Moral Hazard, the CFO Put and how Active Engagement helps

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As volatility in global equity markets persists, one traditional source of calm has been missing. The so called 'Fed Put' – accommodative Federal Reserve policy to counterbalance rising market turmoil – is no longer in play. Instead, extraordinary levels of corporate cash can act as market balm and help markets find a valuation floor.

Our Active Engagement approach, which helps shape capital allocation plans with emerging market companies, is a way that such floors can be effectively formed.

Moral hazard and market inequilibria

We often see it with more aggressive driving following a newly issued car insurance policy. It was also evident in the run up to the 2008 Financial Crisis, as banks ratcheted up exposure to risky subprime mortgages. Even today, how individual members within NATO have approached their defence spending and energy policy is evidence of 'moral hazard' at play. Moral hazard describes situations where one party engages in risky behaviour since it knows the other party bears the economic consequences of that behaviour. This can lead to suboptimal results and resource misallocation when individual behaviour does not bear the full cost of its risk.

Beyond motor insurance and geopolitics, we have also seen this pattern of behaviour in equity markets. Over the last two decades, an ever more accommodating Federal Reserve had effectively put in place a 'buy the dip' mentality. Investors quickly built muscle memory that market friendly policies could be accelerated if ever market health felt fragile. Since the 2008 Financial Crisis, 72% of the return of the S&P 500 Index has come from 'buying the dip' when the market had been down over the prior week. Only 28% of the return was generated being long on days when the market was up the prior week[1] . Over that same period, this return composition has been correlated with the growth in central bank balance sheets. Excess liquidity found its way into markets, cushioning selloffs and helping drive reversals.

[1]Morgan Stanley (March 2022)

Armed with such market insurance, investors continued to digest and drive higher nosebleed valuations, buoyed with the confidence that any incremental uncertainty would be resolved by the Fed changing course. Inflation, after all, was a distant threat. Moral hazard in action.

Today, this is no longer in place. High inflation is not a phenomenon reserved for macroeconomic textbooks and troubled states – it is here, and it seems, here to stay. With the Fed focussed on driving down inflation towards its 2% target, market volatility has begun to spike[2]. With unemployment lower and inflation higher and stickier, the days of ultra-stimulative monetary policy are likely over. This points to an environment of higher interest rates with tightened financial conditions as Fed purchases of treasury and mortgage bonds end. Add to this the mounting geopolitical worries in Russia-Ukraine, uncertain global responses to resurgent COVID waves and global energy price distortions, markets have struggled to find support and reach equilibria.

Seeing through the noise: companies awash with cash

This new normal has stimulated much talk of 'long winters and bursting bubbles'[3]. We have seen a violent market rotation away from long duration assets which are largely beneficiaries of the old order of accommodative Fed policy and associated moral hazard. As one would expect, comparisons are made with historical periods of prior market turmoil including the dot-com bubble where the Nasdaq Index lost over 80% of its value[4]. However, corporate fundamentals today are incomparable with that period – both in developed and emerging markets. Today, comparative technology driven companies are at the heart of global economies and are crucially blessed with cash positions that have never been seen before[5].

Whilst markets yearn for support to replace the recently extinguished 'Fed Put'[6], a new form of insurance policy is emerging which can form a floor under equity losses. Management teams across a wide range of sectors and markets are in an enviable position to act and unlock significant shareholder value. By deploying their rapidly growing warchest of cash through buybacks and/or accretive M&A, they are able to build long term value per share, drive higher expected returns for shareholders and reinforce existing competitive advantages. In doing so, this helps form floors for valuations in the market. This 'CFO Put' (coined after Chief Financial Officers) represents a valuable, and indeed, overlooked source of calm for markets – driven in turn by the stunning financial health that many companies find themselves in. Whilst the days of the 'Fed Put' and resulting moral hazard are perhaps numbered, the prospect of a 'CFO Put' and the range of optionality that accretive capital allocation decisions can offer, can be no less valuable.

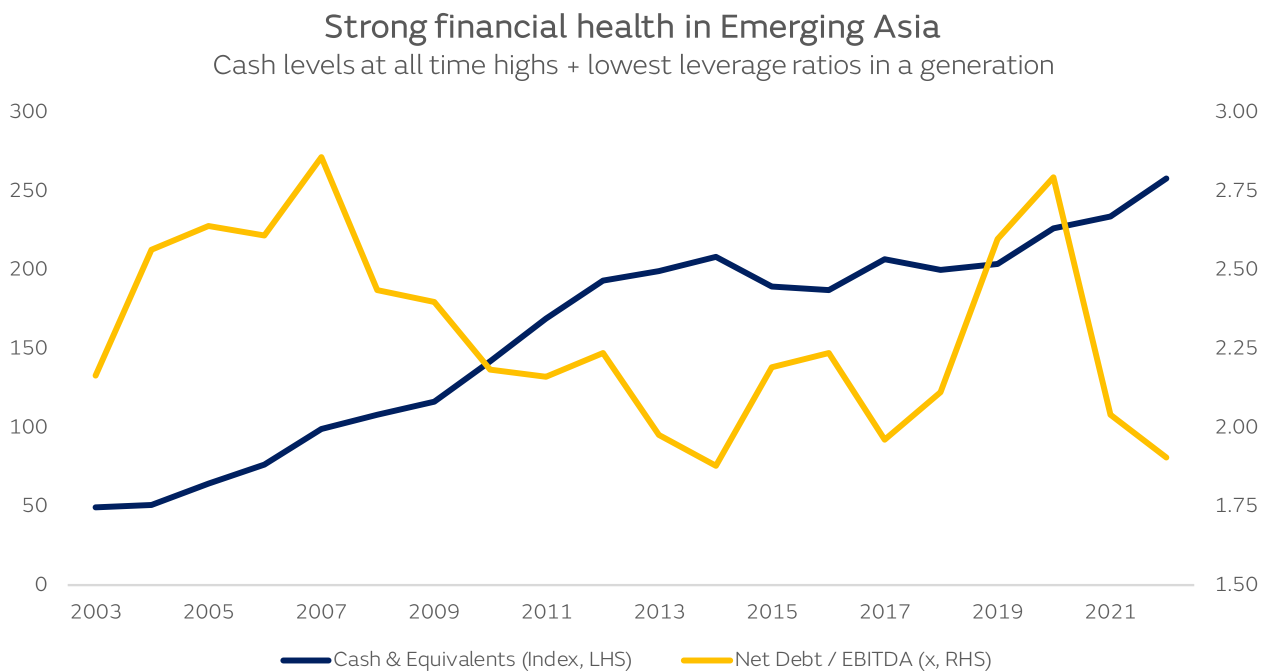
Active engagement to unlock trapped shareholder value

As we've argued before, true active management must mean much more than active share and style biases. For us, active management must fully integrate the tool of engagement across the portfolio to unlock as well as drive greater market recognition of that fundamental value. Our approach focuses on investing exclusively in emerging market companies for which potential change through engagement is central to the investment thesis[7].

[2] https://www.cnbc.com/2022/03/15/why-the-federal-reserve-raises-interest-rates-to-combat-inflation-.html
[3] J. Grantham (January 2022), "Let the Wild Rumpus Begin"
[4] Bloomberg (2022)
[5] S&P 500 cash and cash equivalents = $2.4tn (2021) vs. $1.6tn (2019)
[6] "The Fed put, a play on the option term 'put', is the market belief that the Fed would step in and implement policies to limit the stock market's decline beyond a certain threshold" (A Greenspan, 1987)
[7] https://gibam.com/assets/Engagement-in-Emerging-Markets_Final.pdf (September 2021)

Our engagement approach focuses on two categories to catalyse improvements across our portfolio companies – firstly, unlocking value through higher incremental returns; and secondly, lowering the implied cost of capital. In particular, our partnership with companies to focus on strategic capital allocation (dividend policy formalisation, buyback programs and accretive M&A) is an important lever to unlock trapped shareholder value.

Recent macro, geopolitical and valuation turmoil has created a material opportunity to engage on strategic capital allocation across the portfolio. Next year, Emerging Asian companies are expected to have the lowest leverage ratios seen in 23 years[8]. Cash levels are at the highest they have ever been, 25% higher than in 2016[9]. Within our portfolio, more than 75% of exposure has more than a 5% cash-to-market cap ratio, whilst more than a third of exposure carries more than a 10% ratio. On an overall basis, the portfolio remains net cash, whilst more than half of exposure is trading below its 70th percentile on its 5 year historical valuation [10]. This is the first time this has occurred in the preceding four years.



Source: Bloomberg, 2022

Given the current backdrop of heightened market volatility, associated de-rated valuations alongside formidable underlying company financial health, we see a compelling opportunity to engage across our portfolio. This focuses on the deployment of bloated cash reserves. Such engagement seeks to propel a higher incremental return on capital through augmented buyback programmes, or accretive M&A solely for business models which thrive on reinforcing their ecosystems, alliances and network effects. This is not raiding our companies of cash, rather we partner with them to optimise their capital allocation strategy to balance the needs of reinvestment with capital efficiency.

There remains a significant opportunity for trapped shareholder value unlock, with initial signs particularly encouraging. A number of our portfolio companies have responded by bolstering buyback plans or kicking off M&A reviews. In China, two companies have recently increased their buyback authority by more than 10%, with one committing to purchasing up to 5.5% of its market cap. There is likely more to come: the cash-to-market cap ratio for MSCI China (ex-Financials) has reached a historical high of 23%[12].

[8]Net debt / EBITDA, Bloomberg (2022)
[9]Ibid.
[10]Price to Sales ratio, Bloomberg (Feb 2022)
[11] https://www.cnbc.com/2022/04/01/stock-buybacks-in-asia-goldman-morgan-stanley-predict-whos-next.html
[12]Ibid.

In Brazil, a leading software holding, successfully took advantage of wider discounted sector valuations to acquire a complementary asset – reinforcing its ecosystem and service offering in the process. Meanwhile in Turkey, a cash rich software and services leader similarly initiated an opportunistic buyback to capture the opportunity of building long term value[13].

Conclusion

In our view, such capital allocation decisions have pleased the market, with the actions above being met with positive share price reactions. These management teams have been able to successfully articulate how capital deployment can build long term value per share. Empirically, strong and well timed buybacks tend to coincide with market bottoms and precede positive index returns. In a period of heightened market uncertainty, they are perhaps the most effective way to reward shareholders, shore up investor confidence and stabilise share prices.

It is the underlying strength of corporate fundamentals that makes this possible. At the same time, we believe it is our process of targeted active engagement that can help companies along this way. Whilst market participants may feel they require a novel form of insurance to bail them out in times of trouble, the solution may lie in the hands of the very companies they invest in.

[13]Bloomberg (2022)

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