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Q&A

With New Perspective Portfolio Manager Steve Watson

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FOR PROFESSIONAL INVESTORS ONLY

Contrarian value investor Steve Watson gives his take on global stock markets

Steve Watson

Equity Portfolio Manager
Based in Hong Kong
30 years of investment experience
(as at 31 December 2017)

With 12 years of experience on the New Perspective strategy and 30 years in the investment industry, Steve Watson is no stranger to market cycles and is constantly seeking to take advantage of changing global secular trends. In this Q&A, he shares his thoughts on global markets and describes his investment style. Key conclusions are as follows:

- Despite some headwinds, the overall outlook for global equities remains positive in the near term.
- Herd behaviour in stock markets can often lead to mispricing opportunities for contrarian, value-oriented investors.
- On-the-ground, globally integrated research offers a basis for identifying secular trends.

1. What is your outlook for global equities?

Many people are talking about the end of the bull run in stocks. The nine-year bull market is being threatened by high valuations, rising interest rates and geopolitical uncertainty, they say. Some are suggesting that it is time to raise cash. Others propose selling growth-focused companies and seeking safe harbour investments.

I beg to differ. US equity valuations have indeed gone up but many markets around the world remain attractively valued. Emerging market stocks, for example, look set to offer better long-term returns compared with the Standard & Poor's 500 Index, simply because of their relatively low starting valuations.

Also, while we are probably in the final phase of a fairly synchronised global expansion, I think that may have some time still to run. Rather than build their businesses organically, companies had been storing away cash, or using it for share buybacks and mergers and acquisitions. They have really only started investing again in their own productive capacity in the last year or two. I think that growth can continue for a while, which is why I am fully invested and hold very little cash.

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2. But what about the headwinds facing equity markets?

Don't get me wrong. Headwinds are everywhere. They always are. There are clearly rising trade tensions, particularly between the US and China, as the ideal of free trade is being questioned. Continuing volatility in share prices partly reflects this uncertainty. A full-blown global trade war could be challenging for stock markets but I am perhaps more optimistic than most about countries' ability to resolve their differences.

It is also worth remembering that much of the focus on trade disputes has been on the trade in physical goods. The flow of data and capital across borders, on the other hand, continues to expand at dramatic rates. That should remain a powerful motor of growth for the world economy. Many of the strong, multinational companies that are held in the New Perspective portfolio, including Alphabet, Microsoft and JPMorgan Chase, are engaged in data or capital flows and could prove resilient.

And while we are in a period of rising interest rates, history tells us that higher rates need not be bad for stock prices – unless rates rise too quickly. I believe inflationary forces will stay muted for some time. Accordingly, interest rate hikes are likely to remain gradual.

So overall, there are still things that could go wrong but, in my view, they are unlikely to derail equities' bull run. As the saying goes, bull markets always climb a wall of worry. I am cautiously confident that stocks will continue to move higher over the next couple of years. As a bottom-up investor, my focus is on individual companies. And as a contrarian, value-oriented investor, I avoid companies where there is excessive optimism and seek out those that appear undervalued because of excessive pessimism.

3. Can you elaborate on your contrarian, value-oriented investing approach?

I believe we can capitalise on the mispricing in stock markets that arises when sentiment is overly optimistic or overly pessimistic. Often, these cycles stretch over a relatively long period of time, which suits me well given my long-term investment horizon. I identify companies that the market is uncomfortable with, or whose potential is underestimated, and I hold them until their full value is realised. Let me give you a couple of examples.

Brazil's Vale is one of the biggest metal and mining companies in the world. In 2012, its share price halved from its 2011 peak of around US$37 as iron ore prices plunged amid a supply glut and a slowdown in Chinese demand. It did not help that the company became embroiled in a corruption scandal, while political and economic crises at home added to its troubles. Despite these seemingly intractable problems, our analysts recognised Vale's substantial underlying value. When others were selling, we bought and held its shares over subsequent years. It has proved rewarding: Vale's shares have surged 300% since the start of 2016 – and we are not even in the final phase of excessive optimism.

Another example of this contrarian, value-oriented investment approach is our holding in Netherlands-based ASML. Thanks to its extreme ultraviolet lithography (EUV) technology, ASML has become the leading supplier of lithography equipment to the semiconductor industry. When we first initiated a position in ASML over five years ago, markets had not yet grasped the full potential of its EUV technology. We believed, however, that it would become the dominant technology in the industry and that ASML would count such companies as Intel and Taiwan Semiconductor Manufacturing Company among its clients. It has been a lengthy development process but the long-awaited technology has finally arrived. ASML's share price closed at €167 at the end of May, compared with €64 five years ago. I think there is still more value to be had.

Past results are not a guarantee of future results. This information has been provided solely for informational purposes and is not an offer, or solicitation of an offer, or a recommendation to buy or sell any security or instrument listed herein.

4. What other developments have you been watching?

The path of the oil price has been interesting. Its precipitous fall began back in 2014, driven by the US shale boom and weakening global demand growth. In less than two years, Brent crude oil had fallen from above US$100 a barrel to below US$30. I thought then that was simply too cheap, and that I would see oil at US$80 a barrel again during my investment career. And guess what? Although Brent crude oil has been volatile, it edged close to US$80 a barrel in May this year. Oil majors have benefited greatly from the rebound in oil prices. Royal Dutch Shell, a significant holding for me, is up by over 20% in the last 12 months to the end of May.

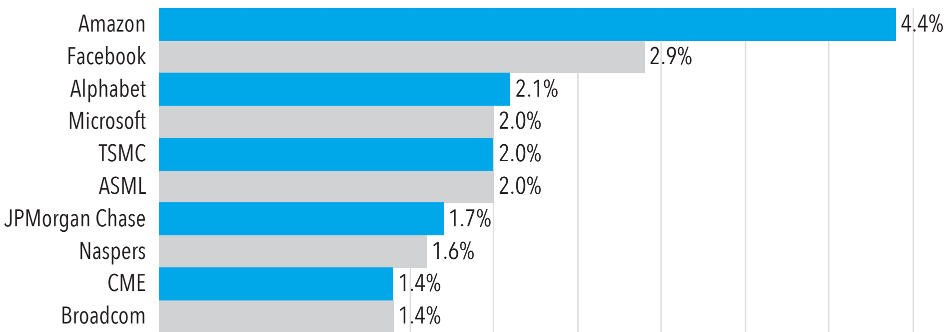
That said, oil services and equipment providers have failed to keep pace with improving industry fundamentals. Schlumberger, for example, is down about 1% on a 12-month view. In short, they have a lot of catching up to do. However, I think the industry is on the cusp of a return to better growth and profitability. These are the long cycles that we monitor diligently, and our long-term approach allows us to capitalise on the opportunities as they arise.

5. And how do you identify these secular trends?

The credit largely goes to our extensive and highly experienced global research team. Before they recommend investments, our analysts conduct first-hand research, focusing on company fundamentals. In addition, they establish relationships with company management and local officials as they often cover the same companies and sectors over several years and market cycles. This boots-on-the-ground approach helps analysts and portfolio managers like myself gain perspective and identify long-term investment opportunities.

We believe that the sharing of insights across asset class teams, as with our first-hand research, gives us a competitive advantage. Equity and fixed-income analysts meet regularly, both formally and informally, to debate investment themes and challenge one another's assumptions. To a large extent, our investments in firms that have been able to benefit from China's remarkable e-commerce growth were borne out of these discussions from long ago. South African media giant Naspers, which has a sizeable stake in China's largest internet provider Tencent, has been a rewarding investment and remains a large holding today.

New Perspective strategy – Top 10 Holdings



As at 31 May 2018. Source: Capital Group

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- **This material is not intended to provide investment advice or be considered a personal recommendation.**
- **The value of shares and income from them can go down as well as up and you may lose some or all of your initial investment.**
- **Past results are not a guide to future results.**
- **If the currency in which you invest strengthens against the currency in which the underlying investments of the fund are made, the value of your investment will decrease.**
- **Depending on the strategy, risks may be associated with investing in emerging markets and/or high-yield securities; emerging markets are volatile and may suffer from liquidity problems.**