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The asset plays and turnarounds stories that benefit from ESG factors

According to legendary investor Peter Lynch, there are six different types of stocks. When I was a sector analyst covering automobiles and capital goods, I did not fully understand these categories, and was simply attracted by shares that had a low price-earnings ratio (PER). However, to my distress, my performance subsequently weakened. In order that those reading this report may be spared the same mistakes, I have summarised the six categories of stocks in the table on the next page.

First, there are the "slow growers," the "stalwarts" and the "fast growers," each of which is named in accordance with the rate of growth in profits. In addition, there are the three categories of the "cyclicals," whose profits rise and fall in line with the business cycle, the "asset plays" that own assets such as cash or land, and the "turnarounds" that seem likely to recover from the risk of bankruptcy. For example, automotive stocks are typically regarded as cyclicals whose profits fluctuate sharply in accordance with demand. It is often the case that periods of low trailing PERs coincide with peaks in business performance, and these stocks need to be sold as soon as signals of deteriorating market conditions, such as rising inventories, become visible.

The Six Categories of Stocks, according to Peter Lynch

Type	Characteristics	Sector Examples	Peter Lynch's Investment Strategy
Slow Growers	・Annual EPS growth of around 3%. ・Usually larger, older companies. ・Typically offer higher dividends.	Financials, Pharmaceutical, Electric Power & Gas	・Lynch basically does not recommend investments in these stocks as they often offer limited upside. ・Investors should be focused on dividends (dividend payout ratio, dividend profiles and the possibility of dividend hikes, etc.)
Stalwarts	・Annual EPS growth of 5-10%. ・Earnings tend to be stable even during recessions.	Information & Communications, Medical Devices & Equipment, Foods/Retail Trade, Toiletry	・Should normally comprise 10-20% of portfolio. ・Lynch recommends that investors take profits when share prices increase by 30-50%. ・PER is the most critical factor when investing in these stocks. Investors should then think about whether there is any upside left to their business growth.
Fast-Growers	・Annual EPS growth of 15% to 25%. ・Often small or medium-sized, aggressive companies that are growing rapidly. ・Frequently found in slow-growing rather than fast-growing industries.	Services, Other Products	・Should normally comprise 30-40% of portfolio. ・Focus should be put on sustainability of business growth. ・Take profits when PER of these stocks reach 40x-50x threshold.
Cyclicals	・Sales and profits tend to rise and fall in a cyclical manner. ・Investors often lose their money as these are easily confused with Stalwarts, and thus look like safe investments. ・Timing is crucial when investing in these stocks as investors should find a better entry point when earnings are improving. ・Share prices of these companies could either increase ten-fold or decline to one-tenth of the current levels.	Automobiles, Construction/Machinery, Marine & Air Transportation, Steel/Chemicals	・Should normally comprise 10-20% of portfolio. ・Investors should find entry point when the market is at the bottom of the cycle in order to capture significant upside. ・Decline of PER ratio often indicates that profits reaching their peak. ・Exit the position when you identify; 1) worsening market conditions, 2) higher volumes of inventory, 3) increased market competition.
Asset Players	・Companies that own assets with hidden value that are overlooked by investors. (e.g. cash, stocks, land, patents, brands, losses carried forward, etc.)	Railroads, Warehousing, Broadcasting	・Invest as appropriate. ・Investors should focus on hidden value and on the possibility of mergers and acquisitions. ・Exit the position if an acquisition is announced by a third party.
Turnarounds	・Companies with the potential to overcome risk of bankruptcy or default. (e.g. government bailout, recovery from incidents, etc.) ・This would also apply to companies that are highly diversified, but shifting back towards core businesses. ・Movements in share prices tend to be distorted in the market.	Electric Appliances Wholesale Trade	・Invest remaining capital in turnarounds. ・Key aspects of investment include: 1) size and structure of liabilities, 2) degree of commitment to restructure unprofitable businesses and to reduce costs, 3) ability of companies to achieve their targets. ・Exit the position when earnings reach their targets.

Source: DSBI (Tokyo), based on "One Up on Wall Street" (2001 edition) by Peter Lynch
*Since different assumptions were applied to U.S. equities at the time, the characteristics and sector examples have been modified by the fund manager to reflect the current Japanese equity market.

Peter Lynch did not fixate on any one particular type, but achieved strong performance by adjusting the type of stocks held in accordance with market conditions. Recently there have been forecasts that ESG (Environmental, Social and Governance) investing will grow in the Japanese market, including the integration of ESG factors into our investment processes. Under such conditions, what type of stocks should we invest in?

I believe that the “asset plays” and “turnarounds” will benefit the most from ESG investment. In Japan, the asset plays have historically been neglected in the equity market for long periods of time. The reason is that corporate governance challenges such as cross-shareholdings and anti-takeover measures have made it difficult for Japanese companies to execute mergers and acquisitions (M&A) to unlock the hidden value of the target company. However, there has been substantial progress in the reduction of cross-shareholdings and in the elimination of anti-takeover measures through the recent corporate governance reforms promoted by the Japanese government. As a result, an increasing number of shareholders appear to be advocating the unlocking of hidden value, through such ideas as using excess cash to improve shareholder returns, or selling off certain assets to generate profits. We presume that ongoing changes in corporate governance will encourage companies to develop M&A ideas and strategies to unlock hidden value, as Japanese companies are often cash-rich and tend to hold a substantial amount of “hidden assets” such as real estates and marketable securities (i.e. stocks).

Another area of focus should be companies in the “turnaround” category. As ESG investing continues to grow over time, any incidents or scandals could cause severe damage to companies’ ESG profiles and asset managers would be likely to become increasingly wary of investing their money in the stocks of such companies, regardless of their fundamentals. In reality, however, there have been many cases in the past in which companies actually improved their ESG profiles as they worked through issues, and sometimes even reduced their ESG risks in the long term despite bouts of criticism in the media. In such cases, we believe that investors should put their money into these “turnarounds” at an early stage, after measuring the impact of the incidents in question, as their share prices tend to recover to a level that reflects their fundamentals once ESG risks are reduced. Therefore, we think it is critical for asset managers to establish frameworks for ESG investment, as it is quite difficult to generate returns in “turnarounds” unless investing when share prices are declining in the middle of a crisis.

The “stalwarts” would also benefit from ESG investment in the short term, but not to the same degree as the “asset plays” and “turnarounds” in the medium-to-long term, as their fundamentals tend to be fairly stable. It is true that the “stalwarts” often score well on ESG practices, which means that growth in ESG investment would also be positive in terms of demand and supply of these stocks. However, it is not very easy for companies to achieve higher ESG ratings as many of them adopted business strategies for sustainable growth and won their reputations for corporate social responsibility (CSR) long before ESG come into play.

While we can expect hidden value to be unlocked in the “asset plays”, and improved financials and ESG risks in the “turnarounds”, we do not often find any significant changes in the “stalwarts” that would affect their share prices. Thus, if investors crowd into the “stalwarts” based on ESG factors, and valuations of these stocks get stretched as a result, we expect their share prices to correct, as has often been the case in the past. This, in other words, means that there will be more undervalued “turnarounds” in the market whose share prices do not reflect their long-term fundamentals.

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