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WHY NOW IS THE RIGHT TIME FOR VALUE

LEGG MASON MARTIN CURRIE SELECT OPPORTUNITIES FUND

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> *"Asset allocators need to be positioned in Value stocks ahead of the inflection point to capitalise on future narrowing spreads"*

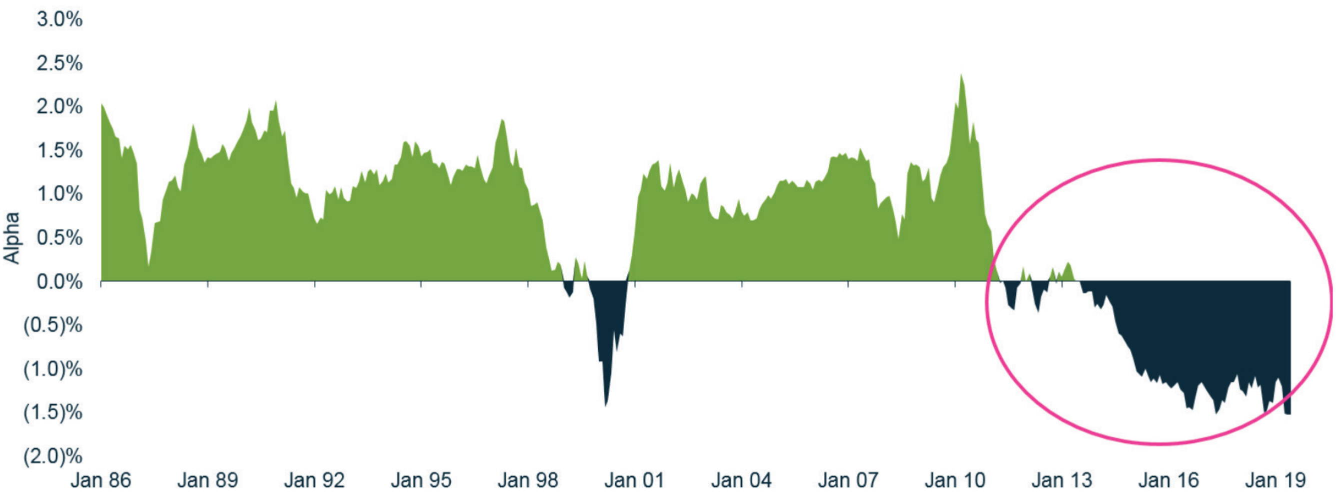
The past two years has seen poor performance for value style indices and typical value managers globally, and stronger performance for Momentum, Growth and Quality factors. There have been recent comments in the market that Value is broken or that this could be the death of Value. Or, given how expensive the market has become, is now actually the time to overweight the style? Below I discuss what value spreads really tell us about what lies ahead for the Value style, and value managers like Martin Currie Australia.

VALUE NORMALLY OUTPERFORMS GROWTH

Globally, the value style (based on the MSCI World Value Index) has underperformed the broader market (MSCI World Index) in the last few years. But on a rolling 10-year basis, the level and persistence of this underperformance looks quite extraordinary in contrast to the long-term.

Similarly, if you think about this in the inverse, the persistent outperformance of the Growth style (based on MSCI World Growth Index) is also peculiar, as it is historically known to underperform Value over the long-term. This is backed up by research studies by Fama and French, Kahneman and Tversky.

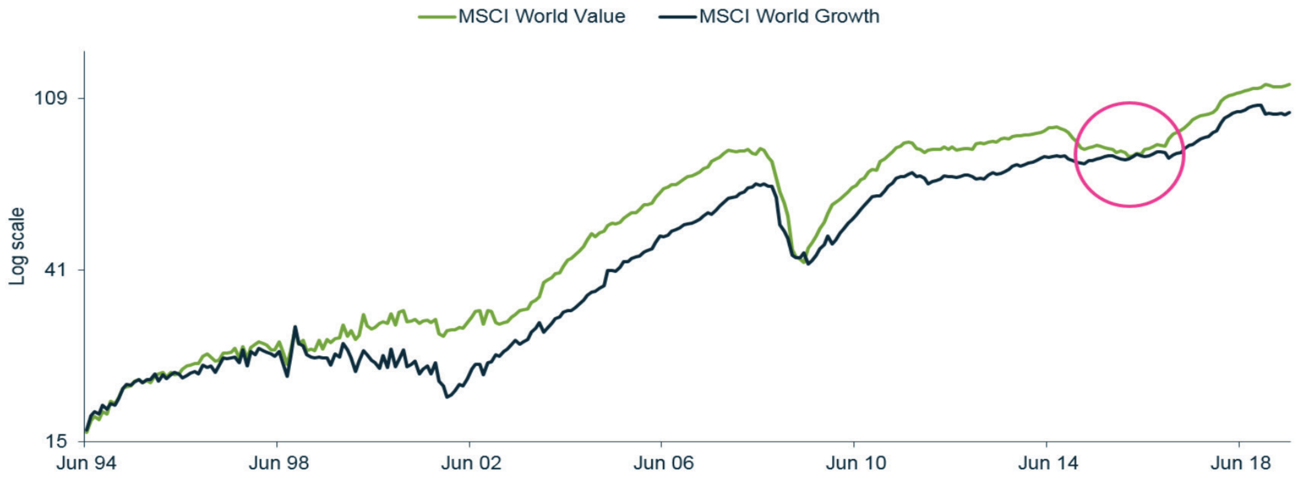
MSCI Word Value - MSCI World (rolling 10 year alpha)



VALUE OUTPERFORMS OVER TIME BECAUSE HIGH EPS EXPECTATIONS GO UNMET

A key reason why Value typically outperforms Growth in the long run is Value's superior EPS growth relative to Growth stocks. Investors have a bias towards trend extrapolation and over optimism of future EPS, but the reality is that paying more for an unmet expectation doesn't add value, and Value's fundamentals prevail in the end. The continued trend of superior EPS, despite poor value style performance in the last few years, gives us confidence that the value style works when the market focusses on underlying fundamentals.

Forecast EPS (next twelve months)

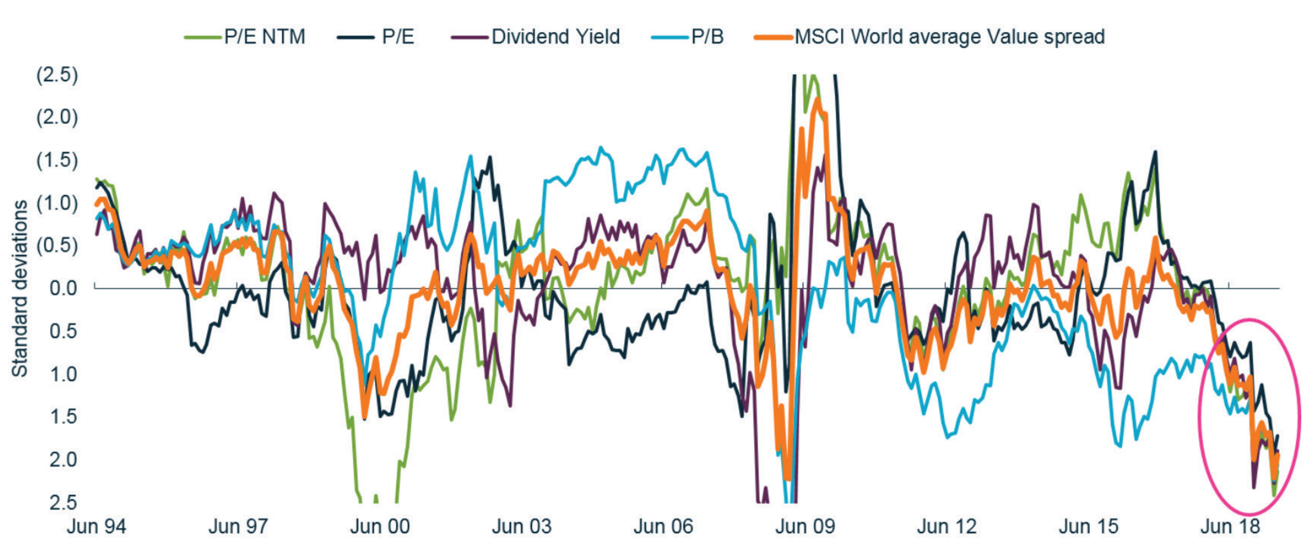


> *"Wide value spreads have then historically preceded strong future alpha for Value-biased managers."*

VALUE SPREAD = THE FORWARD OPPORTUNITY

The relative valuation of the style indices, i.e. a value spread, can give us another way to look at the behaviour of Value and Growth stocks over time and how recent behaviour is out of kilter. I've measured a value spread for the MSCI World using a naive average of the log of the spread between the two indices, for P/E, P/E NTM, dividend yield and P/B valuation measures.

Valuation spreads



SPREADS NORMALLY MOVE WITH VALUE STYLE PERFORMANCE

Historically, data suggests that widening value spreads usually go hand in hand with poor Value style performance. Wide value spreads have then historically preceded strong future alpha for Value-biased managers.

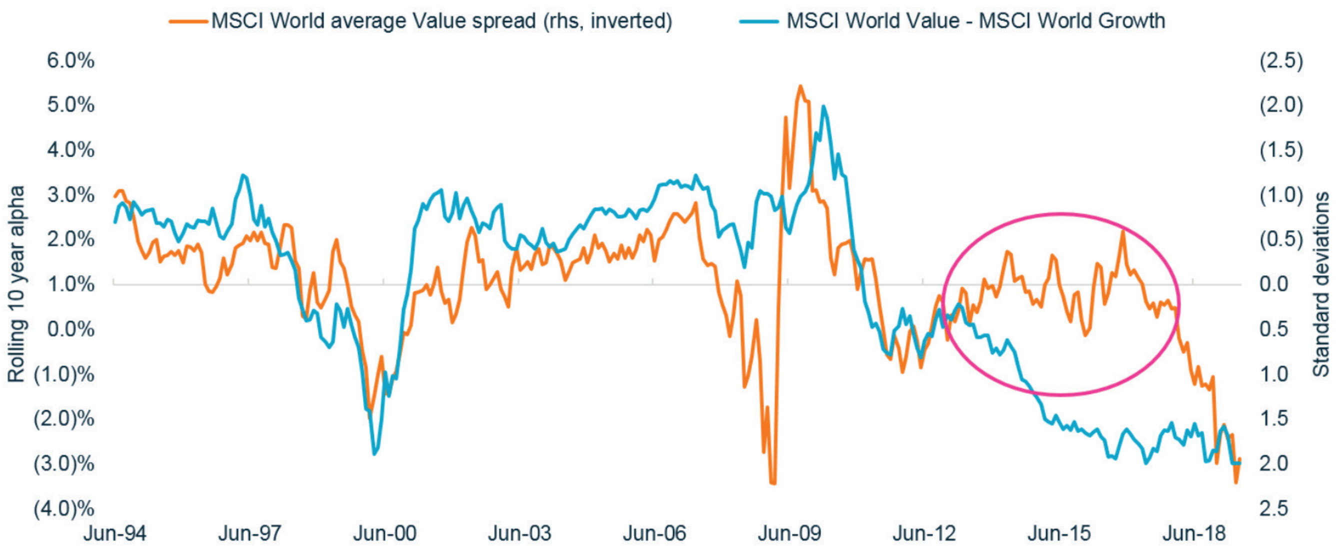
BUT SPREADS MOVEMENT NOT FOLLOWING HISTORY

Unusually, despite Value underperforming Growth throughout 2013-2017, the value spreads did not immediately widen due to falling relative EPS growth for Value, making the Value superiority appear to be "broken"

The persistently narrow spread situation through to 2017 made it hard to "pound the table" for asset allocators to be overweight Value and be ready for the rebound that should occur when spreads begin to narrow again.

The situation dramatically changed in 2018, with spreads exploding out to greater than GFC and Tech bubble levels across all metrics. The relative EPS issue to Growth is now no longer an issue, so we do not believe it is justified to call the death of Value.

Value spread and style alpha



AUSTRALIAN SPREADS HAVE MOVED IN STEP WITH GLOBAL FACTORS

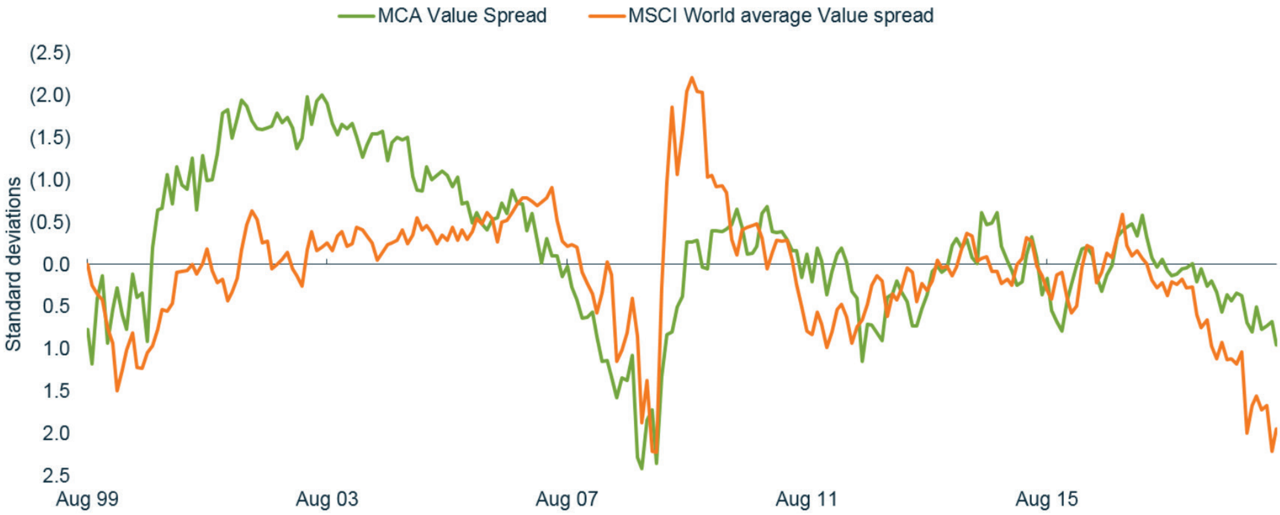
Our 20+ years of in-house discounted cashflow valuations of Australian companies provides us with great insight in understanding the Australian market. Therefore, for analysing the Australian market, we have used Martin Currie valuations data instead of MSCI index data. We use our proprietary valuation of the 80th percentile stock (representing cheap stocks) versus the 20th percentile (representing expensive stocks).

Consistent with my long-held thesis that factor performance of the Australian market is strongly dominated by global macro and factor performance, I have found that the Australia value spread is also highly correlated with the World value spread, with notable and understandable exceptions around the Asian crisis, Tech bubble and naughties China boom.

This relationship between MSCI World value spread and that for Australia has only strengthened over time, especially since the GFC. This is explainable by the low growth/Quantitative Easing world, and financial market weaponisation (or development) of, for example, commodity futures trading (CTAs) that allows trading of common factors on a global basis.

> *"Today's situation of high value spreads and an expensive market looks more like the Tech bubble than the GFC"*

World and Australia Value spread



DRIVERS FOR CHANGE IN THE SPREAD

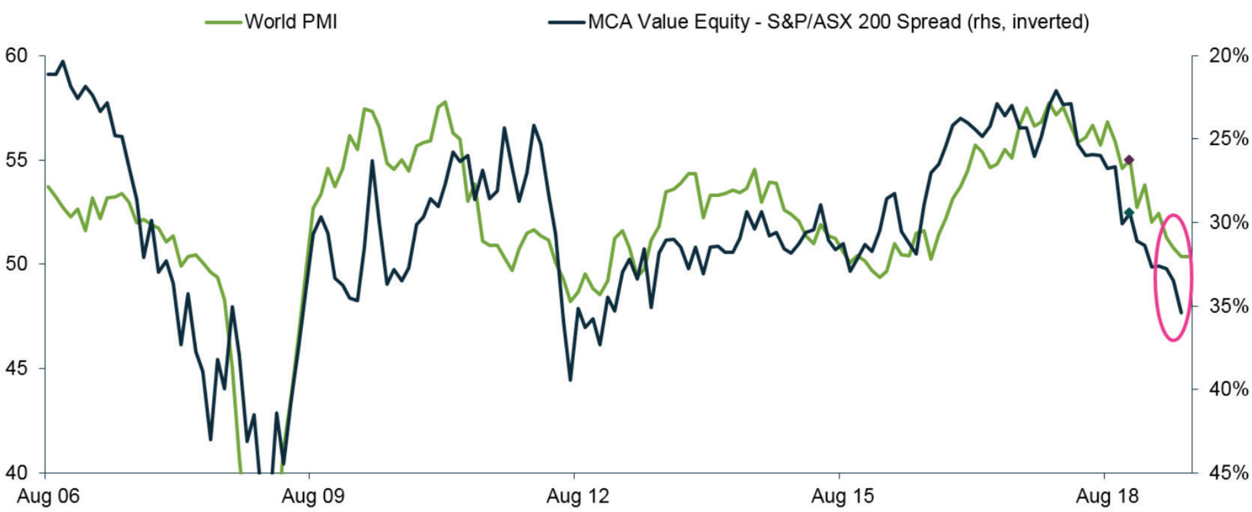
I have looked at what has been really driving changes in value spreads, and my analysis shows that the level and change in economic growth (e.g. based on our in-house business cycle indicator or PMI), bond yields (e.g. the US 10yr) and the yield curve, have all generally moved in concert with value spreads. This tells us that value style performance should turn around when economic growth stabilises, bond yields are no longer falling, and central banks cut rates to stimulate the economy. In other words, when the world doesn't remain in a constant state of deterioration.

DATA SUGGESTS THE TIME FOR VALUE IS NEAR

Based on the historical relationship between value spreads and macro data, current value spreads imply that there are no further Fed rate cuts, PMI is set to trend below 50, and further falls in bond yields are on the way. But the world doesn't retain a state of panic/euphoria for an extended period.

The bottom of a cycle is notoriously hard to time. The value spread based on the holdings in our Legg Mason Martin Currie Select Opportunities Fund[1] versus the S&P/ASX 200 Index, appears to already be pricing recessionary outcomes and no response by policy makers. As such asset allocators need to be positioned in value stocks ahead of the inflection point to capitalise on future narrowing spreads.

Economic growth



[1]Based on a representative Legg Mason Martin Currie Select Opportunities Fund

'VALUE AS A DEFENSIVE' WHEN VALUE SPREADS TIGHTEN

Wide value spreads in the Tech bubble were associated with an expensive market, whereas in the GFC, wide spreads were associated with a cheap market. Post the Tech bust, when spreads again started to narrow, value stocks were attractive as they were considered defensive/low beta and provided strong alpha, but post GFC, value stocks became less attractive as their correlation to beta rose.

Today's situation of high value spreads and an expensive market looks more like the Tech bubble than the GFC. Therefore, in the coming cycle, it is more likely today's cheap stocks prove more defensive than expensive Growth stocks which have been low beta in recent years.

The Legg Mason Martin Currie Select Opportunities Fund is positioned away from the overvalued 'High Growth/High PE/ High Momentum' part of the market to maximise long-term income and returns.

IN SUMMARY

Now is the time to position for Value, not to chase expensive stocks. We believe that our Legg Mason Martin Currie Select Opportunities Fund is able to capture alpha for clients based on three sources:

- The long-term Value premium available because of the market's behavioural bias towards over optimism;
- Our tactical allocation approach to style and risk based on our deep understanding of value spreads and the Value opportunity;
- Superior stock selection over time from our experienced research team's fundamental and quantitative insights into company **Valuation**, **Quality** and **Direction**.