What happened to value stocks?

In this issue
Mind the valuation gap
Durable themes with room to grow
What happened to value?
Cannabis stocks: Too high on hype?

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 growth and value portfolio managers offer their views on the changing landscape and how the best approaches today may differ from those that worked best 10 years ago. We also take a look at investment prospects for the nascent cannabis industry.

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

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>-2.43%</td>
<td>5.67%</td>
<td>-3.68%</td>
<td>7.08%</td>
<td>30.21%</td>
<td>28.86%</td>
<td>21.16%</td>
<td>21.64%</td>
</tr>
<tr>
<td>2016</td>
<td>4.09%</td>
<td>17.34%</td>
<td>-3.04%</td>
<td>5.02%</td>
<td>-1.51%</td>
<td>13.68%</td>
<td>8.45%</td>
<td>11.24%</td>
</tr>
<tr>
<td>2017</td>
<td>3.42%</td>
<td>30.21%</td>
<td>21.16%</td>
<td>21.64%</td>
<td>-1.51%</td>
<td>13.68%</td>
<td>8.45%</td>
<td>11.24%</td>
</tr>
<tr>
<td>2018</td>
<td>12.28%</td>
<td>14.70%</td>
<td>-12.83%</td>
<td>14.70%</td>
<td>-1.51%</td>
<td>13.68%</td>
<td>8.45%</td>
<td>11.24%</td>
</tr>
<tr>
<td>2019 (YTD as of 5/31)</td>
<td>17.34%</td>
<td>30.21%</td>
<td>21.16%</td>
<td>21.64%</td>
<td>12.28%</td>
<td>14.70%</td>
<td>-12.83%</td>
<td>14.70%</td>
</tr>
</tbody>
</table>

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

Not FDIC insured | May lose value | No bank guarantee
Mind the valuation gap

Shep Perkins, CFA
Chief Investment Officer, Equities
Portfolio Manager of Putnam Global Equity Fund
and Putnam Sustainable Leaders Fund

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.

“ The threat of obsolescence has been yet another headwind for value investors. ”

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.
Durable themes with room to grow

Looking back on a multiyear period of strong performance from growth stocks, it is natural to question whether this group of stocks still has room to outperform. The answer is yes, though there are some important distinctions to be made. To this point, our priority is finding durable long-term growth ideas with multi-year drivers. We conduct rigorous front-end analysis that is based on growth prospects over time periods of years rather than months or quarters. We also identify companies that have demonstrated above-market growth rates and have the potential to continue delivering that level of growth for years to come. At a high level, the companies we target tend to be in areas of the market that are less vulnerable to fluctuations in the economy. In fact, we explicitly factor in prior-cycle downside capture as part of our investment criteria.

“We research key trends or problems that businesses are working to address.”

Given this framework, a logical question would be: How does one determine the longevity of a company’s growth potential? Our approach includes a thematic overlay. We identify key themes — trends or problems, for example — that businesses are working to address. We constantly monitor the themes to determine which companies are poised to benefit. Recent themes include personalized medicine, the rise of robotics, the humanization of pets, cloud infrastructure and software, health-care inflation, and the transition from cash and credit cards to digital wallets.

Investment opportunities emerge from an array of themes

**Theme:** The humanization of pets  
**Company:** IDEXX Laboratories (IDXX)

Pets have become an increasingly important part of the typical household, receiving the same level of attention, care, and preservation of health as human family members. Demand for quality pet care is strong and growing, and IDEXX Laboratories is a leader in capitalizing on this trend. IDEXX is an animal health-care company specializing in diagnostic testing, including in-office testing kits for veterinarians. IDEXX has a 70% market share of point-of-care veterinary facilities, and has been growing its earnings at double-digit rates. The company’s testing kits, components, and supplies — many of which are disposable items — generate a healthy level of recurring revenue. We believe the double-digit growth rates should continue for many years to come regardless of variations in the underlying economy.

**Theme:** Digital wallets and e-commerce  
**Company:** PayPal Holdings (PYPL)

The rapidly growing use of digital transactions is a key theme in our research. Among our top investments is PayPal Holdings, which enables businesses and individuals to electronically transfer money. In addition to the growing number of PayPal customer accounts, we are optimistic about the potential to monetize Venmo, the company’s app that provides peer-to-peer payments. User growth has been very strong across the platform, particularly among younger consumers. With 40 million existing accounts, PayPal has the potential to tap into that user base with a number of additional offerings, including innovative banking services. PayPal’s agnostic platform — it is not reliant on a limited ecosystem like Apple’s iPhone — puts it in a strong position to keep adding users and services to its existing base, which should help power its future growth.

As of 3/31/19, IDEXX represented 1.33% of Putnam Growth Opportunities Fund assets, and PayPal represented 3.17% of fund assets.
What happened to value?

Darren A. Jaroch, CFA
Portfolio Manager of Putnam Equity Income Fund and Putnam International Value Fund

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.

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 keeps us on top of the changing market and brings us to places beyond traditional value sectors.

Concentration in sectors is a significant driver of index performance
Most indexes are only rebalanced once a year, and index performance is affected greatly by sector concentration.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Russell 1000 Growth</th>
<th>Russell 1000 Value</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information technology</td>
<td>33.64%</td>
<td>9.99%</td>
<td>23.64%</td>
</tr>
<tr>
<td>Financials</td>
<td>4.39</td>
<td>22.83</td>
<td>18.44</td>
</tr>
<tr>
<td>Consumer discretionary</td>
<td>15.28</td>
<td>5.34</td>
<td>9.94</td>
</tr>
<tr>
<td>Energy</td>
<td>0.76</td>
<td>9.33</td>
<td>8.59</td>
</tr>
</tbody>
</table>

As of 4/30/19
Fertile ground: 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 promising 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.

“For the first time in a while, we view the equity universe as fertile ground for attractive, undervalued companies.”

Relative value example: Cigna
Cigna’s valuation is at its lowest level in almost a decade. And it is a great example of how we differentiate cheap versus undervalued. Shares of this managed care company have declined for a number of reasons. But we believe that short-term challenges have caused investors to underestimate the company’s long-term potential.

In 2018, Cigna acquired Express Scripts, a pharmacy benefit management firm. While many investors believed that Cigna overpaid for it, our view is more positive. We believe the deal enhances Cigna’s core business, improves the customer experience, and will generate significant additional free cash flow. Investors also shunned Cigna in response to proposals from presidential candidates for a single-payer or “Medicare for all” system in the United States. We believe such a system is not even a remote possibility. In fact, if Medicare expands, which is a more likely outcome in our view, the managed care industry as a whole would benefit.

As of 3/31/19, Cigna represented 1.30% of Putnam Equity Income Fund assets. It was not a holding in Putnam International Value Fund.

Relative value example: Microsoft
Microsoft, one of our top holdings, is an example of relative value. Why is this technology stock, a significant component of growth stock benchmarks, in our portfolio? The reason is relative value — it is attractively valued for what it offers. Microsoft excels in its three core businesses. Most of its peers focus on just one of those businesses, yet those peers trade at much higher multiples.

Microsoft’s divisions include its classic Office 365 franchise, a software-as-a-service business that is now offered as a paid subscription. Its cloud-computing business, Azure, has delivered solid revenue growth and is a key competitor in this segment of the market. And Microsoft’s video gaming business, best known for Xbox, offers an impressive lineup of gaming platforms.

As of 3/31/19, Microsoft represented 3.31% of Putnam Equity Income Fund assets, and it was not held in Putnam International Value Fund.
Cannabis stocks: Too high on hype?

Matthew M. Culley
Portfolio Manager, Putnam Global Equity Fund
Analyst, Global Consumer Sector

I spend a great deal of time researching the global consumer sector, and cannabis is a very popular topic. There are many questions and plenty of hype around this industry, which is in its infancy — at least from a legal investing perspective. I will begin with a conclusion. I believe we are at the peak of inflated expectations for cannabis investing.

Gaining the “social lubricant” market share

Analysis around cannabis valuations is largely focused on the sheer size of the industry as it shifts from illicit to legal, and its potential to compete with alcoholic beverages. Proponents of cannabis products cite inherent benefits over alcohol, such as lower levels of carbs and calories, and no hangovers. To illustrate my views, I’ll use Canopy Growth, one of the first publicly traded cannabis producers in North America and the largest by market capitalization (trading on the Toronto Stock Exchange as WEED).

Canopy is commanding a very high valuation in part because it is the first and largest company of its type. The “first mover” advantage for consumer product companies can be a challenge because consumers at this stage have yet to develop any brand awareness. An open question remains as to whether Canopy will be able to create the “Budweiser” equivalent of cannabis. Despite this lack of clarity, Canopy has a $15 billion valuation, with revenues of just $61 million for fiscal 2018, and $172 million expected for fiscal 2019. The market is currently valuing the company at nearly 100x expected revenues. If the company paid out as annual dividends all of next year’s revenues (revenues, not profits), it would take nearly a century to break even on an investment today. It’s safe to say that the market is assuming Canopy becomes a significantly bigger company in the future.

The global beverage market presents some formidable competition. Molson Coors, for example, is valued at $13 billion, but generates $11 billion in revenue and over $1 billion in free cash flow. Another important note: Cannabis is federally legal for recreational use in just one country, Canada. The estimated size of the Canadian recreational cannabis industry is roughly $8 billion. Canopy is being valued at two times the addressable market. Molson Coors, on the other hand, is a global beer company primarily competing in the $6 billion Canadian market, as well as the $35 billion U.S. market and the similarly sized pan-European market.

“Investors sometimes forget that it can take decades for an industry to establish itself and for winners to emerge.”

What makes a winner?

Ultimately, for Canopy to come close to the leaders in consumer packaged goods, it would need to generate comparable gross margins in the 40%-60% range. The question we ask is, what incremental value is a company bringing to the consumer above and beyond what it costs to make the product? It may be luxury brand status or superior product quality, but given that Canopy has only spent about $100 million in sales and marketing and less than $10 million in R&D since inception, it is much too early to make these determinations.

Flashback to 1999

A look back to the late 1990s offers some perspective. The Internet hype had companies with zero revenue valued at billions of dollars. Of course, it all came crashing down, and from the ashes astute investors found some very lucrative investments. Even Amazon shares plunged from $100 to $6. But we must remember that the recovery took years. Investors sometimes forget that it can take even decades for an industry to establish itself and for winners to emerge. Today it makes sense to wait out the marijuana hype until there’s more evidence that these cannabis producer business models can support their valuations.

As of 3/31/19, Canopy Growth and Molson Coors were not held in Putnam Global Equity Fund.
An active, research-driven approach to investing in equities

Equity investing at Putnam features a tenured and talented team of portfolio managers backed by an integrated group of research analysts with worldwide reach. Our research organization is structured to focus fundamental analysis on the factors that matter most in global equity markets.

EQUITIES AT PUTNAM

Shep Perkins, CFA
Chief Investment Officer, Equities
Investing since 1993
Joined Putnam in 2011

Kate Lakin
Director of Equity Research
In the investment industry since 2008
Joined Putnam in 2012

The power of independent research

Fundamental research has always been an important driver of security selection for Putnam. Our firm is built with the scale to research global markets while also allowing analysts to achieve thorough conviction in their recommendations. Our research organization thrives in an entrepreneurial and collaborative environment, where out-of-the-box critical thinking is encouraged, and analysts are focused on developing differentiated insights.

MSCI EAFE Growth Index (ND) is an unmanaged index that measures the performance in 20 countries within Europe, Australasia and the Far East with a greater-than-average growth orientation.

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.

Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Russell® is a trademark of Frank Russell Company.

The views and opinions expressed are those of the authors: Shep Perkins, CFA; Richard E. Bodzy; Darren A. Jaroch, CFA; and Matthew M. Culley, as of May 31, 2019, are subject to change with market conditions, and are not meant as investment advice.
Consider these risks before investing: International investing involves certain risks, such as currency fluctuations, economic instability, and political developments. Investments in small and/or midsize companies increase the risk of greater price fluctuations. Emerging-market securities carry illiquidity and volatility risks. Growth stocks may be more susceptible to earnings disappointments, and value stocks may fail to rebound. Stock prices may fall or fail to rise over time for several reasons, including general financial market conditions and factors related to a specific issuer or industry. Risks associated with derivatives include increased investment exposure (which may be considered leverage) and, in the case of over-the-counter instruments, the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. You can lose money by investing in the fund.