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Value's Resurgence: Flash in the Pan or Here to Stay?

Can value's recent outperformance be sustained? Here are some questions worth asking.

Insight from sub-adviser Schroders Investment Management

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Low-valued stocks trumped those with higher growth potential by a significant margin in 2022. The MSCI World Value Index[1] significantly outperformed the MSCI World Growth Index[2].

This was the second consecutive calendar year in which value outperformed growth after having underperformed in seven of the previous eight years by a wide margin. Those seven lean years led many to pose the question "Is value investing dead?" Value acolytes are now hoping the better recent performance will have marked 2020 as the investment style's nadir.

The big question for equity markets today is whether value's recent outperformance is simply a (slightly prolonged) flash in the pan, or if a genuine regime shift is bringing a return to a heyday for cheap stocks.

Key Points

The relative valuation between growth and value tends to revert to the mean over time. Few expensive companies continue to get more expensive. Few cheap companies remain cheap forever.

While cyclical companies trading at bottom valuations have a lot of bad news already baked in, the investor should be prepared to appear naive until the tide turns.

We see many compelling cheap-valuation opportunities around the global-equity market aside from banks and energy. Value isn't just a one-way sector bet.

After Value's Strong Run, Can It Continue to Outperform?

Guessing whether value or growth will outperform next quarter has proven to be a fool's errand. However, relative valuation[3] is one guide that can offer strong powers of prediction for long-term performance between the two.

The reason? The relative valuation between growth and value tends to mean-revert[4] over time. In other words, very few expensive companies continue to get increasingly more expensive, and very few cheap companies remain cheaper forever. We see this relationship in **FIGURE 1**, which shows the relative valuation between growth and value for the MSCI World Index.[5]

Value's median discount to growth[6] has been 42% since 1975 (**FIGURE 1**). You can see that whenever the discount moves significantly above or below this level (the dotted green line), mean reversion kicks in to bring it back to this long-run median.

FIGURE 1
Value Is Still Trading Below Median Discount To Growth
MSCI World Value Index % premium[6] to growth on P/E, P/BV, and P/Div

As of 12/30/22. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Price/earning ratio (P/E) = stock price divided by the company's earnings per share; price/book value (P/BV) = the ratio of a stock's price to its book value per share. Price/dividend ratio (P/Div) = the ratio of a stock's price divided by its dividend yield, or the income paid to investors as percentage of price. Sources: MSCI, Morgan Stanley Research.

Despite value's recent strong run of performance, it still trades at an approximate 60% discount to growth and far below the long-term median. Whichever region you pick, the story is the same; in the UK, Europe, emerging markets, or globally, value stocks are still "on sale."

As we can see from **FIGURE 1**, there's only one precedent for today's level of valuation dispersion: the post-dotcom era. Of course, past performance does not guarantee future returns, but when the discount disappeared following the bursting of the dotcom bubble, value saw its most successful period on record. Proponents of the value style hope mean reversion continues to offer a powerful tailwind for its continued outperformance.

Of course, this argument is built on relative valuations. While the low relative valuations and the potential relative outperformance is welcomed, it's absolute performance that ultimately grows capital.

In that regard, despite value's strong performance, its absolute valuation is still compelling, with the cheapest quintile of the global-equity market trading on a cyclically adjusted price-to-earnings (CAPE) ratio of 9.2-times-earnings compared to the long-term average of 13.0-times-earnings (**FIGURE 2**). History shows that low absolute valuations are attractive for long-term prospective returns. (The CAPE ratio—also known as the Shiller P/E multiple—is a valuation measure that uses real earnings per share over a 10-year period to smooth out fluctuations in corporate profits that occur over different periods of a business cycle.)

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FIGURE 2

Cheapest Fifth of the Market Is Still Trading Below Long-Run Average

Shiller P/E of the cheapest quintile of MSCI World Index

Past performance does not guarantee future results. Chart data: 1/31/90-12/31/22. Median Shiller P/E by quintiles of Global Value. Value is based on composite score from the equal-weighted average of the 12-month forward P/E, price-to-book and the total yield (dividend yield plus net buyback yield). The universe is the MSCI World Index. Stocks are equal-weighted and portfolios rebalanced every quarter. Source: Morgan Stanley Research.

Is It Crazy to Own Value Going into a Recession?

Some people believe that value may struggle to maintain its recently improved performance because of the likelihood of a recession. Recessions tend to hit cyclical companies—those most sensitive to the economic cycle—the hardest, and many cyclicals are considered value stocks given the volatility of their earnings.

The idea that earnings for these businesses will fall, perhaps dramatically, as we move into a recession isn't controversial. However, the stock market typically moves ahead of earnings downgrades when it values businesses, and does so even more when a recession is well-signaled, as is the case today.

In other words, consider being prepared to buy ahead of the completed earnings-downgrade cycle. Wait too long, and the market may already see through the other side of a recession. By then, the valuation could have already moved and you may have missed out on the bulk of the return.

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This is why it's important to have a long-enough time horizon to hold businesses through the tough times brought by a recession. It's equally important to be judicious about which economically sensitive businesses you choose to own. We spend a lot of time scrutinizing debt levels and stress-testing financial accounts to see what it would take to break the valuation. To provide a crucial margin of safety, the more room to maneuver, the better.

While cyclical companies trading at bottom valuations have a lot of bad news already baked in, investors should be prepared to appear naive until the tide turns. History shows trying to time the exact point at which that turning point may come is a virtually impossible task. In the eyes of the die-hard value investor, it's better to be early than late.

Moreover, the assumption that owning value in a market sell-off or going into a recession is a bad idea is based on experience from the recent period of quantitative easing and ultra-low interest rates. It's not reflected in the longer-term data, nor in 2022. Prior to the Global Financial Crisis in 2008, and particularly given the strong outperformance during the dotcom bust, value was considered by many to be defensive. Value stocks proved defensive in the 1970s and 2000s in the aftermath of the Nifty-Fifty[7] and dotcom-growth bubbles as well as during periods of higher inflation, as they have also proved to be, again, in 2022.

When bubbles burst, owning undervalued businesses—that is, the ones that didn't become egregiously overvalued—has tended to be a good idea. This was the case after the dotcom bubble, when growth didn't outperform value for seven years.

Isn't Value Just a Sector Bet on Financials and Big Oil?

It's true that both the financials and energy sectors were key drivers of value's strong outperformance in 2022. However, their contribution to the total outperformance of value in 2022 is perhaps less than many would assume.

Only a small amount of the MSCI World Value Index's outperformance over the MSCI World Growth Index came from financials and energy; the rest was spread across all the other Global Industry Classification Standard sectors, with the exception of real estate. Versus the MSCI World Index, the value index's best sectors were information technology, communication services, and consumer discretionary.

As of today, we see a number of compelling cheap-valuation opportunities around the global-equity market aside from banks and energy. US technology has seen share prices fall, not only among the mega-cap tech businesses that have been grabbing headlines, but also supporting products and services such as those in the memory space. China as a whole has clearly seen a significant sell-off. Elsewhere, communication services remain attractively valued as well as a number of European cyclical businesses, such as German industrials or UK homebuilders, that are on depressed multiples. So while energy and financials—especially European banks—continue to be part of the value opportunity set, value isn't a one-way bet on these sectors, and sensible sector diversification can be achieved while maintaining valuation discipline.

For more insights on opportunities in value investing, talk to your financial professional.

[1] **MSCI World Value Index** captures large and mid-cap securities exhibiting overall value-style characteristics across 23 developed-market countries. The Index is designed to represent the performance of companies with relatively low valuations and high-quality characteristics. The value-investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price, and dividend yield.

[2] **MSCI World Growth Index** captures large and mid-cap securities exhibiting overall growth-style characteristics across 23 developed-market countries. The growth-investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend, and long-term historical sales per share growth trend.

[3] **Relative valuation** is a business valuation method that compares a company's value to that of its competitors or industry peers. It's an alternative to absolute valuation models, which try to determine a company's intrinsic worth based on estimated future free cash flows discounted to present value, without any reference to another company or industry average.

[4] **Mean reversion**, or reversion to the mean, is a theory used in finance that suggests that asset-price volatility and historical returns eventually will revert to the long-run mean or average level of the entire dataset.

[5] **MSCI World Index** captures large and mid-cap representation across 23 developed-market countries. With 1,508 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in each country.

[6] **Discount to growth/premium to growth:** These terms compare the valuations of value stocks relative to growth stocks. When value stocks are undervalued relative to growth stocks, they're trading at a discount. Conversely, when value stocks are overvalued relative to growth stocks, they're trading at a premium.

[7] **Nifty Fifty** was a group of 50 large-cap stocks on the New York Stock Exchange that were most favored by institutional investors in the 1960s and 1970s. Companies in this group were usually characterized by consistent earnings growth and high price/earnings ratios.

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