# Pzena Investment Management

## First Quarter 2016 Commentary

**We are well advanced in a classic value cycle defined by oversupply in energy, commodities and capital equipment. Prevailing valuations provide a good environment for value investing.**

### Introduction

As value investors, we notice when extremes emerge and valuations become provocative.

We believe we are at one of those points.

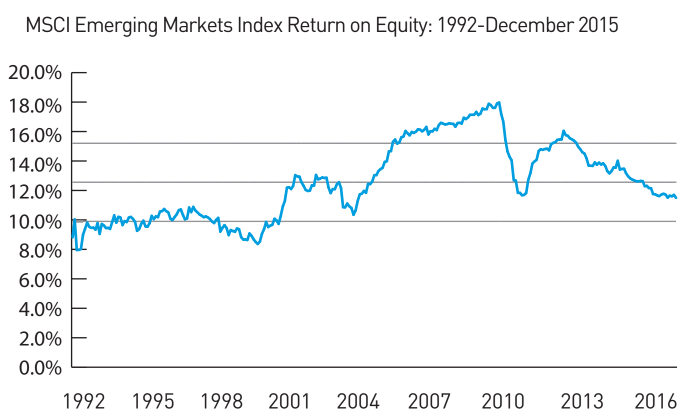
Value stocks have significantly underperformed over the last five years (Figure 1) and are now much cheaper than usual throughout the world. Value has suffered in the U.S. since April 2011 even though the economy has been expanding since 2008. The link between the economy and the value cycle in the developed world seems to have broken down. Although oil has captured the headlines since 2014, all commodities and many industrials have plunged. This has caused investors around the world to seek safety and certainty, driving down valuations of value stocks.

**Figure 1: Value Has Underperformed Growth**
**Trailing 5 Year USD Returns Through March 31, 2016**

| | MSCI World | Russell 1000 | MSCI EAFE | MSCI Europe | MSCI Emerging Markets |
|---|---|---|---|---|---|
| Value Index | 5.2% | 10.3% | 0.8% | -0.4% | -5.9% |
| Growth Index | 7.8% | 12.4% | 3.7% | 4.3% | -2.5% |
| Value Underperformance | -2.6% | -2.1% | -2.9% | -4.7% | -3.4% |

Source: MSCI, Russell.

**Figure 2: The Five Year Slide in Emerging Market Profitability**




Source: Sanford C. Bernstein & Co., Pzena Analysis

### How We Arrived Here

The last period of value underperformance started in March 2007 reflecting the U.S. housing collapse and subsequent financial crisis. Aggressive monetary and fiscal intervention provided massive liquidity to unfreeze the financial system and stimulus to mitigate a collapse in aggregate demand. Unnatural forces of quantitative easing followed and are still with us. China also pumped massive stimulus into its economy in the form of capital investment, propping up emerging markets and commodity-based economics.

Although the recovery (pro-value) phase of the cycle started in December 2008, it lasted only 28 months, cut short in March 2011 before value could reach its full potential, as China toned down its fiscal stimulus and interest rates plunged to zero, rendering banks unable to earn an adequate return in spite of improvements in credit quality and capital levels. Company profitability has been sliding in emerging markets ever since (Figure 2). As a result, it was the shortest U.S. value cycle in the last 50 years, and the only instance where value failed to outperform across the entire cycle (Figure 3).

**Figure 3: The Last Value Cycle Cut Short**
**Performance of Deep Value* vs. S&P 500****

| | Deep Value | S&P 500 | Relative Performance | # Months |
|---|---|---|---|---|
| Feb '69 - Jun '73 | -8.3% | 19.3% | -27.6% | 53 |
| July '73 - July '79 | 206.9% | 30.4% | 176.4% | 73 |
| Full Cycle (Annualized) | 10.4% | 4.3% | 6.1% | 126 |
| Aug '79 - Nov '80 | 17.4% | 45.6% | -28.3% | 16 |
| Dec '80 - Aug '88 | 414.7% | 160.7% | 254.1% | 93 |
| Full Cycle (Annualized) | 21.9% | 15.8% | 6.1% | 109 |
| Sep '88 - Oct '90 | -16.2% | 25.1% | -41.3% | 26 |
| Nov '90 - Aug '95 | 247.9% | 113.2% | 134.6% | 58 |
| Full Cycle (Annualized) | 16.5% | 15.1% | 1.5% | 84 |
| Sep '95 - Feb '00 | 71.8% | 163.0% | -91.2% | 54 |
| Mar '00 - Feb '07 | 187.5% | 15.5% | 171.9% | 84 |
| Full Cycle (Annualized) | 14.9% | 10.1% | 4.8% | 138 |
| Mar '07 - Nov '08 | -56.3% | -33.4% | -22.8% | 21 |
| Dec '08 - Mar '11 | 130.9% | 55.9% | 75.0% | 28 |
| Full Cycle (Annualized) | 0.2% | 0.9% | -0.7% | 49 |
| Feb '69 – Mar '11 (Annualized) | 14.0% | 9.7% | 4.3% | 506 |
| Current Cycle | | | | |
| Apr '11 – Mar '16 | 36.9% | 74.2% | -37.3% | 60 |

*Cheapest quintile price-to-book of the ~1,000 largest U.S. stocks. Does not represent specific performance of any Pzena service.
**Cap-weighted data.
Source: Sanford C. Bernstein & Co., Pzena Analysis

We believe the causes for this downturn are related to a classic case of overinvestment, whereas the 2008 global downturn was exacerbated by a financial crisis. In a way, the current downturn can be viewed as the last act of a protracted global cycle that started with the U.S. financial crisis and ends with the rollover of emerging markets.

### The Emerging Markets Slowdown and the Value Stock Downturn are Well Advanced

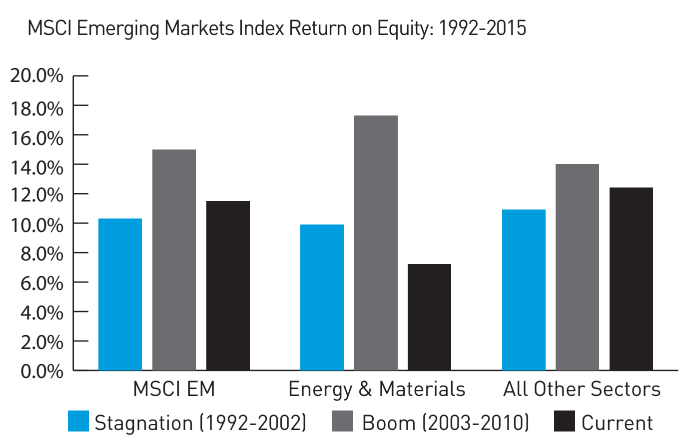
China is the only economy where as much as 50% of GDP remains driven by capital investment, compared to roughly 20% in developed economies. Given this intensity, the waning stimulus has resulted in serious headwinds to cyclical businesses worldwide. The profit deceleration in emerging markets has now been grinding on for almost five years. Deconstructing returns by sector, we see an even clearer picture: the boom/bust cycle has been driven almost entirely by energy and materials where the drop has been particularly acute, with other sectors – including consumer – virtually unaffected (Figure 4).

### Commodities Have Already Troughed

Investors fear a further collapse in capital spending that will lead to global recession, but the evidence suggests that the collapse is well underway. We see this across oil & gas, the highest-profile example of over-investment, but it is also observable in global mining and capital equipment sales in general. It is hard to know with certainty at what point the cycle has bottomed, but as investors wait for the proverbial "other shoe" to drop, to a high degree it already has.

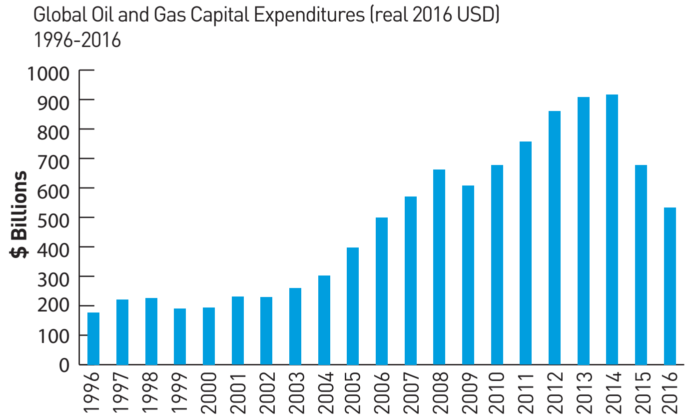
Global oil & gas capital spending has fallen a whopping 40% in the last 18 to 24 months (Figure 5). Although the industry invested less in 1996 through 2004 than current levels, the earlier period started with approximately 25% excess supply of oil, versus today where we estimate global oversupply at 2% to 3%. Rig counts have fallen from 3,500 to 1,500, more than halfway to zero. We also see these trends in the hard commodities (Figure 6) and suppliers of heavy equipment to the sector. Capital equipment sales have declined in each of the last two years (Figure 7); consensus estimates for 2016 indicate an expectation that the decline may already be over.

**Figure 4: Severe Profit Downturn in Commodities, Energy and Industrials**



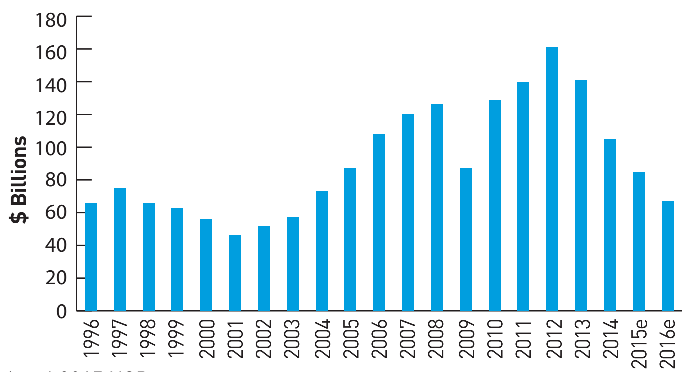

Source: Sanford C. Bernstein & Co., Pzena Analysis

**Figure 5: 40% Decline in Oil & Gas Capital Investment**




Source: Rystad Energy, Pzena Analysis

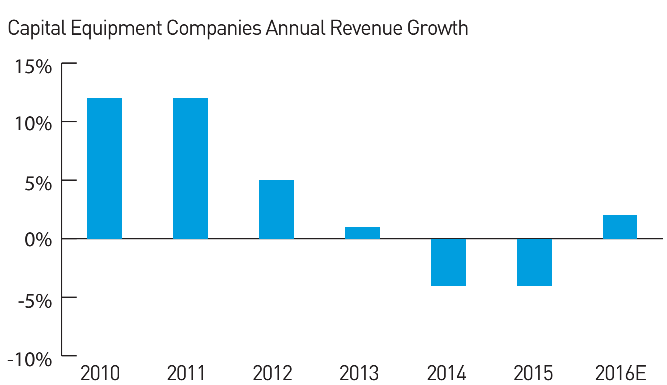
**Figure 6: Global Mining Capital Expenditures***




*real 2015 USD

Source: UBS, Reserve Bank of Australia, Pzena Analysis

**Figure 7: Decline in Capital Equipment Sales**

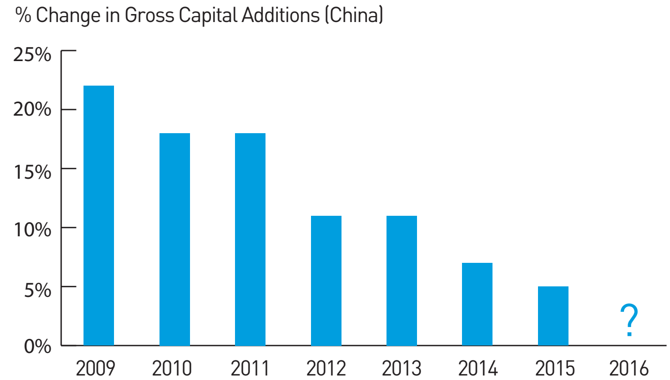



Capital equipment stocks drawn from Pzena Global Value Universe (2,000 largest stocks)

Source: Capital IQ, Pzena Analysis.

There is almost irrefutable evidence that China's growth in capital stock has slowed dramatically, and has been for the past six years (Figure 8). Even if one discounts official data from the Chinese government, the fall in steel, power, and cement consumption corroborate the trend. Worries about a dramatic slowdown in China appear somewhat belated.

**Figure 8: Growth in Chinese Capital Stock has Slowed Dramatically**



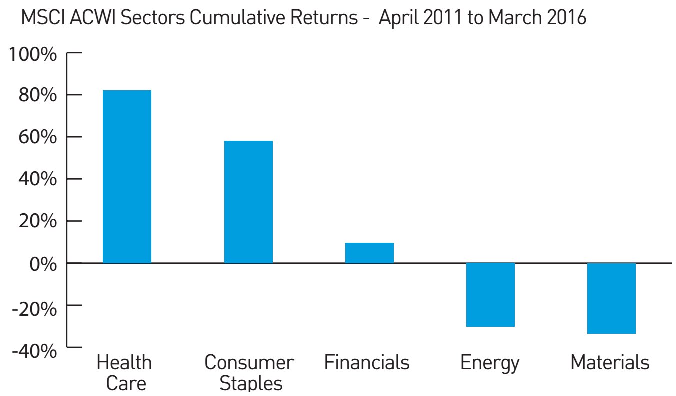

Source: CEIC, NBS Statistics Yearbook, CLSH, Pzena Analysis.

## Conclusion

Valuations of banks, energy, commodity, and many capital equipment stocks are at unusually deep discounts. The entire world appears to have gone "risk-off," elevating safe sectors and growth at the expense of capital cycle businesses (Figure 9). We believe the key is to invest in companies that can win regardless of whether there is an upturn in China demand growth. It is impossible to know when the bottom of the cycle occurs except in hindsight, but the shift to a pro-value recovery phase can happen quickly. These pro-value phases have historically lasted for multiple years and provided extended periods of outperformance as earnings recovered, sentiment improved, and beaten down stocks were re-rated.

Although the cycle has taken longer than usual to play out, we believe the ability of value to deliver excess returns remains intact. As long as human emotions drive investors away from uncertainty - this cycle no exception - it creates opportunities for the long-term, patient investor to exploit undervaluation. ■

**Figure 9: Cyclical Sectors Hard Hit in Flight to Safety**




Source: MSCI, Pzena Analysis.

## DISCLOSURES

*Past performance is no guarantee of future results. The historical returns of the specific portfolio securities mentioned in this commentary are not necessarily indicative of their future performance or the performance of any of our current or future investment strategies. The investment return and principal value of an investment will fluctuate over time.*

*The specific portfolio securities discussed in this commentary were selected for inclusion based on their ability to help you understand our investment process. They do not represent all of the securities purchased, sold or recommended for our client accounts during any particular period, and it should not be assumed that investments in such securities were, or will be, profitable.*



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