

Value Is Back

BY: PERRY TEPERSON

In the eye of the storm in June 2020, we published a piece for clients on value investing. Referencing the hot Netflix documentary at the time, we titled it ‘Has Value Had Its Last Dance?’ and the article asked if value’s best days were behind it. Like the storied Chicago Bulls in Michael Jordan’s final year, were the good times gone? Was value dead?

It’s pretty typical when assessing investment performance for concern to really elevate just as a cycle is about to turn. It’s during those periods of style under-performance that the need is greatest for investors to stick to their investment discipline. For value managers, this directive was difficult enough in the post-2016 years as growth stocks significantly outpaced value, but with the early winners of the pandemic turning out to be many of the same large, growing tech companies (i.e., FANMAGs), it was enough to cause capitulation among some value managers.

As *Figure 1* illustrates, growth and value stocks generated broadly comparable returns from 2010 to 2016, but then growth took off delivering annualized returns nearly 15 per cent per year above those of value stocks over the subsequent four-plus years (the ‘Value Gap’).

Our view through 2020 was that vaccine approvals would provide a catalyst. Confidence would then return, the economy would recover from the COVID lockdowns, and a ‘game on’ mentality for overlooked and undervalued stocks in sectors like financials, industrials, and consumer stocks would take hold – areas which are essential components of a functioning economy.

The key was sticking to what you know and do well:

- Revisit all positions in the portfolio.
- Exit those that may be losers.
- Deploy into out-of-favour sectors to capture the rebound as much as possible.

These trades are not meant to feel comfortable in the middle of a market crash (and they are not). Comfort would be buying the market winners

– getting exposure to Big Tech, especially the stay-at-home winners like Amazon and Netflix.

Capitulation

But comfort would also mean capitulation. In hindsight, however, buying value-centric stocks like consumers, banks, and select natural resources would have added materially to outperformance from those market lows.

As it happened, the nadir for relative performance between value and growth hit around the end of August 2020. Since

then, there has been a material turn in performance (See *Figure 2*). Value stocks outperformed growth nearly 7:1 over the subsequent seven months and through the 13 months ended September 2021, value outstripped growth by over 10 percentage points (9.2 per cent annualized).

The question is ‘are we now in the beginnings of a sustained run for value?’

John Kenneth Galbraith, the Canadian-American economist, is famed for saying “there are two kinds of forecasters: those who don’t know and those who don’t know they don’t know.” One must approach the question of whether value will go on a sustained run with humility, but we feel very good about the prospects for value relative to the broad markets. We have seen value go on many sustained runs in the past and we are cautiously optimistic that we may be entering such a period again.

There are several fundamental reasons why we feel confident.

While value stocks are up materially since the bottom in March 2020, they still have a significant valuation advantage as growth stocks continue to trade at much higher multiples than normal. *Figure 3* shows the ratio of forward price/earnings (P/E) ratios for growth versus value stocks since 2016. Being above one indicates growth has traded at higher multiples than value and the march up and to the right shows the increasing valuations accorded to growth stocks over time, relative to value.

As of September 2021, even after value’s rally, growth stocks were still 86 per cent



Figure 1

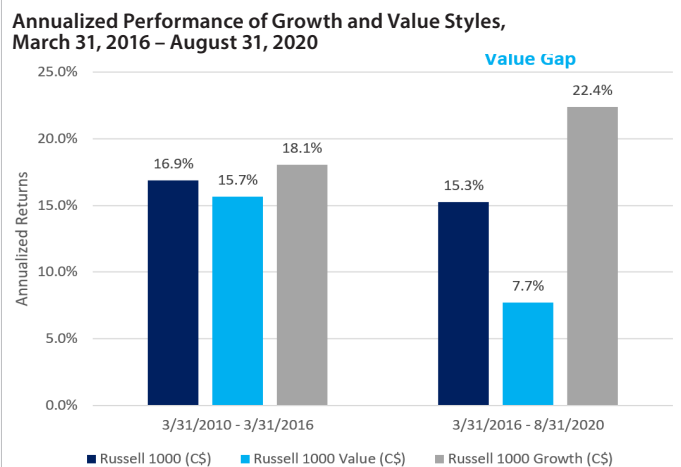
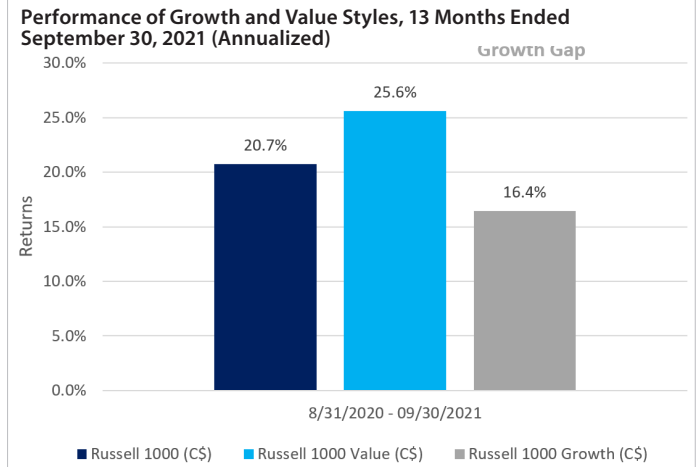


Figure 2



more expensive than value stocks. But they have risen primarily due to an expansion of their P/Es as investors have agreed to pay ever-higher prices for future, not-yet-delivered growth. This advantage is not sustainable. The resulting greater-than-normal valuation discounts within the value universe, however, should be a powerful tailwind as the economy continues to recover and portfolios can re-rate higher, adding to return.

Positive Earnings Surprises

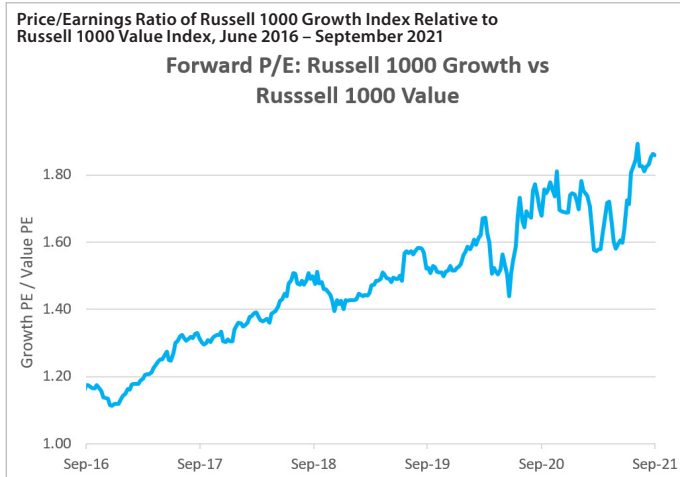
Companies that have focused on paring back their cost structures through operational efficiencies during the pandemic should emerge leaner, stronger, and better able to take market share from weaker competitors. We are already seeing several examples of positive earnings surprises and all of this bodes well for multiple expansion in value portfolios.

A look at the historical performance of value stocks during economic recoveries is also encouraging. *Figure 4* illustrates the significant excess three- and five-year returns earned by value stocks over growth stocks in four of five recessions since 1980.

While bond yields have rallied since the spring, they remain elevated relative to pandemic lows, possibly reflecting lingering concern about rising inflation and/or optimism about economic growth. Rising yields may not be an impediment to equity markets, however, if they coincide with improved economic conditions.

Figure 5 shows eight periods of rising rates in the U.S. since 1993. The S&P 500 Index rose an average of 17.7 per cent per year during those eras when 10-year yields rose an average of 1.7 per cent. In such an environment, the prospects for value stocks appear better to us as well. Higher yields are generally good for financial stocks which have a higher weight in value indices. Growth stocks

Figure 3



Source: Factset.

Figure 4

Outperformance of value stocks vs growth stocks following GDP low, 1980 – present

Recession	GDP Low During Recession	One Year Later	Three Years Later	Five Years Later
Fed Tightening	Q3 1980	10.8	21.4	56.6
Energy Crisis	Q1 1982	-6.5	26.5	36.0
Savings and Loan Crisis	Q1 1991	-2.5	18.9	19.8
Tech Bubble	Q3 2001	5.6	19.6	42.4
Global Financial Crisis	Q2 2009	3.3	-6.9	-0.1
Covid-19	Q2 2020	1.2	?	?

Sources: Russell Investment, St. Louis Federal Reserve, Morningstar. Growth represented by Russell 1000 Growth Index and value by Russell 1000 Value Index.

BENEFITS AND PENSIONS MONITOR EXCLUSIVES

There's more to the story, online.

The thought leadership content of *Benefits and Pensions Monitor* goes beyond the pages of its eight issues.

Between publications, www.bpmmagazine.com showcases more great reads.

Visit the website today to see articles on:



The Green Revolution: A New Frontier For Utility Stocks

Bobby Chada, an equity investment analyst at Capital Group, says clean energy is benefiting from a 'Green Trifecta'.



Could Your Business Introduce A Four-Day Working Week?

As the world returns to normal, Paul Sleath, CMO at TopSource Worldwide, believes the four-day work week could take hold.



In A Low-Rate World, Real Estate Can Be Key

Eric Menzer, Greg Spafford, and Matthew S. Warner, of Manulife Investment Management, suggest real estate may provide a solution to rising negative yielding debt.



Aon's Governance Surveys: Plan Governance Seems To Be 'Strong'

Governance generally seems to be 'strong,' but some areas are in need of attention, says François Parent, an associate partner at Aon.

The website is also the home for research from some of Canada's leading experts.

BENEFITS AND PENSIONS MONITOR

The Canadian Magazine Of Employee Pension Fund Investment And Benefits Plan Management

For more information, contact Joe Hornyak at jhornyak@powershift.ca

are valued primarily on uncertain cash flows further out in the future and are sensitive to the growth rate of those cash flows. All other things being equal, applying higher discount rates to those longer duration cash flows will negatively affect their prices more than it will for value stocks. This bodes poorly for the highest multiple growth stocks, but may create an opportunity in time to buy some of these businesses after their prices return to Earth.

Immense Popularity

The immense popularity of the Netflix documentary has put Michael Jordan back in the spotlight – the result being that one cannot get Nike Air Jordan shoes when they are released by the stores

Figure 5
S&P 500 Performance During Periods of Rising Interest Rates, October 1993 – March 2021

Time Period	Absolute Change in 10-year Yield	Change in GDP (\$)	S&P 500 Return (annualized)
9/30/93 – 11/30/94	2.5%	7.1%	1.8%
12/31/95 – 8/31/96	1.4%	3.8%	11.3%
9/30/98 – 1/31/00	2.2%	7.7%	28.3%
5/31/03 – 6/30/06	1.8%	22.2%	11.3%
12/31/08 – 12/31/09	1.6%	1.3%	26.4%
7/31/12 – 12/31/13	1.5%	5.3%	25.7%
6/30/16 – 10/31/18	1.7%	11.8%	13.8%
7/31/20 – 3/31/21	1.2%	4.1%	22.8%
Average	1.7%	7.9%	17.7%

Source: Strategas Research Partners, Barrow Hanley.

by simply walking in. As my son explains it, one has to enter a store lottery before release day and when that doesn’t work, kids are buying Air Jordans in an online aftersales market from other kids or pros – shoe scalpers – who scoop shoes using sophisticated online buying tools. At about 40 per cent or more above retail, it doesn’t strike me as particularly good value, but my son tells me there may be a greater fool to re-sell them to at a profit. Buying Air Jordans these days actually looks to me a lot like some of the overpriced growth stocks in the market, fueled by retail investors looking to make a quick profit before exiting.

My parting point is that Jordan and his team had that last amazing season, but that was not his last dance: his brand endures beyond that decade or two when he was playing and we believe the same durability is true of value investing. Value lagged for a few years recently, but over time owning quality businesses at cheaper prices, with reasonable assumptions about their growth, should trump owning ones that are expensive with too much optimism baked in. This fundamental concept has proven out over the decades and this time, or next time, isn’t different.

BPM



Perry Teperson (CFA, FCIA)
is vice-president and portfolio manager at Leith Wheeler Investment Counsel.



Passion and commitment:
leading group benefits
innovation in a changing world

We’re pleased to announce Marie-Chantal Côté as our new Senior Vice-President of Group Benefits.

Marie-Chantal joined Sun Life in 1998 and has held progressively senior roles across Sun Life’s businesses. She’s a well-known champion of employee benefits. Under her leadership, Sun Life has brought many innovations to market, including Sun Life’s Mental Health Coach and Lumino Health Virtual Care. She’s also a vocal advocate for diversity, equity and inclusion and mental health in the workplace.

In her new role, Marie-Chantal will retain her strong focus on building innovative solutions to meet Client needs. Her passion and commitment will continue to strengthen Sun Life’s focus on supporting the health of Canadians.

Group Benefits are provided by Sun Life Assurance Company of Canada, a member of the Sun Life group of companies.