

When Value Might Not Be Preferable – Market Commentary

Global developed markets outperformed the US in August with the MSCI World ex-US returning +4.4% vs the S&P 500 at +2.0% in USD terms though both were positive. Japan was notable for its +7.0% USD return while Canada, another relatively large market, returned +5.5%. The MSCI World i.e. inclusive of the US, returned +2.6%.

Emerging Markets underperformed in aggregate at +1.3% but South Africa outperformed materially at +3.5% in local currency terms, assisted by some currency appreciation for +5.8% in USD terms. The bulk of the return came from Gold shares.

Finally Value outperformed Growth at +3.6% vs +1.7% with the Tech-heavy Nasdaq returning +0.9%. Tech performed poorly as a sector in August, returning +0.4% for the month.

These various returns are summarised in Table 1 below. It is important to note South Africa is the best-performing market for the year-to-date in USD terms, primarily courtesy of its Gold and Platinum exposure.

Table 1. South African and global equity returns (USD) for August 2025*

	Aug-25	YTD 2025
FTSE/JSE ALSI (ZAR)	3.5%	23.6%
FTSE/JSE ALSI (USD)	5.8%	31.8%
MSCI World	2.6%	13.8%
MSCI World ex-US	4.4%	22.7%
MSCI EM	1.3%	19.0%
MSCI Value	3.6%	14.9%
MSCI Growth	1.7%	12.7%
S&P 500	2.0%	10.5%
Nasdaq 100	0.9%	12.0%

*Total return indices, Source: Factset

A global Value fund has recently gained some prominence in South Africa due to good performance and a commensurate increase in assets (a sincere well done on this success). At a recent conference the fund manager pointed to a US beauty retailer as an example of a Value share which has helped fund performance and indicated that he expects more. The share has recently returned +96.7% so the position has undoubtedly been a success. Out of interest we looked into the company and its share price performance. Somewhat surprisingly we found reasons why we would prefer not to invest in such a share even with a prospective +96.7% return. Instead we thought it was an interesting case study of diverging approaches, or styles.

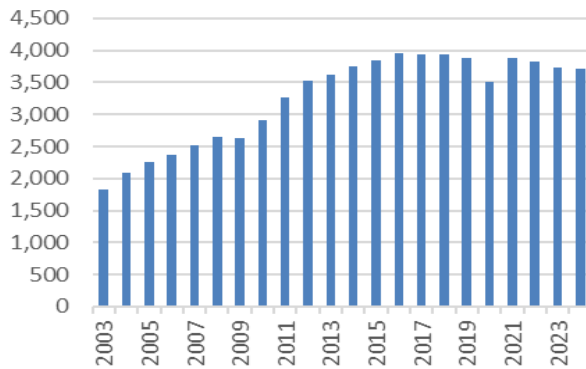
To be clear we are not writing this commentary about the fund, its manager or their choices but as a reflection on our own investment process.

The business in question is Sally Beauty Holdings, a USD1.5bn market cap US small cap supplier of beauty products (hair, skin and nails). It distributes products through two segments – Sally Beauty Supply which are retail stores open to consumers and professionals, and Beauty Systems Group, more focussed on professionals, salons and trade clients. The Group sells through 4 500 outlets globally, including franchise units.

How has the business performed operationally?

The business is under consistent pressure. Chart 1 below illustrates Sally Beauty's aggregate sales.

Chart 1. Sally Beauty annual revenue in USDm



Not that one would guess from the company's management presentation or commentary but per Chart 1 above sales have been consistently declining since 2017, well before any Covid-related disruption. Projections are not much better. If anything, we see beauty as a defensive category and would not have been surprised to find some resilience during the Covid period but this does not appear to have been the case.

The company's management has been closing unprofitable stores, but we think the problems run deeper, evidenced by an equally consistently declining profit margin, presented in Chart 2 below. Profitability has been declining from 2014, even earlier than when sales started to decline. Recent management action does not appear to be bearing fruit.

Chart 2. Sally Beauty operating profit margin



The consistently declining profitability eventually reflects on return on capital and cash flow metrics presented in Charts 3 and 4 below.

Chart 3. Sally Beauty return on capital

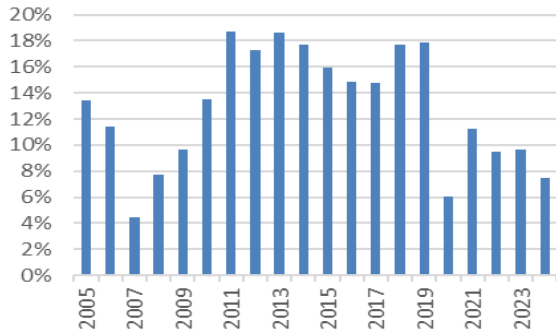
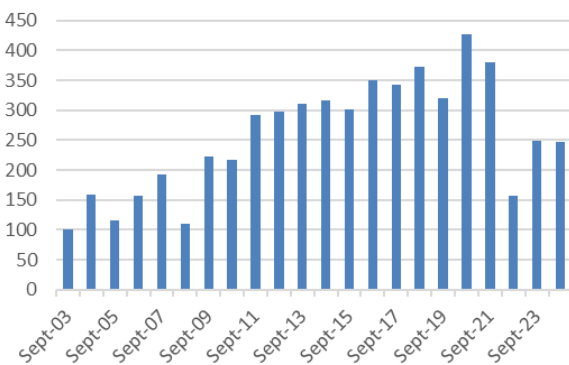


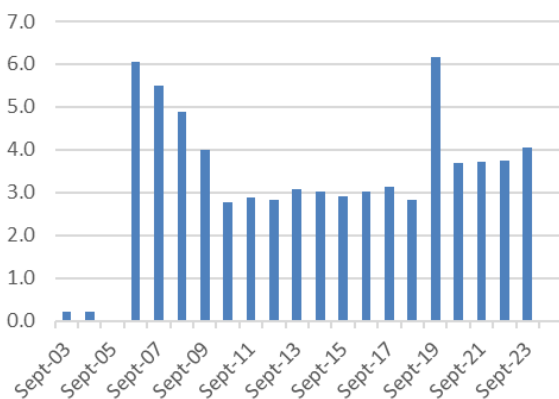
Chart 4. Sally Beauty operating cash flow in USDm



While the company managed to increase operating cash flow in the face of declining sales, it is of course a matter of time before things break down, and this duly happened in 2022.

Last but not least, debt. Per Chart 5 below while debt is declining, profits are declining at a faster pace so Debt / EBITDA, never particularly healthy, is closing on 4x (we tend to prefer 3x and below)

Chart 5. Sally Beauty debt to EBITDA



Summary operating performance

We could continue with further more detailed descriptions but you get the idea. Warren Buffett's famous quote about the reputation of the industry remaining intact comes to mind. We do not reproduce the quote here. There is always the possibility of a

management turnaround, and these do happen, but are typically difficult to execute and success is relatively rare. Turnarounds do offer opportunities but we think Sally Beauty is not such an opportunity.

What about the price?

This is indeed a key issue. If an asset is sufficiently cheap, a case could always be made for generating a capital return from its shares. This is the case with Sally Beauty. Per Chart 5 below, there is no question at a PE of 8 its valuation is low, especially in the lower interest rate US environment (and lower prior to its most recent move).

A low PE on its own does not necessarily make a value investment case. One would have to consider expected future profits, dividends, price to NAV etc.

Chart 5. Sally Beauty PE ratio



Price performance

Per Chart 6 below, after strong outperformance in 2021, the stock price declined to 2025. Most recently it has enjoyed a sharp burst, rerating by a strong +96.7% as the market price adjusts to current and expected future profits off a low base.

Chart 6. Sally Beauty price performance relative to the S&P 500



The short term return is very attractive, yet unsustainable. The underlying business is not performing well and the share price will ultimately underperform (as it has to date), complete with short, sharp bursts as has just occurred.

The best a Value manager could hope for is to gain off these short sharp bursts. In order to be consistently successful however one has to be consistently, and sufficiently, correct on these re-ratings across multiple assets. Moreover, almost inevitably, these assets never have good operating performance. If they did, the price would typically not fall sufficiently to enable a strong rally as we have seen. As it is, poor operating assets are far more prone to further downside surprises over and above their already low valuation.

Another aspect to consider is the holding period. In theory one could hold for years until "value is realised". In practice, especially with the volatility seen in the US, holding periods until a target price or return are achieved are relatively short. In this, Value investing often resembles consistent trading in and out of poor assets generating trading costs, which may or may not be successful.

All of the above is not to say this sort of approach is unsuccessful – clearly it can be. There are different ways of outperforming however.

Investing in an asset with better operating performance might take longer, but, we find, more consistent and less risky. Prices are usually not as low but move in line with the better and more consistent operating performance. This type of approach is also closer to what an intuitive understanding of investing is – buying an asset generating a return, an underlying operating return that is, which the stock price then follows. This sort of approach also has its challenges – the market environment has not necessarily been favourable since 2022 for example.

With consistency of underlying performance however we think sooner or later the returns materialise.

Incidentally, on our numbers, the expected return on Sally Beauty from here is +5% p.a. so if we were Value investors it would be time to sell. In reality we would be far more inclined to sell the share short in a hedge fund strategy as part of a set of diversified short positions, and wait for a declining business to decline further.