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Global Investment Strategy

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Value Investing: Alive and Well in Today's Market

Value could be poised for a period of outperformance—here are five questions to consider.

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Is value investing dead? A provocative question that I've had to answer a lot in recent years, and a fair one in light of market performance patterns over the past decade-plus. Excluding the stunning rebound of value stocks post-pandemic, growth-style equities have more or less reigned supreme since the Global Financial Crisis (GFC), as the search for fast-growing companies relative to lackluster economic growth became a guiding principle for many equity investors.

Can we be sure the next decade of equity investing will look the same? I don't think so. In fact, I believe the drivers of the next economic and market cycle could favor value stocks over their growth counterparts.

Key Points

- Historically, periods of value outperformance have lasted anywhere from 10 to 20 years and don't always line up neatly with economic recessions.
- Sector compositions of the Russell 1000 style indices have shifted markedly over time, resulting in value now being much more diversified than in the past.
- We may be in a new investment landscape characterized by higher inflation and rates, and increased spending aimed at enabling the energy transition. In light of this, investors may want to consider increased value allocations.

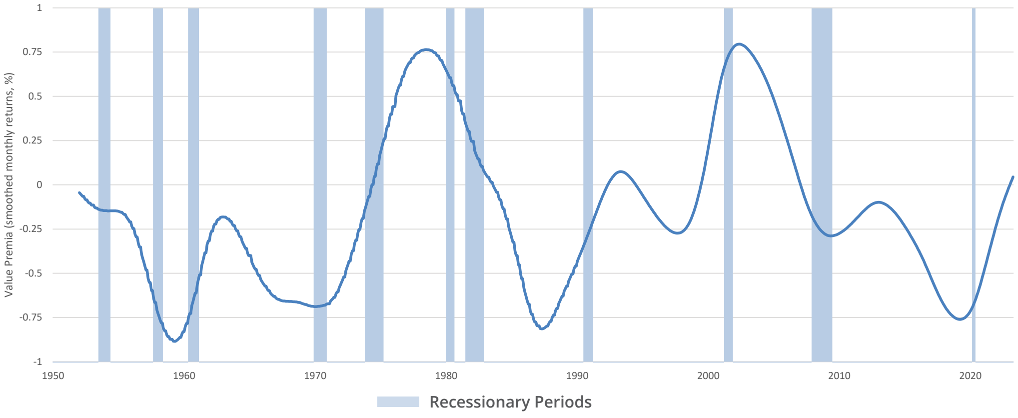
Challenging My Thesis: Five Recurring Client Questions

To illustrate, I put my thesis to the test against some questions clients have been asking me lately:

1. Doesn't equity performance depend on the prevailing economic cycle?
Conventional wisdom says yes, but our research shows this is only true to some extent: Historically, periods in which value stocks have outperformed before giving way to growth leadership have lasted anywhere from 10 to 20 years and don't always line up neatly with economic recessions. As **FIGURE 1** shows, value *sometimes* outperforms growth coming out of a recession, but not without fail. I think a more accurate guide to equity style performance can be found in a set of four factors—inflation, real interest rates, liquidity, and GDP—that seem to better align with value cycles, and suggest that we're still in the early stages of the value cycle that began in 2020.

FIGURE 1

Value/Growth Cycles Have Historically Lasted Around 10-20 Years on Average
Performance of the Russell 1000 Value Index minus the Russell 1000 Growth Index



As of 4/28/23. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. The value risk premium refers to the excess return that value stocks, or stocks perceived to be undervalued, tend to generate over growth stocks, or those with higher valuations. Sources: Smoothed monthly returns of the Russell 1000 Value Index and Russell 1000 Growth Index returns, backfilled using proxy methodology prior to 1980, 5/23. Please see last page for index definitions.

2. Isn't value dominated by financials and energy?
This is another commonly held assumption that doesn't hold up to scrutiny. In reality, the sector compositions of the Russell 1000 style indices have shifted markedly over time, resulting in value now being much more diversified than in the past. As of 4/30/23, the growth camp is highly concentrated in technology (46%), followed by consumer discretionary (17%) and industrials (13%). Value, meanwhile, has its largest sector weightings allocated to financials (18%), healthcare (16%), and industrials (13%). So, among other things, this greater sector diversification means the value index may now be better positioned to weather a sudden, sharp downturn in any one sector.

3. Value stocks have been cheap for quite a while, so what's different now?

Despite value's strong performance in 2021 and 2022, broadly speaking, these stocks remain inexpensive on a simple price/earnings[1] basis. What has changed is profitability in the value space. I look at a profitability metric (free cash flow relative to enterprise value) to assess how efficiently companies are generating cash relative to their total market value.

For most of the post-GFC era, growth has scored higher on this ratio than value, but that flipped in 2020, rendering value more attractive from that perspective. Just remember that valuations alone aren't typically a primary catalyst for outperformance by value, but they can provide support if other positive drivers are in place, particularly higher inflation and interest rates, and the ongoing transition to green energy.

4. How exactly would higher or stickier inflation change a bullish value outlook?
If anything, it would boost my conviction in my outlook because value has historically delivered some of its strongest performance runs during higher-inflation periods, punctuated by the hyperinflation stretch the US experienced in the 1970s and 1980s. While I don't expect today's inflation to approach those lofty levels, I do think several macro forces could conspire to keep consumer prices elevated over the next few years: Ongoing labor and commodity shortages, post-COVID supply-chain reorganization, the broad trend toward deglobalization, and the inexorable energy transition are all elements of what could be a new higher-inflation, higher-interest-rate regime.

5. What could go wrong that might undermine this thesis?
A scenario in which the US Federal Reserve rapidly cuts interest rates, while unlikely as of this writing, could propel growth over value, given the former's inherently longer duration. However, while an economic recession would seem like a big risk, value actually *outperformed* growth during the US recessions of 1960, 1973, 1990, and 2001. If I'm right though, higher-for-longer inflation and rates could assert themselves as key engines of value-stock outperformance in the period ahead.

Value has historically delivered some of its strongest performance runs during higher-inflation periods.

My Investment Bottom Line

The value/growth debate is much more nuanced than the facile rules of thumb that investors frequently apply. I believe investors should consider that we may be in a new investment landscape characterized by higher inflation and rates, plus increased investment and spending aimed at enabling the energy transition. At the very least, with growth indices becoming more concentrated in mega-cap technology stocks, I believe many investors should consider increased allocations to value in an effort to improve overall portfolio diversification.

Talk to your financial professional about the right balance of growth and value stocks in your portfolio.

[1] Price/Earnings is the ratio of a stock's price to its earnings per share.

Russell 1000 Value Index is an unmanaged index measuring the performance of those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values.

Russell 1000 Growth Index is an unmanaged index which measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

Important Risks: Investing involves risk, including the possible loss of principal. • Different investment styles may go in and out of favor, which may cause an investment to underperform the broader stock market. • Diversification does not ensure a profit or protect against a loss in a declining market.

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