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Equity Insights

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Why We Support the Value Underdog

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In brief

- The end of zero-rate policies removes one of the supporting pillars of longer-duration growth stocks.
- Concentration risk: including value-oriented exposure provides an alternative source of return and diversification in a portfolio.
- Richly valued growth stocks create opportunities for value investors to be selective, targeting quality businesses at reasonable prices.

Interest rates

We believe potential interest-rate headwinds for the value style are largely reflected in current valuations. Value benchmarks are typically correlated with inflation and interest rates given that they are dominated by cyclical companies and industries like financials, energy, materials and industrials. With inflation nearing its target levels and interest rates expected to fall, we expect the bulk of the decline in rates to occur at the short end of the yield curve, normalizing its shape. In other words, we think long rates are unlikely to fall materially from current levels either side of 4% absent a recession. With central banks having lost their appetite for zero-rate policies, sub-1% 10-year yields supporting speculation and growth stock valuations is very unlikely.

Expectations of slower growth are not good for value

Much of the cyclicality inherent in value benchmarks is driven by their reliance on book to price as a measure of value. Today, intangibles, which are not captured by this measure, represent much of a company's assets. In this environment, it is lazy to rely on book to price and mean reversion to drive value exposures. Valuation is more nuanced, and not all value stocks rely on the economic cycle to drive their returns.

Many value stocks are large, well-diversified, less cyclical companies that are simply slower-growing, higher-yielding durable franchises that can steadily compound earnings over time. Another group of value stocks are those that face short-term obstacles but where the businesses remain structurally sound, are well managed and are poised to recover. Exposure to these idiosyncratic risks and opportunities tends not to be correlated with the economic cycle.

Benchmarks are concentrating risk

In our view, including value-oriented exposure provides an increasingly important source of return and diversification in a portfolio. Growing concentration has seen both growth and core benchmarks dominated by the same companies. Consequently, the same stocks and factors are driving performance for both growth and core benchmarks. The top-10 companies represent 21.6% of the MSCI World Index and 37.4% of the MSCI World Growth Index but only 3.5% of the MSCI World Value Index. In the United States it is worse. The top-10 companies constitute 32.5% of the S&P 500 and the same 10 companies make up 53.3% of the Russell 1000® Growth Index and do not appear in the Russell 1000® Value Index.

AI is not just a tech sector thing

Artificial intelligence has been a major contributor to rising expectations, but it should not just be considered a benefit to tech companies. AI will potentially drive productivity and margin improvements across many industries. Those who can harness it and incorporate it into their processes could profit significantly. In a recent note, Absolute Strategy Research highlighted how, after technology, the largest increase in the use of the phrase AI in Q4 2023 earnings calls came from industrials.

Valuation matters

The Magnificent 7 stocks currently trade at approximately 33x earnings, more than double the 16x of the rest of the MSCI World Index. While some deserve their premium valuations more than others, much of the positive news about these stocks is priced in, and they will need to deliver on their elevated earnings growth expectations to justify those premiums.

The table below looks at next-twelve-months PE ratios for the US market. Factoring in next year's expected earnings growth forecasts, value is trading around its long-term average but growth is closing in on its peak for the past 10 years, reflecting an approximately 30% premium to its long-term average.

INDEX	LATEST	AVG 1yr	AVG 3yrs	AVG 5yrs	AVG 10yrs	PEAK	TROUGH
S&P 500	20.02	18.52	19.04	18.86	17.62	22.88	14.42
Equal Weighted	16.08	15.21	16.22	16.46	16.33	21.74	12.89
Value	15.45	16.06	15.88	15.46	15.04	17.86	11.70
Growth	26.64	21.46	23.48	23.37	20.87	29.53	16.36

Though we agree that valuation is not a good near-term predictor of performance, longer term it is, so higher prices today imply lower future returns. While you may not want to bet against all growth stocks, it is rational to be cautious and a lot more selective at these levels. Outside the Magnificent 7 and a narrow cohort of growth stocks, equity markets are reasonably priced and offer opportunity.

Conclusion

Opinions on value investing performance are generally framed around how value indices behave. We believe there are better ways of harnessing the value premium than book to price, which encourages cyclical outcomes.

Despite expectations for modestly slower near-term economic growth and falling interest rates, there are tremendous opportunities for value-focused investors to benefit from longer-term structural growth drivers and a sustained capital investment cycle. This is juxtaposed against growth stocks losing the structural support of ultralow interest rates.

Concentration in benchmarks is resulting in an increasing reliance on the same drivers of return for both growth and core benchmarks. When taking next year's earnings into account, growth is historically expensive, and investors should carefully assess their exposure to growth across both their core and growth mandates. In our view, it makes sense to add selectively to value strategies that offer diversification but that are not inexorably linked to the economic cycle.

Index data from Bloomberg as of 31 January 2024.

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