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European Select strategy: the case for quality investment

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- **2022's value rotation was a headwind for high-growth areas such as technology, in which the European Select strategy has greater weightings**
- **High quality companies should be better placed to weather a higher interest rate environment and recession, if it comes**
- **The strategy's long-term outperformance of the benchmark and our previous experience in recovering from short-term setbacks means we remain confident as we enter the last third of 2023**

The background for quality investment was tough over 2022, in both small and large cap areas. The context of growth versus value in the current environment is key, particularly the impact of interest rates and the risk of recession.

Our approach in the Threadneedle European Select strategy has a bias towards growth and not value – this is a key distinguishing feature of our style. The strategy's performance and structure correlates better with growth indices than with value, and analysis of the portfolio by specialists such as Style Analytics also bears this out. Reinforcing this is sector distribution: the portfolio has greater weightings in technology and consumer sectors and lower exposure to traditional value sectors such as energy, utilities and banks.

2022 saw a value rotation at the expense of growth stocks, although this has partly reversed in recent months. This hurt the strategy, much more so than competing funds with a "value" orientation. Reinforcing the earlier argument, the main sector in positive territory in indices was energy; the worst sectors were high-growth areas such as technology. As a result, the first half of 2022 was the most damaging in terms of relative performance.

The main reason for this rotation was the changing pattern of interest rates – a switch to tighter policies which was necessary to address inflation. These inflationary pressures came from supply chain bottlenecks, but most importantly from the effects of the Ukraine conflict – higher energy prices and shortages of key foodstuffs and other raw materials. The underlying impact on growth companies, in operational and profit-and-loss terms, was not the key factor. Growth stocks typically have stronger balance sheets and lower borrowings and as such suffer less impact from borrowing costs. Whilst higher interest rates may hurt, they hurt more for value stocks where they have more borrowings, creating an overall relative benefit for growth stocks.

However, the impact on performance from higher interest rates is more closely linked to valuation methodologies. The move to higher interest rates is paused in some regions, but the market is discounting some further rises in the future. This particularly affects those companies where discounted cash flow (DCF) models are used as long-term returns become less valuable if they are discounted at a higher rate. Effectively the market is forced to become shorter term in mindset, no longer able to grant high valuations for long-term sustainable business models with repeatable predictable earnings.

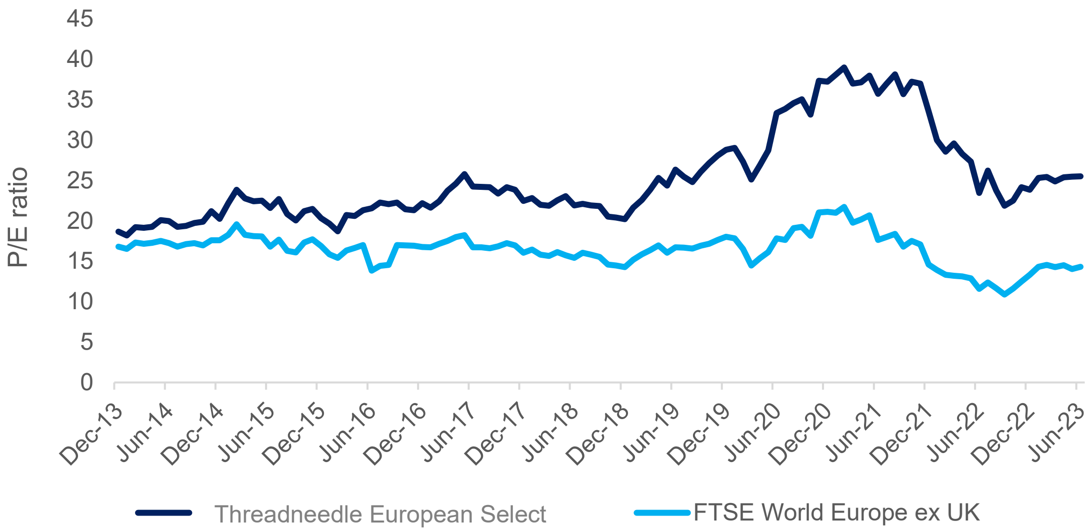
In the immediate future, our contention is that the overall picture looks brighter. Firstly, the impact of interest rate rises may well prove to be a one-off correction in valuation levels, much of which has already occurred. It has happened before, albeit cycles are never identical. Long term, valuation levels follow earnings and growth stocks – by definition – grow their earnings faster; they have just suffered as the value attached to these growing earnings has taken a knock.

There is perhaps another reason for optimism, at least in relative terms. Many commentators believe a global recession looms, and this is borne out by our macroeconomic analysis and thinking. In a recession, the riskier, less stable and more cyclical business models are likely to suffer disproportionately. Growth-type models with more sustainable returns, less vulnerable to the economic cycle, are likely to stand up better and because of this their earnings may well command a higher valuation.

Similar arguments can be made around the recent rise in inflation and its impact on the market. Higher inflation has been disruptive in the short term, hurting economies and some business models. It is a major, perhaps the only, cause of higher interest rates. Its impact on value stocks will be more painful than for growth stocks, and more specifically the type of growth stocks we hold. We have long had a focus on pricing power and its advantages, making detailed use of the Porter’s Five Forces model and economic moats analysis. The current macroeconomic environment makes this even more important. If we can find companies with pricing power, they can pass on increasing raw material and production costs to their customers with little adverse impact on their own sales or profitability. Value stocks will suffer if they are unable to do this. The inability to pass on higher costs to customers would squeeze margins, just as higher interest rates bite – so the risks mean that a valuation differential between high- and low-quality companies is deserved.

So, the outlook for growth and high-quality stocks may well be more attractive again. As discussed, our approach is more skewed towards such companies than the index; our focus on pricing power, economic moats and high-quality business models means we are more growth oriented. This means our portfolio appears more expensive in terms of price-earnings (P/E) ratios and other valuation measures, although the differential is not as wide as it was in mid-2021 (Figure 1).

Figure 1: Threadneedle European Select (representative account) P/E versus benchmark



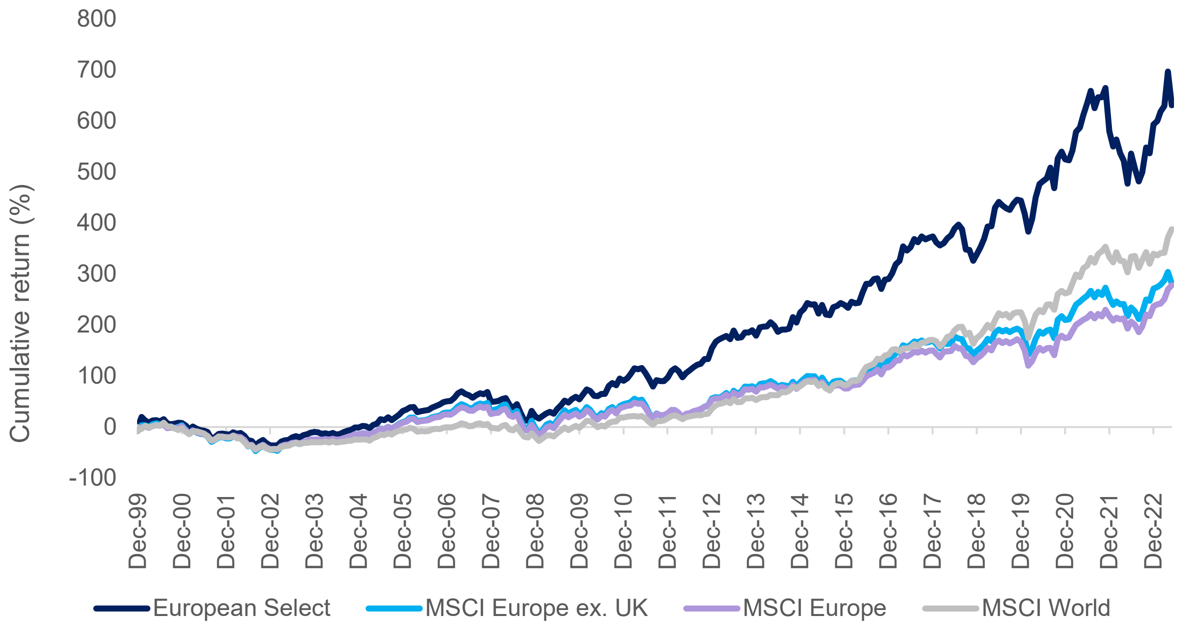
Source: Columbia Threadneedle Investments, July 2023

This translated – unfortunately but not unexpectedly – into disappointing relative returns over 2022. A reversal of all these trends, prompted by an end to the value rotation and an understanding that recession brings risks for fragile business models, may well act to our benefit.

Finally, the European Select strategy has been here before and recovered. In 2013 the value rally was prompted by the European Central Bank promising to “do what it must” to defend the euro. In 2016 the value rally was prompted by Brexit and the expectation that the surprising US election winner Donald Trump would reflate the economy. On both occasions the value rally petered out and our relative performance got back on track. This time the rotation has been more savage, but the likelihood of a recession (prompting renewed interest in high-quality business models) means it may well not continue. Q4 2022 and the first half of 2023 has already seen some reversion to quality, and some repair of our underperformance.

Figure 2 gives an indication of how we have achieved strong long-term returns for clients and have recovered after previous similar negative periods.

Figure 2: Cumulative returns of the European Select strategy since December 1999



Source: Columbia Threadneedle Investments/Bloomberg, January 2023. Past performance does not predict future returns. Calculated in USD and gross of fees. Gross of fee fund returns are time-weighted rates of return net of commissions, transactions costs and non-reclaimable taxes on dividends, interest, and capital gains using pricing of investments which is either the last traded price or a bid basis. Index returns include capital gains and assume reinvestment of any income. The index does not include fees or charges and you cannot invest directly in it

In conclusion, we clearly regret the underperformance in 2022, but our long-term record remains strong and recent returns should be viewed in this context. In an uncertain world, certainty should price at a premium, so we believe the European Select strategy is well-positioned to protect and bolster client portfolios.