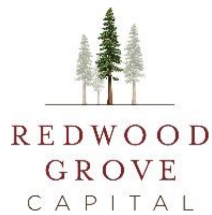

October 16th, 2017

Value and Growth

For the past several years, and year-to-date, growth stocks have outperformed value stocks. As value investors we've long held that valuation is a, if not the, key consideration. That holds especially true today as growth stocks are in an extended period of multiple expansion that started after the 2008/9 financial crisis. In the past year alone, the Russell 1000 Growth Index has increased from a P/E ratio of 23x to 27x while the Russell 1000 Value Index is unchanged at 19x. **In other words, investors paid a 20% premium for growth stocks a year ago and now pay a 43% premium. The gap in expectations between growth and value stocks has rarely been greater.** We believe that this will serve us well going forward. To put this in context, Redwood Grove's portfolio is valued at 14x forward earnings compared to the S&P 500 Index valuation of 18x.

Additionally, corporate profit margins have reached highs not seen since WWII. So high multiples are being applied to high margins, the inverse of what should happen if you believe, as we do, in mean reversion. This can partly be explained, as growth stocks benefit during periods of low interest rates, since future earnings have a higher net present value with a low discount rate. While the economic outlook seems benign after 8 years of economic expansion, reversion to the mean of both margins and multiples and the Fed's increasingly hawkish stance makes value stocks look more attractive prospectively.

Secular not Cyclical

One of the biggest challenges facing value managers today is identifying industries that are in cyclical not secular decline. The retail and coal sectors act as cautionary tales that mean reversion is not assured. Low multiples in a vacuum can dangerously mislead investors. Our focus on a company's business and competitive landscape helps us avoid secular value destruction. We incorporate many secular trends into our investment thinking, including themes related to AI, automated vehicles, cybersecurity, e-commerce and aging in developed countries. We believe the single most disruptive secular trend to the global capital markets over the next 20 years is our transition to a low carbon economy. We are loathe to use Silicon Valley's most overused word, disruption, but in this case it is appropriate.

The International Energy Agency estimates that over the next 22 years the global community will invest $9 trillion to decarbonize electricity and an additional $6.4 trillion in energy efficiency. The European Commission has estimated that to reach its 2050 carbon reduction goal, it will have to invest 270 billion euros or 1.5% of GDP annually. These large swings of capital do not necessarily represent an increase in total capital spend, rather a shift in how it is allocated. That shift will drive growth in a broad array of industries even if global expansion is modest.

Public Equity Climate Change Risk

The public equity market will be impacted by climate change. The economic implications will vary depending on four main factors: technological innovations and their cost curves, changing consumer behavior patterns, global, federal and state regulations, and the physical implications of climate change including resource constraints.

Divesting fossil fuels is a noble approach to de-risking an investment portfolio. But carbon risk unlike the focus of previous divestment movements, (tobacco, guns or geo-political risks,) does not stop at the doors of the producers or the country's borders. Carbon is a necessary energy source today and touches every single industry. In fact, industries that are significant consumers of fossil fuels and producers of greenhouse gas emissions, such as Chemicals, Metals, Truck and Auto manufacturers do not show up on most divestment lists. And, of course, almost all companies and consumers are responsible for some carbon footprint.

Hank Paulson best articulated the growing imbedded risk of climate change in investment portfolios in his 2014 New York Times Op-Ed, "It is easy to see the similarities between the financial crisis and the climate challenge we now face. We are building up excesses (debt in 2008, GHG emissions now). Our Government policies are flawed (incentivizing us to borrow too much to finance homes then, and encouraging the overuse of carbon-based fuels now.) Our experts (financial experts then, climate scientists now) try to understand and explain what they see and to model possible futures. And the outsized risks have the potential to be tremendously damaging (to the globalized economy then, and the global climate and economy now)."

And while the impacts of climate change will be felt across asset classes, public equities may represent the greatest unpriced risk and opportunity. Mercer completed a portfolio level analysis for CALSTERS in 2016 and concluded that in a scenario where we kept global temperatures below 2 degrees Celsius, the area of greatest risk to climate change was to their developed markets equity exposure.

Our Approach: Concentrated, Diversified, Value based on Long Term Fundamentals

At Redwood Grove, we do not invest just in clean tech or "climate solutions," nor do we draw a line around any specific industry and exclude it. Instead we rely on a bottoms-up analysis of a company's business, management, and valuation in conjunction with an analysis of its climate strategy, c-suite commitment, and the economic exposure to climate change. Many investors ask us how we frame the investable landscape. Broadly speaking, we divide the public equity market into four main groups: Direct Negative, Indirect Low, Indirect High, and Direct Positive.

Direct Negative companies are in industries where the core business is the extraction, refining or distribution of fossil fuels. In these companies, the transition to the low carbon economy represents a fundamental secular risk to the business. In contrast, Direct Positives are companies that are clearly in the way of the transition and will see growth even when the broader economy experiences little growth. Interestingly, when climate risk/opportunity is clearly associated with a company, it is often reflected in the stock multiple. One need only compare Tesla's P/E to Arch Coal's P/E to see that the low carbon economy's secular trend is impacting the valuation. However, not all beneficiaries are as obvious or have as charismatic a leader as Elon Musk.

Between the Direct Negative and Direct Positive groups are the most companies and the majority of the economy. The main distinction is the materiality of the economic impact of the transition. Indirect Low companies, like Healthcare or Finance, have less economic exposure to carbon while Indirect High names, like transportation and industrials, have material economic exposure. Currently, 30% of the portfolio is invested in Indirect Low, 35% Indirect High, 10% in Direct Positive and 25% cash.

A name we've highlighted in our past letters, General Motors, has significant business risk to a low carbon future, but has distinguished itself from its peers by proactively pivoting its business model toward both the electric and automated vehicle. The stock price moved up 25% over the past few weeks, in part due to better-than-expected sales numbers, but also because of GM's competitive advantage in the electric vehicle space. It's good to see the market beginning to take notice of GM's leadership. We know there are many more companies whose leadership and strategic advantages for the transition to the low carbon economy are still being overlooked by the broader market.

If you have any questions, please do not hesitate to reach out to us at IR@redgrovecap.com