

Macro and Multi-Asset

February 2022, Mergence Investment Managers

This note summarises our macro asset allocation views and positioning. Our macro-outlook has remained largely unchanged since our last update while our asset allocation views have generally been rewarded by market moves year to date. In our research piece, we look at quality versus value investing from a quantitative perspective and try to understand what drives the relative performance of these two styles.

Current Views

Underweight Risk Assets	Overweight SA Equity vs Global Equity	Overweight SA Fixed Income	Underweight Global Fixed Income	Neutral USDZAR
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Asset Allocation Views

Asset Class	Valuation based 3-Year Forecast Return	Underweight	Neutral	Overweight
SA Equity	16%			Overweight
SA Property	21%		Neutral	
SA Fixed Bonds	10%			Overweight
SA Inflation-Linked Bonds	8%		Neutral	
Emerging Market Equity	9%		Neutral	
Developed Market Equity	4%	Underweight		
US Large Cap	3%	Underweight		
US Mid Cap Value	5%		Neutral	
UK Equity	11%			Overweight
European Equity	9%		Neutral	
Japanese Equity	15%			Overweight
Global Bonds	3%	Underweight		
USD Cash	1%	Underweight		

Source: Mergence calculation. All forecasts in ZAR

When is a good business a good investment?

Buy good companies, don't overpay, and do nothing."

Terry Smith – Fundsmith



Can a poor business be a good investment? Or is a good business and a good investment one and the same? Are good businesses so often overpriced that the only way to gain a sufficiently variant perception to beat the market is to buy low-quality businesses that are priced very cheaply and shun 'glamour' stocks?

Debates between adherents of the competing investing philosophies of value, growth, and quality can invoke such passion as to compete with religion, politics, and views on vaccination for the status of banned dinner table conversation. But style performance has been a large driver of relative equity returns over the past decade and so at Mergence we try to engage this question from a data-driven perspective while attempting to maintain our status as welcome dinner guests.

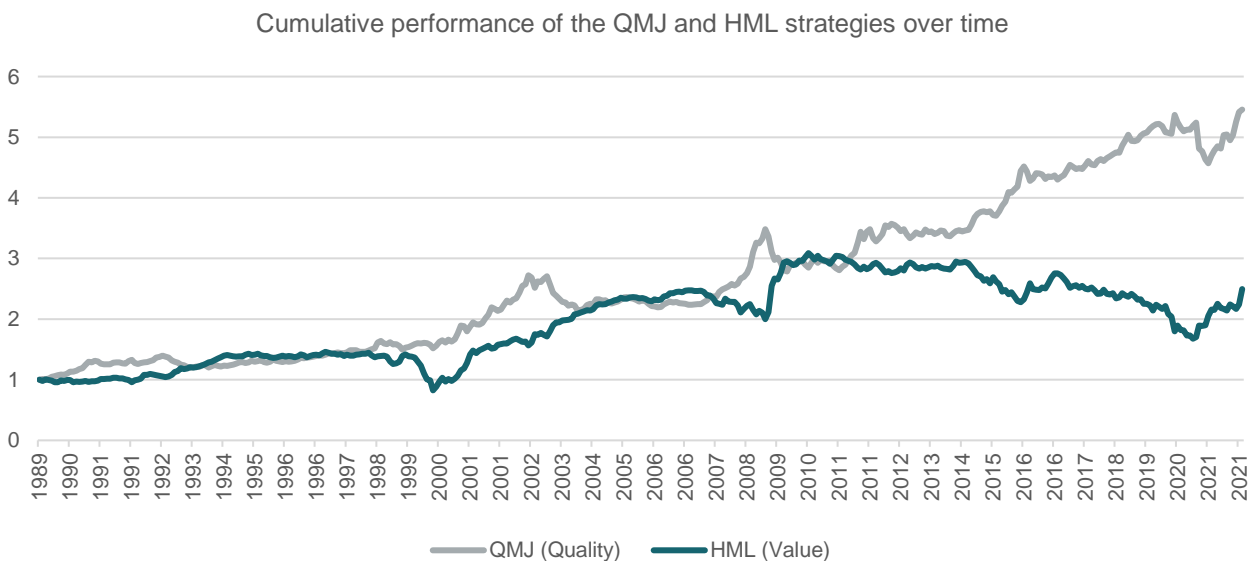
To this end, we use the excellent factor data (AQR Capital Management, n.d.) that AQR Capital Management generously update and make freely available on their website.

In their 2019 paper, Quality minus Junk (Asness, Andrea, & Pedersen, 2019), AQR define a quality factor that attempts to capture profitability, growth, and low risk. We use this QMJ factor as a proxy for quality investing and the traditional High minus Low Book Value (HML) factor of Fama and French to proxy value. The effect is that we classify good businesses as those that score high on the QMJ measure - those businesses that exhibit high margins, high returns on capital, a history of growth, low gearing, and less volatile share prices.

For both factors, AQR publish the performance of buying the cheapest / highest quality stocks in their universe and selling the most expensive/ lowest quality monthly. We analyse this data for a universe of global stocks to see what it can tell us about buying good businesses verses buying cheap businesses.

You can outperform both by buying good businesses and by buying cheap businesses

The chart below shows the performance of both the Quality (QMJ) and Value (HML) factors since 1989 in a global universe of stocks. These returns are for a hypothetical long-short strategy and so any positive return over time implies a strategy that adds value.

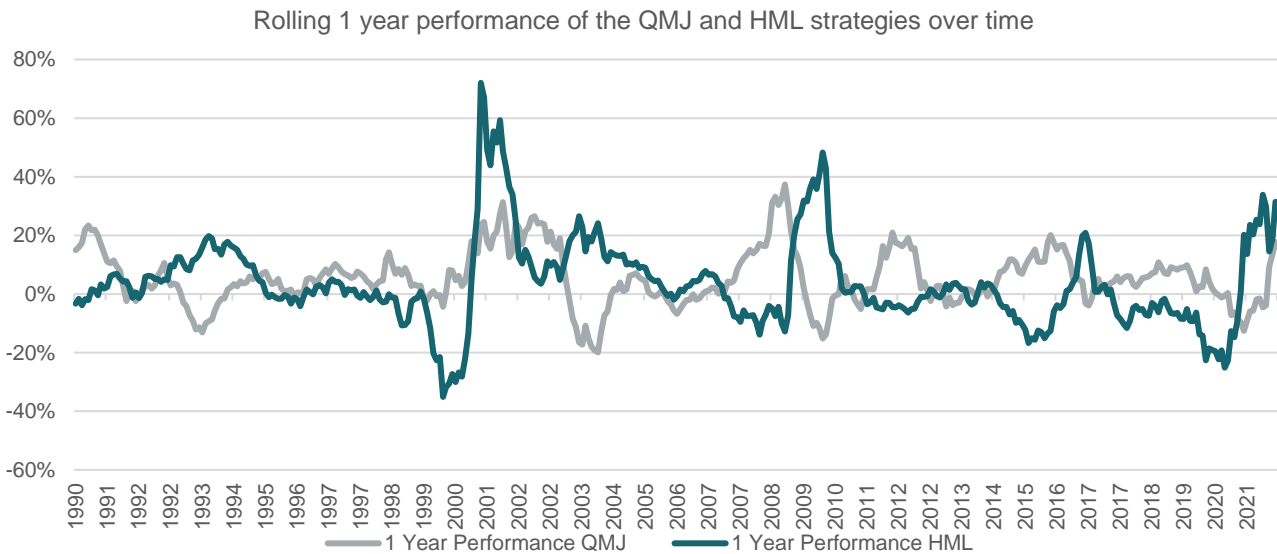




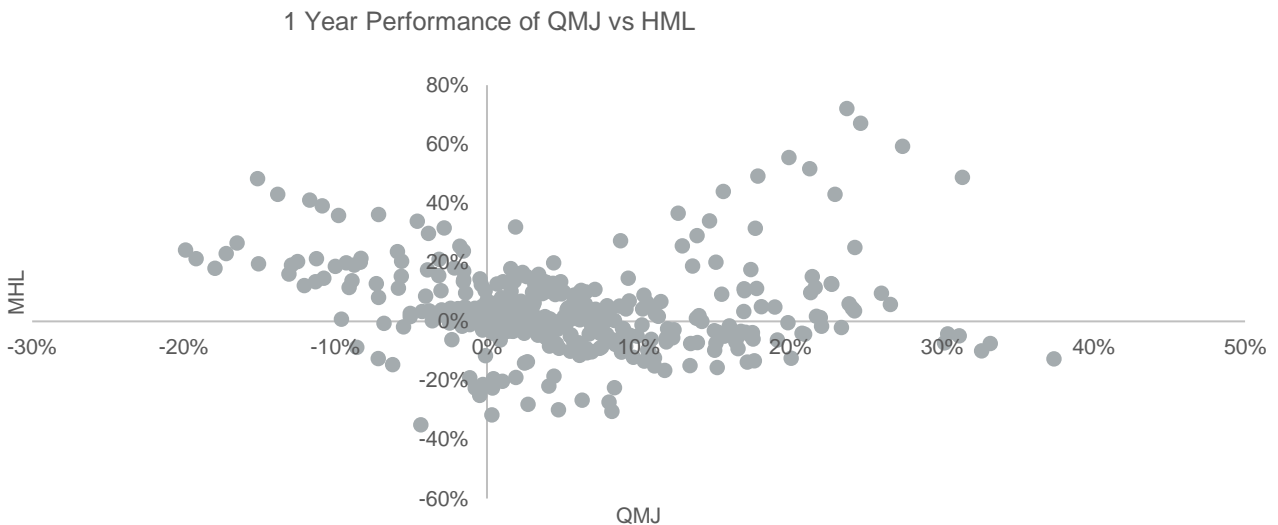
Over the long term, both quality and value investing have generated excess returns.

These two approaches often, but not always, produce opposite results

The chart below shows rolling 12-month performance of the QMJ and HML factors. Visually there are multiple periods where value is positive while quality is negative and vice versa. This lends support to the claim that often a good business is a poor investment if it is overpriced.



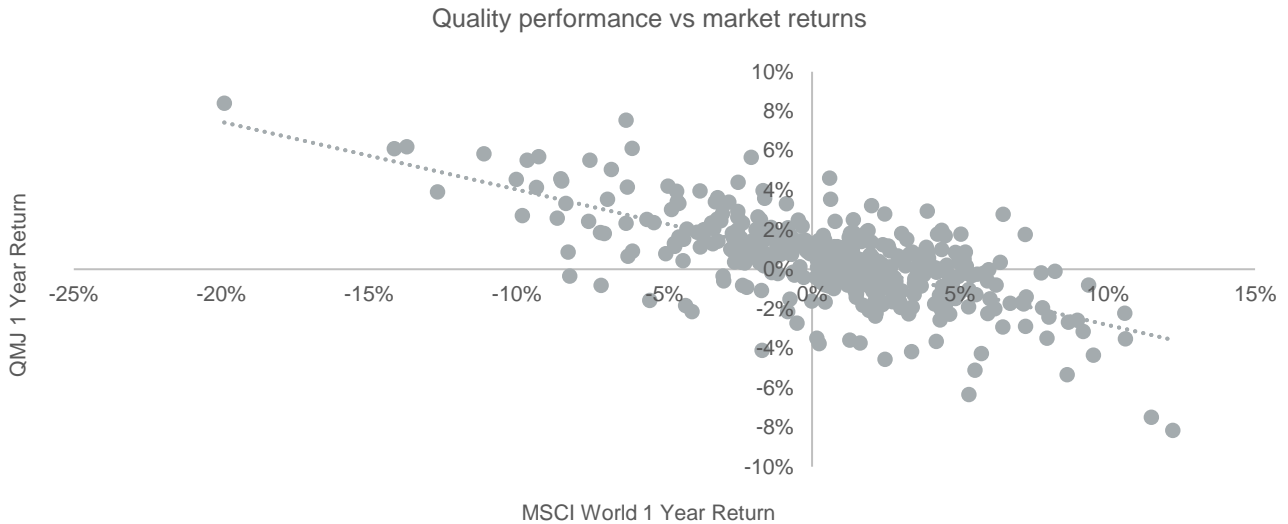
But plotting the same data as a scatter plot shows that rather than being negatively correlated, value and quality are merely independent over time. If poor quality, high growth glamour stocks outperform you may see both quality and value underperform at the same time, and then both outperform as the bubble in poor quality expensive stocks deflates. The recent meme stock bubble and its subsequent bursting is a good example of this.





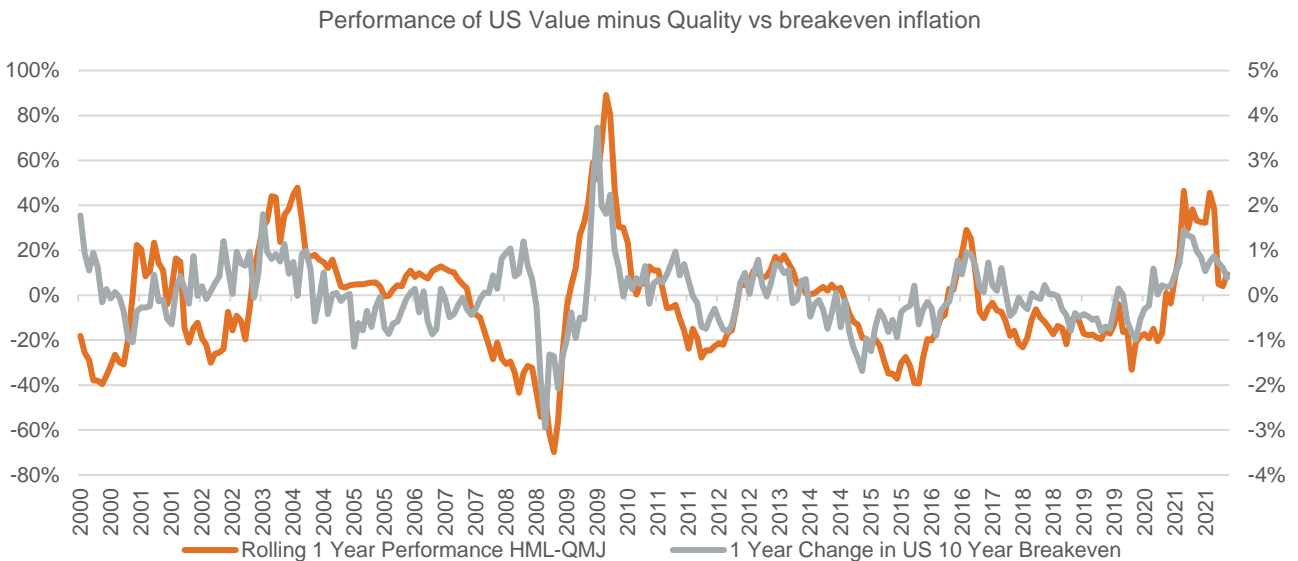
The flight to safety is real. Quality outperforms in a falling market.

Plotting the one-year return of the MSCI World Index against the performance of the QMJ factor shows that QMJ tends to perform strongly during periods when the overall market falls. This is partly by design as low Beta is an input in the QMJ factor.



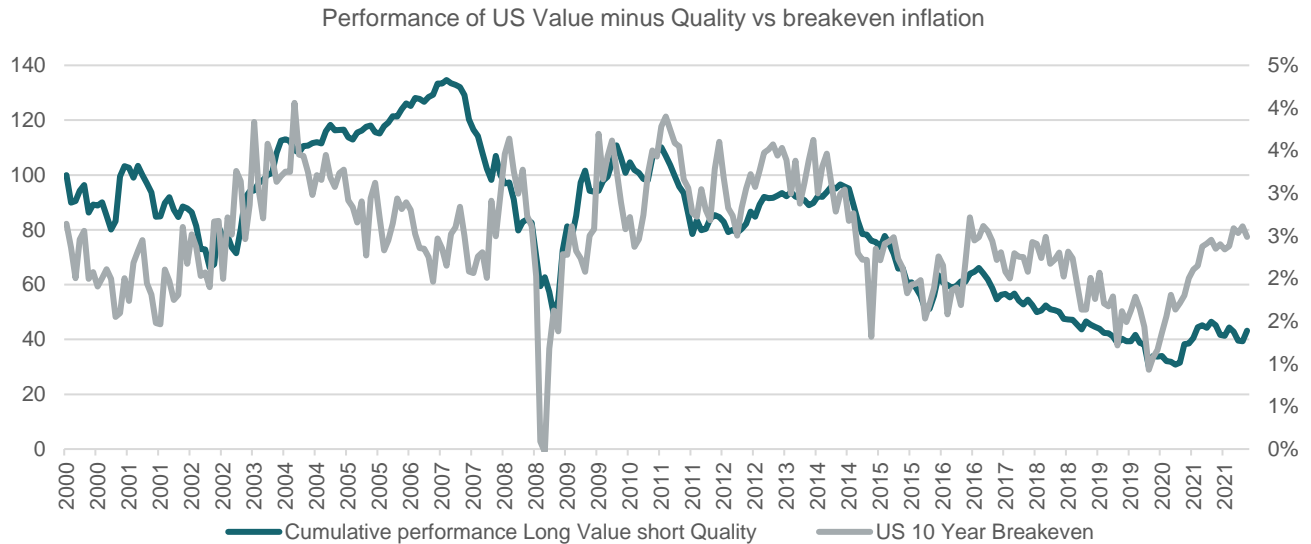
Value outperforms when inflation expectations are increasing

The relationship between inflation and value has been topical recently, with value staging a strong recovery as rates and inflation have moved higher. We have tested several macro factors and find that change in breakeven inflation has historically had a high correlation with the performance of value versus quality. Rising inflation has coincided with value outperforming quality.





Falling breakevens seem to be able to explain some of the long period of value's underperformance from 2010 to 2020.



The same business can be high quality at one point in time and low quality at another

Some measures of quality of a company are persistent and tied to the industry or specific to the business model. Widely used markers of quality such as economic moat or industry structure change infrequently or slowly. Others such as margins, returns on capital, and balance sheet strength are more cyclical. Most of the factors captured by QMJ fall into the second category and so based on this measure a company may be classified as low quality at a point in time and high quality a few years later. To illustrate this point, we show a few quality measures that are inputs into the QMJ formula for five JSE listed stocks over the period from 2016 to 2021.

Metric	FY 2016					FY 2021				
	AMS	TRU	TBS	BTI	MRP	AMS	TRU	TBS	BTI	MRP
Gross profits over assets (GPOA)	9.5%	52.9%	31.8%	74.4%	40.6%	49.0%	51.0%	28.5%	82.3%	42.2%
Return on equity (ROE)	4.8%	32.9%	24.8%	56.4%	49.7%	78.0%	33.3%	13.0%	11.3%	26.0%
Return on assets (ROA)	0.8%	16.4%	13.5%	11.7%	32.8%	43.8%	15.6%	8.3%	5.0%	13.3%
Gross margin (GMAR)	9.5%	52.9%	31.8%	74.4%	40.6%	49.0%	51.0%	28.5%	82.3%	42.2%
Delta GPOA	-3.1%	70.1%	12.9%	-3.4%	84.2%	127.7%	-2.7%	-3.7%	25.6%	17.7%
Delta ROE	-3.1%	17.8%	10.5%	12.8%	70.6%	196.6%	-7.2%	-11.6%	18.6%	0.6%
Delta ROA	-3.4%	13.8%	4.5%	5.7%	42.3%	100.8%	-5.0%	-5.8%	5.4%	0.0%
Delta GM	-5.3%	55.5%	10.2%	-6.0%	30.5%	160.2%	-2.8%	-3.0%	68.9%	7.5%
Leverage (Inverse)	-16.4%	-25.8%	-11.3%	-49.0%	-2.8%	-0.3%	-31.6%	-2.5%	-28.9%	-29.9%

We colour code each metric to show its level versus the 4 other companies displayed here, high relative performance shown as green cells and low relative as red. This illustrates how, despite no changes to their business model, Anglo American Platinum shifted from a potentially low QMJ quality score to a high score over the 5 years, while Tiger Brands deteriorates from a moderate score to a potentially low QMJ score.



What does this mean for investing right now?

From a multi asset perspective we have actively allocated towards value and less so toward growth. We have implemented this through various exposures such as value indices, an overweight position in UK equity, a thematic position in energy stocks, and a tilt favouring South African equities over global equities.

Our equity investment process attempts to capture both the quality and value premia. Our assessment of quality is derived through bottom-up fundamental analysis, which shares some of the characteristics of quantitative quality measures but also includes a focus on slower moving qualitative aspects of the company. Over the period from 2013 to 2019 we found that the quality component of our process contributed most of the value add. Over the period from 2020 to 2022 this has reversed, and currently, the companies that our analysts think are cheap are outperforming those that are considered expensive, whilst our assessment of quality has shown a weaker correlation with forward returns. As we illustrated above, quality and value are quite uncorrelated factors and while both are expected to add value through the cycle, they often contribute at different times. Our process explicitly aims to capture both factors to benefit from this diversification effect as we aim to add value when either value or quality contribute. We achieve this by focussing our exposure on the opportunities that our research identifies as both high quality and cheap.

References

AQR Capital Management. (n.d.). *AQR Datasets*. Retrieved from <https://www.aqr.com/Insights/Datasets>

Asness, C. S., Andrea, F., & Pedersen, L. H. (2019). Quality minus junk. *Review of Accounting Studies*(24), 34-112. doi:<https://doi.org/10.1007/s11142-018-9470-2>

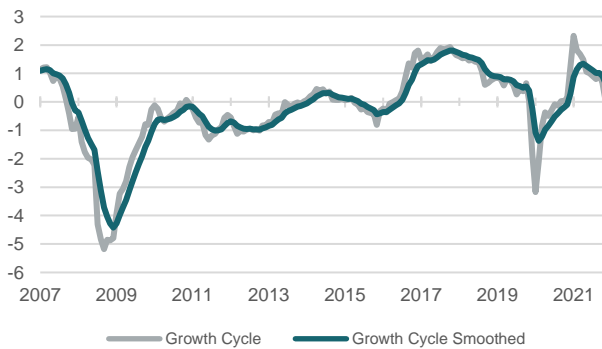


Key Indicator Forecasts

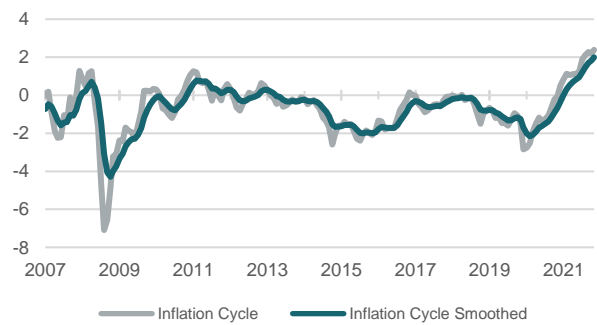
Indicator	Current	1 Year	3 Year	5 Year
USDZAR	15.3	14.6	15.4	16.3
SA 10 Year Yield	9.3%	9.0%	8.5%	8.5%
SA Inflation	5.9%	5.5%	4.5%	4.5%
US Inflation	7.0%	3.0%	1.8%	1.8%
US 10 Year Yield	2.0%	2.3%	2.5%	2.5%
Fed Funds Rate	0.1%	1.1%	2.0%	2.0%
SA Repo Rate	4.0%	5.0%	6.0%	6.0%

Key Charts

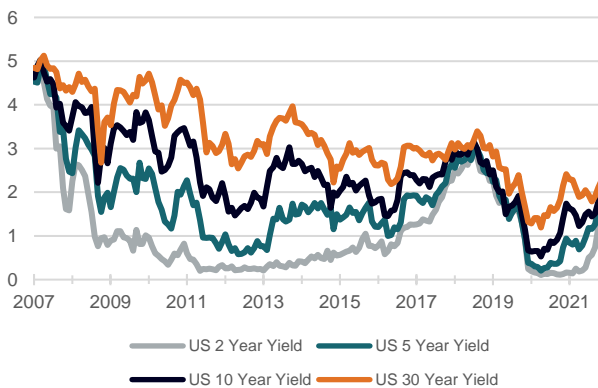
Mergence Growth Cycle



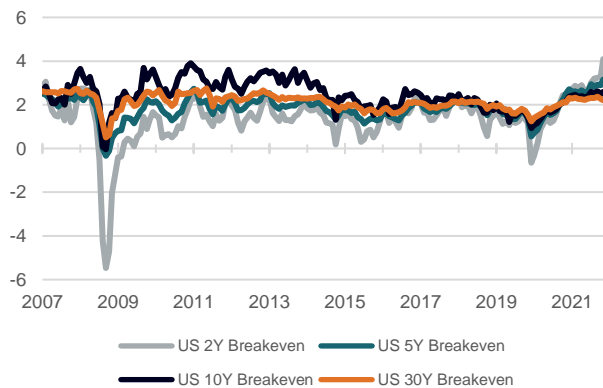
Mergence Inflation Cycle

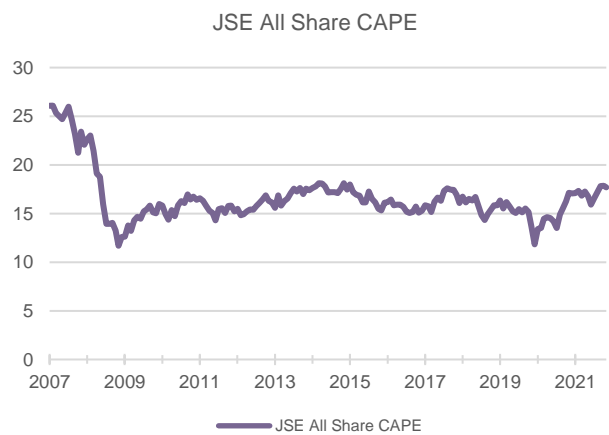
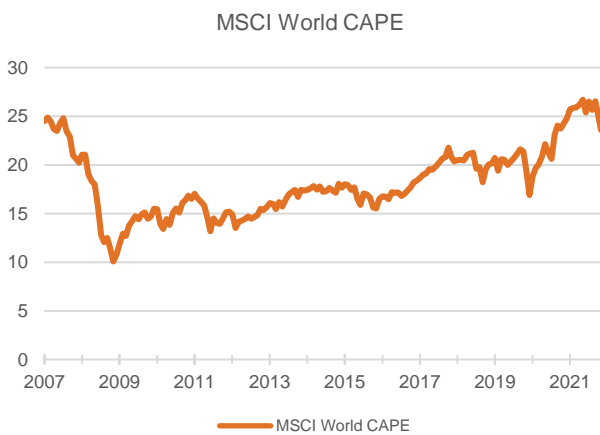
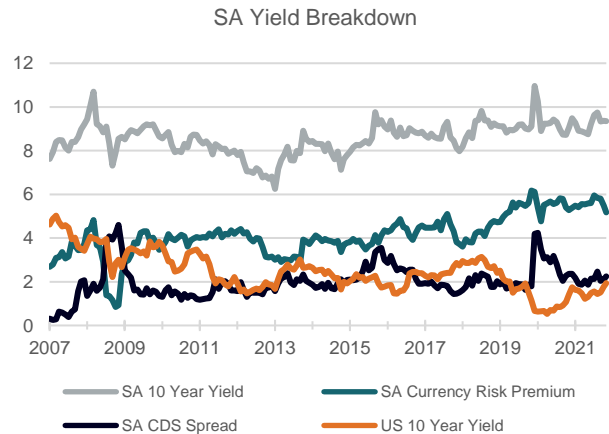
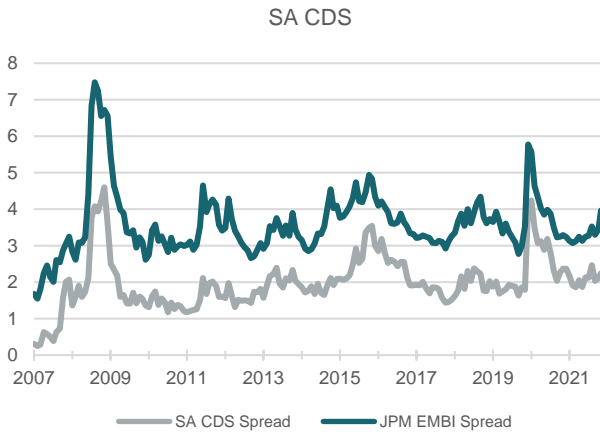
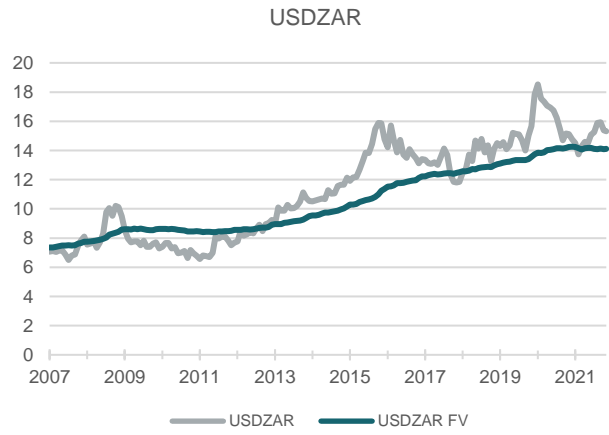
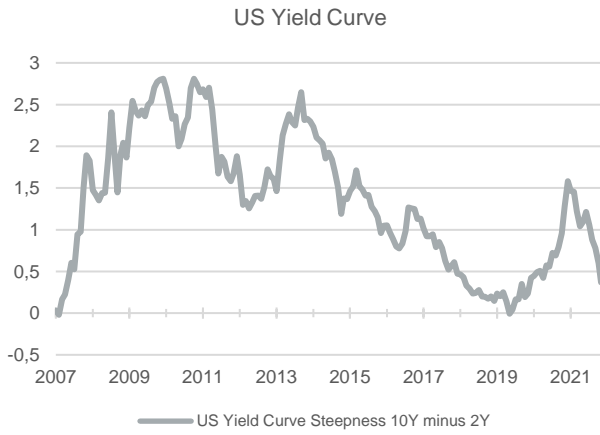


US Bond Yields



US Breakeven Rates







JSAPY Price to Book



SAPY Yield Gap



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