Value Stock Investing Disrupted but Not Destroyed

Growth stocks' dominance pressures value investors.

January 2020

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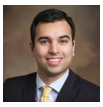


Som Priestley
Portfolio manager, Multi-Asset Division

KEY INSIGHTS

- Historically, value stocks have outperformed growth stocks, but value has lagged growth for more than 13 years through 2019—a record span of underperformance.
- Technological disruption has driven growth stocks to the detriment of value. But value stock managers say the classic value investing model hasn't changed.
- Two U.S. value strategies, one based on fundamental analysis and the other on quantitative factors, can be combined for potential benefit, their managers say.

Following another year in which U.S. growth stocks have extended their unusual cycle of outperformance over U.S. value stocks in terms of both duration and magnitude, investors may well be wondering if something has radically changed.

Historically, over long periods of time, value stocks have outperformed growth stocks by a substantial margin. However, that has not been the case for more than 13 years as of December 2019, the longest period of growth dominance on record. During that time, the magnitude of value's underperformance has been surpassed in only two prior cycles going back to the 1930s.

After such cycles of extreme underperformance, there usually has been a sharp and sudden reversion to outperformance by value. But now, with technological change and disruption having driven growth stock performance for so long—forces showing few signs of abating—does that mean the historical cycle of mean reversion is dead or dampened?

Investing in value stocks in this new era was the central focus of a recent T. Rowe Price webinar featuring Heather McPherson, co-portfolio manager of the US Large-Cap Value Equity Strategy; Farris Shuggi, portfolio manager of the QM US Value Equity Strategy; and Som Priestley, a portfolio manager in the Multi-Asset Division.

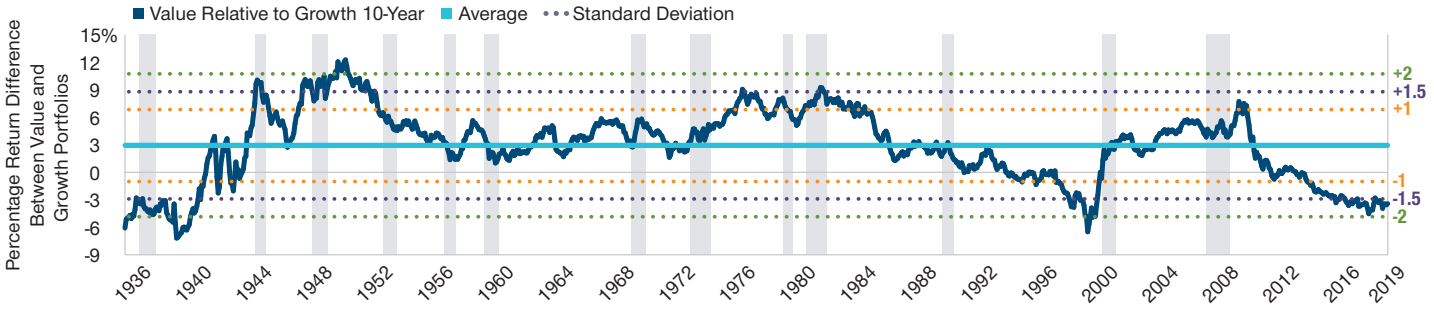
Value Changed, Not Destroyed

While the tech disruption has driven many growth stocks higher, it generally has collapsed the profit margins of many value stocks, made them very cheap, and posed heightened existential risks for some. That means that investors shouldn't just wade into value stocks and buy companies based on their potential for mean reversion alone, McPherson says.

(Fig. 1) Current Growth Cycle Unusually Strong

Value-growth differential, rolling 10-year periods

As of December 31, 2019



Past performance is not a reliable indicator of future performance.

Source: June 1936–December 1978: Fama French benchmark portfolios representing "Big Value" and "Big Growth." The Fama French benchmark portfolios are rebalanced quarterly using two independent sorts, on size and book to market. The size breakpoint for "Big" versus "Small" is the median NYSE market equity. The growth/value breakpoint is the 30th and 70th NYSE percentiles of book-to-market ratios. January 1979–present: Russell 1000 Value and Growth indexes monthly total returns. Analysis is for research purposes only and does not represent actual portfolios or investments (see Additional Disclosure).

"You have to be even more thoughtful about value stock investing than in the past."

— **Heather McPherson**

Co-portfolio manager, US Large-Cap Value Equity Strategy

"You have to be even more thoughtful about value stock investing than in the past," she says. "Eventually the growth-value performance cycle will turn, but you have to really do the research necessary to understand the fundamentals of value stocks and their competitive threats."

While disruption has made value investing much more difficult, McPherson says, the classic value investing model has not fundamentally changed.

"We look to invest in high-quality companies that we think are trading below their intrinsic value," she says. "That's typically because of some shorter-term disruption, controversy, or setback in the market. We find opportunities because stock prices often oscillate much more than the true underlying fundamentals of a company. We seek to take advantage of these mispricings and other investors' short-term horizons."

The T. Rowe Price Approach

T. Rowe Price's approach to value investing is differentiated, McPherson says, by combining the deep insights of approximately 150 global research analysts and sector portfolio managers with a disciplined approach on valuation and taking a long-term time horizon that "enables us to be contrarian, to be investing when others are selling."

She cites the example of a chipmaker that was "viewed as a loser" three to four years ago because of a decelerating smartphone market and stronger competition. At the time, the company was spending billions of dollars on research and development to better position itself for the future, she says, enabling it to pivot successfully to 5G wireless networking.

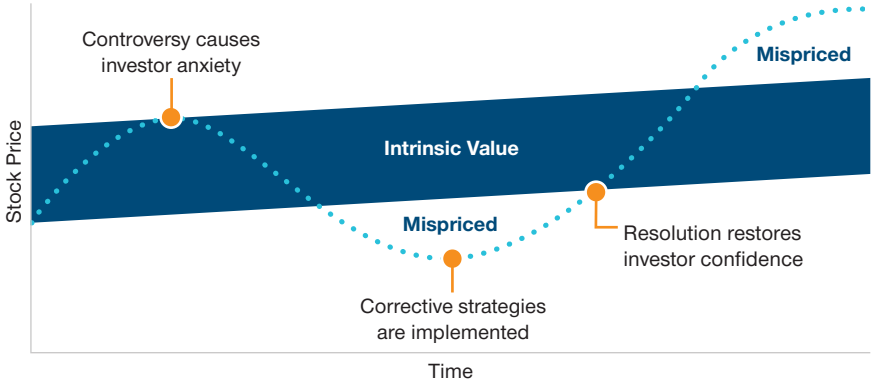
A key for McPherson in assessing valuation is constant collaboration with Shuggi, manager of a quantitatively driven value strategy.

Shuggi says his QM strategy "hinges on a systematic application of fundamental investing principles. We're using metrics to identify companies that are cheap relative to their industries, generate strong free cash flow, buy back stock, grow their dividend, and hopefully have a little bit of positive momentum in their business and stock prices."

He notes that "secular risk is definitely something investors must consider because value stocks often face challenges. But just because a

(Fig. 2) Value Distortions, Investor Psychology

Large-caps sometimes mispriced



For illustrative purposes only.

company may not have the brightest future, that doesn't mean we can't still generate alpha in such stocks."

In recent years, Target (TGT) has been an example of this sort of stock, he says. Many outposts of brick-and-mortar retailing have been widely subject to the market taking an apparent trend and extrapolating it, as in this narrative, he says: "Brick-and-mortars are going to fail. Everybody's going to online shopping, and anyone with a storefront is in trouble."

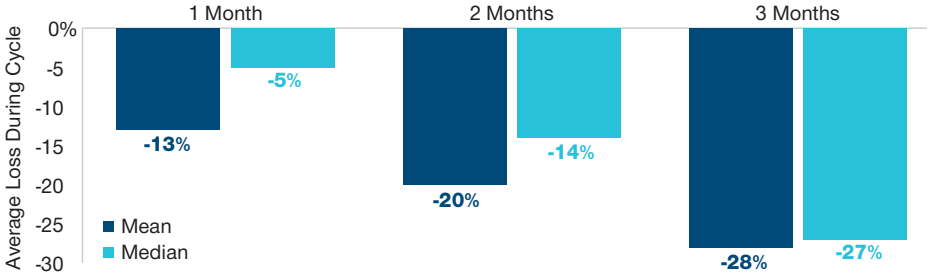
But a quantitative assessment of Target showed that it was still generating strong cash flow, buying back stock, and growing its dividend, without excessive leverage, Shuggi says.

"With stocks like this, there's elevated risk, and they're more challenging," he says, "but that doesn't mean that there is no opportunity here."

(Fig. 3) Being Late to Value Cycle Can Be Costly

First three months of value cycle outperformance*

January 1929 through September 2019



Past performance is not a reliable indicator of future performance.

Source: Fama French. Analysis by T. Rowe Price.

*Average Loss During Cycle is defined as the average percent of the cumulative relative return of large-cap value over large-cap growth when the first 1, 2, or 3 months of the value cycle are missed across the 10 value cycles measured in the period. A negative average value represents the return lost (e.g., missing the first month of value cycles resulted in a 13% and 5% reduction in return based on the mean and median respectively). This chart uses Russell 1000 Value and Growth indexes monthly total returns (see Additional Disclosure).

> A combined portfolio creates the potential to deliver less volatility.
>
> — **Farris Shuggi**
> *Portfolio manager, QM US Value Equity Strategy*

T. ROWE PRICE BEYOND THE NUMBERS

Constant Collaboration Is the Key

Value managers, analysts share insights, a T. Rowe Price hallmark

The two U.S. value stock managers featured in this article take different approaches with the aim of achieving positive returns for clients. McPherson is a traditional fundamental investor, relying on the firm's analysts and her own balance-sheet analyses and up-close examination of companies, including field visits and interviews with managements and related entities. And Shuggi runs a quantitatively driven portfolio based on a systematic application of fundamental investing principles.

However, the two are very much in sync when it comes to information sharing—constantly collaborating, benefiting each other's strategies. For example, McPherson regularly runs by Shuggi stocks that interest her because of her team's close study to find out what his quantitative analyses say about them. In turn, Shuggi frequently brings his list of stocks highlighted by means of quantitative metrics to McPherson to find out what she knows from a more qualitative perspective. "We believe this sort of collaboration is unique to T. Rowe Price," Shuggi says.

Sudden Reversals of Fortune

Despite growth stocks' outperformance, Priestley, a portfolio manager in the Multi-Asset Division, says he usually remains style neutral, equal weighting growth and value stocks—with some modest technical shifts.

"It may be tempting to consider aggressive moves into and out of growth and value," Priestley says, "but that can be very costly as changes in style leadership and relative performance can happen very quickly."

As shown in Figure 3, he notes that being a month late in the reversal from growth to value cycles in the last 10 transitions dating to 1929 could have cost investors an average of 13% missed outperformance, and being a quarter late could have cost an average of 28%.

Moreover, even within long-term cycles of growth outperformance, there also have been abrupt shorter periods of value outperformance.

Shuggi says that growth's outperformance has left value negatively correlated with other assets that investors tend to hold, so adding some value exposure "can provide diversification benefits."

Priestley and Shuggi say that it's also important to diversify within value sectors. Just as there has been a growth-value cycle, there are also cycles in which value stocks with certain metrics (EBITDA or earnings before interest, tax, depreciation, and amortization; price-earnings, enterprise value-to-sales; etc.) have led the way.

Accordingly, Priestley says, internal research suggests that the two strategies' excess returns (relative to the Russell 1000 Value Index) occurred at different times, and as a result, investors interested in further diversifying their value stock investments might consider a combination of the two portfolios.

A combined portfolio creates the potential to deliver less volatility, Shuggi says. "The idea is that two value portfolios can complement each other and give smoother excess returns over time."

WHAT WE'RE WATCHING NEXT

The firm's value managers are watching whether interest rates will turn higher. McPherson says that "could have a pretty dramatic impact on value versus growth," because disruptive companies might have less access to capital to fuel their growth and because the business models of financial stocks, which often are value stocks, likely would have better support. Also, higher rates might be tied to higher inflation, which could boost commodities and materials.

"A lot would depend on why debt is getting more expensive—whether it's the normalization of rates or a credit problem, which could be tricky for value," she adds. Shuggi agrees: "We've had 10 years of expansion with subdued inflation. If reflation takes hold, we'd expect value to pick up."

The specific securities identified and described in this article do not represent all securities purchased, sold, or recommended for the portfolios mentioned, and no assumption should be made that the securities identified and discussed were or will be profitable.

In the QM Value Equity Strategy as of December 31, 2019, Target was the largest holding and the largest bet relative to the strategy's benchmark in the retail sector.

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ID0002829 (01/2020)
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