Q3 2019 | Equity Outlook

What happened to value stocks?

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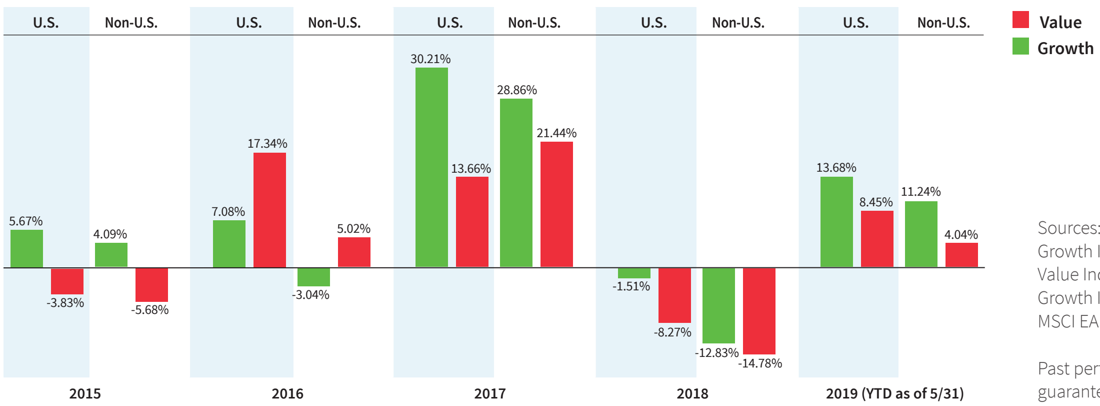
What happened to value?

Market observers are aware of the fact that growth stocks have outperformed value for most of the past decade. Even more notable are trends over the past five years. During this period, the two styles diverged considerably, with growth taking the lead by a wide margin. In fact, the valuation spread — the difference between the market's cheapest and most expensive stocks — is at one of its widest points in history.

What could trigger a reversal of this trend, and how should equity investors be positioned? Our investment professionals offer their views on the changing landscape and how the best approaches today may differ from those that worked best 10 years ago.

Growth has trounced value in U.S. and international markets

Annual performance



Sources: Russell 1000 Growth Index; Russell 1000 Value Index; MSCI EAFE Growth Index (ND); MSCI EAFE Value Index (ND)

Past performance is not a guarantee of future results.

For use with institutional investors and investment professionals.

Mind the valuation gap

Shep Perkins, CFA
Chief Investment Officer, Equities

Growth versus value — it's a frequently discussed and debated topic for equity investors. History has shown us that both styles alternate in leading the market, and neither wins indefinitely. But that may be little comfort to value investors over the past 10 years. For most of the past decade, growth has outperformed, and it has been most pronounced over the past five years, when growth has trounced value in both U.S. and international markets.

Cheap stocks have never been cheaper

Today, the valuation spread — the difference between the most expensive and the cheapest stocks — is at one of its widest points in history. The highest price/earnings multiples in today's market, which belong almost exclusively to growth stocks, are extremely elevated relative to the market's lowest P/Es, the bulk of which are in the value universe.

Why don't investors want value?

Since 2014, despite equity market advances, there has been a lingering cloud of concern about the pace and sustainability of global economic growth. The persistent fear that we are in the late innings of the economic cycle has done nothing to boost the popularity of value stocks. Economically sensitive sectors, such as financials and energy, make up a significant portion of value indexes. GDP growth matters to these businesses, and investors do not want to own them at the start of a downturn, as their earnings are viewed as vulnerable.

At the same time, many growth companies today appear to offer the benefit of durability. Investors believe their products and services are likely to remain in demand regardless of overall economic conditions. Many of today's leading growth companies are developing faster, cheaper — and groundbreaking — offerings that can be adopted globally. They are generating attractive returns on invested capital with higher margins and much lower capital intensity than many traditional businesses.

Obsolescence: A risk for all businesses, old and new

Enormous strides in innovation and technology have made obsolescence risk a key consideration for today's equity investors. Traditional businesses are under great stress. Television broadcasters, rural telecom providers, retailers, legacy software, advertising agencies, and many other industries face new forms of intense competition. It has been brought on by the advent of mass digitization and the global, low-cost reach of the internet. While many businesses will meet, and even overcome, these challenges with innovations of their own, the threat of obsolescence has been yet another headwind for value investors.

This threat is certainly not limited to value stocks or older businesses. It is a risk even within the narrow band of large-cap technology stocks that have dominated the market in recent years. These companies must continually work to create and sustain moats and maintain their competitive advantage, recognizing that a new and better version of themselves could emerge at any time. Among the many examples is Yahoo!, an Internet pioneer and one of the most popular search engines in the late 1990s and early 2000s. It was, of course, eclipsed by Google, which was launched later than Yahoo! but offered innovative features that led to its market share dominance today.*

Time for new market leadership?

What could bring about a shift in the dominance of growth stock performance? A jump in inflation could be a catalyst. Inflationary pressure could force the currently dovish Federal Reserve to hike rates. As a result, we may see investors less willing to pay the steep price-to-earnings multiples that growth stocks command in today's low-interest-rate environment. A recession — or more specifically, the aftermath of one — could also revive value stocks. Typically, value stocks outperform in a recovering economy, especially when their earnings are depressed but are starting to recover. The recession itself would be painful for both styles, but growth stocks are likely to take a harder hit, as their elevated P/Es have the farthest to compress.

* Investment examples are shown for illustrative purposes only and should not be considered a recommendation to purchase or sell any security. The reader should not assume that an investment in the securities identified was or will be profitable. As with any investment, there is a potential for profit as well as the possibility of loss. Yahoo! and Google are the two largest search engines per market share as of May 2019 (Source: http://gs.statcounter.com/search-engine-market-share).

What happened to value?

Darren A. Jaroch, CFA
Portfolio Manager

As a value investor for over 20 years, I have a few observations about the asset class today. The past decade has often been painful for value investors. The approaches that worked best 10 years ago aren't likely to work as well today. But there are always opportunities for those who know where to look.

Why has value underperformed?

Looking at the past decade, the core of the problem has been the response by central banks to the global financial crisis. The market was flooded with liquidity, which encouraged investors to move higher on the risk curve, sending them out of value and into growth. As growth became a scarce commodity, investors were willing to pay up for it, even when multiples reached extreme highs.

Sector biases and the shortcomings of indexes

The value investing environment has changed dramatically, but some measurements of value, such as benchmark indexes, have not caught up. Most indexes are only rebalanced once a year, and index performance is affected greatly by sector concentration. The financials sector, for example, makes up a considerable portion of value indexes. This is largely because financials have historically had low price-to-book values.

Indexes place a heavy emphasis on price-to-book value, which we believe is less relevant today. Relying solely on price-to-book as a measure of value is a sure way to miss opportunities elsewhere. Intangible assets, which are often overlooked, can be more important in analyzing value. Looking back 10 or 20 years ago, value stocks were more easily classified by sector, and tangible assets such as factories, land, and equipment, were an important, and relatively static, measure of value.

> "We differentiate between cheap and undervalued, and our strategy brings us to places beyond traditional value sectors."

Don't confuse cheapness with value

Cheap stocks are easy to identify. And in many cases, they are cheap for a reason. In our view, a passive benchmark is not the way to target value in the market. Our strategy is to differentiate between cheap and undervalued. To do this, we assess the equity universe daily — across both growth and value styles. We combine a six-factor quantitative model with classic fundamental research. Defining value in this way helps keep us on top of the changing market and brings us to places beyond traditional value sectors.

Fertile ground: Potential great finds in what's left behind

Over the past three years, so many stocks have been left behind by investors who were only attracted to a select group of high-multiple growth stocks. Until very recently, it was challenging to find value in those "left behind" names. While some of these businesses are permanently impaired, many others were unfairly punished in the 2018 fourth-quarter downturn. Today, for the first time in a while, we view the equity universe as fertile ground for attractive, undervalued companies.

Across this landscape, we look for relative value. This means identifying companies that are attractively valued relative to businesses within the same sector. The most attractively priced technology stock, for example, could be considerably more expensive than most utility stocks. That doesn't preclude it from being an attractive value opportunity, in our view. This is how our portfolio can differ from the benchmark and, ideally, outperform it.

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MSCI EAFE Value Index (ND) is an unmanaged index which measures the performance of equity securities representing the value style in countries within Europe, Australasia, and the Far East.

Russell 1000 Growth Index is an unmanaged index of those companies in the large-cap Russell 1000 Index chosen for their growth orientation.

Russell 1000 Value Index is an unmanaged capitalization-weighted index of large-cap stocks chosen for their value orientation.

S&P 500 Index is an unmanaged index of common stock performance.

Indexes assume reinvestment of all distributions and do not account for fees. It is not possible to invest directly in an index.

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