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There is still value in value shares

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It's no secret that, until recently, value investing has struggled against its growth opponent.

Evidence of the one-sided contest is glaringly apparent across all measures of relative performance. In turn, that's created a sizable dislocation between what investors are prepared to pay for a dollar of earnings in each of the two styles.

For the last six months or so, value shares have outperformed on a relative basis. However, a recent pause in this trend has many questioning the sustainability of the growth to value rotation. For the reasons outlined below, we think the relative outperformance of the value style has further to run.

Before we get into our justification, let's define the two styles.

What differentiates value from growth?

Typically, value shares trade at prices beneath their intrinsic value. That discount is often reflected in low price-to-book (PB) and/or price-to-earnings (PE) multiples, or high dividend yields (DY) for those that distribute earnings to shareholders. Growth shares, on the other hand, are generally characterised by high PE and PB multiples and low DYs.

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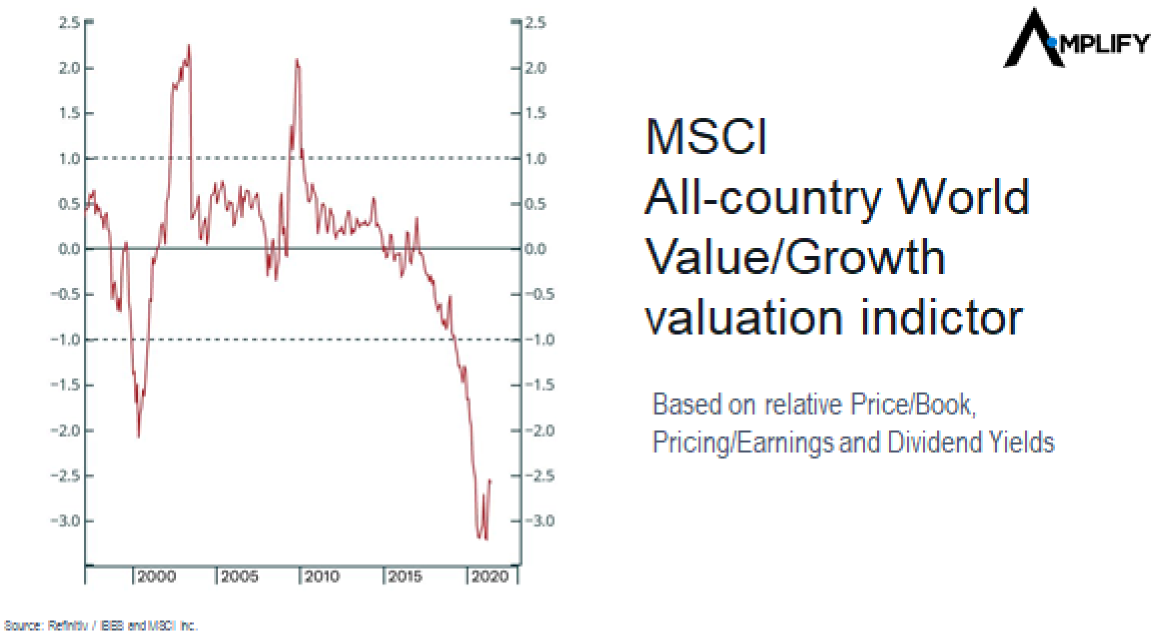
One of the best examples of a growth share is Amazon, the third largest stock in the Russell 1000 Growth Index. After a spectacular decade of growth, investors are willing to pay an amount equal to 45 times the earnings (PE) they expect the business to generate over the next 12 months. Although a less meaningful measure given its business model, its PB ratio stands at 16 times.

Contrast that with JP Morgan, the second largest stock in the Russell Value Index, which trades on a PE of 13x and a PB of just under 2x.

To illustrate the extent of the dislocation between the two styles, refer to the below chart from Bank Credit Analyst (BCA) which they have created using the MSCI World Growth versus Value indices, incorporating PE, PB, and DY metrics.



With respect to relative valuation, it's evident that value shares and indices are at historical lows relative to their growth counterparts. The question we now turn to is as follows: what might cause that gap to close?

It might sound counterintuitive, but strong economic growth should set in motion a sequence of events that benefits value-style investing more so than growth.

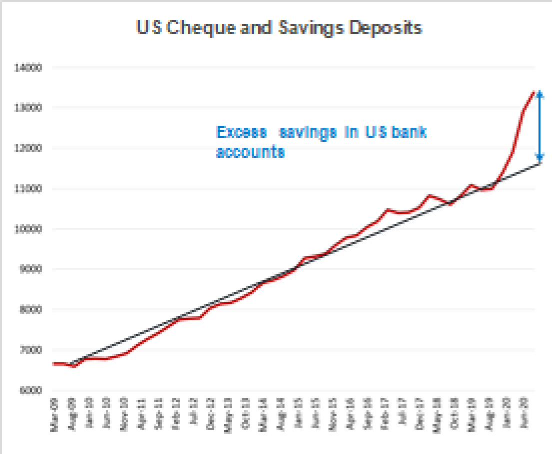
Growth bad for growth?

Leading indicators like the US ISM – a steer on future economic activity based on manufacturing survey data – are signalling a magnitude of coming growth that's likely to stir interest rates from their slumber. As with most recoveries, the growth is demand-led.

The US consumer has built up an excess of savings well beyond their usual bank balances. Further stimulus payments, compliments of President Biden and his weighty fiscal policy, will only deepen their pockets. And once vaccines have been widely distributed, the theory goes, it's a good bet that those consumers will have the confidence to spend their disposable income. This is not a phenomenon unique to the US; consumers in other developed markets also have more cash to spend than usual.

The cyclical tailwind

Excess savings



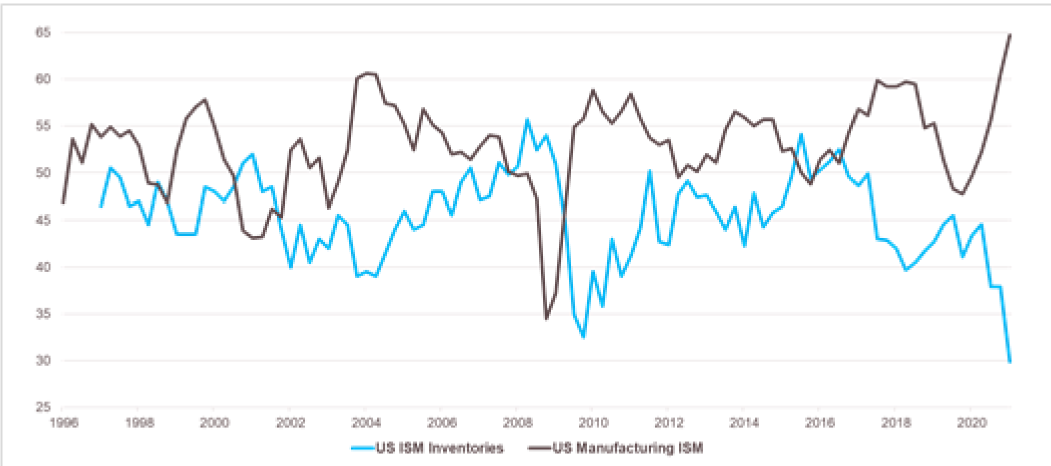
Source: Bloomberg

If these pent-up savings combine with freedom of movement, it's the sectors that were battered by the pandemic (think hospitality, energy, travel, brick-and-mortar retailers), all of which fall into the value bucket, that stand to experience the greatest earnings revivals. That's the single most important driver needed to sustainably reverse the fortunes of value investors. There's more evidence to support such an outcome in the sections that follow.

The supply side of the growth equation looks equally poised to support a strong economic rebound. Inventory levels fell off a cliff during the pandemic as businesses scaled back their production. However, with new orders rushing in (see ISM rebound below), US manufacturers must quickly put their people and equipment to work. That should be good for employment and capital investment, the two important prerequisites for the virtuous cycle that causes sustainable growth.

The cyclical tailwind

Inventory rebuild



Source: Bloomberg

With consumer demand set to rise rapidly and supply chains under pressure to meet their needs, the stage is set for higher inflation. That creates a floor for interest rates and stokes expectations that they may rise.

The interest rate effect

It's critical to understand how influential both the level and direction of interest rates are in the growth versus value investing debate.

To start, low and falling rates may be used to justify higher equity valuations because future cash flows suffer less discounting which makes them worth more in present value calculations.

However, this dynamic benefits growth shares to a greater extent because a bigger proportion of their projected cashflows sits in the future, i.e. the impact of lower discount rates has a larger effect on their relative valuations. For value stocks, the market is discounting a lower trajectory of growth, reducing the sensitivity of their valuations to lower interest rates.

If interest rates tick upwards, this long-standing support for punchy growth share valuations will likely wane. That's not the only impact of higher rates, though.

The financial sector (think banks and insurers) is the stalwart of current-day value investing. Sure, regulation has made it harder for the likes of banks to lend. But even when they do, the interest they earn doesn't excite investors. Insurance companies face a similar conundrum when they invest liability-conscious premiums at low yields. In general, higher interest rates will improve their margins and, therefore, earnings growth.

It's also become apparent that some banks and insurers have overprovisioned for the losses they expected to incur as a result of the pandemic. That should provide further support for that all-important rebound in the earnings of value shares.

More support from commodities

Separating cause and effect in financial markets is not for the fainthearted. One of the more decipherable relationships is that between economic growth, cyclical counters, and value shares.

Assuming our view of better global growth is correct, led by the US economy, commodity prices will likely find continued support as manufacturing activity everywhere absorbs more raw material. In turn, cyclical businesses like miners stand to generate stronger cashflows. If they think higher commodity prices are sustainable, they'll borrow from the banks to fund expansion of their mining operations. So, not only do bankers stand to enjoy better margins through higher interest rates, but also better top line growth through increased lending.

In addition to the higher demand for materials that comes with accelerating global growth, there's a spreading belief that US dollar strength may have reached a ceiling. That would make dollar-based commodity prices more affordable, providing further demand impetus. There are two dynamics to support that claim:

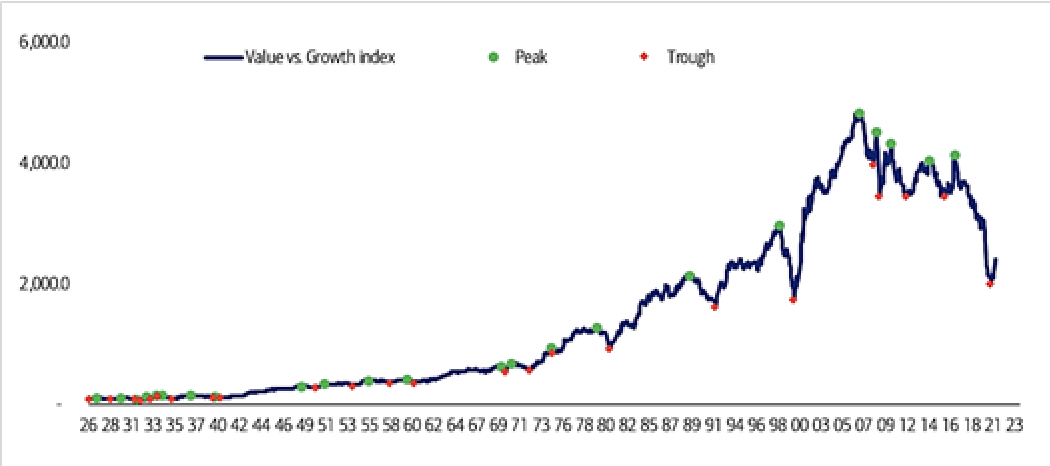
1. The risk-on environment we're heading into will see investors switch from the likes of US Treasuries into higher-yielding, risker assets denominated in other currencies.

2. The explosion of US debt, used to finance its massive fiscal stimulus, has weakened the fundamental strength of the greenback.

There's merit to both those claims.

The beginning of a trend

Value-style investing began its comeback in the third quarter of 2020, but in relation to the damage it has absorbed over the last decade, the rotation may have only just begun. Research from Bank of America Merrill Lynch shows that when value outperforms growth it does so for a period of about 33 months. So far, we've had six.



Source: Tuck School of Business data library, BofA US Equity & Quant Strategy | March performance based on the Russell 1000 Value and Growth Index

We believe the dynamics we've highlighted have a structural, longer-term feel to them that will level the playing field between value and growth investing. And given the upside on offer from the former, we think it prudent to tilt the international exposure in our multi-asset funds towards value. We will continue to weigh up pragmatically the inherent risks to achieve the best risk-adjusted returns for our clients going forward.

Glacier Research would like to thank Brian Thomas for his contribution to this week's Funds on Friday.

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Prior to joining Laurium Capital in September 2017 as a retail analyst and co-portfolio manager of the Amplify SCI* Balanced Fund, Brian was the lead international client services fund manager at Coronation Asset Management. Brian spent 5 years as the managing director of the Central European, Middle East and Africa (CEMEA) equity sales desk for Deutsche Bank in London, a position he took after 8 years in equity sales at Deutsche Securities in Johannesburg.