Robeco Global Consumer Trends

2022 mid-year update: Consistency matters

- Interest rate expectations and recession fears hammer growth stocks
- Valuations retrace to their pre-pandemic average
- Remaining consistent to our investment style is essential

Growth stocks have gone through the wringer in the first half of 2022. The potent cocktail of quickly rising interest rates, persistently high levels of inflation and elevated valuations proved to be a lethal combination. More recently fears of an impending recession wreaked havoc on global stock markets overall, and previous strongholds like energy and commodities stocks have also succumbed to the increasing downward pressure. While this has clearly pressured absolute returns further, it does seem that growth stocks have started to do better from a relative perspective.

In this article we'll look back on the reasons for the weak performance of stocks, growth and otherwise. We will also explain why we continue to have faith in our long-term quality growth philosophy and why we believe style consistency is of utmost importance. On to the update!

Article
For professional investors
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We were probably due a market correction, although we'll immediately acknowledge that the timing, speed and magnitude has taken even us by surprise. With hindsight of course all the signs were there, as we all witnessed a number of excesses that were indicative of a market peak.

However, something like a perfect storm made this excessive risk-taking happen. First, in their response to the pandemic outbreak, the Federal Reserve announced an emergency rate cut, lowering interest rates to near zero, and launched a massive quantitative easing program. Even though interest rates were already very low, the actions led investors to believe that central banks around the world would have a 'whatever it takes' approach to protect the economy.
As a result, the stock market boomed and in the case of the S&P 500, by August 2020 the full year-to-date decline had already been erased. Led by digitally exposed large-cap growth stocks, Apple (+81% in 2020) and Amazon (+76%) in particular, the bull market gained steam and investor

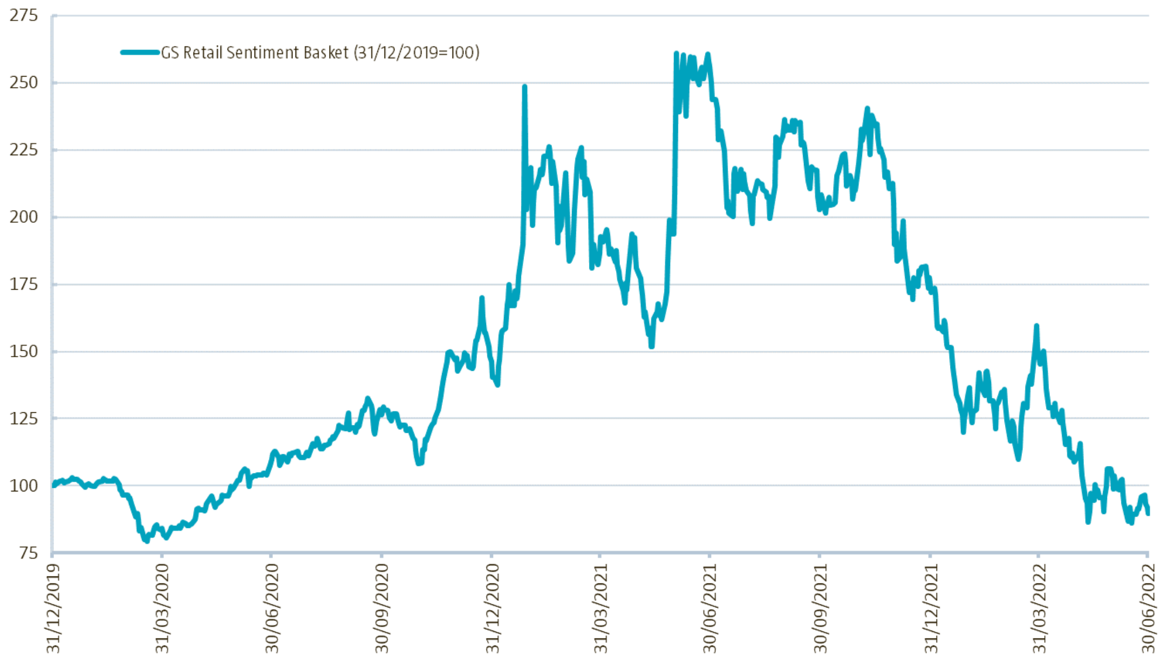
sentiment rose rapidly. The number of money-losing IPOs rose substantially and to satisfy the demand for new offerings many companies chose to go public via a special purpose acquisition company (SPAC); basically a blank-check vehicle that aims to acquire businesses. These SPACs were often issued at USD 10 and today most SPACs have since lost more than 50% of their value.

"Panics do not destroy capital; they merely reveal the extent to which it has been previously destroyed by its betrayal into hopelessly unproductive works."

John Mill, British economist (1867)

In early 2021 the stock market became the place to go betting for many retail investors. Driven by commission-free trading and the rise of WallStreetsBets – an online community on Reddit where participants discuss stock and options trading – meme stocks were born. Companies like GameStop (a video game retailer) and AMC (a movie theater operator) gained cult-like followings and their stocks soared. At one point, shares of GameStop rallied more than 1,000% (!) in less than two weeks, despite the fact that their underlying business was shrinking due to pandemic-related store closures. Hedge fund Melvin Capital, which tried to benefit from the expected downturn in their financials by shorting the stock, lost more than half of its USD 12 billion in assets and eventually had to shut down.

Figure 1 | The rise and fall of meme stocks



Source: Bloomberg, Goldman Sachs, 30/06/2022

There were plenty of other signs like bitcoin mooning to USD 69,000, the spectacular collapse of Archegos Capital which managed to lose USD 20 billion in two days using derivatives, people quitting their jobs to become day traders, YOLO investing, record insider selling and much more. When markets turn, investors generally find out that a lot of money has been invested in unproductive or loss-making ventures. This time the catalyst for the shift in sentiment was rising levels of inflation and, subsequently, expectations of markedly higher interest rates.

Growth stocks, companies with above-average growth expectations, bore the brunt of the losses as these tend to trade at premium multiples of current earnings with investors paying up for the longer-term earnings potential. Growth stocks have been much more vulnerable to the increase in long-term interest rates as this impacts the rate at which future profits are discounted.

Valuation correction

Exactly twelve months ago inflation was already a topic high on investors' minds. In our second half of 2021 update we argued that a portfolio of quality growth stocks would better protect investors from persistently high levels of inflation, as their earnings would hold up better thanks to their higher margins and pricing power. While that may have been true, growth stocks were definitely more sensitive to the effect of rising interest rates on their valuation.

In the table below we've repeated last year's table consisting of a selected number of high quality growth stocks. We included this table to explain that high-margin companies are relatively better positioned to offset higher levels of inflation. And while their earnings have held up even better than expected, their average earnings multiples certainly haven't. Multiples for the group have nearly halved, despite the steady rise in expected forward earnings.

Figure 2 | Last year's selected group* of quality growth stocks from our portfolio

Company	Industry	Next 12M P/E 30/06/2021	Next 12M P/E 30/06/2022	12M Change in Forward Earnings	12M Change in Multiple	12 Month Return
Intuit	Software	45.8	27.7	30%	-39%	-21%
Zoom Video Communications	Videoconferencing	80.8	26.7	-16%	-67%	-72%
Estee Lauder	Cosmetics	44.4	31.2	14%	-30%	-20%
Kering	Luxury goods	26.2	14.0	24%	-46%	-34%
Zoetis	Animal health	36.7	29.9	13%	-19%	-8%
Visa	Payment Infrastructure	33.0	23.4	18%	-29%	-16%
Average		**44.5**	**25.5**	**14%**		

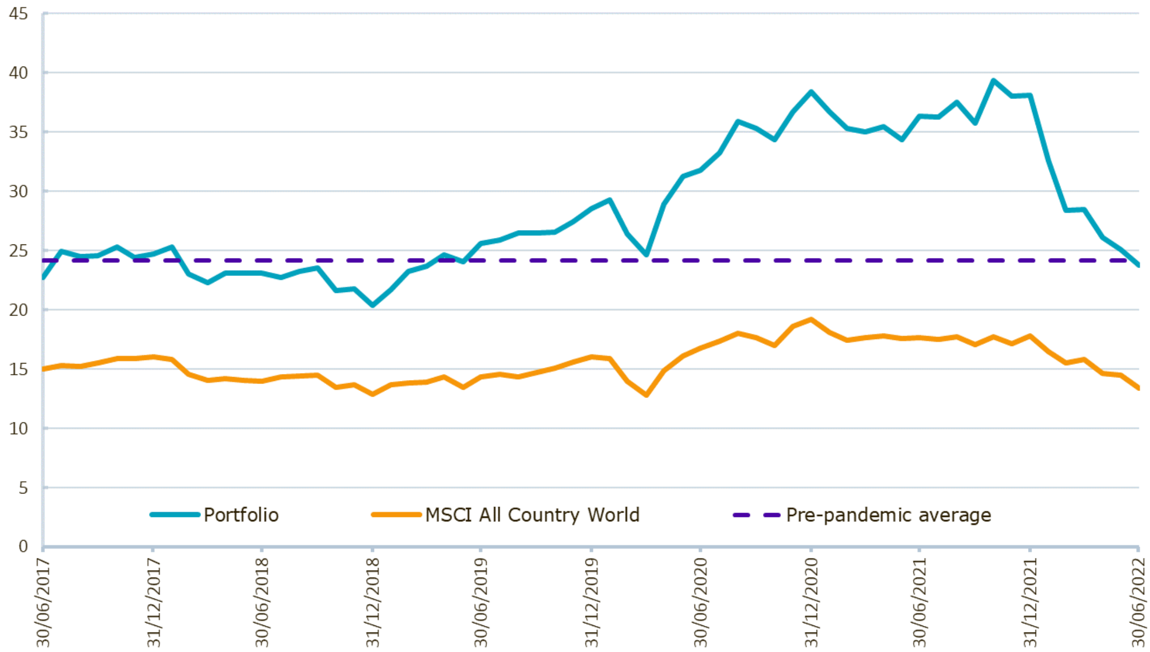
Source: Bloomberg, Robeco, 30/06/2022 * Excluding Meta Platforms, which is no longer in our portfolio

While we recognized the premium valuations of growth stocks and their sensitivity to corrections, we certainly underappreciated the size and speed of this valuation correction. We had anticipated valuations to come down over time and many of our companies to grow into their valuations, i.e. their stock prices rising more slowly than overall earnings. Obviously this has now happened much more quickly than anticipated.

It's interesting to notice that multiple contractions is the major factor in the realized returns. Earnings growth – with the exception of Zoom Video – has actually been pretty strong (+14%) across the board. Zoom Video has indeed been by far the weakest stock of the group, but this is also the only company where earnings expectations have been coming down over the past twelve months.

We are convinced that the majority of the valuation correction is behind us as the overall valuation of the portfolio is now more in line with the historical pre-pandemic average. At the end of the June, the forward P/E multiple of our portfolio was 23.7x with an estimated three-to-five year earnings growth of roughly 19%. The pre-pandemic average multiple of our portfolio (using data up to 31/12/2019) was actually 24.2x (see graph below).

Figure 3 | The valuation (measured by next year's price-to-earnings ratio) of our portfolio versus the market



The above shows that portfolio valuation multiples have now contracted to somewhat below historical levels. One could of course argue this is deserved given the more challenging economic outlook with a potential recession coming our way. We won't argue with that notion, but would note that going forward the prospective returns of our portfolio are likely to correlate highly with the to-be-realized earnings growth of our investments, and that multiple expansion or contraction will be less of a determining factor in the overall returns than over the past two years.

First principles & style consistency

When times are tough and the portfolio is underperforming the market by a wide margin, as has been the case over the past twelve months, it makes sense to take a step back and look at the underlying fundamentals of the selected long-term trends. In this case, we returned to the first principles of trends investing to check whether our original assumptions are still valid.

As a reminder, trends investing strives to benefit from profound changes in society. These include technology-related changes, policy-driven change (regulations), and sociocultural and demographically driven change. Structural changes generally make it difficult for incumbent companies to stay in control of their market positions. However, challenger firms or up-and-coming business ecosystems are often able to capitalize on these changes in order to enter existing markets or establish new ones. These moves are reflected in constantly shifting profit pools. Anticipating and taking advantage of these shifts is our main objective.

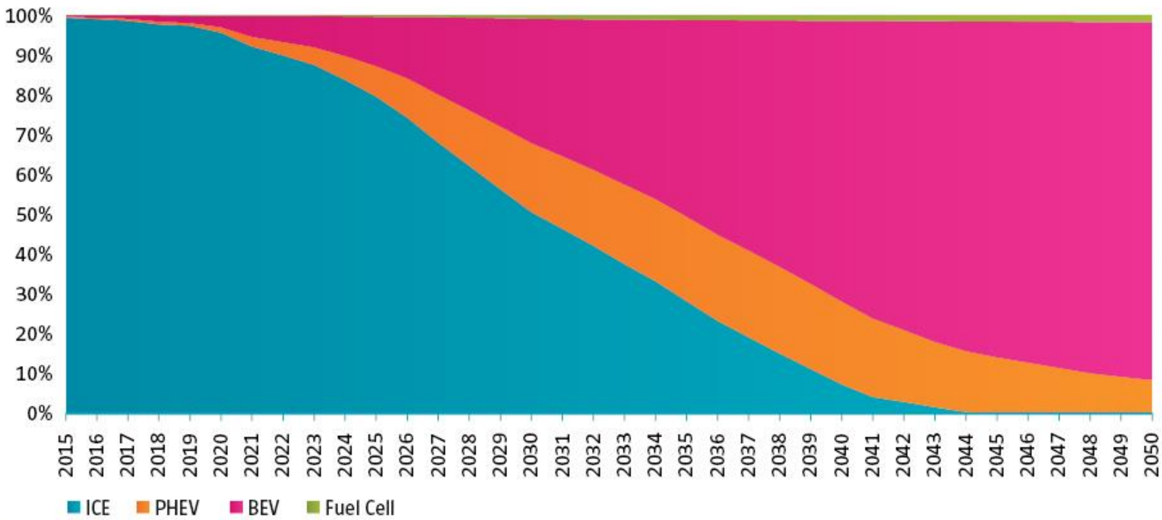
Vehicles on volt

In 2021 sales of fully electric, battery electric light vehicles grew 107% Y/Y to 4.5M, representing 5% of total light / passenger vehicles. There are currently 12 million passenger EVs on the road, representing just 1% of the global fleet. Over the next decade Robeco expects battery electric vehicle sales to expand at a 30.6% compound annual growth rate reaching 30M in 2030, representing 31% of total new light / passenger vehicles. Electric vehicles represent a $7 trillion market opportunity between today and 2030, and $46 trillion between today and 2050. Notably, we also expect internal combustion engine sales to continue past 2040 – and with a useful life of 10 to 20 years, fossil fueled powered vehicles will be on the road for decades to come (unless regulated off the road as some city centers have already begun). To borrow a phrase from Hemingway, change happens 'gradually and then suddenly.

EV Penetration Higher in China & Europe, Lower in the US

In 2021, EV sales reached 14% of passenger vehicles in Europe, 9% in China, and under 3% in the U.S.. BNEF forecasts that by 2025, EVs will account for nearly 40% of total passenger vehicle sales in Germany and 25% in China. EV manufacturer Tesla shipped nearly a million cars in 2021, but only a third of them were estimated to have been sold in the US, despite the fact that the company has its manufacturing base in Fremont, California—ironically, on the site of GM's old headquarters.

Robeco Auto Forecast



Source: Robeco, 2021

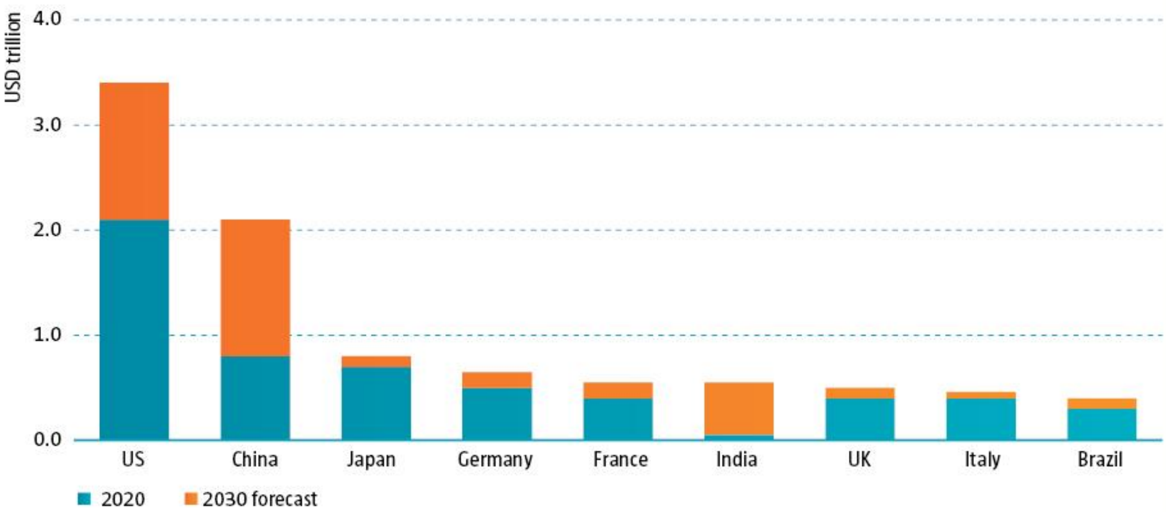
Another benefit of a trends approach is that it typically means abandoning rigid regional or sector classifications that often provide little added value in terms of evaluating the growth potential of companies. Trends usually span multiple regions and sectors. Looking for consistent exposure to a particular trend ensures the portfolio is structurally geared towards higher growth and economic value creation. The forward-looking nature of trends investing forms a sharp contrast to widely used benchmark-based frameworks that rely heavily on conditions in the present.

In the specific case of Global Consumer Trends the three long-term trends (digital transformation of consumption, the rise of the middle class in emerging markets, increased consumer attention on health & wellbeing) are still as valid as they were last year. For example, we think it's highly unlikely that the shift towards digital payments – whether online or via contactless options like tap-to-pay or ApplePay – will come to a standstill just because interest rates are rising. However, given the increased economic and geopolitical uncertainty (high inflation, interest rate increases, oil prices at USD 120 a barrel, Russia's war in Ukraine and so on) investors have significantly shortened their investment horizon. While that has led to a meaningful contraction in valuations in the first half of the year, it certainly hasn't changed the longer-term validity of the selected themes.

Silver economy

Spending by seniors is forecast to grow substantially over the coming decade. Senior consumers are defined as those aged 65 years or older and who spend more than USD 11 per day. It is estimated that this group will increase from 459 million worldwide in 2020, to 760 million by 2030 – a growth rate of 66%. Interestingly, China and India are forecast to show the largest growth in spending by seniors, due to their aging population and expanding disposable income. Who stands to benefit? Mostly healthcare-related companies. Compared to the average, seniors spend more on health insurance, medicine and medical services such as nursing homes.

Spending of upper and middle class aged 65+

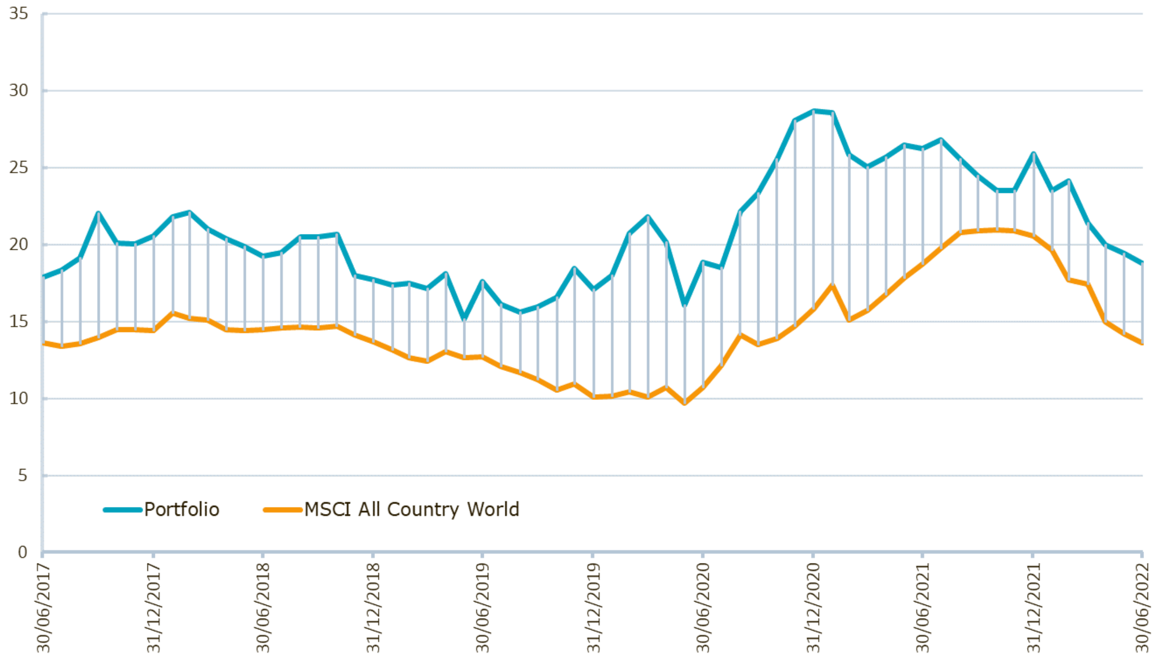


Source: Robeco, 2021

Secondly, even though our more concentrated focus on consumer and consumer-related companies isn't exactly helping our returns this year, over the long term we continue to believe that investing in structurally growing quality companies will deliver attractive returns. This is why, from a style perspective, we think it's very important to stick to our philosophy at all times. While this is relatively easy in good times, pressure tends to build in times of underperformance. The natural inclination to shift to 'whatever is working' may provide some short-term comfort, but more often it is to the detriment of long-term returns.

In the graph below we compare the earnings growth of our portfolio companies to the overall level of earnings growth in the broader market (measured by the MSCI All Country World Index).

Figure 4 | The expected future earnings growth (in percentage terms) of our portfolio versus the market



With the exception of 2020 the gap between the two lines has remained relatively stable over time. At the end of June 2022, both time series have more or less returned to their pre-pandemic averages: 18-20% earnings growth for our portfolio and low double-digit growth for the broader market. We think maintaining style consistency is very important because it increases the recognizability, trust but ultimately also the long-term performance of the strategy. Academic research on the topic[1] also supports the conclusion that, on average, more style-consistent funds significantly outperform less style-consistent funds on a risk-adjusted basis.

In our case that means a continued focus on structural growth trends, attempting to find the winners within those trends and constructing a diversified portfolio of quality compounders to deliver healthy long-term returns for our investors. Like any strategy this will of course have times of relative underperformance, but we remain convinced in the superior long-term returns of said strategy.

[1] Brown, Keith C. and Harlow, W. Van and Zhang, Hanjiang, Staying the Course: The Role of Investment Style Consistency in the Performance of Mutual Funds (2009)

Conclusion

Stocks market were particularly weak in the first half of the year, with the American S&P 500 suffering its worst half of the years since 1970. Growth stocks fared even worse, with the Nasdaq (a proxy for growth stocks) losing 29% up until the end of June. The initial weakness was blamed on inflation worries and expectations of higher interest rates, but more recently recession fears have taken over as the most pressing reason to sell equities. Certainly the macro environment is very tough to call with oil prices rising 40%, a war in Europe, supply chain concerns, and a looming recession.

At the same time, given the worst start to a year in more than five decades, equities seem to have already priced in substantial pressure on earnings. We have shown that also in the case of our strategy the elevated valuation multiples following the pandemic have now completely retraced back to their pre-Covid averages. And while valuation multiples are hardly a predictor of future returns, it does give us comfort that the long-term returns of our strategy are now again mostly dependent on the future earnings growth of our investments.

Our strategy of investing in structural winners, i.e., firms with a competitive advantage that can compound wealth at above-average rates, should continue to perform well over the economic cycle. These companies have in the past demonstrated that they not only have the ability to grow revenues and earnings in more difficult environments, but that they actually thrive in periods of economic headwinds. Therefore, in a less buoyant economic scenario, high quality companies with strong balance sheets, low capital intensity, above-average free cash flow generation, secular growth prospects and reasonable valuations should continue to deliver attractive long-term returns. We will continue to focus on exactly that as we've historically proven to be able to generate excess returns based on this philosophy and we are confident of being able to repeat that in the future. Thanks for believing in us and our strategy.

We hope you enjoyed reading this update and we wish you a great summer!

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The sale of the Fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. The Fund must not be offered or sold to the public in Uruguay, except in circumstances which do not constitute a public offering or distribution under Uruguayan laws and regulations. The Fund is not and will not be registered with the Financial Services Superintendency of the Central Bank of Uruguay. The Fund corresponds to investment funds that are not investment funds regulated by Uruguayan law 16,774 dated September 27, 1996, as amended.

Additional Information concerning RobecoSAM Collective Investment Schemes

The RobecoSAM collective investment schemes ("RobecoSAM Funds") in scope are sub-Funds under the Undertakings for Collective Investment in Transferable Securities (UCITS) of MULTIPARTNER SICAV, managed by GAM (Luxembourg) S.A., ("Multipartner"). Multipartner SICAV is incorporated as a Société d'Investissement à Capital Variable which is governed by Luxembourg law. The custodian is State Street Bank Luxembourg S.C.A., 49, Avenue J. F. Kennedy, L-1855 Luxembourg. The prospectus, the Key Investor Information Documents (KIIDs), the articles of association, the annual and semi-annual reports of the RobecoSAM Funds, as well as the list of the purchases and sales which the RobecoSAM Fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, via the website www.robecosam.com.