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Investment perspectives

Can value underperformance continue? – Part 1

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After a decade of lagging the broader market, does the value style factor still deserve a place in an investor's equity portfolio over the long term? This article, the first in a two-part series, will consider some of the key reasons for value's underperformance along with examining the conditions it traditionally performs well under and the catalysts for it to rebound.

What is value investing?

Value investing is a simple concept in principle: buying securities at a discount to their intrinsic value and waiting for the market to correct that mispricing. It was first applied to mainstream equity investing after Benjamin Graham and David Dodd released their 1934 book Securities Analysis. Some of the common characteristics of value stocks include high dividend yields, low price/book ("P/B") ratios and low price/earnings ("P/E") ratios.

What has caused the under-performance of the value premium?

Over the long term, the value factor has been a source of market outperformance. However, since 2008 with growth dominating, value has lagged the market.

The recent valuation dispersion between growth and value has become more pronounced and prolonged than in the past and this was exacerbated even more during the COVID crisis, as can be seen in Chart 1. A large part of the sustained underperformance of value relative to growth since 2008 can be attributed to declining interest rates, subdued economic growth and structural factors driven by technological disruption. This has created new industry leaders which has led to significant index concentration, especially in the United States where many of these companies reside.

Chart 1: Valuation spread between value and growth (based on P/E ratios)

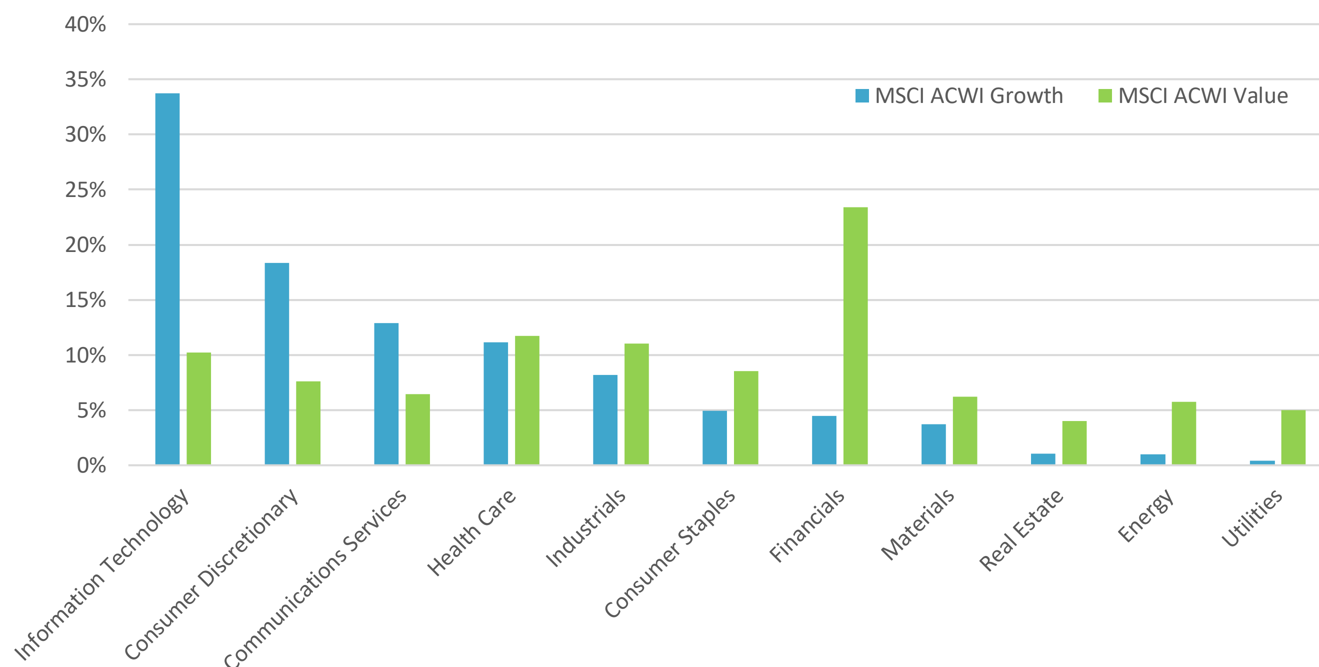
Source: Bloomberg. P/E represents index price / earnings-weighted average of index constituents

Since the Global Financial Crisis ("GFC"), the liquidity injected into the system by central banks has been significant and further support was again provided during the COVID crisis, where the amount of quantitative easing doubled. In addition, economic growth has slowed since 2008, leading to fewer companies being able to sustain high levels of growth. Those that can are often found in disruptive sectors such as technology and communication services, with investors prepared to pay a premium for this growth. This, coupled with low interest rates, has benefited such long duration assets because valuations for companies that can sustain higher-than-average growth rates have tended to increase as interest rates have fallen.

As investors have continued to pay a premium for growth, stock concentration (i.e. the top 10 stocks' share of an index) in the major indices has increased significantly. Companies like Facebook, Amazon, Apple, Netflix and Google, known collectively as the 'FAANG's, now represent c.10% of the MSCI All Country World Index ("MSCI ACWI"). These trends accelerated in 2020 as many of these companies benefited from strong performance through the onset of the pandemic driven in part by the 'stay-at-home' movement and investors continued preference for these larger, more profitable companies.

Another contributing factor to consider for the dispersion in performance between growth and value is the construction of style indices: the MSCI ACWI Value Index has a value-orientated weighting methodology whereas the MSCI ACWI Growth Index has a growth-orientated weighting methodology. These indices use P/B ratios as the primary measure of valuation to classify stocks as either value or growth. A company's book value measures its total assets minus its total liabilities but does not account for intangible assets (i.e. patents, licencing agreements, brand value and network effects) which currently comprise a large part of the company's assets, especially in the technology sector. The use of PB ratios as the main valuation metric has led to significant sector biases in these indices. The MSCI ACWI Growth Index has a large exposure to technology stocks (see Chart 2) which have benefited from secular tailwinds while the MSCI ACWI Value Index has a larger exposure to financials which have faced headwinds such as regulation and low interest rates that have negatively affected performance.

Chart 2: MSCI ACWI Growth Index and MSCI ACWI Value Index sector allocations (%)



Source: MSCI, as at February 2021

Market environments when value performs well

The style indices outlined above date back to the early 2000s and an analysis of the historical data shows that the value cycle tends to peak at, or near, inflection points of an economic cycle. As the economic cycle picks up, which could increase government bond yields (which is a positive for value stocks) and increases the earnings of more cyclically- exposed businesses such as materials, energy and financial stocks. In contrast, value struggles during momentum-driven and/or growth-driven markets.

Conditions for value to re-bound and main risks that it won't deliver

We believe that the following factors could result in a sustained rebound in value's fortunes:

- **Valuation dispersion –** The extreme valuation dispersion between growth and value stocks, although one could argue this was already pronounced even before the pandemic (as shown in Chart 1 earlier).
- **Low interest rates –** Limited scope for interest rates to fall further, leading to reduced tailwinds for growth stocks.
- **Inflation –** An unexpected increase in inflation expectations, which may force central banks to raise interest rates.
- **Momentum trade reversing –** A potential unwinding of the growth momentum trade due to concerns over the sustainability of the current high level of growth rates, particularly in technology stocks.

Regarding the last point, some of the fastest growing companies are currently trading at valuations which reflect expectations that a high level of growth will be sustained for a very long time and if these companies' earnings normalize or slow in the future this could be a risk to investors. This could result from: an acceleration of the deglobalisation trend; increased industry regulation; and questions about the sustainability of growth levels. These concerns could result in investors refocusing their attention on companies trading at lower valuations and/or in sectors outside of technology and communication services.

One of the main risks of value not delivering is due to long-term disruptive structural changes. Some of the businesses that have emerged as winners over the last decade have strong pricing power and are less cyclical due to their exposure to long-term structural growth areas (examples include cloud computing, e-commerce, digital payments and artificial intelligence). The earnings of these businesses are less sensitive to changes in interest rates and/or commodity prices and can continue to do well as

technology is adopted across other industries. Another consideration is ESG and sustainable investing which is being embraced at a faster pace by the investment industry having implications on companies across sectors. This will be discussed in more detail in the follow-up paper.

Summary

Value stocks have had a prolonged period of underperformance since 2008 and the main reasons for this are:

- structural, due to technological disruption.
- low economic growth, which has led many investors to pay a premium for growth.
- low interest rate environment which has benefitted the higher growth companies in the technology and communication services sectors.

In addition, the simplicity of mainly using P/Bs as the key metric for constructing style indices has led to significant sector biases in the growth and value benchmarks. As discussed, the P/B valuation does not account for other intangible assets which comprise a large part of the assets in the high growth companies.

We will consider intangible assets, how long-term value investors have adapted over time and how value fits in a portfolio in our follow up article.

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