

The Coming Bull Market in Value Investing

This article is authored by MOI Global instructor Glenn Surowiec, portfolio manager at GDS Investments, based in West Chester, Pennsylvania.

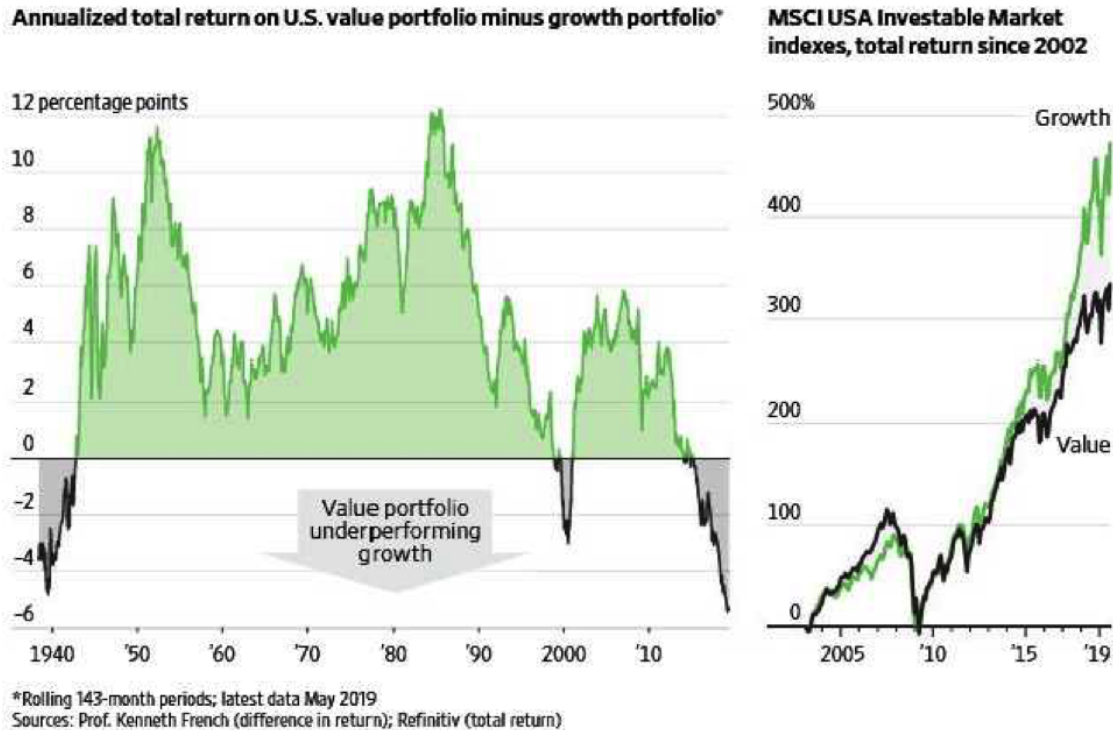
For some time, we included in our Mid-Year Letters and Year-End Letters our insight about the political environment and government tension which have characterized the last several years of American life. We consistently strove to remind ourselves that the shenanigans and political tension on display in Washington and state capitols were a sideshow. We reminded you that sideshow was, ultimately, separate and apart from the nation's financial health and that investors should look beyond the turmoil with an eye on long-term gains and confidence that the best of American businesses are resilient beyond the tweet storm *du jour*.

Though each daily news cycle tests those propositions, we remain confident in the long-term fundamental strength of the American economy. Over the next 17 months America will undoubtedly experience politically-based turbulence unlike anything seen in more than a generation. That turbulence will occasionally create ripples through the stock market. We will, without question, hear attacks on the competency and intelligence of the Federal Reserve and its Chairman along with daily commentary on the fairness of the country's various trade relationships. The course which GDS Investments has laid out through the end of 2020 does not ignore those factors but, rather, uses them to aid in our always ongoing search for high quality companies selling at discounted prices (*i.e.* "value" investments).

Although we remain upbeat about the long-term strength of the U.S. economy, we do have several concerns after the decade long period of the current expansion. Presidential election cycles create a "pump the primer" environment in which interest rates are kept artificially low. That, coupled with the tidal wave of cash caused by the Tax Cuts and Jobs Act of 2017, will continue to fuel the current bubble in growth (*i.e.* index) stocks.

Unfortunately, the market is still largely comprised of "buy high - sell low" investors who habitually pour money into stocks which have gone up and just as habitually withdrawal money from stocks which have gone down. The risk of the bubble to growth equity and bond investors over the next decade comes from the fact that interest rates and inflation will gradually move higher as the government's accommodative monetary and fiscal agenda moves to the sidelines. When that happens, as it did in all prior growth bubbles, investors who bid-up growth stocks will find themselves on the wrong side of the equity cycle.

As you can see from the following chart which appeared in *The Wall Street Journal* on July 15, 2019, history favors a value investing mentality. Because of the current growth stock bubble, the relative attractiveness between growth stocks and value stocks hasn't been as wide as it is now. That difference prompted JP Morgan & Co. to recently declare a "once-in-a-decade opportunity" to wager on value stocks with the current valuation gap being "the largest relative valuation bubble in modern equity market history."



Source: The Wall Street Journal.

This opportunity is not lost on GDS Investments. We have filled client portfolios with “best of breed” companies which have leading market positions, growing and durable brands, and balance sheets which are built to withstand all economic environments. Despite the fact that the growth-oriented broader averages (S&P 500) hit new highs this year, the funnel of high-quality yet inexpensive “value” stocks has widened considerably over that period. If history is any guide, value stocks will be the winning bet over the next decade.

Before our discussion of some of GDS Investments’ individual positions, we offer our commentary on the Trump Administration’s trade-related policies and note our (and any free-market capitalist’s) distaste for the use of tariffs (real or threatened), especially as a tool for implementing non-economic policy.

We do not think that the Senate or the business community would have allowed immigration-related tariffs against Mexico to remain in-place long-term. We are concerned, though, that the Administration was so willing to weaponize for non-trade purposes a trade-related tool... and one which does not enjoy a high rate of success. Had Mexico not allowed the President to save face and back-down from his bellicose rhetoric, large portions of the United States economy would have suffered from misguided tariffs at the southern border.

One nation which will not be so deferential to the President is China.

As a practical matter, we cannot expect that China will move overnight from the preferential trade

policies, which it enjoyed while a developing country, to policies that put it on a level playing field with the United States.

Any rational observer must conclude that many of our trade agreements with China are outdated, having been negotiated when China represented less than 2% of global GDP. China, of course, now represents approximately 16% of global GDP. With its ever-increasing percentage of the world economy, China has little incentive to move quickly and/or be bullied into agreements which aren't in its long-term best interests.

In as little as a decade, China will own a larger percentage of the global GDP pie and, as such, will be more able to dictate trade terms to the west. With the benefit, then, of past policies and future growth, China is able to focus its present economy on supporting growth sectors and green development opportunities. Meanwhile, and of greater concern, the United States is looking back to the 20th Century by attempting to prop up "zombie" industries like coal. These factors make China a country that will not bend easily to the President's bellicosity.

With China on the mind, we turn to Chinese internet search firm Baidu, Inc. (NASDAQ: BIDU). At a price of approximately \$115.00 per share, the company's stock is at a 6-year low after it reported its first ever publicly-traded quarterly loss.

Interestingly, that loss is largely attributable to one factor: the company's higher-than-normal operating costs during the first quarter when Baidu served as the main sponsor of the 2019 CCTV Chinese New Year Gala. In terms of television viewership, that gala is something like producing ten Super Bowl-level events all at one time. In a win for the company, though, and despite the high costs it incurred, Baidu doubled its daily active users. That, of course, should lead to better top-line results in the future.

To the extent other factors influenced the unexpected weakness in Baidu's bottom-line results we can point to the company's 58% ownership in iQIYI, Inc. (NASDAQ: IQ), a Netflix-like on-demand video streaming service and 19% ownership of Ctrip (NASDAQ: CTRIP). Collectively these two holdings comprise roughly 30% of BIDU's current market capitalization.

With clear leadership in search, video streaming, AI and autonomous vehicle technology, Baidu is one the best and cheapest ways to gain access to these emerging growth technologies. Though the YTD performance of this company is disappointing, we remain optimistic about its long-term prospects.

We are likewise optimistic about two other China-based investments in the GDS Investments portfolio: Alibaba Group Holding Limited (NYSE: BABA) and BYD Company Limited (OTC: BYDDF). Both companies are superbly positioned over the next decade as leaders in their respective industries.

Another core holding with exciting turnaround prospects is General Electric Company (NYSE: GE). There, Larry Culp and his team continue to improve the balance sheet and position the company for growth by restructuring and stabilizing GE Power while accelerating the strengthening of GE Aviation and GE Healthcare. During the Q1 conference call and later investor presentations, corporate leadership suggested that 2019 will be a "reset year" with a return to positive free cash flow in 2020 and an acceleration of this metric in 2021. To achieve those goals, the company will focus on margin improvement, better overall execution, and the continuation of business simplification through corporate separations.

In that regard in late-February, General Electric agreed to sell GE Biopharma to Danaher Corporation (NYSE: DHR) for \$20B in a net cash sale which should close in Q4 2019. In other restructuring news, General Electric's merger of GE Transportation with Westinghouse Air Brake Technologies

Corporation (NYSE: WAB) is closed. In that transaction, General Electric received \$2.9B in cash and 24.9% equity ownership of Wabtec. Furthermore, and as we noted in previous letters, we would not be at all surprised if other transactions are announced over the next 12-18 months. We remain mindful of the possibility that GE Healthcare may eventually be spun-off into a separate company.

Finally, our bullish outlook on General Electric is supported by the recent recovery of the company's publicly traded bonds, all of which are up significantly this year. That recovery is a sign that investors are becoming more comfortable with Mr. Larry Culp's turnaround and ability to generate meaningful cash flow in future years.

In the first half of 2019, we continued our position in QUALCOMM Incorporated (NASDAQ: QCOM). The big news for this company is that it and Apple, Inc. (NASDAQ: AAPL) agreed to a comprehensive global settlement of all litigation between the two companies. Pursuant to that settlement, Apple will make a one-time payment to Qualcomm (which is estimated to be between \$5B and \$6B) and obtain a new six-year license. Immediately following the settlement, Qualcomm increased its Earnings-Per-Share run-rate by \$2.00 share. Based on previous unit demand quantities, that increase implies that Apple is paying a royalty rate of roughly \$9.00 per iPhone.

In settling with Qualcomm, Apple acted in its own best business interests. Over the years, Qualcomm built a massive research and development operation. Facing down that operation, Apple was very likely never going to be able to create an in-house modem business quickly enough to stay inside the 5G growth curve. Meanwhile, Apple's other modem supplier, Intel Incorporated (NASDAQ: INTL), was losing money in that field and years behind Qualcomm's rollout schedule. Indeed, so field-changing was the Apple-Qualcomm settlement that, the day after its announcement, Intel stated its intention to altogether exit the smartphone 5G modem business. Then, in mid-July, Intel announced that it would sell its modem patents and other related assets to Apple for \$1B. That move strongly suggests that, even while it enjoys the benefits of its license arrangement with Qualcomm, Apple may try to develop internally its own 5G modem technology.

The market responded quite favorably to the Apple-Qualcomm settlement... the company's share price increased more than 50% within days after the settlement was announced. Frustratingly, a portion of the gain coincided with a flurry of negative headlines about the company. Those headlines included postponement of the United States-China trade deal and an unfavorable ruling by a U.S. District Judge about Qualcomm's licensing practices in the computer chip market. Qualcomm appealed that ruling and several government agencies have come out publicly in support of Qualcomm's business practices.

All of the recent headlines about Qualcomm have generated some higher than normal volatility for the stock. At a recent price of \$75/share, and with over \$7.50-\$8/share in core EPS, we intend to hold the position until some of the uncertainty dissipates and a higher multiple ensues.

Another of GDS Investments' positions was DowDuPont, Inc. (NYSE: DWDP). Before the voluntary break-up of the company, DowDuPont was the largest chemical conglomerate in the world with over \$86B in sales in 2018. Now, the former components of the company are trading as three separate and independent businesses. Those are (1) Dow, Inc. (NYSE: DOW) (which will now focus on commodity chemical production), (2) DuPont de Nemours, Inc. (NYSE: DD) (which will now focus on specialty chemical production), and (3) Corteva, Inc. (NYSE: CTVA) (which will now focus on agricultural chemicals).

All conglomerates are prone to bloat and suffer under their own weight. That is especially true when, like DowDuPont, a company has distinct products, distinct customers and distinct supply chains. To overcome that fate, DowDuPont chose to break itself into three distinct businesses.

After that separation, we divested Dow from the GDS Investments portfolio. The nature of the products which a stand-alone Dow sells require high volumes with low margins and a very limited ability to raise prices beyond market rates... in other words, it is a classic commodity business. Our objective is to own high-quality companies which are undervalued in the market. We concluded that the stand-alone Dow is not such a company and sold our holdings. We then used the proceeds to purchase more shares of DuPont. That purchase allows us greater exposure to DuPont and the (as-of-then) not-yet spun off Corteva business.

When Corteva was spun off on June 1, 2019, DuPont shareholders received one share of Corteva for every three shares of DuPont which they owned. The remaining legacy DuPont (which boasts \$23B in annual sales) is now listed under ticker symbol DD and sells lower volume/higher margin plastics and adhesives typically used in auto, consumer goods, and electronics end-markets. The company's better margin profile is the result of intellectual property and specialized manufacturing processes which its competitors just don't have.

Corteva, meanwhile, produces specialized agriculture chemicals which have FDA approval (similar to prescription drugs) and maintains a duopoly position in the domestic seed market (Bayer AG ADR (OTC: BAYRY) and Corteva control roughly 60% of the domestic market). The company begins its new life with \$14.3B in global sales, \$2.8B in EBITDA, and expected growth of 6%-10%.

The mechanics of Corteva's spin-off left the company with cash on the balance sheet which should exceed \$2B by the end of 2019 and make the company attractive in an agricultural industry which has seen a lot of merger activity over the past several years. We see every reason to continue to hold Corteva and, if possible, take advantage of that activity in the future.

Finally, we note other positions which we sold since our 2018 Year-End Letter. We divested Exxon Mobil Corporation (NYSE: XOM), Schlumberger Limited (NYSE: SLB), and FireEye Inc. (NASDAQ: FEYE). Doing so allowed us to take advantage of the availability of other companies with comparable underlying quality but at much more discounted prices.

The political turmoil which grips America right now will continue through at least November of 2020. Meanwhile, the bubble in growth stocks which is being fed by cheap money is coming to an end. In that environment, GDS Investments will maintain its steady course of value investing... always looking for quality, but undervalued, opportunities while growing increasingly bearish on growth stocks and Fed-induced cheap credit. Because of the current generational valuation disparity between growth and value stocks, the expected payoff for owning the cheapest quartile of the market has not been this high in many decades. That is where we will continue our efforts.