital levels, higher quality capital, much improved funding models and liquidity levels, a vastly improved asset quality, and a rationalization of the business into more focused businesses, so restructuring, cutting costs, and also shedding assets that are capital hungry. And we're at a point now where actually the earnings quality we think is quite high, and the companies are at the beginning of being able to distribute significant amounts of capital back to shareholders.

Scot Hoffman: So what do we need for perception to change and for these investments to work out over time?

Diana Strandberg: I think ultimately, investors will recognize that earnings and ROEs are improving. Now they have been improving. It's been at a slow and incremental pace and it could continue at a slow and incremental pace. But even against the headwind of low rates these metrics have been improving. So I think it will be a recognition and in fact, when we look at what's really driven the share prices, it has been a P.E. contraction, so valuation contraction, not a fundamentals deterioration. And we think ultimately the improved fundamentals will be recognized by the market. So far, from the summer, where we hit a very low point in valuations, so far, through the fourth quarter, valuations in share prices of European financials, in particular, have improved markedly.

Scot Hoffman: So do we need higher interest rates for these investments to work?

Diana Strandberg: Well, importantly, our analysts aren't embedding forecasts of rising rates in our financials holdings. So the earnings improvement and the ROE improvements are really driven largely by self-help and management action.

Charles Pohl: And we believe that the valuation spreads are so wide at this point that even if interest rates remain stable, there is an opportunity for these stocks to outperform.

Scot Hoffman: So it's easy to miss the opportunity if you're just thinking about value versus growth. Growth often is associated with technology stocks, but we actually like some technology companies. Where do we see the valuation opportunities there?

Charles Pohl: Well, you have to realize that with the technology stocks, oftentimes you don't see them trading at low multiples of book value, per se, which might be a traditional metric that we'd use for valuation. Because, you know, they in many cases lack the need to have large amounts of property, plant, and equipment that companies in many traditional industries have to have. We look for other places to find value. The strength of the business franchise, for example. We look for companies that have very defensible market positions, large market shares in growing markets, particularly where they generate a lot of free cash flow. You can take a look at a company like Alphabet, which is in our portfolio, and we believe that it meets all of these criteria: Very defensible market position, dominant in a number of markets, generates a lot of free cash flow, and if you model the thing out, you can model very attractive expected return for this stock, even though it's not trading at a particularly depressed multiple book value or P.E., you know, which might classify it as a traditional value stock.

Diana Strandberg: And I think this is really the benefit of doing bottom-up fundamental research, because we can go in and look at what's embedded in the valuation. And Charles, as you mentioned, we look at a lot of different metrics. When we're looking at Alphabet, for example, we look at the sum of the parts. We can look at some of the component pieces, and we think we're able to invest in the underlying search, the core search business at a very attractive valuation, for example. And just looking at the headline numbers might obscure the underlying fundamental value or actually even financial value of the business.

Scot Hoffman: Diana, let's come back to the victims and spend a few minutes on Energy. What do you see as the opportunity there?

Diana Strandberg: Well, we have to start with valuation relative to the fundamentals of the business, and from a valuation standpoint, energy companies globally are trading at very low multiples relative to the global benchmark on an earnings and cash flow basis. And I think that reflects investors' concern about energy prices being lower for longer. We think that there are some reasons for oil prices, for example, to be stronger than investors might think when we look at supply and demand over the next three-to-five years. And in particular, there has been a significant decrease in the amount of investment in the industry, even adjusted for inflation, that points to the fact that we're not replacing depletion in this industry, as demand continues to grow. Now our analysts spend a lot of time on the ground meeting with company managements, oil ministers, industry experts to develop, we think, an insightful regional view of supply and demand, but also importantly, they're visiting individual oil fields to assess the operations and give themselves the ability to compare across companies to gain better insight into how individual managements are able to drive earnings and cash flow from their resources.

Scot Hoffman: Would you give us an example of a recent addition to the portfolio in the energy sector?

Diana Strandberg: So we started an investment in Hess this summer. We followed the company on a research basis for quite a long time, and we felt that the valuation had gotten to an attractive enough level to start an investment. And this is largely because they're making a significant investment in Guyana, and you're seeing the spending hit on the income statement as they're developing this resource. And we think there's the potential to generate significant free cash flow in the future. And to our way of thinking, this is really one of the advantages of having a long-term view, is that we can look past the short-term earnings pressure to really the long-term value of the asset they're developing and invest in the company when it's inexpensive because of this earnings pressure, and then get the benefit of that free cash flow in the future.

Charles Pohl: And, you know, their partner in that field was Exxon, in the field in Guyana. We think it's an extraordinary opportunity for them and is not fully reflected in the price that we see in the market today.

Scot Hoffman: So what you're both really saying is that this time is not different from those other three periods we talked about at the beginning. But why shouldn't investors just own the winners?

Charles Pohl: Starting valuation matters a lot in investing, and if we go back over the decades, we see at times when these valuation discrepancies have gotten very large that they tend to correct over time, and that the returns can be very attractive to someone who has the courage and the patience to invest in some of the lower valuation stocks when they're trading at a truly large discount to the market as a whole.

Scot Hoffman: The macro environment, I think, is part of the picture, as we've talked about here. Diana, how do our investment committees really think about the macro environment, and do we really need a robust economy for these ideas that we've talked about to play out?

Diana Strandberg: Well, we think a lot about the macro picture. Our analysts work hand-in-glove really with our fixed income team in a variety of aspects of our due diligence. Our fixed income team helps us understand what bond markets are pricing in in terms of interest rates and economic growth and currency, and our industry analysts, our corporate credit analysts, who are looking at the full stack of the balance sheet, not just the equity, and we think that helps us round out our views. However, it's an input. It's something that we're thinking about as a backdrop or the operating environment in which a company then is doing business. We would assert from valuation starting points today, these valuations are sufficiently low that a lot of macro pessimism is already really baked in. And so we don't think you need a robust macro environment for these investments to work. Consider when we talked about the Financials in the U.S. and in Europe, this significant capital return that we're getting as investors on top of actual fundamental improvement in the business. We talked about energy companies. Their dividend and share repurchase there is in the mid-single digits so still very healthy capital return levels and cash flow levels because of the capital discipline that they're displaying. And I'm bringing that up as the returns are coming from improvements that these managements have made in their businesses in the current environment. So we don't think that we need an improvement for these investments to remain attractive. Now, if we got a big macro improvement, then these have the potential to be extraordinary.

Scot Hoffman: So Charles, this brings us to the broader question of what should investors expect their manager to be doing in an environment like this?

Charles Pohl: I think the most important thing is that the manager remain true to their investment philosophy and process, that they, especially at this point where valuation gaps are large, that they not deviate from their focus on trying to find true values in the marketplace. We've seen in past cycles like this people get into a lot of trouble by abandoning their principles, by not staying focused on the long term, by not staying focused on a valuation discipline. And the people that are able to do that through difficult periods in time like this are the ones that long term emerge the winners.

Scot Hoffman: Actively managing the portfolio is a big part of that. Could you elaborate on that a bit more?

Charles Pohl: Well, hopefully, through the course of this podcast it's come through that we're very focused on bottom-up analysis of individual companies, and we've talked occasionally about some broader observations about the marketplace, like the disparities between value and growth. But really this always comes down to investment in individual companies. And it's one of the things that we tried to highlight when we were talking about the issue of interest rates as it applies to value and growth, is that when you start looking a little deeper at the actual industries and companies that comprise these different indices, you start to come to some conclusions that are a little bit different than you might if you were just looking at it from a top-down basis. So we continue to be big believers in doing bottom-up research. We believe that there's a real opportunity, particularly in a market like this, for someone who is an active manager and doing bottom-up research on individual companies.

Scot Hoffman: Diana, any other thoughts you would add?

Diana Strandberg: Well, I think as Charles said, I would just underscore the ability to stick with your convictions. There are huge pressures to abandon your beliefs around what creates investment value when you're seeing these disparities widen out in the market. And we think that being independent, for example, confers a really big advantage because we have no outside stakeholder pressuring us to give up at what in hindsight could be the wrong time.

Scot Hoffman: Thank you very much, Diana and Charles, for sharing your thoughts.

Diana Strandberg: Thank you.

Charles Pohl: Thank you, Scot.

Scot Hoffman: And thank you for listening. This podcast was posted in January 2020. Statements in this podcast represent the opinions of the speakers expressed at the time the podcast was recorded, are not a complete analysis of every material fact concerning any market, industry or investment, and may change based on market and other conditions without notice. The statements are not intended to serve as investment advice or a recommendation to buy, sell or hold any security. Any securities identified are subject to change without notice and do not represent a fund's entire holdings. This podcast should not be copied, distributed, published or reproduced in whole or in part without express permission of Dodge & Cox. This information should not be considered a solicitation or an offer to purchase shares of Dodge & Cox Worldwide Funds PLC or a solicitation or an offer by Dodge & Cox Worldwide Investment and its affiliates to provide any services in any jurisdiction. The views expressed herein represent the opinions of Dodge & Cox Worldwide Investments and its affiliates and are not intended as a forecast or guarantee of future results for any product or service. To obtain more information about the Funds, please refer to the Funds' prospectus at dodgeandcoxworldwide.com.