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Investors Should Be Ready to Buy When We Are Clearly in Recession

Sarah Ketterer, Co-Founder and CEO of Causeway Capital, favors defensive pharmaceutical stocks such as Novartis and Roche. The renowned value investor explains how she is betting on China's comeback and which stocks promise the most potential when the economic downturn arrives.

Fear runs high in the financial markets. From America to Europe to Asia, investors are confronted with a toxic cocktail of high inflation, rising interest rates and a cooling economy. Richly valued growth stocks in particular have suffered significant losses in recent months.

For Sarah Ketterer, these challenging conditions also create opportunities. Since more than twenty years, her Los Angeles-based investment boutique, Causeway Capital, focuses on international value strategies and manages about $44 billion in assets. The firm's team-based approach is characterized by combining quantitative research with fundamental analysis on individual companies.

"The point we're making to our clients lately is that there is much less risk in the markets now," Ms. Ketterer says. "As the air comes out of the bubble, it becomes a much saner environment for making medium to long-term assessments of stocks," she adds.

In this in-depth interview with The Market/NZZ, which has been edited and condensed for clarity, the renowned value investor explains why she favors defensive pharmaceutical stocks such as Novartis and Roche in the current environment. She also says why she invests in European banks, how she is betting on the re-opening of China's economy, and which stocks have the most potential if the global economy falls into a recession.

Ms. Ketterer, financial markets face a difficult environment. What is your big picture assessment from a value perspective?

> It looks like investors are returning to their senses. When there is no cost of money, when cash is worthless to you, you're willing to pay anything. That's why long duration stocks had such a huge advantage in the past environment where way too much money was being created; not just by the Federal Reserve, but certainly by the ECB and the Bank of Japan, too. They were all way out over their skis. I can't blame them for their highly expansionary monetary policy during the pandemic, but they should have moved very quickly to reign it in.

Now, central banks seem to be determined to quickly bring inflation under control. What does this mean for the outlook on the markets?

When investors bake in lofty expectations and pay a very high multiple for a business that doesn't generate any earnings or cash flow, they are taking a lot of risk. But now, there is a cost of money. As rates rise, investors value income today as opposed to being more than willing to wait for the big cashflow surprise later on. That's why so many of these very speculative stocks are off 50%, 60% or 70% year-to-date: The «later on» doesn't look so good anymore.

What are the implications of this fundamental change for investors?

The point we're making to our clients lately is that there is much less risk in the markets now. As the air comes out of the bubble, it becomes a much saner environment for making medium to long-term assessments of stocks. Yet, everybody is panicking.

What is your strategic approach against this backdrop?

Globally, some parts of the market are cheap, especially outside the US because international stocks were hit harder when the Russian invasion of Ukraine occurred. The stocks that got hit the hardest in our global portfolio were the European stocks. It was a sell-first-ask-questions-later mentality, and particularly high-beta stocks plummeted: banks, industrials and then materials and consumer discretionary. Now, some of them had a little bit of a recovery, but I would argue that in the developed world, European stocks are still the cheapest.

Causeway Capital pursues an active investment style and is in constant contact with hundreds of companies from all over the world. What do you hear from the executive floors?

We hear a lot of winching because they thought that the supply chain disruptions were temporary. But the problem is getting worse, not better. Part of this is another exogenous shock, namely the Chinese lockdowns in places like Shanghai, and partially in Beijing and Shenzhen. These are major manufacturing, transport and shipping areas of China. We've never seen anything like this because the Chinese government used to favor growth over everything else, hence the environmental damage etc. Now that growth has been sabotaged in lieu of a false choice: lockdowns vs. pandemic. But it's very hard to lock down an incredibly communicable disease like the Omicron variant.

Around the globe, there are increasing signs that the economy is cooling down. How great is the risk of a recession in your view?

We think it's sort of inevitable, it will happen everywhere. In Europe, you might not only be in a recession, but wanting a sweater because there will be certain days of the week when power will be harder to get than on other days. Having China as the manufacturing hub of the world in lockdown is just the last shock of three, and they all happened way too close to each other. Having a pandemic was certainly horrifying, and so is moving into a war with a bellicose country that has threatened to use nuclear weapons. As a result, we're starting to see earnings downgrades and even guides: Companies are telling their shareholders that it isn't looking as rosy as they thought. They have huge problems with access to labor, raw material prices are skyrocketing, and then they can't ship.

What does this mean for valuations?

In bull markets, not only do earnings rise but typically multiples do too. In the last several years, multiples rose even more because we had such tremendous money creation and asset price inflation. But the opposite is true as well: When earnings come down, so do multiples. And again, this multiple compression will be accelerated by rising interest rates. That's why I'm not particularly optimistic about markets overall, but there are places to go and areas to research. Investors should be ready to buy when we are clearly in recession across the various regions of the world. Because the next stage will be recovery.

For the immediate future, however, fears of a recession and rising interest rates will continue to dominate events. What's the best way to position yourself in the current environment?

Everybody suffers from recency bias. Even our long-standing institutional clients who manage themselves billions of dollars sometimes forget that the markets are extraordinary discounting mechanisms. Equity markets in particular anticipate events well before they will come to pass, and some economically cyclical stocks already reflect a global recession. So in prior cycles with significant downturns like the bursting of the TMT bubble or the 2008 global financial crisis, the key was to be reasonably defensive.

What kind of companies match this profile?

As we discussed in our previous interview, we predominantly own European pharmaceutical companies. This is that very area. The sector was such a laggard last year, and some clients even looked at us with a little bit of sadness: How could we bother with Novartis or Roche? What's the point of owning AstraZeneca or GSK? But these stocks have proven their defensive strengths exactly as we expected.

And what specifically makes pharmaceutical stocks appealing?

It's hard not to like them. They are just great cash flow generators, and they passed their patent cliffs, so they don't have that worry in their revenue stream. These companies have excellent management teams, great financial strength, and most claim they are only doing bolt-on acquisitions. That means we don't have the risk of some major disruptive acquisition and a depreciation period. Also important: Getting more than 4% dividend yield upfront and having that compounding on behalf of clients is very attractive.

One of the core positions in the Causeway International Value Fund is Novartis. After the sale of the stake in Roche the company has plenty of cash. What should it do with this money?

That's part of our job as asset managers: We communicate frequently with management teams, and if we can't get their attention we sometimes go to the board of directors. For a company like Novartis - and that's just one example - we usually ask that we want to see them return a significant portion of that cash to shareholders, since we're looking at total return, and not just at share price return. We think a good third of the total return of these pharma stocks over the long-term will be income - and if we're not getting it, we're going to be very upset.

At Novartis, the generics business Sandoz has been up for a spin-off or sale for some time now. Yet little has happened. How pressing is this matter to you?

Let's put it this way, and other institutional investors probably see it the same way: We have other fish to fry. There are other companies who have really not done a great job of restructuring, and we're pressuring them. What's more, there is often a tax effect in these kinds of transactions, and it takes a long time to figure out how to mitigate that. So as they evaluate their options, we are leaving them to their own devices.

Meanwhile, the share price of many biotech companies has plummeted. To what extent does this open up takeover opportunities for a pharmaceutical giant like Novartis?

Historically, most biotech acquisitions made by large cap pharma have done pretty well. But they take a long time to pay off for shareholders. That's why we're very clear: Don't get too excited! If a pharmaceutical company buys a biotech company, usually that's just an R&D investment masked as an acquisition. It takes five, six or seven years before investors see a payback. So as valuation experts, we don't put any value on that. And, if there is a payoff of significance from that business, that's additional. The same applies for the pipeline. We usually don't give new drugs any valuation unless they're in phase III. That's what it means to be very conservative.

Roche is one of your portfolio companies as well. What's the bull case here?

We're waiting for more information about that big Alzheimer's drug. We're giving it a fifty-fifty chance, since we just don't have any incremental information that persuaded us one way or another. The share price could swing up 10% or down 10% on the news. But even if it turns out to be a disappointment, we still like the stock a lot.

What other names do you favor in the pharma space?

I'm a little bit hesitant to give you too many names because some of them have done so well that I'm not sure if we still own them by the end of the year. I expect some of those that are stalwarts in our portfolio, like Novartis, to stay because they are so cash generative that they continue to compound earnings for our clients. But there are others we may end up losing as a source of cash to fund cyclicality. Like I said: It's not time yet, but when we see the jaws of recession, when it's very clear the economies are slowing, that's the time to start adding cyclicality because the recovery is next.

How do you go about picking such stocks?

We don’t look just for the cheapest stocks, we never have. More than anything, it’s important to find businesses that have the ability to recover and sustain their recovery. Usually, that means they have very active management teams who can effectively cut costs in the downturn, bolster the business, maybe make a few opportunistic acquisitions to improve competitive positioning. These companies typically have tremendous financial strength which is so important in environments like today: having that extra financial strength means they don’t have creditors knocking on their door. They don’t have to worry about rising interest payments, and they can use their access to financial markets to improve their business. But while they’re improving their business, usually the market isn’t noticing. The market just notices it when it’s already improved.

What companies meet these criteria today and are already attractively valued?

Some of the European banks collapsed after the Russian invasion, many of them even halved. This is crazy because these stocks weren’t expensive to begin with. Now, they trade at 30 or 40% of tangible book value, and they’re buying back their own stock. As a result, the book value per share goes significantly up because there are so many fewer shares. It’s great for shareholders when managements recognize that their stocks have been mistreated by the market and indiscriminately sold off. That’s when we get really pushy with companies.

Then again, Europe’s economy is suffering heavily from the war in Ukraine, and the global outlook is clouding over. Isn’t that a problem for the banks?

Maybe Europe will fall into a recession, but we see a commitment to spending on defense that wasn’t there prior to the Russian invasion, especially out of Germany. Nobody who’s managing money today has ever seen this. It’s the greatest alignment and cohesion of European forces since the end of World War II; exactly the opposite outcome of what Putin wanted. In two years’ time, Europe’s energy problems will largely be solved in our view. LNG terminals are being built, and a huge amount of money will be spent on renewable energy. All these investments have to get financed, and the banks have to be involved in that. Also, the ECB will be very careful to try its best not to choke the economy. So a quick recession and then a recovery, especially if it coincides with some sort of detente in the Russian-Ukrainian relationship, would be huge for Europe.

Which financial groups are attractively positioned against this background?

We like UniCredit. They are so overcapitalized that they can buy back half their market cap, or some crazy high number over the next three years. The market doesn’t seem to care too much, but when we look at what this is going to do to their book value per share, we’re absolutely astonished.

In our last conversation a year ago, you also spotted value in Credit Suisse. Does that still apply after the recent series of disappointments?

We think the recovery in Credit Suisse is going to take longer than we have time to wait. That stock is not one that we are going to add client capital to. Since we’re not confined to Swiss equities, there are so many other cheap, well-run banks to choose from that don’t have these problems, like ING Group for instance. What UniCredit and ING have in common is that the market decided that they have Russian exposure, therefore they are a «Sell». But neither of them has such significant exposure that it makes much of a dent at all; certainly not in their capital, and very modestly in their earnings.

Shares of technology companies have suffered a severe setback as well. How attractive is the IT sector after the sharp correction?

Things are changing. Software is still expensive, but the hardware area, especially in semiconductor production equipment, looks really interesting. If I had to use my crystal ball, I think that’s where our clients will end up having a bigger exposure. What we already own is «defensive tech»: companies that provide business process outsourcing and digital services, effectively software services businesses like Concentrix and Genpact. They are not all that well known and kind of medium-size companies, but they provide mission critical services. That’s usually the last thing a client will cut, because once you’ve started migrating your finance and accounting system to the internal cloud - which is facilitated by some of these companies - you can’t stop.

One topic on which opinions differ widely is China. What do you think of Chinese equities?

China is the biggest conundrum in all of international investing outside of the US, because Chinese stocks have gotten really cheap. When you think of the ADRs, you can have some world class companies in a huge market with lots of pent-up consumer spending. China will come out of the pandemic, it's just a question of when not whether they will open up their economy. But the big question is what sort of discount rate you use in a market where the government has decided to reinvigorate regulation and crack down on private sector companies. That's the hardest part of my job right now.

And what is your answer to that key question?

So far, we added very small amounts. We like the thematic version: What will do best coming right out of the lockdowns? It will probably be travel and leisure, and those areas are outside the government's scope of crackdown since neither of them involve national security, at least not yet. We like for example the western run casino companies like Sands China and LV Sands. When the lockdowns are lifted and people revert to prior patterns, they want to get out and travel, they want to go shopping, and they want to go see things. So they will go to Shanghai Disneyland, and they will definitely book travel which favors Trip.com, a go-to destination for travelers in China. We also bought some of the airports like Beijing Capital International Airport and Shanghai International Airport. They are money machines when people are traveling. So at the margin, we're ready for the recovery.

About Sarah Ketterer

Sarah Ketterer is the chief executive officer at Causeway Capital, fundamental portfolio manager, and is responsible for investment research across all sectors. Ms. Ketterer co-founded the firm in June 2001 and is a member of the operating committee. From 1996 to 2001, Ms. Ketterer worked for the Hotchkis & Wiley division of Merrill Lynch Investment Managers (HW-MLIM). There, she was a managing director and co-head of the firm's international and global value team. From 1990 to 1996, Ms. Ketterer was a portfolio manager at Hotchkis & Wiley, where she founded the International Equity product. Ms. Ketterer earned a BA in economics and political science from Stanford University and an MBA from the Tuck School, Dartmouth College. She is currently a member of the Stanford University Board of Trustees, a board member of the Los Angeles World Affairs Council and Town Hall, chair of the investment committee for the Music Center Foundation, and serves on the Girls Who Invest President's Council.

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