M&G (Lux) European Strategic Value Fund

Value outlook 2023

Richard Halle

January 2023

- Value outperformed the broader market in 2022 – with valuation spreads still wide, we believe value has further to go.
- The fund captured the value tailwind and delivered its best ever annual return relative to its benchmark.
- We see a wide range of opportunities across the market, particularly in the energy and consumer discretionary sectors.
- Despite some challenges in Europe, we think we can construct a diversified portfolio that combines attractive valuation characteristics with decent fundamentals.

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested. Where performance is mentioned, past performance is not a guide to future performance.

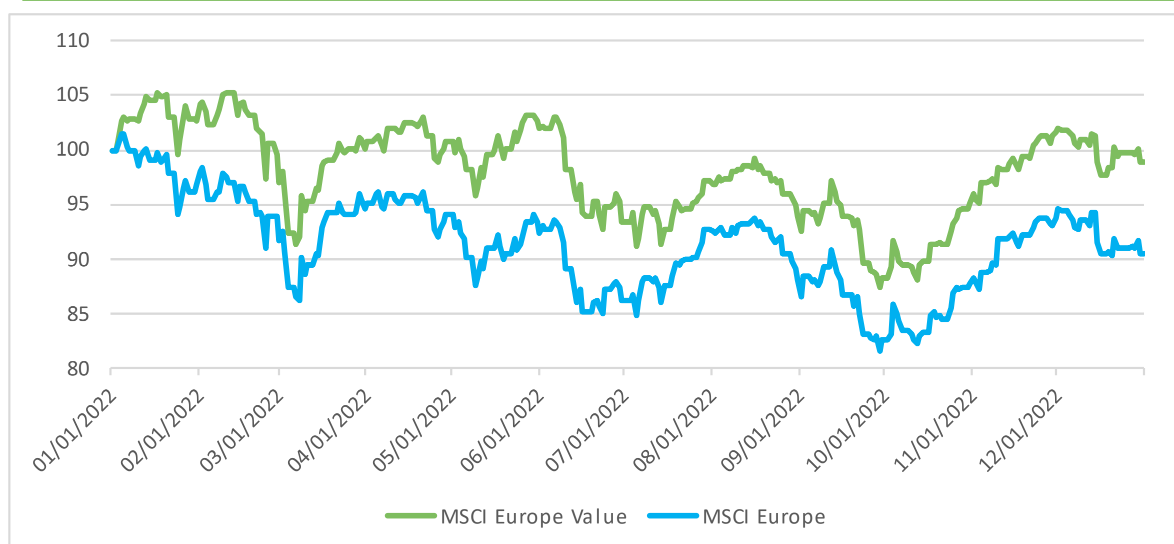
2022: Value resilient in tough year

2022 was a tough year for European investors as many assets fell materially in value. And yet, for value investors, who focus on lowly valued, out-of-favour stocks, it proved to be a relatively good year as the value investment style was resilient and outperformed the broader market by a significant margin (Figure 1).

2022 was notable for a couple of other reasons. Firstly, it marked the end of the 'COVID period', an extraordinary occurrence in world and stockmarket history. We are delighted to have managed this period of multiple landmines (ie, opportunities to have got stockpicking, portfolio construction, factor rotation, risk assessment and macro positioning horribly wrong) without any major upsets.

The second reason is that 2022 was the first time in well over a decade where the value style did well without then faltering. Indeed, it was the 'growth' rally which faltered in the middle of the year, with value returning in the last quarter (despite market strength amid hopes that inflation had peaked). (Growth stocks are generally expected to deliver above-average increases in earnings and profits.)

Figure 1: Value outperformed the broader European market in 2022



Past performance is not a guide to future performance

Source: Factset, 31 December 2022. Rebased to 100 at 31 December 2021. Total Return Indices

UCITS HAVE NO GUARANTEED RETURNS, AND PAST PERFORMANCE IS NOT A GUIDE TO FUTURE PERFORMANCE

Fund performance

In this challenging environment, when very few active managers beat the market, we are pleased that the fund performed well. Our consistent value investment approach helped the fund capture the value tailwind and it delivered returns ahead of its benchmark. In fact, it was something of a landmark year for the fund as it registered its best ever annual performance relative to its benchmark (in euros), the MSCI Europe Net Return Index, outperforming by more than 10 percentage points.

At least 80% of the fund is invested in the shares of companies, across any sector and of any size, that are based, or do most of their business, in Europe. The fund invests in securities that meet the ESG Criteria. Norms, sector and/or values-based exclusions apply to investments. The fund manager expects at least 70% of the fund to be aligned to the promoted environmental and social characteristics. At least 20% of the fund will be in sustainable investments.

Five-year fund performance (%)

	YTQ	1yr	3yr pa	5yr pa	Since launch *** pa
EUR A	1.8	1.8	5.4	3.6	5.0
Benchmark (EUR)*	-9.5	-9.5	3.1	4.4	4.9
Sector average	-6.3	-6.3	1.6	1.2	2.8
Quartile ranking**	1	1	1	1	1

Discrete-year performance, 10 years (pa, %)

	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
Fund (EUR)	1.8	25.4	-8.3	19.3	-14.4	10.7	3.5	10.0	6.6	26.1
Bmark* (EUR)	-9.5	25.1	-3.3	26.0	-10.1	10.9	3.2	8.8	7.4	20.5

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YTQ = year to most recent quarter

* **Benchmark (EUR)** = MSCI Europe Net Return Index

** **Peer group** = Morningstar Europe Large-Cap Value Equity Sector

*** Fund launch date is of the M&G European Strategic Value Fund (a UK-authorised OEIC) , which launched on 1 February 2008. Fund performance shown prior to 20 September 2018 is that of the EUR Class A Accumulation share class of the M&G European Strategic Value Fund, which merged into this fund on 7 December 2018. Tax rates and charges may differ.

From 1 January 2012 to 19 September 2018 the benchmark is the MSCI Europe Index stated as Gross Return. From 20 September 2018, the benchmark is the MSCI Europe Net Return Index.

The benchmark is a comparator against which the fund's performance can be measured. It is a net return index which includes dividends after the deduction of withholding taxes. The index has been chosen as the fund's benchmark as it best reflects the scope of the fund's investment policy. The benchmark is used solely to measure the fund's performance and does not constrain the fund's portfolio construction.

The fund is actively managed. The investment manager has complete freedom in choosing which investments to buy, hold and sell in the fund. The fund's holdings may deviate significantly from the benchmark's constituents. The benchmark is not an ESG benchmark and is not consistent with the ESG Criteria.

2023: Value rebound continues

We will not make any firm predictions here, but we still think the recent value rebound has further to go. We are in a volatile and uncertain world with a lot changing and new leadership emerging in a market where valuation spreads are historically very wide. We think this is a good environment for the style, even if inflation has peaked.

As we go through the year, we are likely to see the market wrestle with some big issues, including:

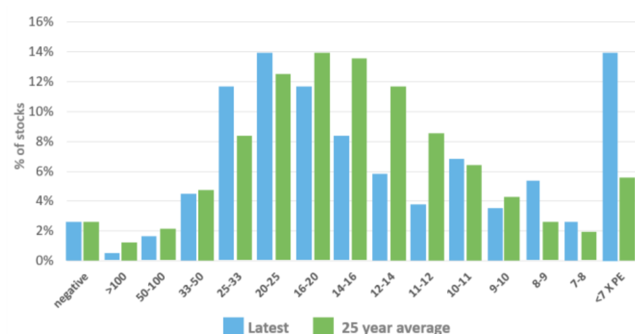
- What is going to happen in the Russia/Ukraine war?
- Where will European energy costs go?
- What is going to be the path of global and European inflation?
- Will the European Central Bank (ECB) be able to contain the fragmentation of European Union (EU) country bond yields in a year of high issuance and quantitative tightening?
- Will China be able to contain its property slowdown and re-engage with the rest of the world following the end of its zero-COVID policy?

We think this is a very different environment to the one that has prevailed recently where inflation was negligible, central banks were able to snuff out all market volatility with quantitative easing (QE) policies (that is, buying financial assets such as bonds to bring down borrowing costs in order to boost the economy), the cost of capital was low and we had a nicely growing, harmonious global economy.

Wide opportunity set

Portfolio construction challenges vary year-by-year. (For example, at the beginning of 2020 the key challenge for us was trying to dampen the macroeconomic risk that was inextricably tied to value stocks at the time.) But the scale of the above questions, and their great unpredictability (never mind that there will be others we have not even thought of), suggests to us that now, even more than usual, it will be important to have a very balanced portfolio, even if trying to construct a portfolio which is balanced against such a multitude of binary events is in itself quite a task.

Fig. 2 Distribution of stock valuations in Europe (MSCI index)



Source: Societe Generale, January 2023

But this prospect does not trouble us unduly given the opportunity set we see in the market currently. So much is changing, and valuation spreads are so wide across so much of the market (see Figure 2), that we feel there are many areas offering individual opportunities. We think this arises from:

- The very long previous period of outperformance by growth stocks which has resolutely not come close to fully unwinding yet.
- An out-of-favour asset class. Amid challenging conditions for Europe (soaring energy costs, rising interest rates and the war in Ukraine), there was a massive outflow from European equities last year which is estimated to be in the region of €100bn. In our view, this could mean lots of people have been selling stocks they didn't want to – and there have not been people buying stocks that they think they should hold.
- Changing leadership within the market. We think this is an evident and profound factor which is exacerbated by the previous two points.

Energy sector: positive change in fundamentals

An example of the type of opportunity we see is the energy sector. This remains our biggest overweight position, relative to the benchmark index, despite excellent performance last year as we observe the most dramatic positive change in industry fundamentals (underlying characteristics or performance) going hand-in-hand with the most dramatic scepticism towards the industry. The market simply only wants to believe in the worst-case scenario here (or perhaps there are believers, but they are unable to invest in the sector on Environmental, Social or Governance (ESG) regulatory hurdles, rather than reality), despite multiple points of evidence to the contrary.

For example, we see the Organization of Petroleum Exporting Countries (OPEC), a group of the world's leading oil producers, more in control of the oil market than they have been for decades; we see robust demand growth for hydrocarbons; and we see companies generating more cash and being more constrained with their capital spending than ever before. Despite these factors, we can still buy energy companies trading on a valuation of only 4 times (x) earnings, which we regard as very attractive.

Consumer discretionary: looking beyond the expensive luxury goods companies

Another area where we are excited by the dichotomy between valuation and fundamentals is consumer discretionary. Luxury goods is a major sector in Europe, and these companies' sales have boomed beyond all expectations. This trend is forecast to continue as China's economy reopens. While we accept this could happen, we refuse to get involved given the very high multiple of these high earnings that we are being asked to pay for these companies.

At the same time, we find it unlikely that the very negative scenario which is priced into many other consumer discretionary stocks can co-exist in a world where people are buying handbags and luxury watches with abandon. So, we are very pleased to be able to invest in many consumer discretionary names, which are dominant or very strong players in their categories, at earnings multiples from as low as 3x and in most cases only in single digits.

New investments

Last year, we also took the opportunity arising from the hysteria around power prices in Europe to add to three high quality, large-cap industrial cyclical (or economically

sensitive) companies: BASF, Siemens and Saint-Gobain. Additionally, we felt these all helped to balance out portfolio construction given the sense that the fund had a lower weight to industrial activity than the market.

Whilst we are concerned about what the future holds for the European chemical industry, in a world where not only is it disadvantaged in its key input cost (energy), we felt that things had gone too far for Germany's BASF when its valuation declined to 7x earnings. This is the world's largest chemical company, with assets all over the globe, and given its "*Verbund*" (integrated/efficient) approach, we believe it is in a significantly stronger position than many of its European competition to still do well. Not to mention its large oil and gas assets.

We also felt the worries over a potential recession gave us a chance to invest in German conglomerate Siemens (we had already bought into its subsidiary Siemens Energy earlier in the year). In our view, Siemens is a world-class company in many areas, including industrial automation and technology, which are going to be crucial in the years ahead. As a result, we are willing to ride out any short-term weakness to get the sort of exposure they offer.

Finally, in relation to French materials firm Saint-Gobain we felt that at a valuation of 7x earnings, the market was not only overplaying construction downturn risk, but also not appreciating the incredible internal turnaround which has happened at this company over the last few years. In addition, we believe investors were missing that this company will be providing key products to decarbonise one of the biggest emitting sectors in the economy, construction and buildings.

Challenges for investors in Europe

While the overall market does look very cheap to us, Europe remains a frustrating place to invest. It sometimes seems that the EU has been hijacked by a "cabal of its enemies" from an industrial perspective. Examples include trying to classify defence spending as a "dangerous good" in its ESG taxonomy; its inability to grow renewable energy output while at the same time trying to outlaw its oil and gas industry; and the desperate position certain industries, in particular the chemicals sector, have been placed in given energy policies that were laid bare by Russia.

Indeed, many parts of the chemical industry have already been decimated in Europe even before this current structural problem of high energy costs. At the same time, through the Chemicals Strategy for Sustainability, the EU has made the chemical regulatory system even more stringent (ie, costly).

We are becoming increasingly concerned that another key industry, automotive production, is facing an imminent and sustained threat as the Chinese dominate an industry previously dominated by the Europeans. We note this not principally out of frustration, but to highlight that value mean reversion in Europe is not a given, and there are going to be structurally challenged companies which will require investment managers' skill to avoid. We will do our best.

Potential for surprises

Putting it all together, the key summation point we always emphasise is: given all the above, what sort of portfolio can we construct for our clients? And does that sort of portfolio give them a good chance of generating a decent return?

We are pleased to report that given the well-publicised difficulties in Europe, we feel we can still generate a diversified, reasonably balanced portfolio with very attractive valuation characteristics combined with decent fundamentals.

Whilst we are very aware a lot could go wrong in 2023, these metrics suggest the market is expecting a lot of bad news. But we are also aware the world is a surprising place, and some good things could happen. In the first half of January, we have already seen gas prices plummet, inflation numbers start to fall materially and China comprehensively re-engaging with the world and aggressively shoring up its construction sector. Let's hope that sets the tone for the year; we wish you an uninteresting 2023.

Other key fund risks

- The fund can be exposed to different currencies. Movements in currency exchange rates may adversely affect the value of your investment.
- In exceptional circumstances where assets cannot be fairly valued, or have to be sold at a large discount to raise cash, we may temporarily suspend the fund in the best interest of all investors.
- The fund could lose money if a counterparty with which it does business becomes unwilling or unable to repay money owed to the fund.
- Operational risks arising from errors in transactions, valuation, accounting, and financial reporting, among other things, may also affect the value of your investments.

Further risks associated with the fund can be found in the fund's Prospectus.

Other information

The fund invests mainly in company shares and is therefore likely to experience larger price fluctuations than funds that invest in bonds and/or cash.

Investing in this fund means acquiring units or shares in a fund, and not in a given underlying asset such as a building or shares of a company, as these are only the underlying assets owned by the fund.

European investors can find the fund's sustainability-related disclosures at the links below:

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Austria
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