FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

04 March 2022
Volume 1126

What's behind value's recent renaissance?

Author: Nick Kirrage, Co-head Global Value Team, Schroders

The debate over the value and growth investment styles has been intense in the opening weeks of this year. Value's relative outperformance has been eye-catching, with the MSCI World Value index returning -1.3% in January compared to -9.3% for MSCI World Growth.

In some ways though, this is just a continuation of last year's oscillations which saw some periods of outperformance for growth and some for value.

In a nutshell, value investing involves buying stocks that appear to be trading at a significant discount to their true value. Growth investing, on the other hand, is when investors favour companies perceived as faster growers and are willing to pay a premium for them on the basis of their future growth prospects.

I am somewhat surprised that people are still getting so excited by the growth versus value debate.

What it ultimately comes down to is whether you think value investing works, and what drives it – is it the interest rate environment, politics, a theme, or something else?

Markets change, but people stay the same

My very basic philosophical view is that value investing is based on the one thing in stock markets that never changes: people.

Right now, the human emotional element of markets is as strong as it's ever been. We see over market cycles that people become very positive on shares and very greedy, and then they become very scared.

Many people buy into the narrative that as interest rates go up, value historically outperforms. And conversely, that in a low inflation or low interest rate environment, you can justify a higher multiple for growth stocks, which is why they've been doing so well.

But if you look back over longer timeframes – 30 or 40 years – those relationships don't always hold.

Take Japan, for example. It's a market where we've had three decades of nothing but incredibly depressed interest rates and deflation. Value has worked as a strategy pretty consistently over that three-decade period. That's an inconvenient truth for people who are sold on the narrative around interest rate movements.

Finding value requires diversification

Looking around the world for value, there are some geographies where it's harder to find opportunities than others. Around 70% of the MSCI World index is composed of US companies, and the US is at one of its highest ever valuations in terms of cyclically adjusted price-to-earnings (CAPE) multiples.

According to data from the Schroders Equity Lens, produced by my colleague Sean Markowicz, the US CAPE was 38 at the end of December 2021, which is 61% above its average over the last 15 years. CAPE is defined as price divided by the average of ten years of earnings, adjusted for inflation.

History tells us that it's very hard to make a positive return over the next ten years if you start off by paying those kinds of multiples.

By contrast, a notable trend of recent weeks has been the outperformance of value in Europe. The MSCI Europe Value Index was positive in January, gaining 2.7%.

European stocks have been depressed for quite a while. The overall European index is trading on a valuation multiple comparable to the very cheapest parts of the US market. The picture is even starker-looking at some individual countries. The UK for example, has, in relative terms, been getting cheaper versus the rest of world for over 10 years.

While Europe is made up of multiple economies that are moving at different paces, many of its companies or sectors are multinational. Healthcare is one example. It's fairly homogenous globally in terms of the market drivers. However, a company listed in Europe could potentially be exposed to a very different financing background than one in the US, with the European Central Bank likely to be slower to tighten policy compared to other central banks.

That kind of difference could be influential. Ultimately, though, the important point for a stock picker like myself is to avoid ending up with a portfolio that's a bet on a single type of macro environment, so diversification is key.

Japan is another geography where there are opportunities for value investors. Change is happening on the corporate side; there's a lot of private equity money going in and activism is picking up too. Japanese shares have had a reasonable run in the last couple of years, but it's still a very interesting region relative to the rest of the world.

Then there's China, where stocks had a difficult 2021 and valuations have come down in some sectors. It's too early to say for certain that value opportunities will emerge in some of the more exciting tech or financial franchises, but it's definitely one to watch.

Energy sector is about more than the oil price

Turning to sectors, energy is one that performed well in 2021. The typical narrative is that this is due to the rising oil price but it's more nuanced than that. As oil prices rise, costs tend to adjust to the new normal so it's not necessarily the case that higher oil prices simply flow through to higher profit margins.

It's also a nuanced narrative when we come to the debate over energy companies and the climate crisis. Some people will take the view they no longer want to invest in hydrocarbons at all, but on the other hand many energy businesses are well placed to be part of the solution to climate change.

This is going to be a lengthy transition and we will need conventional energy to build the wind and solar farms that produce renewable energy. Some energy companies themselves are investing in renewables capacity.

Then there's the transition of existing consumer franchises: the infrastructure and forecourts that currently supply petrol but increasingly also electricity for transport.

And while all of that is happening, the oil & gas businesses of these companies will continue to generate cash. This can be used by the company for investment in the transition but can also be handed back to shareholders. Regardless of oil prices, there's no reason to assume energy firms will remain lowly valued forever.

Embrace the contradictions

As we can see, wherever we look in markets there are nuances, and no narrative is quite as simple as it may appear. But contradiction is helpful for stock pickers. It means opportunity, dispersion, and diversity of ideas.

The changing interest rate environment and its impact on the value and growth investment styles has been a popular narrative in the first weeks of this year but investors need to be careful of mistaking a correlation for causation.

The history of stock market investing suggests to me that we need to challenge such prevailing narratives and look elsewhere for the justifications about why certain stocks and sectors are doing well and others are doing badly.

Ultimately, if you buy decent businesses with long-term business models and reasonable balance sheets at good prices, there's always the potential for investment returns to be made.

Glacier Research would like to thank Nicholas Kirrage for his contribution to this week's *Funds on Friday*.

Nicholas Kirrage
Co-head of the Global Value Tean
Schroders

Nicholas Kirrage is a co-head of the Global Value Team at Schroders, and a founding member in 2013 of this team of value investors who manage UK, European and global portfolios. He is co-manager of the SISF Global Recovery Fund. He joined Schroders in 2001 and is based in London.

Nicholas was a fund manager and analyst at Schroders from 2001 to 2013, commencing his career in the Pan European research team with responsibility for transport, metals & mining and aerospace & defence sectors.