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STYLE REGIME CHANGES—LESSONS FROM HISTORY

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Value's underperformance versus MSCI World is now unprecedented in recent decades, in both its duration and magnitude. The regime extends back to the end of 2006, and the performance shortfall of over 30% is now a two standard deviation event. Recent economic and market events (rise in volatility) have triggered a debate as to whether this could be about to end. However, observing past occurrences when value has reasserted itself, these occurrences cannot consistently be attributed to developments in the external environment (steepening yield curves, inflation, etc.). They can play a part at particular times, but a more consistent influence on when regimes change are endogenous factors—namely market dynamics and valuations.

For now, the "who needs value?" mentality continues, but with markets elevated, I feel relative prices are nicely stacked in my favor. Plus the external environment appears to be evolving—at least very recently—into a state that could potentially be more constructive than obstructive for value investors. For observers assessing previous regime shifts in favor of this style, this may sound like a familiar setup, but, as the saying goes, history does not repeat itself, but it does rhyme.

IS THERE CHANGE AFOOT?

After an unusually prolonged period of calm, volatile equity markets in February could have shaken investors out of their state of complacency. Although there has been a partial reversal, the U.S. yield curve has steepened as both higher inflation expectations and real rates have kicked in. Typically, this is seen as a supportive move for value investors. Further, dysfunction in certain corners of the market may also prompt a shift in sentiment. It's early days though, and, so far, the market appears unwilling to break what is now a habit of over a decade's long duration, and value has shown no signs of reversing its pattern of underperformance. So far this year, the MSCI World Value Index is down -0.94% versus +0.98% for the MSCI World Index.[1] Plus ça change!

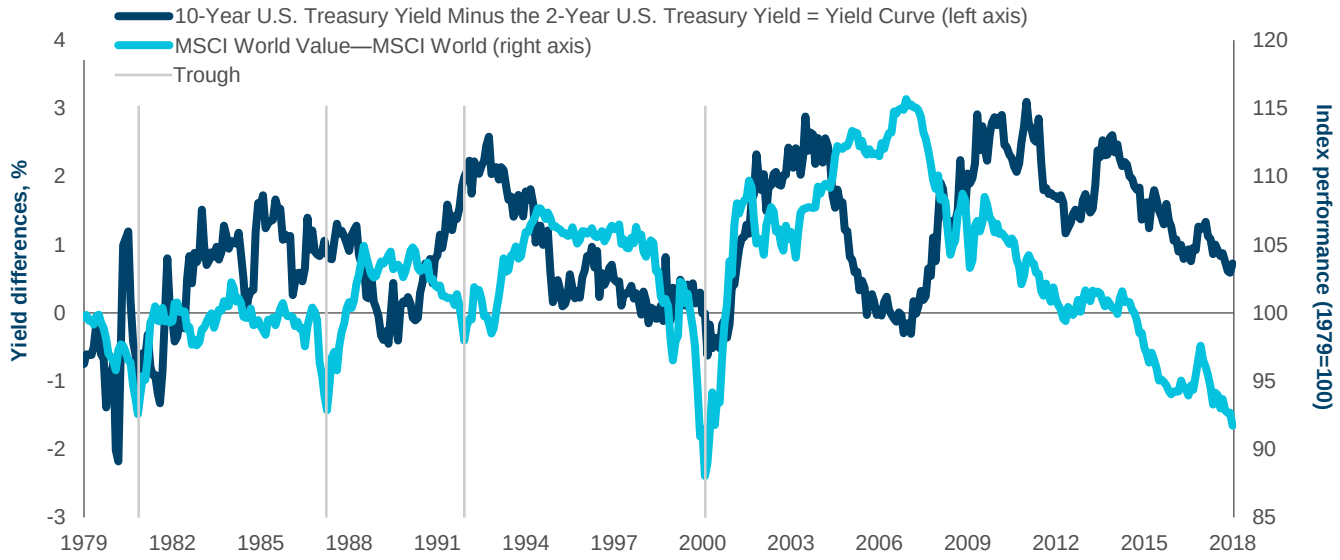
As a fundamental investor focusing on specific stocks, my conviction in value investing is based upon the opportunities that I observe on the ground, rather than higher-level sector composition considerations. But I can understand why an inflationary curve-steepening backdrop is consensually perceived as favorable for value. Financials, despite the structural change that banks have endured, remain highly leveraged to interest rates, especially at the long end of the curve. Meanwhile, energy, materials, and many other industries benefit directly from topline inflation. This end of the style spectrum is more exposed to "cyclical" as opposed to "secular" growth than the more glamorous other end (the latter's characteristics shining through more when growth is scarcer and discount rates lower).

[1]Year-to-date performance to February 28, 2018.

In recent decades, value has had better relative performance when the curve is steepening rather than flattening, although the results are not dramatic and the economic context and valuation starting point differs widely across the data set. The consensus that "steepening is good" has probably been reinforced by recent experiences. Figure 1 shows the long-term relative performance of value against developments in the U.S. yield curve. Looking at the last seven years, the curve has generally been flattening and this has been a time of continued value underperformance. Plus the only times in this period that value has materially outperformed has been against a steepening backdrop (the second half of 2016 and mid-2012 to mid-2013). While one can see how the casual relationship is drawn, we would caution that this period has been a time of unprecedented central bank easing and interest rate suppression, potentially resulting in a dislocation of investment fundamentals and correlations that may be atypical.

Figure 1: **Value's Relative Performance Versus the U.S. Yield Curve**

As of January 2018



Past performance is not a reliable indicator of future performance.
Sources: MSCI and FactSet.

Less supportive to the case that "steepening is good" is that the current extended regime of value underperformance from 2006 began as the yield curve started to shift from inversion, and the steepening would carry on for more than two years. Looking to the longer term, we have marked the previous major troughs that value has endured (Figure 1). This suggests that a steepening of the curve should not be regarded as a powerful trigger for value to commence a sustained run of outperformance.

There is a broader general point to be made here. Over the long term, there does not appear to be a consistent link between the major turning points for value and economic instruments (rates, currencies) or states (the economic cycle, inflation). What is true is that the landscape is ever changing—the influence of these variables is likely to be state-dependent, and the nature of "value" is constantly evolving. This is not to say that there are no such relationships within a period of value underperformance or outperformance—indeed, at times these can appear to be significant—but they do not appear to be consistently the catalysts for a major pivot in fortunes.

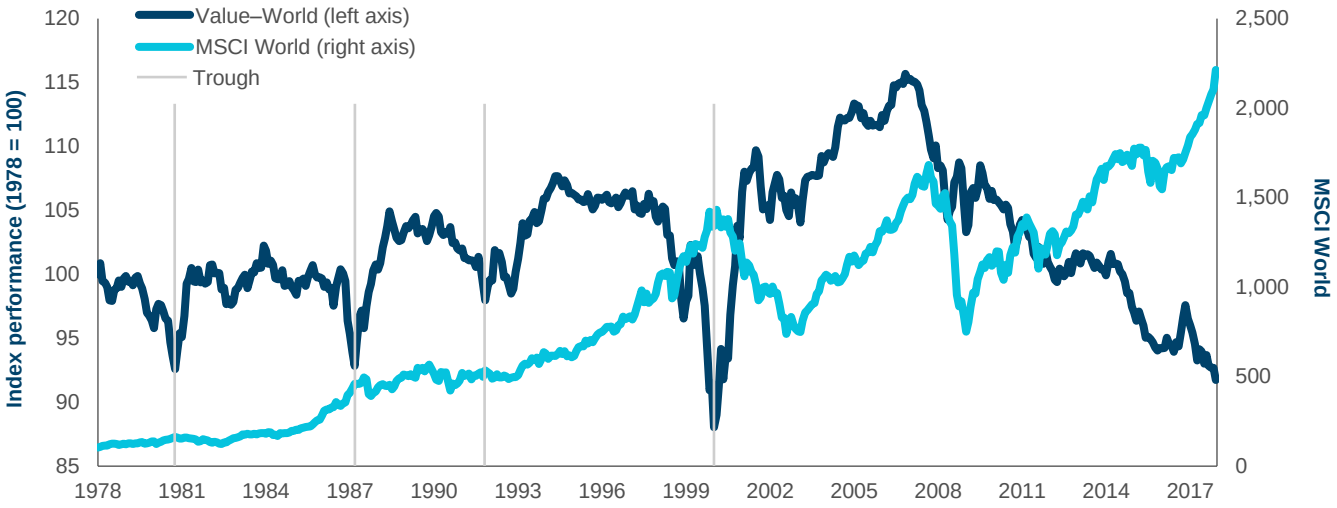
More instructive influences on where the trough of value's fortunes may be marked appear to be market dynamics and relative valuation, both endogenous factors. As to the former, by definition previous troughs are preceded by marked underperformance, but in all previous cases, there was also a final period of capitulation, with an acceleration of the downward trend. These can also be seen in Figure 1.

Patience is a perennial friend of the value investor. Given this, it is important to stay the course through market uncertainties but also to balance your approach to value investing.

Does it appear that the market is again in a state of deep revulsion toward value? Such has been the severity of underperformance that perhaps the market has become inured to the trend and the nadir of sentiment is now marked by the disdain of studied indifference. Markets are always learning: It is not a given that we need to have a final dramatic sell-off before any recovery. What is also very noteworthy is that three of the four previous troughs signaled the top of the broader market after sustained market appreciation (the exception being 1991 where the market movement had been sideways in recent years), as shown in Figure 2.

Figure 2: **Relative Performance of the MSCI World Value and MSCI World Index**

As of January 2018



Past performance is not a reliable indicator of future performance.
Sources: MSCI and FactSet.

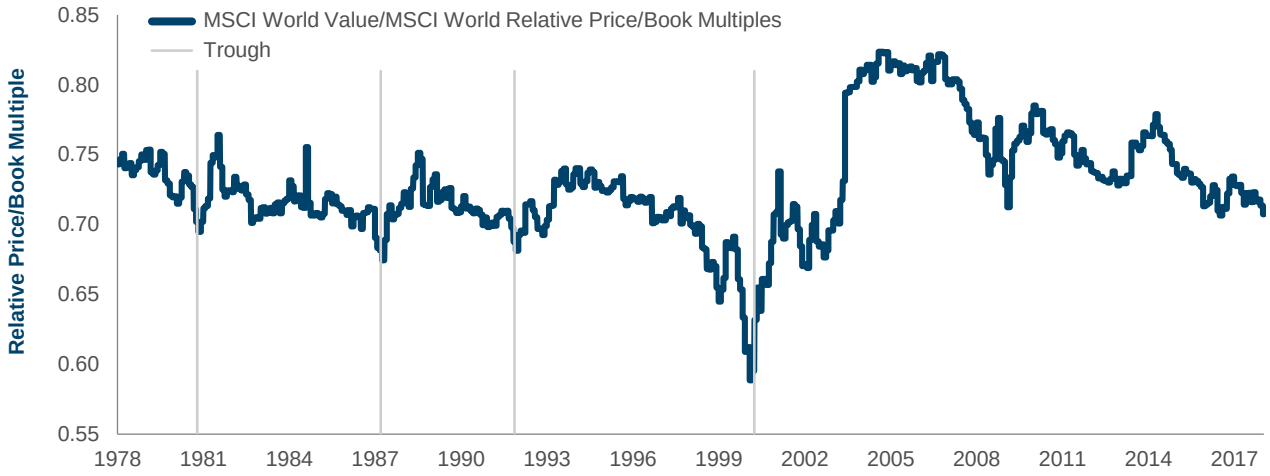
Given the marked underperformance of value into the trough, it should not be a surprise that its relative valuation typically becomes heavily discounted, even if one believes that fundamentals are less attractive than at the "sexier" end of the style spectrum. But two measures do appear to provide some useful information in the levels previously reached. As demonstrated in Figure 3, on a price/book basis relative to the MSCI World, value has bottomed at a discount of 30%–33% in the first three of the four turning points. (In February 2000, it plunged to 40%, and glided past the previous bottom 18 months earlier. Currently, we are at a 29% discount.) Second, all of the previous turning points occurred when the MSCI World Value traded at a 20%–30% price/earnings discount to the MSCI World (Although it has also given two false indications. We are currently at a 16% discount). Other measures (dividend yield, cash flow measures) do not present such a consistent picture.

FOCUS ON THE FUNDAMENTALS, BUT BE WILLING TO ADAPT

Patience is a perennial friend of the value investor. Given this, it is important to stay the course through market uncertainties but also to balance your approach to value investing. At the same time, in all market environments, we encourage investors to focus on stock fundamentals. One key foundation to investment success in recent years has been the ability to stay engaged with stocks during periods of distressed sentiment in order to benefit from the transition to a better outlook.

Figure 3: **Valuations May Be the Key to a Style Change**

As of February 12, 2018



Sources: MSCI and FactSet.

My focus remains on identifying the most attractive global stock opportunities from across the value spectrum. This diversification is expected to result in a more “all weather” pattern of performance than a narrower value approach, especially while value remains out of favor. But if sentiment were to shift in favor of this style, I would expect this to result in a dramatically better environment for my strategy.

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