Investment Strategy
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By **Rory Palmer**

“We are not single-outcome investors”: The value perspective in difficult market conditions

Remaining disciplined and using periods of volatility to find opportunities are key tenets of the US Value Team at Artisan Partners.

Valuations in parts of the market are favorable for some investors, offering a chance to buy-in to companies at a time when they are trading below intrinsic value.

However, the current macro environment and corporate earnings landscape may prove difficult for stocks.

Critics have warned that the bear market is not over yet, and stocks could fall further. This, coupled with the danger of value traps offer a precarious route for investors.

That said, the value trade has enjoyed a resurgence over the last two months. The MSCI ACWI Value Index has returned 10.7% since 20 June and is up 5.4% year-to-date in GBP.

Investment Strategy spoke to the US Value team at Artisan Partners for their thoughts on the current outlook and how advisers can navigate through for their clients.

Attractive price, but avoid the traps

Daniel Kane, managing director and portfolio manager on the US Value team, said: “Investors should expect higher long-term returns at today’s prices compared to those several months ago. However, the attractiveness of the buying opportunity isn’t obvious when you examine historical valuations and interest rates.”

Therefore, despite broad US equities still selling at above-average multiples, there are still pockets of value.

“Attractive valuations catch our attention, but we want to avoid value traps—the stocks that are cheap for a reason.”

Long-term prosperity, Kane added, can be found in the free cash flow generation, and return of capital capabilities in a business.

“Focusing on these elements helps us avoid the cheap-for-a-reason stocks,” he said. “It helps ensure that we have a business where value can accumulate and move forward over time.”

Advisers will look to build in a margin of safety—or the difference between the intrinsic value of a stock and its market price—when building portfolios.

Kane said Artisan look for three criteria when it comes to margin of safety: attractive valuation, sound financial condition and attractive business economics.

He added: “What’s inherent in each of these elements is a high level of risk awareness. We think that’s an important overlay in value investing. You can’t be risk adverse. You have to be willing to take risk as an investor.

“But you can choose to avoid extreme risk, and you can choose to make sure you’re focused on getting properly compensated for the risks you do involve yourself with.”

Getting away from fair value

It is key, therefore, to understand why companies drift away from fundamental value.

“Our view is this really only happens when there’s fear and uncertainty priced into share prices, so rather than run from fear and uncertainty, we are going to be attracted to this weakness to find opportunities,” said Kane.

During the bull run of the pandemic, growth stocks saw price-to-earnings levels soar. Detaching prices from inherent value, the high levels were based on the assumption that someone else was prepared to pay a higher price.

Craig Inman, managing director of Artisan Partners and portfolio manager in the US Value team, said the 'Fed put' subsidized the market—encouraging prices to drift substantially from fair value.

"We saw evidence in that with everything from SPACs to Crypto and NFTs," he said. "These asset prices went up as people believed that someone else would pay a higher price, regardless of any intrinsic value—this is the central principle of any Ponzi scheme."

This was not limited to speculative areas of the market and equities experienced wild swings in valuations.

"As disciplined value investors, this environment presents a greater opportunity. Fear in the market means many market participants sell stocks with the same emotional magnitude as their fervor led them to bid other stocks well beyond any notion of value," said Inman.

'We don't invest based on a specific scenario playing out'

Thomas Reynolds, also managing director of Artisan and manager on the US Value team said the rest of the year presents a wide range of outcomes for investors.

"There's been significant volatility in interest rates, foreign exchange markets and emerging market debt, amid generational-high inflation, supply chain problems, a war and food and energy supply shortages," he said.

"These problems are related but are likely to resolve individually. We are not single-outcome investors. We don't invest based on a specific scenario playing out and are always mindful of economic diversification when we invest and as we construct the portfolio."

Indeed, Covid is an apt example of investing to protect against a specific scenario playing out.

"We seek to use fear and uncertainty to our advantage, coupled with a long-term time horizon, to generate excess returns across the market cycle,"

Reynolds said rather than trying to forecast the pandemic and position for a certain outcome, Artisan did what they could—created a diversified portfolio of businesses with strong fundamentals and low correlation to the macro-outlook.

"The bottom line is we welcome periods of volatility as our odds of finding investments which meet our margin of safety criteria increase when markets shift from risk-seeking to risk-fearing modes.

"We seek to use fear and uncertainty to our advantage, coupled with a long-term time horizon, to generate excess returns across the market cycle," he said.

This article represents the views of Investment Strategy and Artisan U.S. Value team portfolio managers Tom Reynolds, Craig Inman and Daniel Kane, managers of the Artisan Value Fund, Artisan Value Income Fund, and Artisan Mid Cap Value Fund; as of August 17, 2022, and those views and opinions presented are their own. Artisan Partners is not responsible for and cannot guarantee the accuracy or completeness of any statement in the discussion. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation. This material is provided for informational purposes without regard to your particular investment needs. This material shall not be construed as investment or tax advice on which you may rely for your investment decisions. Investors should consult their financial and tax adviser before making investments in order to determine the appropriateness of any investment product discussed herein.

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Definitions: **Margin of safety**, a concept developed by Benjamin Graham, is the difference between the market price and the estimated intrinsic value of a business. A large margin of safety may help guard against permanent capital loss and improve the probability of capital appreciation. Margin of safety does not prevent market loss—all investments contain risk and may lose value. **Return on Equity (ROE)** is a profitability ratio that measures the amount of net income returned as a percentage of shareholders equity. **Return of Capital** is a return from an investment that is not considered income. **Price-to-Earnings (P/E)** is a valuation ratio of a company's current share price compared to its per-share earnings. A **special purpose acquisition company (SPAC)** is publicly listed company formed for the express and sole purpose of raising capital via initial public offering in order to acquire a separate, existing company at a later date. **NFT** is a non-fungible token consisting of digital data stored in a blockchain.

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