



EQUITY PERSPECTIVES

Finding Value in Volatility

November 10, 2015

How Lord Abbett portfolio managers Justin Maurer and Tom Maher have scoped opportunities in a market rife with rich valuations, earnings misses, commodity deflation and sector sell-offs.

In Brief:

- The U.S. economic recovery is creating pockets of opportunity, but is not a broad tailwind. With the Chinese economy slowing, a return to hyper-growth seems unlikely. In managing three value equity strategies, Lord Abbett portfolio managers Justin Maurer and Tom Maher continue to focus on U.S.-centric companies that have financial and capital management flexibility to compete strategically.
- M&A is an investable theme in the portfolios they manage—both in terms of potential buyers and sellers.
- Convinced that “boring is more beautiful than ever,” the team focuses on best-of-breed companies especially in volatile periods.
- The drop in crude oil prices is having different consequences than in past cycles. As of October 27, 2015, they have exited four positions within the energy sector and entered one.
- Amid uncertainty about when interest rates may rise, their preference as of October 27, 2015, is to diversify financial sector exposure broadly across banks, capital markets, insurance, and high-quality REITs.

Irving Kahn, a former partner of legendary investor Benjamin Graham, once said that value investing—the strategy of selecting stocks that trade for less than their fundamental, or intrinsic, value—was more an art than a science. The hardest part, in his view, was having the discipline and temperament to resist your impulses. “Prices are continuously molded by fears, hopes, and unreliable estimates,” he said. [And] capital is always at risk unless you buy better than average values.”

For their part, Lord Abbett Partners **Justin Maurer** and **Tom Maher** focus on **finding stocks** that are most mispriced by the market consensus and actively managing those

positions with rigorous attention to downside risk and upside potential throughout the investment process. Depending on market conditions, they aim to have a reward to risk ratio of at least 3:1, and will often pass on buying a high reward-to-risk ratio stock if the absolute downside price risk is too large.

While some of those stocks may be “fallen angels” which have fallen substantially from their all-time highs, they try to avoid “falling knives” which have declined sharply and may drop more, or “dead cat bounces” exemplified by the small, short-lived recovery of declining securities.

In a recent conversation with a major client, Maher provided a rich perspective on how his team has managed during the latest market volatility. Historically, his value team has done well with industrials and some materials stocks by ferreting out best-in-class companies—an approach that tends to have performed well on both a relative and absolute basis in such periods. But the confluence of China’s economic downturn and a weak energy sector has had such an impact that they have eliminated any exposure to chemicals and cut holdings in the metals, machinery and oil field services sector, except for companies that are more focused on the United States, or have very resilient business models.

“Commodity deflation is such a strong headwind that it doesn’t matter how much a company is changing its business,” Maher said. “Sure, some plastics companies have benefitted from lower petrochemical prices, but even companies engaged in so-called “self-help” strategies [like cost cutting, acquisitions or stock buybacks] are not likely to be rewarded.”

Outside those hard-hit sectors, the team has been somewhat defensive, looking for companies with a recurring sustainable base of revenues, the type of business where 60-80% of a company’s revenues are effectively locked in when the quarter begins.

“The downside to those kinds of stocks in a ripping bull market is you tend not to have the ability to blow the lights out on an upside quarter,” Maher said. “But in a market like this, investors take a lot of solace in stable business models of well managed companies.”

Such characteristics have been particularly evident in the financial services sector, where the timing of higher interest rates has complicated projections of higher earnings growth. Despite such uncertainty, some investors have sought refuge in payment processors and financial technology firms, or for that matter, in insurers with dominant market positions or turnaround potential.

“Boring is beautiful,” Maurer quipped. “These are companies that tend to hold up well when things tough.”

That said, Maurer has also favored several banks with a distinctive specialty or geographic advantage in parts of the country where economic growth is better than average.

Real estate investment trusts (REITs), on the other hand, have been more of a

challenge. In the past, the team has invested in broken companies hoping they'll get better, but such turnarounds tended to take longer given the time it takes to fix and sell properties and reallocate the proceeds. As a result, the team gravitated toward higher quality REITs with less balance sheet leverage and a more sharply defined strategy in terms of the assets they own. Case in point: a strip mall owner in the mid-Atlantic that buys and rehabilitates rundown properties in order to attract higher quality tenants willing to pay higher rents.

Theme Catchers

With the seemingly inexorable march of information technology, Maher and Maurer continue to explore opportunities in reasonably valued networking companies poised to exploit the burgeoning demand for greater bandwidth needed to drive e-commerce, streaming media, and wireless communications.

"That's another pocket of secular growth we've found," Maher said. "There are some good plays there...although some of them take a little while to work out in terms of greater capacity utilization and increased involvement in customers' success."

Another theme the team has explored is the nation's ongoing housing recovery, fueled by a combination of low interest rates, an improving job market, and relatively better mortgage availability. That has translated to some exposure to a mortgage insurer, home builder, furniture retailer, and two real estate services companies. While the team would like to find more ways to play housing, first-time home buyers constitute a lower percentage of the market than one would expect at this point in the business cycle. So the question is to what extent does the vast millennial generation want to switch from rentals to home ownership as affordability improves.

Hurray for M&A

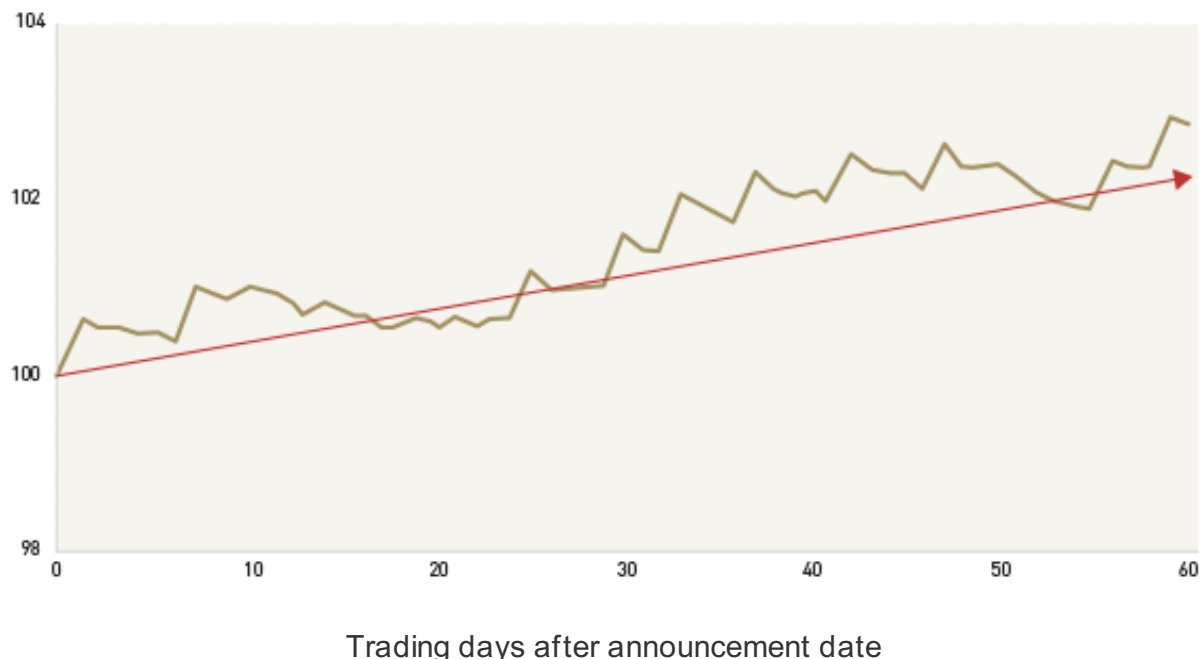
While Maher and Maurer rarely invest in a company solely on the basis that it will be acquired, a fair number of companies in their portfolios have been taken out at significant premium in recent years. On the other hand, some companies in the portfolios have done well as acquirers.

In the past, acquiring companies often saw their stock prices decline after takeovers. Now, with ultra-low interest rates and scarce growth, the market has rewarded companies that have demonstrated the skill and strategic vision it takes to integrate acquisitions, cut costs, and drive their earnings outlook. (See Chart 1.) "It's important for us to identify the companies where M&A is a core competency," Maher said.

That certainly has been the case in the consumer sector, where some companies have benefitted from deals that either complemented existing customer bases, added products and distribution, reduced costs, increased margins and/or opened up new market opportunities. Accretive deals have also been seen in the non-residential and infrastructure space, where a California engineering and construction giant acquired a significant competitor, giving it a stronger foothold in sectors such as power distribution, oil and gas, and federal contracting.

Chart 1. Acquirers Are Being Rewarded for Deals Seen as Accretive

Performance of acquirers relative to the S&P 500® Index, 0-60 days after announcement date, equal-weighted %



Source: Strategas Research Partners

*Chart reflects announced M&A deals from 1/1/14 to 10/1/15. Performance as of 10/1/15.

The S&P 500® Index is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

Performance quoted represents past performance. Past performance is not a reliable indicator or a guarantee of future results. The historical data shown in the chart are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

Due to market volatility, the market may not perform in a similar manner in the future.

Gauging When Stocks Have Hit Bottom

Has this year of volatility generated more value opportunities than the past?

“It’s almost been like a ball rolling down a hill,” said Maurer. “First energy got hit, then the bearishness expanded into materials, then industrials...but we’re reluctant to sift through the damage in some sectors because we don’t know where the low is yet. That said, we are more interested in companies that are through the ringer, as opposed to those that are going through it.”

Sure, the stock market correction has produced some interesting possibilities, but caution seems to be the byword given how high prices have run up. Take the recent sell-off of a global machinery company after it reported disappointing third-quarter revenues and earnings. Could the stock price tumble further? Some value managers believe that company may have to lower its earnings guidance given the terrible state of its mining business.

Expectations of “multiple compression” (i.e., a lower price/earnings ratio) have extended to other sectors as well, which helps explain why Maher and Maurer recently cut their exposure to higher-multiple technology companies across all value equity strategies. “Earnings estimates could be 25-30% too high,” said Maher. “So valuations don’t seem low enough yet.”

For value managers, the same might be said about the hard hit biotechnology sector. Some stocks there may have plunged in price, but their valuations remain high compared to all but recent history. Regulatory and political cross-currents, not to mention the binary nature of their business (FDA scrutiny can make or break a company) suggests an immediate snapback is unlikely.

“Our relative valuation sensitivity should help us avoid some of the stocks that got super expensive because they are likely to fall much harder if fundamentals deteriorate,” said Maher. “We may see some valuation compression in our stocks as well, but hopefully the earnings cuts won’t be as dramatic as they were for some of the really overpriced stocks.”

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There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

A “**fallen angel**” is a stock that used to be strong (hence the term “angel”) but has since fallen out of favor with investors.

A “**falling knife**” is a stock with a rapidly declining price.

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