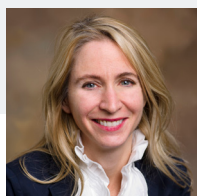




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December 2018

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Equity Strategy*

## U.S. Equities **IS VALUE INVESTING DEAD OR POISED FOR REVIVAL?**

### KEY POINTS

- Over longer periods, value stocks have outperformed growth stocks but have significantly underperformed over the past decade.
- Reversals in growth versus value relative performance are unpredictable but often happen very abruptly and tend to be extreme.
- Despite the superior performance of growth stocks over the past decade, the recent valuation dispersion versus value stocks is not abnormal.
- The recent market setbacks have offered value investors some attractive opportunities.

Over the past decade, value investing has endured one of its deepest droughts of underperformance relative to growth investing. This shortfall has spanned market capitalization and geography—engulfing small to large companies throughout developed and emerging markets around the globe. This begs the question: Is value investing dead or poised for a revival?

While there are no apparent signals to indicate when the relative performance trend may reverse, investors should be aware that such reversals often happen very abruptly and tend to be extreme. It's difficult to accurately time a reversal, but relative valuation is often the catalyst, and in some sectors we are getting close to such extremes.

Moreover, to the extent there is higher inflation and a rising interest rate environment, some commodity and other cyclical companies could become relatively more attractive—for the first time in a long while.

Over very long periods of time, value stocks historically have outperformed growth stocks. But the relative performance tends to be somewhat cyclical—raising the question of the timing of a reversal.

### **IS A VALUE COMEBACK IMMINENT AMID GREATER MARKET VOLATILITY?**

The short answer is that it's impossible to predict when the trend may reverse.

But over the most recent 10-year period, value underperformed growth by almost two standard deviations relative to its average 10-year performance, based on 10-year rolling periods starting in 1926. And following periods of such extreme dispersion between the two styles, history shows that the odds of value outperforming growth over the subsequent three to five years are very high—above 70%.

Value also has tended to outperform growth in periods following recessions because value stocks tend to reflect more cyclical, asset-intensive industries

that benefit greatly from improved demand. However, an economic revival has not always signaled a value revival.

Investors have pivoted to value when the valuation gap between the styles has reached extremes and when concern has risen that the growth leaders could not sustain their momentum. Put simply, growth just becomes too expensive and fundamentals such as high profit margins show signs of peaking.

Interestingly, despite the superior performance of growth stocks over the past decade, the valuation dispersion is not abnormal. At the end of November 2018, the Russell 1000 Value Index 12-month forward price/earnings (P/E) ratio was 0.74x that of the Russell 1000 Growth Index, slightly below the relative average P/E since 1978.

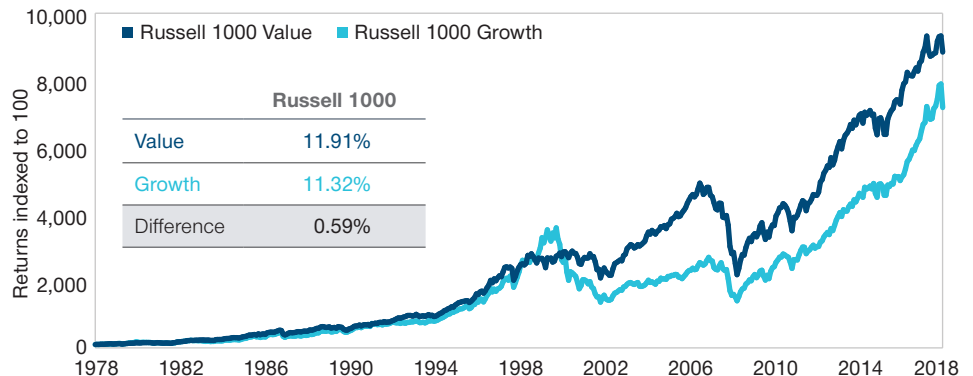
The growth style's dominance since the global financial crisis a decade ago has been particularly propelled by a narrow group of technology titans—the so-called FAANG stocks (Facebook, Apple, Amazon, Netflix, and Alphabet's Google).

For many big tech companies, profit margins and cash flows are at or near all-time highs, so their relative valuations don't appear to be extreme—particularly after the recent downturn in their stock prices. And if you look at relative valuation based on sales or a price-to-book basis, relative valuation is less attractive and would be below average.

We should note that we are in uncharted territory in terms of how these huge tech companies and other high-growth companies will perform in a changing economic environment. Google and Facebook, for example, are very ad-centric. There are no previous cycles where such dominant companies had to adapt to a more sluggish economy that could undermine ad revenues. In the value sector, by contrast, some of the companies have

## FIGURE 1: Value Has Historically Outperformed Growth

Russell Indices Performance (Indexed Total Return, Dividends Reinvested)  
January 1979 through October 2018



### Past performance is not a reliable indicator of future performance.

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been operating for more than 100 years, so it's possible to understand how things have played out for these firms when the economy changed course.

### TAKING ADVANTAGE OF RECENT MARKET OPPORTUNITIES

We focus on investing in relatively high-quality companies that are trading below their intrinsic value, believing that valuation is the most important factor that drives investors' returns and outperformance in the long term rather than the level of earnings growth.

It's more about what you pay for those assets than how fast the company might grow. Sustained, high earnings growth is rare. From 1985 to September 2018, only 45 of 10,845 companies in the Russell 3000 Index with unique 10-year periods of results posted more than 10% earnings growth per share for 10 consecutive years. So, valuation matters because strong growth over long time periods is quite difficult to sustain.

Research by economist Robert Schiller indicates that the annual volatility of stock performance significantly exceeds

the volatility of the actual distributable cash flows of companies. In other words, the stock market tends to oscillate much more than the cash flow of the underlying companies and their intrinsic value. Somewhere in that gap is a disconnect in pricing, and that's what we want to take advantage of.

Given our long-term investment horizon, we want to use this volatility to our advantage to find good companies that are trading below their worth because of some shorter-term controversy or uncertainty.

As for the current investment environment, the overall large-cap U.S. stock market is not cheap despite the recent pullback, but there are pockets of attractive opportunities. Some cyclical stocks with solid balance sheets suffered declines of 30% to 40% this fall as investors began pricing in a recession. Our average holding period is three to four years, so we can be contrarian in looking for turnaround opportunities.

We're focused on finding companies with solid businesses, strong balance

sheets, and durable earnings profiles that we believe can withstand a challenging economic environment. We balance the risk of our more cyclical holdings with steady, defensive companies such as utilities, which offer durable cash flows and higher dividend yields and dividend growth with relatively modest downside risk.

In the housing sector, investors are concerned that higher interest rates will affect affordability, leading to a slowdown. Some stocks are even starting to reflect recession-type levels of demand. Some auto stocks are also reflecting a very poor macro environment, affecting companies that we don't think are as cyclical as the market anticipates. A few stocks in the chemicals and paper and forest products industries and in the materials and consumer staples sectors are pricing in a growth slowdown.

Financials, our largest sector, had a big pullback, but we believe that, for the most part, our portfolio companies have strong balance sheets, maintain high levels of capital, and have been conservative in their lending practices. We expect the financials sector to continue to benefit from a gradual rise in interest rates and relaxation of regulation. Our focus in this sector is on attractively valued, idiosyncratic investments that we expect to be solid performers in most economic scenarios.

In health care, some of the companies with appealing valuations have innovative growth platforms and do not have significant drug pricing risk. Medtronic, for example, is taking advantage of the increased needs of baby boomers for medical technology devices.

**FIGURE 2: Largest Holdings in the US Large-Cap Value Equity Representative Portfolio**

As of September 30, 2018

Issuer	Industry
JP Morgan Chase	Banks
Microsoft	Software
Wells Fargo	Banks
Total	Oil, Gas, and Consumable Fuels
ExxonMobil	Oil, Gas, and Consumable Fuels
Pfizer	Pharmaceuticals
Cisco Systems	Communications Equipment
Medtronic	Health Care Equipment and Supplies
Merck	Pharmaceuticals
Twenty-First Century Fox	Media

These 10 holdings accounted for 26.6% of portfolio assets as of September 30, 2018. The information shown does not reflect any exchange-traded funds that may be held in the portfolio.

The representative portfolio is an account we believe most closely reflects current portfolio management style for the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio shown may differ from those of other accounts in the strategy. Information regarding the representative portfolio and the other accounts in the strategy is available upon request. The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for clients in the composite, and no assumptions should be made that the securities identified and discussed were or will be profitable.

In energy, we continue to expect increasing levels of a low-cost supply of oil and natural gas in the United States as productivity continues to improve through advances in technology used in U.S. shale and global offshore production. Demand has been strong, keeping oil prices relatively high until recently, but we remain relatively bearish on oil prices due to risk of increased low-cost production. However, we own companies that are at the low end of the cost curve, have potential for finding more resources than investors expect, and trade below their net asset values.

Generally, we remain optimistic about the U.S. economy, especially as consumer sentiment remains strong,

wages have increased, and corporate profits have surged due to federal tax reform. However, we continue to worry about U.S. trade policy uncertainty and the ongoing deterioration of the relationship between the United States and China.

At the same time, though, we mainly focus on valuations and fundamentals of individual companies, rather than trying to predict macroeconomic or geopolitical developments. So even if growth continues to lead, there is still attractive return potential within the value index from good stock selection. Over time, we believe the market will recognize the value of our holdings.

**Key Risks**—The following risks are materially relevant to the strategy highlighted in this material:

Transactions in securities of foreign currencies may be subject to fluctuations of exchange rates which may affect the value of an investment. The value approach carries the risk that the market will not recognize a security's true worth for a long time, or that a security judged to be undervalued may actually be appropriately priced.

The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for clients in the composite and no assumptions should be made that the securities identified and discussed were or will be profitable

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